CHAPTER 2

Professional Standards

LEARNING OBJECTIVES

		Review Checkpoints	Exercises, Problems, and Simulations
1.	Name the various practice standards for internal, governmental, and independent auditors and accounting firms and identify their sources.	1	51
2.	Understand generally accepted auditing standards (GAAS) and explain how GAAS affect the audit team's responsibilities.	2, 3	
3.	Describe how the audit examination is affected by the fundamental principles of responsibilities and performance.	4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16	46, 47, 48, 49, 50, 55 (partial), 56 (partial), 59, 61 (partial), 62
4.	Understand the principle of reporting and identify the basic contents of the auditors' report.	17, 18, 19, 20	52, 53, 55 (partial), 56 (partial), 61 (partial)
5.	Identify the need for attestation standards and explain how attestation standards differ from generally accepted auditing standards.	21, 22	54
6.	Understand the role of a system of quality control and monitoring efforts in enabling accounting firms to meet appropriate levels of professional quality.	23, 24, 25, 26, 27	57, 58, 60

SOLUTIONS FOR REVIEW CHECKPOINTS

2.1 For independent (external) auditors of financial statements, practice standards are issued by the AICPA Auditing Standards Board (in the form of *Statements on Auditing Standards)* and the Public Company Accounting Oversight Board (in the form of *Auditing Standards). Statements on Auditing Standards* are appropriate for the audits of nonpublic entities, while *Auditing Standards* are appropriate for the audits of public entities.

For governmental auditors, the Government Accountability Office issues *Government Auditing Standards* (also known as the "Yellow Book").

For internal auditors, the Institute of Internal Auditors issues *Statements of Internal Auditing Standards* (also known as the "Red Book").

For fraud auditors, the Association of Certified Fraud Examiners issues *Professional Standards and Practices for Certified Fraud Examiners.*

For auditors in other countries, the IFAC International Auditing and Assurance Standards Board issues *International Standards on Auditing and Assurance.*

2.2 **Generally accepted auditing standards** are standards that identify necessary qualifications and characteristics of auditors and guide the conduct of the audit examination.

Generally accepted accounting principles represent the requirements for the preparation and presentation of financial statements and accompanying footnote disclosures.

These two types of standards are related to one another because a primary objective of a GAAS audit is to allow auditors to conclude whether an entity's financial statements are prepared and presented in conformity with GAAP.

2.3 The three fundamental principles are:

1. **Responsibilities,** which involves having appropriate competence and capabilities, complying with relevant ethical requirements, maintaining professional skepticism and exercising professional judgment.

2. **Performance,** which requires auditors to obtain reasonable assurance about whether the financial statements as a whole are free of material misstatement by: (1) planning the work and properly supervising assistants; (2) determining and applying appropriate material levels; (3) identifying and assessing the risk of material misstatement; and, (4) obtaining sufficient appropriate audit evidence.

3. **Reporting,** which requires the auditor to express an opinion as to whether the financial statements are prepared in accordance with the applicable financial reporting framework.

Auditing procedures relate to acts to be performed during the engagement. Auditing standards deal with measures of the quality of performance of those acts and the objectives to be attained. Auditing standards are less subject to change and provide the criteria for rejecting, accepting, or modifying auditing procedures in a given circumstance.

An example of the relative stability of standards and procedures is found in the change from non-computerized information systems to computerized information systems. New auditing procedures were required to evaluate computerized information systems, but auditing standards remained unchanged and were the criteria for determining the adequacy of the new auditing procedures.

2.4 **Independence in fact** represents auditors' mental attitudes (do auditors truly act in an unbiased and impartial fashion with respect to the client and fairness of its financial statements?). **Independence in appearance** relates to financial statement users' perceptions of auditors' independence.

Auditors can be independent in fact but not perceived to be independent. For example, ownership of a small interest in a public client would probably not influence auditors' behavior with respect to the client. However, it is likely that third-party users would not perceive auditors to be independent.

2.5 **Due care** reflects a level of performance that would be exercised by reasonable auditors in similar circumstances. Auditors are expected to have the skills and knowledge of others in their profession (known as that of a prudent auditor) and are not expected to be infallible.

2.6 **Professional skepticism** is a state of mind that is characterized by appropriate questioning and a critical assessment of audit evidence.

Professional judgment is the auditors' application of relevant training, knowledge, and experience in making informed decisions about appropriate courses of action during the audit engagement.

Auditors are required to demonstrate professional skepticism and professional judgment throughout the entire audit process.

2.7 **Reasonable assurance** recognizes that a GAAS audit may not detect all material misstatements and auditors are not "insurers" or "guarantors" regarding the fairness of the company's financial statements. The following characteristics of an audit do not permit auditors to provide absolute assurance:

- Mistakes and misinterpretations may occur
- Management judgments and estimates affect financial reporting
- Audit procedures cannot always be relied upon to detect misstatements
- Audit engagements must be conducted within a reasonable period of time and so as to achieve a balance between benefit and cost.

2.8 Three elements of planning and supervision considered essential in audit practice are:

- A written audit plan.
- An understanding of the client's (auditee's) business.
- Policies to allow an audit team member to document disagreements with accounting or auditing conclusions and disassociate him or herself from the matter.

2.9 The timing of the auditors' appointment is important because auditors need time to properly plan the audit and perform the necessary work without undue pressure from tight deadlines.

2.10 **Materiality** is the dollar amount that would influence the lending or investing decisions of users; this concept recognizes that auditors should focus on matters that are important to financial statement users. Materiality should be considered in planning the audit, performing the audit, and evaluating the effect of misstatements on the entity's financial statements.

2.11 Auditors obtain an understanding of a client, including its internal control, as a part of the control risk assessment process primarily in order to plan the nature, timing and extent of substantive audit procedures. A secondary purpose is because of auditors' responsibilities for reporting on client's internal controls under *Auditing Standard No. 5.*

2.12 As the client's internal control is more effective (a lower level of control risk), auditors may use less effective substantive procedures (a higher level of detection risk). Conversely, when the client's internal control is less effective (a higher level of control risk), auditors must use more effective substantive procedures (a lower level of detection risk).

2.13 **Audit evidence** is defined as the information used by auditors in arriving at the conclusion on which the audit opinion is based.

2.14 *External documentary evidence* is audit evidence obtained from another party to an arm's-length transaction or from outside independent agencies. External evidence is received directly by auditors and is not processed through the client's information processing system.

External-internal documentary evidence is documentary material that originates outside the bounds of the client's information processing system but which has been received and processed by the client.

Internal documentary evidence consists of documentary material that is produced, circulates, and is finally stored within the client's information processing system. Such evidence is either not circulated to outside parties at all or is several steps removed from third-party attention.

2.15 In general, evidence that is completely external in nature is most reliable, because the client has not influenced its processing. In contrast, evidence that is completely internal in nature is least reliable, as it may represent a fictitious transaction created or modified by client personnel to enhance perceptions of the client's financial statements.

2.16 As auditors need to achieve lower levels of detection risk, more appropriate evidence needs to be obtained. Thus, auditors should gather higher quality evidence (more reliable evidence). For example, auditors may choose to obtain evidence from external sources rather than internal sources.

In addition, for lower levels of detection risk, auditors need to gather more sufficient evidence. Because sufficiency relates to the quantity of evidence, a greater number of transactions or components of an account balance should be examined.

2.17 A **financial reporting framework** is a set of criteria used to determine the measurement, recognition, presentation, and disclosure of material items in the financial statements. The financial reporting framework is related to auditors' reporting responsibilities because this framework serves as the basis against which the financial statements are evaluated and the auditors' opinion on the financial statements is expressed.

2.18 Four types of opinions and their conclusions:

Type	Conclusion
Unqualified opinion	Financial statements are presented in conformity with GAAP.
Adverse opinion	Financial statements are not presented in conformity with GAAP.
Qualified opinion	Financial statements are presented in conformity with GAAP, except for one or more departures or issues of concern.
Disclaimer of opinion	An opinion cannot be issued on the financial statements.

2.19 The auditors' report is dated at the point when all significant procedures have been completed by auditors and auditors have gathered sufficient appropriate evidence. This date is referred to as the audit completion date.

2.20 Public accountants should issue a report when they are associated with financial statements because users may mistakenly assume that an audit has been conducted and that the entity's financial statements are fairly presented according to GAAP.

2.21 The purpose served by the attestation standards is to guide work in attestation areas and engagements other than audits of financial statements.

2.22 The major differences between attestation standards and generally accepted auditing standards (GAAS) lie in the areas of practitioner competence, materiality and the risk of material misstatement, and reporting.

GAAS presume knowledge of accounting and require competence and capabilities as auditors (meaning auditors of financial statements). The attestation standards are more general, requiring training and proficiency in the "attest function" and knowledge of the "subject matter of the assertions."

The attestation standards have no specific requirement for determining materiality levels or obtaining and understanding of the entity and its environment to assess the risk of material misstatement. Because attestation engagements may cover information not confined to accounting and financial assertions, these activities may not be appropriate for all attest engagements.

Reporting is different because attestations on nonfinancial information do not depend upon generally accepted accounting principles. In addition, GAAS do not address two reporting issues (stating significant reservations about the engagement and indicating that the report is only intended for specified parties) that are important reporting aspects for attestation engagements.

2.23 A **system of quality control** provides firms with reasonable assurance that the firm and its personnel (1) comply with professional standards and applicable regulatory and legal requirements and (2) issue reports that are appropriate in the circumstances.

The six elements of a system of quality control are:

1. Leadership responsibilities for quality within the firm ("tone at the top")
2. Relevant ethical requirements
3. Acceptance and continuance of clients
4. Human resources
5. Engagement performance
6. Monitoring

2.24 In deciding whether to accept or continue an engagement with a client, firms should consider:

- The integrity of the client and the identity and business reputation of its owners, key management, related parties, and those charged with governance.
- Whether the firm possesses the competency, capability, and resources to perform the engagement.
- Whether the firm can comply with the necessary legal and ethical requirements.

If firms decide to withdraw from an engagement, the firm should document significant issues, consultations, conclusions, and the basis for any conclusions related to the decision to withdraw.

2.25 Typically, firms that audit nonpublic companies have peer reviews conducted through the AICPA's Center for Public Company Audit Firms Peer Review Program. While firms that are subject to PCAOB review requirements can elect to have peer reviews conducted under this program, most choose not to do so.

2.26 The PCAOB's monitoring role for firms providing auditing services to public entities includes registering public accounting firms and conducting inspections of registered public accounting firms (similar to peer reviews).

2.27 The frequency of PCAOB inspections depends upon the number of audits conducted by member firms. For firms performing audits for more than 100 public companies, inspections are required on an annual basis. For those performing audits for fewer than 100 public companies, inspections are conducted every three years.

SOLUTIONS FOR MULTIPLE-CHOICE QUESTIONS

2.28	a.	Correct	Gathering audit evidence is a component of the performance principle.
	b.	Incorrect	While reasonable assurance is related to gathering audit evidence, this is not one of the categories of principles
	c.	Incorrect	The reporting principle relates to the contents of the auditors' report
	d.	Incorrect	The responsibilities principle relates to the personal integrity and professional qualifications of auditors.
2.29	a.	Incorrect	This practice relates to accountants' competence and capabilities, not due care.
	b.	Incorrect	This practice relates to the reporting principle.
	c.	Incorrect	Sufficiency of evidence relates to the performance principle and not due care.
	d.	Correct	These practices are a part of due care.
2.30	a.	Incorrect	GAAS relates to the conduct of *audit engagements* and not overall professional services.
	b.	Correct	Standards within a system of quality control are firm- (rather than auditor-) related.
	c.	Incorrect	GAAP relates to accounting and financial reporting, rather than auditing practices.
	d.	Incorrect	International auditing standards govern the conduct of audits conducted across international borders.
2.31	a.	Incorrect	Relying more extensively on external evidence is related to the appropriateness (or quality) of evidence.
	b.	Incorrect	Focusing on items with more significant financial effects on the financial statements is related to materiality.
	c.	Correct	Professional skepticism is characterized by appropriate questioning and a critical assessment of audit evidence.
	d.	Incorrect	Financial interests are most closely related to auditors' independence.
2.32	a.	Correct	Auditors study internal control to determine the nature, timing, and extent of substantive tests.
	b.	Incorrect	Consulting suggestions are secondary objectives in an audit.
	c.	Incorrect	Information about the entity's internal control is, at best, indirect evidence about assertions in the financial statements.
	d.	Incorrect	Information about the entity's internal control provides auditors with little opportunity to learn about changes in accounting principles.
2.33	a.	Incorrect	External evidence is considered to be relatively reliable.
	b.	Correct	Management representations should least affect auditors' conclusions, as they have not been validated or corroborated by external parties.
	c.	Incorrect	Auditor-prepared evidence is considered to be the most reliable form of evidence.
	d.	Incorrect	Although a representation of a client employee, inquiry of the entity's legal counsel is considered more reliable than that of entity management.
2.34	a.	Incorrect	Inquiry of management should least affect auditors' conclusions.
	b.	Incorrect	Although very persuasive, auditors' personal knowledge (choice *d*) provides the most persuasive evidence
	c.	Incorrect	Observation of a client's procedures provides evidence on the effectiveness of the client's internal control, but not the existence assertion for newly-acquired computer equipment.
	d.	Correct	Auditors' personal knowledge provides the most persuasive evidence.

2.35	a.	Incorrect	Inquires of client personnel are the least reliable form of evidence.
	b.	Incorrect	While more reliable than inquiries (choice *a*), inspection of internal documents is relatively low in terms of reliability.
	c.	Incorrect	While sales invoices are documents created by external parties, the fact that these documents were received from client personnel decreases their reliability.
	d.	Correct	Because the statements were received directly from outside parties, this is a more reliable form of evidence than choice (*c*).
2.36	a.	Incorrect	Documentation of this nature would not be related to independence.
	b.	Incorrect	While the quality of the documentation and the conclusions included in the documentation might provide information about competence and capabilities, choice (*c*) is more appropriate.
	c.	Correct	Initials of the preparer and reviewer provide evidence that the documentation was reviewed, which relates to *planning and supervision*.
	d.	Incorrect	While the quality of the documentation and the conclusions included in the documentation might provide information about sufficient appropriate evidence, choice (*c*) is more appropriate

2.37 ***NOTE TO INSTRUCTOR****: Since this question asks students to identify the requirement that is not included in attestation standards, the response labeled "correct" is not included in attestation standards and those labeled "incorrect" are included in attestation standards.*

	a.	Incorrect	Attestation standards require adequate knowledge of the subject matter.
	b.	Correct	An understanding of the client's environment (including internal control) is not required under attestation standards, because internal control may not always be relevant to the subject matter of the attestation.
	c.	Incorrect	Attestation standards require sufficient evidence to be gathered.
	d.	Incorrect	Attestation standards require independence in mental attitude.

2.38 ***NOTE TO INSTRUCTOR****: Since this question asks students to identify the concept that is least related to due care, the response labeled "correct" is least related to due care and those labeled "incorrect" are more related to due care.*

	a.	Incorrect	Due care requires the level of skills and knowledge of others in the auditors' profession, which would require independence in fact.
	b.	Incorrect	See choice (*a*) above.
	c.	Incorrect	Due care refers to the performance of a "prudent" auditor.
	d.	Correct	Due care recognizes that mistakes and misinterpretations may occur during the audit.
2.39	a.	Incorrect	Internal documents are a relatively low quality of evidence.
	b.	Incorrect	Management representations (and the related verbal inquiries) are the lowest quality of evidence.
	c.	Incorrect	While direct, external evidence is of reasonable quality, it is of lower quality than direct personal knowledge of the auditor (choice *d*).
	d.	Correct	Direct, personal knowledge of auditors is the most appropriate form of evidence.
2.40	a.	Incorrect	While it may increase auditors' knowledge about the client, obtaining an understanding of a client's internal control does not directly influence auditors' competence and capabilities.
	b.	Incorrect	Obtaining an understanding of a client's internal control does not directly influence auditors' independence.
	c.	Incorrect	Obtaining an understanding of a client's internal control does not directly help satisfy the quality control standard about audit staff professional development.
	d.	Correct	The primary purpose of obtaining an understanding of a client's internal control is to plan the nature, timing, and extent of substantive audit procedures on an engagement.

2.41	d.	Correct	Independence confirmations would ensure that all firm personnel are independent with respect to that firm's clients, which is related to the "Relevant Ethical Requirements" element of a system of quality control. It would not relate to acceptance and continuance of clients (*a*), engagement performance (*b*), or monitoring (*c*).
2.42	b.	Correct	Government auditing standards are issued by the Government Accountability Office (GAO). Governmental accounting standards are issued by the Governmental Accounting Standards Board.
2.43	a.	Correct	Consultation with a specialist demonstrates due care if auditors do not have expertise in the area in question.
	b.	Incorrect	Auditors are experts in financial matters, not areas of art (and other collectibles) valuation.
	c.	Incorrect	GAAS applies to all audit engagements, including audit engagements for not-for-profit organizations.
	d.	Incorrect	Since (*a*) is correct, (*d*) cannot be correct.

2.44 ***NOTE TO INSTRUCTOR****: Since this question asks students to identify the topic that is not been addressed in the auditors' report, the response labeled "correct" is not addressed in the auditors' report and those labeled "incorrect" are addressed in the auditors' report.*

	a.	Incorrect	The responsibilities of the auditor and management are provided in the introductory paragraph.
	b.	Correct	Auditors provide reasonable (but not absolute) assurance in an audit engagement (this is noted in the scope paragraph of the auditors' report).
	c.	Incorrect	A description of the audit engagement is provided in the scope paragraph of the auditors' report.
	d.	Incorrect	The auditors' opinion on internal control over financial reporting is provided in the internal control paragraph of the auditors' report.
2.45	a.	Correct	Attestation standards differ from generally accepted auditing standards in that they apply to engagements other than those on historical audited financial statements.
	b.	Incorrect	Attestation standards require that the practitioner be independent.
	c.	Incorrect	Attestation standards may apply to prospective "what if" financial statements.
	d.	Incorrect	Attestation standards include requirements related to evidence.

SOLUTIONS FOR EXERCISES AND PROBLEMS

2.46 **Audit Engagement Independence**

a. Auditors should not follow clients' suggestions about the conduct of an audit unless the suggestions clearly do not conflict with their professional competence, judgment, honesty, independence, or ethical standards. Where there is no disagreement about the results to be accomplished and the client's suggestions represent good ideas, auditors can consider these suggestions. Within professional bounds, mutual agreement with the client is acceptable. Auditors must never agree to any arrangement that violates generally accepted auditing standards or the AICPA's Code of Professional Conduct.

b. The reasons that would not support dividing the assignment of audit work solely according to assets, liabilities and income and expenses include the following:

1. Work should be assigned to staff members by considering the degree of difficulty in relation to the technical competence and experience of individual staff members.

2. Sequence of work performed on an examination should be in accordance with an overall audit plan.

3. It is impossible to segregate work areas by major captions because often a close relationship exists among a number of accounts in more than one category. For example, interest and dividend income are normally based on an asset (investments) and interest expense is normally based on a liability (long-term debt).

4. Often a single form of audit documentation is desirable to provide evidence with respect to balances in accounts of various types, such as an insurance analysis supporting premium disbursements, the insurance expense portion, and the prepaid insurance balance.

5. Duplication of staff effort would be more likely to occur if assignments were made on such a basis.

6. Frequently, the scope of work regarding a single account requires simultaneous participation by the staff, such as in the observation of inventories.

Many audit operations are not susceptible to division by category, as for example studying and evaluating internal control, testing transactions, and preparing the report.

c. The audit staff member whose uncle owns the advertising agency should not be assigned to examine the client's advertising account. The firm is responsible for avoiding relationships which might suggest a conflict of interest. Regardless of whether this staff member could be independent and unbiased in such a situation (independence in fact), external parties will likely be influenced in their thinking by the fact that the uncle is the owner of the advertising agency (the staff member would not have independence in appearance). Even if a problem of ethics were not involved, it would be unwise for the firm to assign this staff member because the client's attitude could change significantly and the firm's position would be jeopardized if difficulties later arose in connection with the contract. Any situation in which bias exists or might arise should be avoided.

2.47 **Performance Principle**

The important elements of the performance principle and their relation to the C. Reis Company audit are:

1. Auditors must plan the work and appropriately supervise any assistants. Fulfilling this element would include the preparation of an audit plan for accounts receivable and reviewing it with the assistant prior to beginning the examination. These tasks were not done. Also, the completed audit documentation should have been reviewed to determine whether an adequate examination was performed. The illustration states that this procedure was followed.

2. Auditors must determine and apply appropriate materiality levels throughout the audit. This scenario did not address the process through which materiality levels were determined, so potential strengths and weaknesses related to materiality cannot be assessed.

3. Auditors must identify and assess risks of material misstatement. This element requires auditors to obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The case presented did not reference any work on the internal control. Complete reliance upon prior-year audit documentation in lieu of an evaluation of the existing internal control is improper, because changes may have been implemented to the system and controls by the client.

4. Auditors must obtain sufficient appropriate audit evidence. The assistant's preparation of audit documentation, confirmation requests, and other procedures seem to fulfill the requirements of this standard if the audit work is properly performed and is of sufficient scope.

2.48 **Time of Appointment and Planning**

From a theoretical viewpoint (and, in fact, from a practical viewpoint as well) such short notice of a request for an audit causes difficulties with planning the audit work, establishing staffing requirements, and reviewing the work; all of these features are important elements in the exercise of due care. The December 26 - January 20 period is a serious time constraint for an initial audit engagement. The greatest difficulties involve due care as well as the ability to appropriately perform the engagement (planning and supervision, determining materiality levels, identifying and assessing risks of material misstatement, and obtaining sufficient appropriate evidence). In view of the short notice and the time constraint, there may be some question as to whether an audit could be adequately completed by January 20.

2.49 **GAAS in a Computerized Environment**

With respect to the responsibilities principle, auditors are required to (1) have appropriate competence and capabilities to perform the audit, (2) comply with relevant ethical requirements, and (3) maintain professional skepticism and exercise professional judgment.

1. In an audit of a computerized accounting system, competence and capabilities must be directly related to information technology and controls in a computerized environment. In particular, auditors should be knowledgeable of the functions performed by computer systems, methods of testing the operations of a computerized accounting system, and methods of documentation unique to a computerized accounting system.

2. In complying with ethical requirements, auditors must maintain independence, just as in any type of engagement. In order to demonstrate due care, auditors must possess similar levels of skill and knowledge of others in the profession; in this environment, some of the knowledge in (1) above would be important to permit the engagement to be conducted using due care.

3. Professional skepticism and professional judgment must be demonstrated. It would not be unusual for auditors to be less knowledgeable about many elements of the client’s computerized accounting system and the evidence produced by that system compared to the level of knowledge in a manual system. This would generally lead to heightened levels of professional skepticism.

With respect to the performance principle, auditors are require to (1) plan the work and properly supervise any assistants, (2) determine and apply appropriate materiality levels, (3) identify and assess risks of material misstatements, and (4) obtain sufficient appropriate evidence.

1. As it relates to planning and supervision, some knowledge of computerized accounting systems auditing is necessary for planning access to computerized records and programs and conducting appropriate audit procedures. The planning should provide for an early examination of the computerized accounting system so that further procedures involving non-computer controls and accounting features may be planned should they depend upon computer control activities.

2. The effect of computerized processing has very limited effects on the auditors’ ability and process of determining materiality levels. This aspect of the audit is least affected by the extent of computerized processing used by the client.

3. When assessing the risk of material misstatement, the use of a computerized accounting system will impact both the risks of material misstatements as well as the type of controls implemented by the client. Computer controls need to be evaluated and tested to determine that they are operating effectively.

4. As the auditors obtain sufficient appropriate audit evidence, the type of evidence in a computerized accounting system will differ from that in a non-computerized system. Documentary evidence relating to a computerized accounting system includes program flowcharts, logic diagrams, and decision tables that are not normally used in non-computerized systems. Since these types of documentation are types of evidence, they must be understood by auditors.

2.50 **Independence**

a. **Independence in fact** relates to the auditors' "state of mind" and reflects an unbiased and impartial perspective with respect to the financial statements and other information they audit. **Independence in appearance** relates to others' (particularly financial statement users') perceptions of the auditors' independence.

b. The two general types of relationships that compromise auditors' independence are financial relationships (owning shares of stock or having an outstanding loan to or from a client) and managerial relationships (acting in a decision-making capacity on behalf of a client or providing advice on systems or information that will be audited).

c. 1. While auditors might still be independent in fact with respect to the audit of the client, the large revenues resulting from these services create a financial interest that many users would find to be troubling. For example, consider the possibility that clients might use the revenues from these services as a bargaining tool with auditors if an issue arises during the audit engagement. Currently, no prohibitions exist on the extent of consulting services or revenues, other than the prohibition of certain types of services and the required approval of non-audit services by the client's audit committee.

2. This would clearly pose a compromise to auditors' independence and would not be permitted under current guidelines. The issues in this case are (1) the fact that the auditor is directly involved with the engagement and (2) the executive-level position occupied by his or her spouse with a client.

3. This introduces a similar issue to (2), but would be less likely to compromise the auditors' independence. The major differences in this scenario are (1) the auditor is not directly involved with the engagement, (2) the level of position held by the auditor's relative is not at the executive level, and (3) the relationship between the auditor and other individual is not as close. Professional standards would likely not conclude that this situation would compromise the auditor's independence.

4. This represents a direct financial interest in a client. The issue is whether the fact that the staff member is not a part of the engagement team compromises his or her independence. While professional guidelines would not conclude that this situation compromises the independence of the staff member, many firms have adopted the practice of not permitting any of their professional staff to hold financial interests in their audit clients.

2.51 **Sources of Professional Standards**

	Description	Source
1.	Definition of a financial statement audit for a private entity	AICPA Auditing Standards Board
2.	Guidance for reporting on internal control for a public entity	PCAOB
3.	Standards for the practice of internal auditing	Institute of Internal Auditors
4.	Generally accepted government auditing standards	U.S. Government Accountability Office
5.	Standards of financial accounting	Financial Accounting Standards Board
6.	Auditing standards for public entities	PCAOB (with AICPA Auditing Standards Board serving as *Interim Standards)*
7.	Auditing standards for private entities	AICPA Auditing Standards Board
8.	Guidance for lending credibility to nonfinancial information	AICPA Auditing Standards Board (attestation standards)
9.	Auditing standards for foreign entities	IFAC International Auditing and Assurance Standards Board

2.52 **Auditors' Reports**

a. For scope limitations, the auditors' report would be modified as follows:

- The scope paragraph would be modified to indicate that "except for" the matter of the scope limitation, the audit was conducted in accordance with generally accepted auditing standards (for a qualified opinion). The scope paragraph would be omitted if auditors issued a disclaimer of opinion.

- An explanatory paragraph would be added to the auditors' report to describe the nature of the scope limitation, including dollar effects.

- The opinion paragraph would be modified to either indicate that "except for" the effects of adjustments that might have been identified, the financial statements are prepared according to GAAP (qualified opinion) or to disclaim an opinion (disclaimer of opinion).

Auditors can issue either a qualified opinion or a disclaimer of opinion when scope limitations exist (assuming these limitations are material).

b. For departures from GAAP, the auditors' report would be modified as follows:

- An explanatory paragraph would be added to describe the nature of the departure from GAAP, including dollar effects.

- The opinion paragraph would be modified to indicate either that "except for" the effects of the departure from GAAP, the financial statements are prepared according to GAAP (qualified opinion) or that the financial statements are not prepared according to GAAP (adverse opinion).

Auditors can issue either a qualified opinion or an adverse opinion when departures from GAAP are noted (assuming these departures have a material effect on the financial statements).

2.53 **Association with Financial Statements**

The consequence of being associated with financial statements is that accountants must indicate the nature of the examination and degree of responsibility they are assuming in their report.

a.	Associated	Issue the auditors' report.
b.	Not associated	Tax returns are an exception.
c.	Associated	Issue a disclaimer of opinion (public entity). Issue a compilation report (nonpublic entity).
d.	Not associated	CPA is associated with accounting records but not with financial statements.
e.	Associated	Issue a disclaimer of opinion (public entity).
f.	Associated	Issue a disclaimer of opinion (auditors should have requested that the client not print the auditors' name in this way.)
g.	Not associated	Nothing needs to be done so long as client doesn't mention auditors in the interim statement document.

2.54 **Investment Performance Attestation**

1, 2. Proficiency in the attest function and knowledge of the subject matter: Accountants must be persons who know and understand investment statistics, operations of mutual funds, and SEC rules regarding expenses.

3. Reasonable criteria: Accountants must determine whether standards exist for presentation of investment return statistics and expense ratios, or they must be able to assess the reasonableness of management's presentation of criteria. In addition, accountants must determine whether the statistics can be evaluated against reasonable criteria that are understandable by users of the advertisements.

4. Independence: Accountants must determine that they have independence in relation to Mystery Capital Management and its officers and directors.

5, 6, 7. Due care, planning and supervision, sufficient evidence: Accountants must conduct the field work carefully to obtain the evidence necessary in the circumstances.

8,10. Report: The accountants' report must identify the performance statistics and expense ratios and relate them to the criteria upon which they are based.

9. Reservations: If accountants have any misgivings about misrepresentation of the statistics and ratios management presents, these representations must be stated in the report.

11. Limitation on use of report: In some cases, the report may be intended solely for the information and use of specified parties. As a result, it may not be appropriate for this report to be presented in the entity's advertisements.

2.55 **Principles Case Study**

Responsibilities

1. Auditors are responsible for appropriate competence and capabilities to perform the audit.	1. It was inappropriate for Holmes to hire the two students to conduct the audit. The examination must be conducted by persons with proper education and experience in the field of auditing. Inexperienced persons can assist, if they are supervised.
2. Auditors are responsible for complying with relevant ethical requirements.	2. To satisfy the independence requirement, Holmes must be without bias with respect to the client under audit. Because of the financial interest in the bank loan, Holmes is neither independent in fact nor appearance with respect to the assignment undertaken. In addition, because of a number of actions (hiring unqualified individuals, failure to supervise those individuals, etc.), Holmes did not appear to exhibit due care.
3. Auditors are responsible for maintaining professional skepticism and exercising professional judgment throughout the planning and performance of the audit.	3. The fact that Holmes merely accepted the financial statements without questioning any evidence demonstrates lack of professional skepticism (as well as a lack of good professional judgment).

Performance

1. The auditor must adequately plan the work and must properly supervise any assistants.	1. This element recognizes that early appointment of auditors has advantages for auditors and the client. Holmes accepted the engagement without considering the availability of staff. In addition, Holmes failed to supervise the assistants. The work performed was not adequately planned.
2. The auditor must determine and apply appropriate materiality level or levels.	2. There was no discussion that appropriate materiality levels were determined or applied for the audit by either Holmes or the two accounting students. Thus, compliance with this element is difficult to assess.
3. The auditor must assess the risk of material misstatement based on the entity and its environment.	3. Holmes did not study the client's internal control nor did the assistants. There appears to have been no audit examination at all. The work performed was more an accounting service than it was an auditing service.
4. The auditor must obtain sufficient appropriate audit evidence about whether material misstatements exist.	4. No evidence was obtained to support the financial statements. The auditors merely checked the mathematical accuracy of the records and summarized the accounts. Standard audit procedures and techniques were not performed.

Reporting

1. Based on evaluation of the evidence obtained, the auditor expresses an opinion in accordance with the auditor's findings, or states that an opinion cannot be expressed, in the form of a written report. The opinion states whether the financial statements are prepared, in all material respects, in accordance with the appropriate financial reporting framework.

1. Because a proper examination was not conducted, the report should indicate that no opinion can be expressed as to the fair presentation of the financial statements in accordance with generally accepted accounting principles.

2.56 **Fundamental Principles**

a. This situation is related to the competence and capabilities element of the responsibilities principle. In this case, auditors can accept this engagement assuming that they take appropriate measures to obtain the knowledge necessary to perform the audit and understand important issues affecting this client. It is important to note that the existence of industry-specific accounting issues will require auditors to obtain the knowledge necessary to complete the engagement.

b. This situation is related to the reporting principle, which addresses the conformity of the financial statements with GAAP. If the client elects to treat these leases as operating leases in violation of GAAP, auditors should issue either a qualified or adverse opinion, depending upon the materiality of the departure from GAAP.

c. This situation is related to the performance principle, which indicates that the audit should be properly planned. In this case, auditors should evaluate whether the client's deadline will allow an audit to be properly planned and conducted according to generally accepted auditing standards. The fact that this would be an initial audit makes this possibility even more questionable than usual.

d. This situation is related to the performance principle, which requires auditors to obtain sufficient appropriate audit evidence. Given the low level of control risk, auditors would then proceed to perform the necessary auditing procedures, which provide the basis for their opinion on the client's financial statements. In this case, confirming a smaller number of customer accounts would be appropriate.

e. This situation is related to the responsibilities principle, which requires auditors to be independent. In this particular case, the fact that one of the partner's husband is an officer of the prospective client would likely result in the firm declining this particular engagement because of a lack of independence.

f. This situation is related to the reporting principle. Auditors should insist upon disclosure of the potential litigation and, if the client refuses, issue either a qualified opinion or adverse opinion, depending upon the materiality of the omission of the disclosures. In addition, the auditors' report should provide information regarding the omitted disclosures.

g. This situation is related to the performance principle, which requires auditors to assess the risk of material misstatement, which includes obtaining an understanding of the entity and its internal control. Once this understanding has been obtained, auditors would then proceed to perform the necessary substantive audit procedures.

h. This situation is related to the performance principle, which requires proper planning and supervision. An important element of supervision is critical review of work performed by persons at various levels within the firm. Because the supervisor's review of the work performed by the assistant indicates that the work supports the opinion on the financial statements, no further actions are necessary.

2.57 **System of Quality Control**

a. Leadership responsibilities for quality within the firm
b. Engagement performance
c. Human resources
d. Monitoring
e. Human resources
f. Relevant ethical requirements
g. Acceptance and continuance of clients
h. Leadership responsibilities for quality within the firm
i. Engagement performance

2.58 **Evaluating Quality Control**

a. Both peer reviews and PCAOB inspections involve a review of a sample of engagements conducted by a firm as well as an evaluation of that firm's system of quality control.

b. Peer reviews are normally conducted for firms that audit nonpublic clients (firms that audit public clients may engage in a peer review in addition to the PCAOB inspection, but they generally do not do so). Under the AICPA's current program, firms are required to have peer reviews every three years.

PCAOB inspections are conducted for firms that audit public clients; the frequency of PCAOB inspections is either annually (for firms auditing more than 100 public companies) or every three years (for firms auditing fewer than 100 public companies).

c. A major criticism of the peer review process is that firms were able to select their own reviewers. This feature of the program could explain the relatively small number of unfavorable peer review reports received by firms.

2.59 **Relative Appropriateness of Evidence**

a. Audit evidence obtained from independent sources outside the client provides greater assurance of reliability (appropriateness) than that which is secured solely within the client.

b. Accounting data and financial statements developed under satisfactory conditions of internal control are more reliable (appropriate) than those which are developed under unsatisfactory conditions of internal control.

c. Direct personal knowledge obtained by the independent auditors through physical examination, observation, computation, and inspection is more persuasive than information obtained indirectly.

2.60 **Internet Exercise: Public Company Accounting Oversight Board Inspection Reports**

NOTE TO INSTRUCTOR: If the PCAOB modifies the format of its inspection report, this solution may no longer be appropriate. The following represents the format of the PCAOB inspection reports as of Spring 2009.

a. The major information contained in PCAOB inspection reports includes (1) a summary of audit deficiencies identified by the PCAOB's inspection (Part I), (2) a description of the inspection process (Appendix B), and (3) the firm's response to the draft inspection report (Appendix C). While the results of the PCAOB's inspection of the firm's system of quality control are not provided in the portion of the report available to the "public" (via the PCAOB's website), these results will be made public by the PCAOB if the firm does not satisfactorily address deficiencies within one year of the date of the report.

b. The PCAOB's inspection of firm's system of quality control include practices, policies, and procedures in the following areas:

- Partner evaluation, compensation, admission, assignment of responsibilities, and disciplinary actions
- Independence policies.
- Client acceptance and retention policies.
- Practices for consultations.
- The firm's internal inspection program.
- Policies and procedures for staffing audits.
- Policies related to foreign affiliates.
- Tone at the top.

c – f. The answers here will depend up on the report selected by the student. It is important to emphasize that even the largest and most sophisticated firms have audit deficiencies. One interesting exercise is to randomly assign your students to reports (ensuring that all Big Four firms are covered) and compare the types and magnitude of deficiencies identified. In addition, having students evaluate whether the firm's response is appropriate in the circumstances is an interesting classroom exercise.

2.61 **Professional Standards (Comprehensive)**

a. While university-level training is important, it is also necessary that professionals continue their education throughout their careers, as accounting and auditing standards will change. In this particular case, the staff member would need to stay abreast of current developments in order to meet the competence and capabilities element of the responsibilities principle.

b. Auditors need to be both independent in fact and independent in appearance. While a small financial investment might not impair the auditors' actual state of mind (independence in fact), it is unlikely that financial statement users will perceive the auditor to be independent (independence in appearance). Professional standards would not consider the auditor independent in this case, as no direct financial interests in clients are permitted.

c. Professional skepticism represents a state of mind that is characterized by *appropriate* questioning and a critical assessment of audit evidence. When employing professional skepticism, auditors will not simply accept all evidence provided and assume that clients are unquestionably honest. However, the statement that "[y]ou really have to question everything the client tells you" is a bit exaggerative and goes beyond the concept of professional skepticism.

d. It is correct that internal evidence is generally of lower quality than external evidence. However, the necessary quality of evidence depends upon the risk of material misstatement and the effectiveness of the client's internal control. In this case, the staff auditor's statement that internal evidence is obtained because of time and cost considerations is not appropriate, unless the risk of material misstatement permits lower quality of evidence because of other reasons.

e. While appropriate planning will allow audits to be conducted on a timely basis, it is not appropriate for auditors to ignore transactions and events between the interim date (in this case, November 1) and the client's fiscal year end. Some testing would need to be performed following the year end for transactions occurring between November 1 and December 31.

f. While the primary purpose of evaluating internal control is to determine the nature, timing, and extent of substantive tests, auditors must still conduct some study of internal control to ensure that the condition of the client's internal control has not changed from prior years. If it has, the substantive tests performed by auditors may no longer be appropriate. In addition, for public companies, auditors are required to study internal control and report on the effectiveness of the client's internal controls under *Auditing Standard No. 5.*

g. For departures from GAAP, the choice among opinions would be between a qualified opinion (for less material departures) and an adverse opinion (for more material departures).

h. While the concept of materiality does consider dollar amounts and their effects on users' decisions, qualitative factors also need to be considered when assessing materiality. For example, a small dollar amount (in absolute terms) may influence a company's ability to meet its earnings expectations or report higher earnings than in previous years. Situations such as this need to be considered as well as the absolute dollar amount of an item in assessing materiality.

2.62 **Kaplan CPA Exam Simulation: Generally Accepted Auditing Standards.**

To: Kelly, CPA

From: Engagement Partner, CPA

Planning

Auditors must adequately plan the work and must properly supervise any assistants. An audit plan must be developed prior to substantive testing to ensure that adequate planning has occurred. Also, all evidence is to be recorded within the audit documentation, and then the documentation is reviewed by qualified personnel (i.e., partner in charge of the engagement) to ensure proper supervision.

Internal Control

Auditors must obtain sufficient appropriate audit evidence through audit procedures performed to afford a reasonable basis for an opinion regarding the financial statements under audit. Auditors need to make an assessment of control risk. If control risk is assessed as high, auditors will need to gather more evidence than anticipated or gather better quality evidence. The opposite would be true if control risk is assessed as low.