Auditing and Assurance Services A Systematic Approach 10th edition Messier Solutions Manual

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CHAPTER 2
THE FINANCIAL STATEMENT AUDITING ENVIRONMENT

Answers to Review Questions

2-1 Auditors can be classified under four types:
(1) External auditors—Auditors who are referred to as "external" or "independent" because they are not employees of the entity being audited. Audit financial statements for publicly traded and private companies, partnerships, municipalities, individuals, and other types of entities. May also conduct compliance, operational, and forensic audits for such entities
(2) Internal auditors—Auditors who are employees of individual companies, government agencies, and other entities. Often conduct financial, internal control, compliance, operational, and forensic audits within their organizations. In some cases they may assist the external auditors with the annual financial statement audit. Internal auditors also often are involved in assurance and consulting engagements for their entities.
(3) Government auditors—Auditors employed by federal, state, and local agencies. Government auditors are usually considered to be a type of internal auditor. Conduct audits of activities, financial transactions, and accounts of the federal government. They also assist Congress by performing special audits, surveys, and investigations. The majority of the audits are compliance and operational audits. May also investigate for fraud in government agencies and other organizations subject to federal laws.
(4) Forensic auditors—Auditors employed by corporations, government agencies, public accounting firms, and consulting and investigative services firms. They are specially trained in detecting, investigating, and deterring fraud and white-collar crime.

2-2 Examples of *compliance* audits include (1) internal auditors determining whether corporate rules and policies are being followed by departments within the organization, (2) an examination of tax returns of individuals and companies by the Internal Revenue Service for compliance with the tax laws, and (3) an audit under the Single Audit Act of 1984 to determine whether an entity receiving federal assistance is in compliance with applicable laws and regulations.

Examples of *operational* audits include (1) an audit by the GAO of the Food and Drug Administration to determine the efficiency and effectiveness of procedures for introducing new drugs to the market, (2) internal auditors examining the effectiveness and efficiency of funds being spent on the entity's computer resources, and (3) a university hiring an external auditor to examine the effectiveness and efficiency of student advisory services.

Examples of *forensic* audits include (1) an examination by an external auditor of cash disbursements for payments to unauthorized vendors, (2) assistance by an auditor to a law enforcement agency in tracing laundered monies by organized criminals, and (3) an independent auditor helping identify hidden assets as part of a divorce settlement.

Student answers will likely be less detailed but should capture the general idea of each

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type of audit.

2-3 During the late 1990s and early 2000s, accounting firms aggressively sought opportunities to expand their business in nonaudit services such as consulting. This expansion from their core audit practice, combined with allegations of auditors refusing to challenge management's actions, resulted in conflict between regulators and the accounting profession. Subsequent financial fiascos such as those at Enron, WorldCom, Tyco, and many others caused investors to doubt the fundamental integrity of the financial reporting system. Under pressure to restore the public's confidence, Congress passed the Sarbanes-Oxley Act and created the PCAOB in 2002.

2-4 The accounting profession's expansion into new areas, combined with changes in the overall business environment, resulted in new regulations and guidelines. The scandals of the late 1990s and early 2000s brought into question the profession's ability to self-regulate, resulting in new legislation. While these changes have caused pain and turmoil, they highlight the essential importance of auditing in our economic system. Ultimately, the "back to basics" emphasis, along with auditing firms' renewed focus on thorough and effective financial statement audits, will likely prove healthy for the U.S. financial

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reporting system and for the profession. Further, somewhat ironically, the SOX-mandated audit of internal control over financial reporting has brought significant new revenues to accounting firms.

2-5 Management is responsible to prepare financial statements that fairly present the company's financial condition and operations in accordance with established accounting standards. Note that the auditor's opinion explicitly states that the financial statements are the responsibility of management. The auditor is responsible to issue an opinion in regards to the financial statements prepared by management. In order to issue this opinion, the auditor must plan and perform the audit in accordance with established standards to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. However, it is important to note that an auditor's unqualified opinion does not mean that errors or fraud do not exist but rather that there is reasonable assurance that they do not exist in material amounts.

2-6 The essential components of the high-level model of business offered in the chapter are: corporate governance, objectives, strategies, processes, controls, transactions, and financial statements. Corporate governance is carried out by management and the board of directors in order to ensure that business objectives are carried out and that company assets are safeguarded. To achieve its objectives, management must formulate strategies and implement various processes which are in turn carried out through business transactions. The entity's information and internal control systems must be designed to ensure that these transactions are properly executed, captured, and processed in order to produce accurate financial statements. It is important that the auditor obtain a firm understanding of these components in order to understand relevant risks and to plan the nature, timing, and extent of the audit so that it is efficient and effective.

2-7 The information system must maintain a record of all businesses transactions. It should be capable of producing accurate financial reports to summarize the effects of the entity's transactions. Among other things, internal control is required to ensure that a proper environment is established and that transactions are appropriately conducted and recorded by the information system and company employees. Effective internal control provides safeguards to ensure the (1) reliability of financial reporting, (2) compliance with laws and regulations, and (3) the effectiveness and efficiency of operations. Auditing standards require that the auditor obtain an understanding of the client's environment, including its internal control, in planning the nature, timing, and extent of testing.

2-8 The AICPA issues the following standards:

- Statements on Auditing Standards
- Statements on Standards for Attestation Engagements
- Statements on Standards for Accounting and Review Services
- Statements on Quality Control Standards
- Standards for Performing and Reporting on Peer Reviews
- Statements on Standards for Consulting Services
- Statements on Standards for Tax Services

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2-9 The PCAOB is a quasi-governmental organization overseen by the SEC. It was formed to provide governmental regulation of the standards used in conducting public company audits because of a perceived failure of the profession to adequately regulate itself.

2-10 The SEC has congressional authority from the original Securities Acts of 1933 and 1934 to establish accounting and auditing standards for publicly traded companies; however, in the past the SEC has largely delegated this authority to other bodies, including the FASB and the AICPA's Auditing Standards Board. The Sarbanes-Oxley Act of 2002 gave the SEC the mandate to actively regulate the public accounting profession by establishing and overseeing the PCAOB and its standard-setting process relating to the audits of public companies. The SEC has authority to implement and oversee standards relating to all aspects of the audits of public companies, including standards relating to auditor independence (such as the requirement for audit firms to rotate audit partners off audit engagements every five years).

2-11 The documents most frequently encountered by auditors under the Securities Exchange Act of 1934 are forms *10-K*, *10-Q*, and *8-K*. Forms *10-K* and *10-Q* are, respectively, annual and quarterly reports, which include the audited financial statements periodically filed with the SEC by a publicly traded entity. An *8-K* is filed whenever a significant event occurs which may be of interest to investors, such as a change of independent auditors.

2-12 The four categories of Principles Underlying an Audit Conducted in Accordance with GAAS are *the purpose and premise of an audit*, *personal responsibilities of the auditor*, *auditor actions in performing the audit*, and *reporting*. The Principles Underlying an Audit include all of the key concepts conveyed in the 10 GAAS, but do so in a more organized and coherent manner. They also address other key concepts that are not addressed in the 10 GAAS, such as explicitly identifying the fundamental purpose of an audit and management's responsibilities.

2-13 GAAS is composed of three categories of standards: *general standards*, *standards of field work*, and *standards of reporting*. The ten GAAS and the SAS are minimum standards of performance because circumstances of individual engagements may require the auditor to perform audit work beyond that specified in GAAS and the SAS in order to appropriately issue an opinion that a set of financial statements is fairly presented. As a result, the auditor needs to use professional judgment in following all standards.

2-14 Independence is a fundamental principle for auditors. If an auditor is not independent of the client, users may lose confidence in the auditor's ability to report objectively and truthfully on the financial statements, and the auditor's work loses its value. From an agency perspective, if the principal (owner) knows that the auditor is not independent, the owner will not trust the auditor's work. Thus, the agent will not hire the auditor because the auditor's report will not be effective in reducing information risk from the perspective of the owner.

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Answers to Multiple-Choice Questions

2-15	b	**2-20**	a
2-16	a	**2-21**	a
2-17	a	**2-22**	c
2-18	d	**2-23**	c
2-19	c		

Solutions to Problems

2-24

Item Number	Type of Audit	Type of Auditor
a.	Operational	Government
b.	Financial statement	External
c.	Compliance or operational or possibly internal control	Internal or external
d.	Forensic/Financial	Internal, external, or forensic
e.	Operational	Government, external, or internal
f.	Operational	Internal or external
g.	Compliance	Government
h.	Compliance or forensic	Government, external, or forensic

2-25 a.

Brief Description of Generally Accepted Auditing Standards	Sally Jones' Actions Resulting in Failure to Comply with Generally Accepted Auditing Standards
General Standards:	
1. The auditor must have adequate technical training and proficiency to perform the audit.	1. It was inappropriate for Jones 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. Although a junior

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	assistant has not completed his formal education, he may help in the conduct of the examination as long as there is proper supervision and review.
2. The auditor must maintain independence in mental attitude in all matters relating to the audit.	2. To satisfy the second general standard, Jones must be without bias with respect to the client under audit. Jones has an obligation for fairness to the owners, management, and creditors who may rely on the report. Because of the financial interest in whether the bank loan is granted to Boucher, Jones is not independent in either fact or appearance with respect to the assignment undertaken.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.	3. This standard requires Jones to plan and perform the audit with due care, which imposes on Jones and everyone in her firm a responsibility to observe the standards of field work and reporting. Exercise of due care requires critical review at every level of supervision of the work done and the judgments exercised by those assisting in the examination. Jones did not review the work or the judgments of the assistants and clearly failed to adhere to this standard.
<u>Standards of Field Work</u>:	
1. The auditor must adequately plan the work and must properly supervise any assistants.	1. This standard recognizes that early appointment of the auditor has advantages for the auditor and the client. Jones accepted the engagement without considering the availability of competent staff. In addition, Jones failed to supervise the assistants. The work performed was not adequately planned.

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2. The auditor must 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.	2. Jones did not study the client or its environment, including 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.
3. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.	3. Jones acquired little evidence that would support the fairness of the financial statements. Jones merely checked the mathematical accuracy of the records and summarized the accounts. Several standard audit procedures and techniques were neglected.
Standards of Reporting: 1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).	1. Jones' report made no reference to generally accepted accounting principles. Because Jones did not conduct a proper examination, the report should state that no opinion can be expressed as to the fair presentation of the financial statements in accordance with GAAP.
2. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.	2. Jones' improper examination would not enable her to determine whether accounting principles have been consistently applied.
3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.	3. Management is responsible for adequate disclosure in the financial statements, but when the statements do not contain adequate disclosures the auditor should make such disclosures in the auditor's report. Both the statements and the auditor's report lack adequate disclosures.

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4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefore in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.	4. Although Jones' report contains an expression of opinion, her opinion is not based on the results of a proper audit examination. Jones should disclaim an opinion because she failed to conduct an examination in accordance with generally accepted auditing standards.

b.

Brief Description of Principles Underlying an Audit	Sally Jones' Actions Resulting in Failure to Comply with Principles Underlying an Audit
<u>Purpose and Premise of an Audit</u>:	
An audit is to provide an opinion by an auditor on whether financial statements are presented fairly, in all material respects, according to the applicable framework. Management and those charged with governance are responsible for the preparation and fair presentation of the financial statements and for the design, implementation, and maintenance of internal control over financial reporting. They are also responsible for providing the auditor with all information relevant to the preparation of the financial statements.	Jones expressed an opinion regarding the financial statements, but not on whether the financial statements are presented fairly in accordance with generally accepted accounting principles, or any other financial reporting framework. Therefore, she did not fulfill the primary purpose of the audit. Jones did not ensure that management fulfilled its responsibilities for the fair presentation of the financial statements, since that requires making the appropriate disclosures in the financial statements.

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Responsibilities: Auditors are responsible for having appropriate competence and capabilities to perform the audit; complying with relevant ethical requirements; and maintaining professional skepticism and exercising professional judgment, throughout the planning and performance of the audit.	It was inappropriate for Jones to hire the two students to conduct the audit, because they do not have appropriate competence and capabilities. In order to comply with ethical requirements, Jones must be without bias with respect to the client under audit. Because of the financial interest in whether the bank loan is granted to Boucher, Jones is not independent in either fact or appearance with respect to the assignment undertaken. Neither Jones nor her two assistants exercised professional skepticism or professional judgment in performing the audit.
Performance: The auditor must obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. To do so, the auditor must plan the work and supervise any assistants; determine an appropriate materiality level; identify and assess risks of material misstatement based on an understanding of the entity and its environment, including its internal control; and obtain sufficient appropriate audit evidence about whether misstatements exist. The auditor is unable to obtain absolute assurance that the financial statements are free from material misstatements.	Jones failed to supervise the assistants. The work performed was not adequately planned. Jones did not study the client or its environment, including internal control, nor did the assistants. Consequently, she could not have identified risks of material misstatements. Jones acquired little evidence that would support the fairness of the financial statements. Jones merely checked the mathematical accuracy of the records and summarized the accounts. Several standard audit procedures and techniques were neglected.

Reporting: Based on an evaluation of the audit evidence obtained, the auditor expresses an opinion in accordance with the auditor's findings, or states that an opinion cannot be expressed. The opinion states whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.	Although Jones' report contains an expression of opinion, her opinion is not based on the results of a proper audit examination. Jones should disclaim an opinion because she failed to conduct an examination in accordance with generally accepted auditing standards. Jones' opinion made no reference to the applicable financial reporting framework. Also, since the financial statements did not contain adequate disclosures, they could not have been in accordance with any financial reporting framework.

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2-26

Situation	Applicable GAAS of Reporting	Discussion of Relationship of Client Situation to Standard of Reporting
a.	The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.	A change in accounting principle affects the consistent application of the accounting principle. If the change is material, the auditor should reference the change in accounting in an explanatory paragraph to the audit report.
b.	When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.	Information essential to a fair presentation in conformity with GAAP must be disclosed in the financial statements or the related footnotes. Assuming that the terms of loan agreements, such as restrictive covenants, are material, such information should be disclosed. If the client refuses to disclose such essential information, the auditor should disclose the information and qualify the audit report.
c.	The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).	The improper presentation of material amounts of minority interest in net income and retained earnings constitutes a departure from GAAP. The audit report should be qualified (or adverse) and the information should be disclosed by the auditor.

Solutions to Discussion Cases

2-27 Merry-Go-Round Part I.

a. EY is alleged to have violated all three general standards as well as one, and perhaps two, of the standards of field work.
   - They violated the first general standard in the sense that it appeared that the staff assigned to the engagement did not have sufficient training or experience for the engagement.
   - EY's relationship with MGR's landlords and attorneys likely caused them to violate the second general standard, which requires independence in mental attitude.
   - The turnaround team's slow performance, the fact that the leader of the team took a vacation at a critical time, and the insufficient cost-cutting recommendations suggest that EY did not exercise due professional care, which would be in

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violation of the third general standard.

- Poor staff assignments, the leader's vacation, and the use of inexperienced personnel all suggest that the engagement was not adequately planned and that assistants were not properly supervised, a violation of the first standard of fieldwork.
- Finally, EY's inadequate recommendations suggests that they likely did not gather enough information about MGR's operations to allow them to implement an effective implementation strategy, which would be in violation of the third standard of fieldwork.

b. EY is alleged to have violated the Principles of responsibilities and performance.
   - They violated the Principle of responsibilities in the sense that it appeared that the staff assigned to the engagement did not have sufficient training or experience for the engagement. EY's relationship with MGR's landlords and attorneys likely caused them to violate this Principle, which requires compliance with relevant ethical requirements.
   - Poor staff assignments, the leader's vacation, and the use of inexperienced personnel all suggest that the engagement was not adequately planned and that assistants were not properly supervised, which violates the Principle of performance. Also, the inadequate nature of EY's recommendations suggests that they likely did not gain a sufficient understanding of the entity and its operations.

c. There are arguments both for and against having formal standards for CPAs who consult. Advantages include potential increase in public trust, some assurance that a minimal level of service quality would be attained, and perhaps more guidance for consultants (to allow them to perform more effective consulting engagements). The primary disadvantage would result from the fact that CPAs who consult compete with consulting firms comprised of non-CPAs. If standards were not thought out carefully, perhaps the standards would put CPAs at a disadvantage relative to non-CPAs in the sense that CPAs would be subject to standards that constrain their activities or perhaps result in their not being able to compete with non-CPAs in the area of fees. Note that CPAs face certain restrictions in providing consulting services to audit clients. These restrictions are covered in a later chapter.

2-28 Merry-Go-Round Part II.

a. In one sense, EY acted unethically. That is, it should have disclosed the nature of these relationships to MGR. In another sense, it is difficult to ascertain whether these relationships caused EY to act unethically. Specifically, was EY's advice affected by its relationship with the landlord? Is this relationship the reason that EY's cost-cutting suggestions did not go farther? These questions point out the importance of independence in fact and appearance, even when acting in a consulting capacity. Even if EY acted ethically, this relationship creates the appearance of impropriety.

b. As mentioned in Part a, the relationship with Rouse could have caused EY to hesitate to suggest that the stores for which Rouse was the landlord be closed for fear of

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losing business from Rouse. Its relationship with Swidler could have made EY feel that it could not lose the engagement under any circumstances, thereby possibly explaining its apparently lackadaisical attitude towards the engagement.

Solutions to Internet Assignments

2-29 A search of the GAO's homepage will identify recent audits conducted by this agency.

2-30 a. According to its website, the AICPA's mission is to "provide members with the resources, information, and leadership that enable them to provide valuable services in the highest professional manner to benefit the public as well as employers and clients."

b. The SEC's website states that its mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." It goes on to emphasize that its purpose is to promote and sustain economic growth. The site also mentions that the SEC promotes the disclosure of important market information, maintains fair dealings, protects against fraud, and enforces its authority.

c. During the 1920s, many people began investing heavily in the stock market without fully thinking about the risk that they were taking upon themselves. As a result of poor investment choices and unreliable information, the stock market crashed in 1929. In an attempt to restore confidence in the capital markets, Congress passed the Securities Act of 1933. One year later, the SEC was created by the Securities Exchange Act of 1934.

d. The PCAOB's website provides information on the Board's organization, policies, and standards. It also indicates that the Board uses an expert advisory group to help the Board develop standards. Though many observers dispute this claim, the Board asserts that its standards are also developed in an open, public process to allow all parties of interest to comment. Section 103 of the Sarbanes-Oxley Act empowers the PCAOB to set auditing standards for audits of public companies.

The Dodd-Frank Act amended the Sarbanes-Oxley Act to give the PCAOB the authority to establish auditing and related professional practice standards for audits of the financial statements and selected practices and procedures of broker-dealers. The Board's Office of the Chief Auditor is responsible for developing these standards.

e. The International Auditing Practices Committee (IAPC) was founded in 1978. During its first meeting, the group agreed to issue its publications as guidelines rather than standards. The IAPC's initial work focused on three areas: object and scope of audits of financial statements, engagement letters, and general auditing guidelines. During this initial meeting, the IAPC also agreed to respond to a request from the International Accounting Standards Committee (IASC) chairman and Governors of the Central Banks to develop guidance on inter-bank confirmations.

In 1988, the IAPC approved the release of *The Auditor's Report on Financial Statements* guidelines. It later developed final guidelines on three key subjects: related parties, going

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concern, and management representations.

In 1985, Chairman Justin Fryer called on the IAPC to act in the interests of the public. He also called on the IAPC to resolve differences in auditing standards where differences exist in different countries and to establish a single set of international standards. The IAPC recognized that a fundamental way to protect the public interest was to require the application of a core set of internationally recognized auditing and assurance standards.

IFAC was among the first organizations to refer to international auditing guidelines in its own financial statements. In 1991, the IAPC proposed to IFAC member bodies that the term "guidelines" be replaced with "standards." With that, International Standards on Auditing, or ISAs, were born.

In 2001, IAPC was renamed as the International Auditing and Assurance Standards Board (IAASB). The IAASB then embarked on its first joint project with a national standard setter, the AICPA, which resulted in the development of the suite of audit risk standards.

In 2003, IFAC approved a series of reforms designed to strengthen the IAASB's standard-setting processes so that it are properly responsible to the public interest. By 2007, the IAASB had become arguably the most transparent auditing standard setter in the world.

To encourage greater use of its standards and facilitate translation, in 2004 the IAASB launched a project designed to improve the clarity of its pronouncements. It revised its drafting conventions to make the ISAs more readily understood. By the end of 2008, the IAASB had approved all final redrafted auditing standards. The IAASB is currently working on revising its standards for assurance engagements other than audits.

f. The IASB is the independent accounting standard-setting body of the IFRS Foundation. The IASB is composed of 16 experts with an appropriate mix of recent practical experience in setting accounting standards, in preparing, auditing, or using financial reports, and in accounting education. The IASB is advised by the IFRS Advisory Council which, along with the IASB, is overseen by the IFRS Foundation trustees. The IFRS Foundation is overseen by a monitoring board of public capital market authorities.

The IFRS Foundation is a not-for-profit, private sector body that raises funds to support the operations of the IASB as an independent accounting standard setter. Mandatory levies are issued for listed and non-listed companies in a growing number of countries. The Foundation strives to ensure that its financial support is broad based.

The IASB is responsible for the development and publication of IFRSs and for approving Interpretations of IFRSs as developed by the IFRS Interpretations Committee. All meetings of the IASB are held in public and are broadcast through the internet. In fulfilling its standard-setting duties, the IASB follows a thorough, open and transparent process of which the publication of consultative documents, such as discussion papers

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and exposure drafts for public comment is an important component. The IASB engages closely with stakeholders around the world, including investors, analysts, regulators, business leaders, accounting standard-setters, and the accountancy profession.

The SEC has not yet reached a decision as to how, or even whether, the U.S. will adopt IFRS. Currently, the FASB is working to converge many of its standards with those of the IASB. For example, the FASB recently issued guidance on fair value measurement that is "largely identical" to guidance issued by the IASB. The FASB is currently working on converging its standards regarding revenue recognition, financial instruments, and lease accounting to be more in line with IFRS.

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Chapter 2
The Financial Statement Auditing Environment

Learning Objectives	Review Questions	Multiple-Choice Questions	Problems	Discussion Cases	Internet Assignments
LO 2-1: Be familiar with the different types of auditors.	1	15	24		29
LO 2-2: Be familiar with the various types of audit, attest, and assurance services offered by accounting professionals.	2	16,17	24	27	29
LO 2-3: Understand the organization of public accounting firms and the composition of audit teams.					
LO 2-4: Understand the significant changes that have taken place in the auditing profession over the past decade.	3,4	18			
LO 2-5: Know that management is primarily responsible for the entity's financial statements and understand the auditor's responsibility for detecting errors, material fraud, and illegal acts.	5	19			
LO 2-6: Recognize that an audit is shaped by the auditee's business, industry, and economic environment and understand essential components and processes characteristic of most business entities.	6,7	20			
LO 2-7: Be familiar with a five-component model of business processes used to organize an audit.	7	20			
LO 2-8: Identify and be familiar with the major organizations that affect the public accounting profession's environment.	8,9,10,11	21			29,30
LO 2-9: Understand that auditing standards are established by both U.S. and international standard setters.		22			
LO 2-10: Be familiar with the 10 "generally accepted auditing standards" and the "principles underlying an audit conducted in accordance with generally accepted auditing standards."	12,13	23	25,26	27	
LO 2-11: Understand the nature of auditing standards.					

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LO 2-12: Understand that the auditing profession places a premium on ethical behavior and is governed by a Code of Professional Conduct.	14			27, 28	

NOTE: References to auditing standards in the instructor manual follow a similar convention to that followed in the text: AICPA standards will be referenced by clarified AU section and PCAOB standards will be referenced by Auditing Standard (AS) number.

END OF CHAPTER MATERIALS COMPARISION CHART

Number in 9th edition	Comparison	Number in 10th edition
2-1	Revised	2-1
2-2	Unchanged	2-2
2-3	Unchanged	2-3
2-4	Unchanged	2-4
2-5	Unchanged	2-5
2-6	Unchanged	2-6
2-7	Unchanged	2-7
2-8	Revised	2-8
2-9	Unchanged	2-9
2-10	Unchanged	2-10
2-11	Revised	2-11
2-12	Unchanged	2-12
2-13	Unchanged	2-13
2-14	Unchanged	2-14
2-15	Unchanged	2-15
2-16	Revised	2-16
2-17	Revised	2-17
2-18	Unchanged	2-18
2-19	Unchanged	2-19
2-20	Unchanged	2-20
2-21	Unchanged	2-21
2-22	Unchanged	2-22
2-23	Revised	2-23
2-24	Unchanged	2-24
2-25	Revised	2-25
2-26	Revised	2-26
2-27	Revised	2-27
2-28	Revised	2-28
2-29	Revised	2-29
2-30	Revised	2-30

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Chapter 2 covers the context, or environment, in which auditors function, starting with an overview of the recent changes in the public accounting profession.

[LO 2-1, 2-2] Types of Auditors and Services

We spend a few minutes discussing the different types of audits and services (e.g., internal control audits, compliance audits, operational audits, forensic audits, attest services, and assurance services) firms can provide and the different types of auditors (e.g., external auditors, internal auditors, government auditors, and forensic auditors). Chapter 21 discusses attestation services more thoroughly. **Problem 24** could be covered here.

[LO 2-3] Public Accounting Firms

We briefly review the organization of firms (e.g., proprietorship, general or limited liability partnerships, or corporation), the categorization of the firms (e.g., Big 4, mid-tier firms, regional firms, and local firms), the types of services (e.g., audit, tax, management advisory services, and accounting and review services), and the internal organization (e.g., partner, manager, senior, and associate) that describes the public accounting firms.

[LO 2-4] A Decade of Challenge and Change for Financial Statement Auditors

The time we spend with this topic depends on what was covered in the earlier class. We try to continue the discussion, emphasizing to the students issues facing the profession today or the overall environment the profession is operating in. We focus on

- Events leading up to the current landscape.
- The explosion of scandals that took place.
- Government intervention (i.e., Sarbanes-Oxley Act 2002, Dodd-Frank Act 2010).
- The profession's response (a healthy move back to the basics).

[LO 2-5] Society's Expectations and the Auditor's Responsibility

Students generally find this topic very interesting. We focus on the auditor's responsibility to detect errors, fraud, and illegal acts. Many students falsely believe that auditors have the responsibility to detect all errors, fraud, and illegal acts. Sometimes, we have a guest speaker come into this class to discuss the growing field of forensic accounting.

[LO 2-6] The Context of Financial Statement Auditing

We spend a few minutes emphasizing to the students the importance of an auditor knowing his/her auditees' business and industry characteristics since that is the context or environment within which a particular business operates. We emphasize that it is difficult for an auditor to effectively audit something which he/she does not fully understand. We end this section with a short introduction to a high-level model of a business entity and then spend more time with the five cycles used to break the audit down into manageable pieces covered in LO7.

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[LO 2-7] A Model of Business Processes: Five Components

With the high-level model, we make sure everyone knows how a business operates at the highest level by including the roles of corporate governance, the board of directors, and the audit committee. Then we discuss briefly with the students how objectives are formed and what strategies might be designed to achieve those objectives by asking the students to come up with related examples of each and writing them on the board. Then we write down specific processes that might be set up so that the strategies are implemented. Last, we ask them for specific risks that might threaten the achievement of the objectives we came up with and write these down as well.

We then spend more time with the process part of the above exercise. We ask the students to list the five cycles and relate them to what we discussed above using Figure 2-1. Next, we briefly discuss each of the five cycles individually as well as how they are interrelated:

- The financing process.
- The purchasing process.
- The human resource management process.
- The inventory management process.
- The revenue process.

Use Figure 2-1

Finally, we relate the process components to the "business model." Management establishes processes in the five categories discussed above to implement the organization's strategies and achieve its objectives. The financial statements report the financial results of those efforts to outside parties (the organization's performance and its external reporting and accountability).

[LO 2-8] Organizations that Affect the Public Accounting Profession

We use Figure 2-2 as a framework for discussing the various organizations that affect financial statement audits. We tend to focus on the SEC, the PCAOB, the FASB, and the AICPA.

Use Figure 2-2

[LO 2-9 – LO 2-11] Auditing Standards

Auditing standards provide a systematic approach to auditing and thus should be emphasized to the students. We begin the discussion with the current state of audit standard-setting: ASB and PCAOB. We discuss how the PCAOB issued AS1 to adopt all existing audit standards as of 2003, but we remind the students that standards for audits of private companies are beginning to diverge from those applicable to audits of public companies since both standard-setting bodies are still active. Then we discuss the 10 GAAS (3 general, 3 field, and 4 reporting standards) in detail and explain how the SASs are more detailed interpretations of the 10 GAAS. We use Exhibit 2-2 to illustrate the GAAS. We do not expect the students to memorize the 10 GAAS, but we do expect the students to know the general content of each. **Problems 25 and/or 26** could be covered here.

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Use Exhibit 2-2

[LO 2-12] Ethics, Independence, and the Code of Professional Conduct

We try to demonstrate to the students why it is important for auditors to be independent and act ethically. The key point for the students to learn is that the value in the audit lies in the auditor's reputation for integrity and objectivity, which of course involves independence from the auditee. Users of the financial statements will place little value on the auditor's report if the auditor is not perceived to be honest and objective. We also might spend a little time discussing the issues of low-balling and opinion shopping. We use this section to alert the students to the existence of the Code of Professional Conduct and the importance of independence for auditors (Chapter 19 discusses this topic in greater detail).

Discussion Cases

Discussion cases 27 and 28 present Merry-Go-Round, a real world company that sued its consultants over poor advice. The case covers Ernst & Young's consulting work for the company and provides the instructor an opportunity to expand the discussion of audit versus consulting services. The case also provides an opportunity to talk about how work for one company may affect the objectivity and independence of work on another company.

Internet Assignments

The Internet assignments included in this chapter provide ample opportunity to have the students use the Internet to search for information. If you have access to the Internet in your classroom, show students the AICPA home page (http://www.aicpa.org). **Internet assignment 30** has the students go to this site as well as the SEC, PCAOB, IAASB, and IFRS websites. **Internet assignment 29** provides the students with the opportunity to examine the types of audits conducted by the GAO.

Practice Insight

Practice Insights provide real-world integration. Practice Insight scenarios are included in each chapter to highlight important and interesting real-world trends and practices. These self-contained insights or scenarios focus on current events, student decision-making, and professional problem solving.

IDEA

The Chapter 2 **IDEA** problems are an excellent hands-on supplement to the textbook material. Please go to Connect for chapter assignments.

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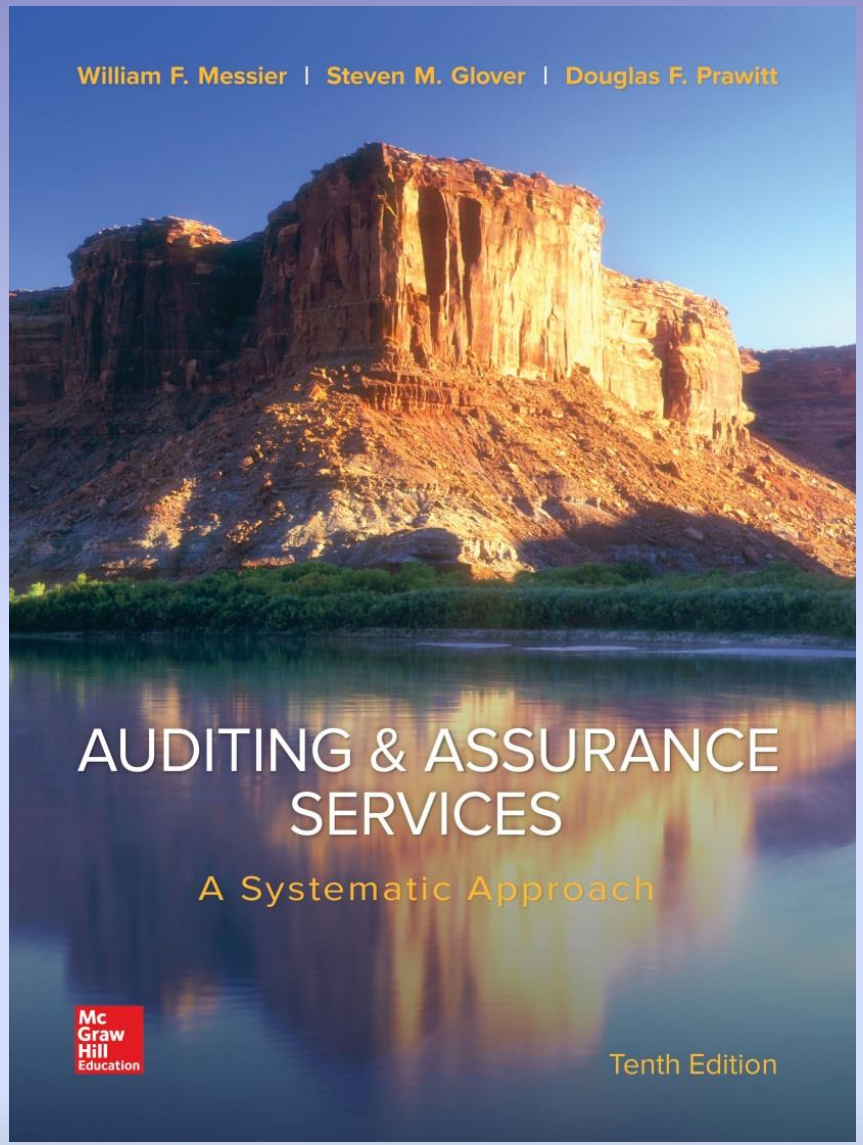

Chapter 2

The Financial Statement Auditing Environment

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Types of Auditors

External Auditors

Internal Auditors

Government Auditors

Forensic Auditors

LO# 2

Types of Audit, Attest, and Assurance Services

Audit Services:

Internal Control Audits, Compliance Audits, Operational Audits, Forensic Audits

Attest Services:

Reporting on nature and quantity of inventory stored in a company's warehouse so that the company can obtain a bank loan

Assurance Services:

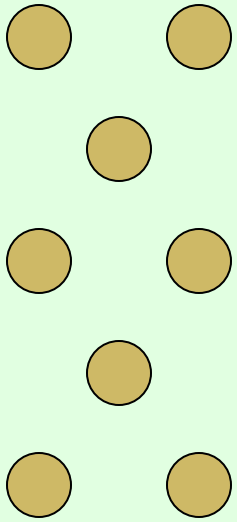
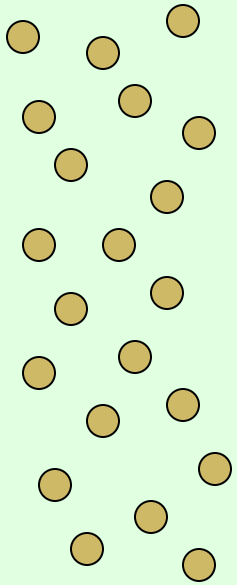
Auditing is a specialized form of assurance service

Nonaudit Services:

Tax Preparation and Planning Services, Management Advisory Services, Compilation and Review Services

Public Accounting Firms

Public accounting firms range in size from a single proprietor to thousands of owners (or "partners") and thousands of professional and administrative staff employees.

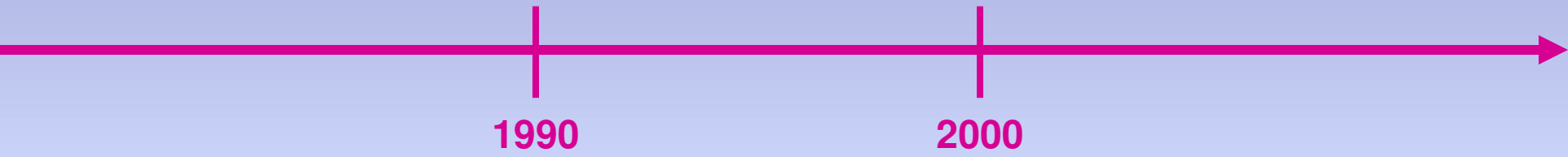
Big 4	Mid-Tier	Regional	Local
PwC	Grant Thornton		
EY	BDO Seidman		
Deloitte	RSM McGladrey		
KPMG			

Audit Teams

Selected Duties of Audit Team Members

Audit Team Member	*Selected Duties*
Partner	• Reach agreement with the auditee on the scope of the service to be provided. • Ensure that the audit is properly planned and that the audit is conducted in accordance with applicable auditing standards. • Assemble an audit team that has the required skills and experience. • Supervise the audit team and review the working papers. • Conclude on the adequacy of audit evidence and sign the audit report
Manager	• Ensure that the audit is properly planned, including scheduling of team members. • Supervise the preparation of and approving the audit program. • Review the working papers, financial statements and audit report. • Deal with invoicing and ensure collection of payment for services. • Inform the partner about any auditing or accounting problems encountered.
Senior/In-Charge	• Assist in the development of the audit plan. • Prepare budgets. • Assign tasks to associates and direct the day-to-day performance of the audit. • Supervise and review the work of associates. • Inform the manager about any auditing or accounting problems encountered.
Associate/Staff	• Perform the audit procedures assigned to them. • Prepare adequate and appropriate documentation of completed work. • Inform the senior about and auditing or accounting problems encountered.

A Time of Challenge and Change



During the economic boom of the late 1990s and the early 2000s, accounting firms aggressively sought opportunities to market a variety of **high-margin nonaudit services** to their auditees.

An Explosion of Scandals

Corporate Giants

Brokerage Firms

Stock Exchanges

Mutual Fund Managers

Public Accounting Firms

Government Regulation

In 2002, Congress passed the Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act.

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act.

LO# 5

Society's Expectations and the Auditor's Responsibilities

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.

Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected.

LO# 6

Context of Financial Statement Auditing

The primary context with which an auditor is concerned is the **industry or business** of his or her auditee. In other words, the context provided by the entity's business impacts the auditor and the audit, and is thus a primary component of the environment in which financial statement auditing is conducted.

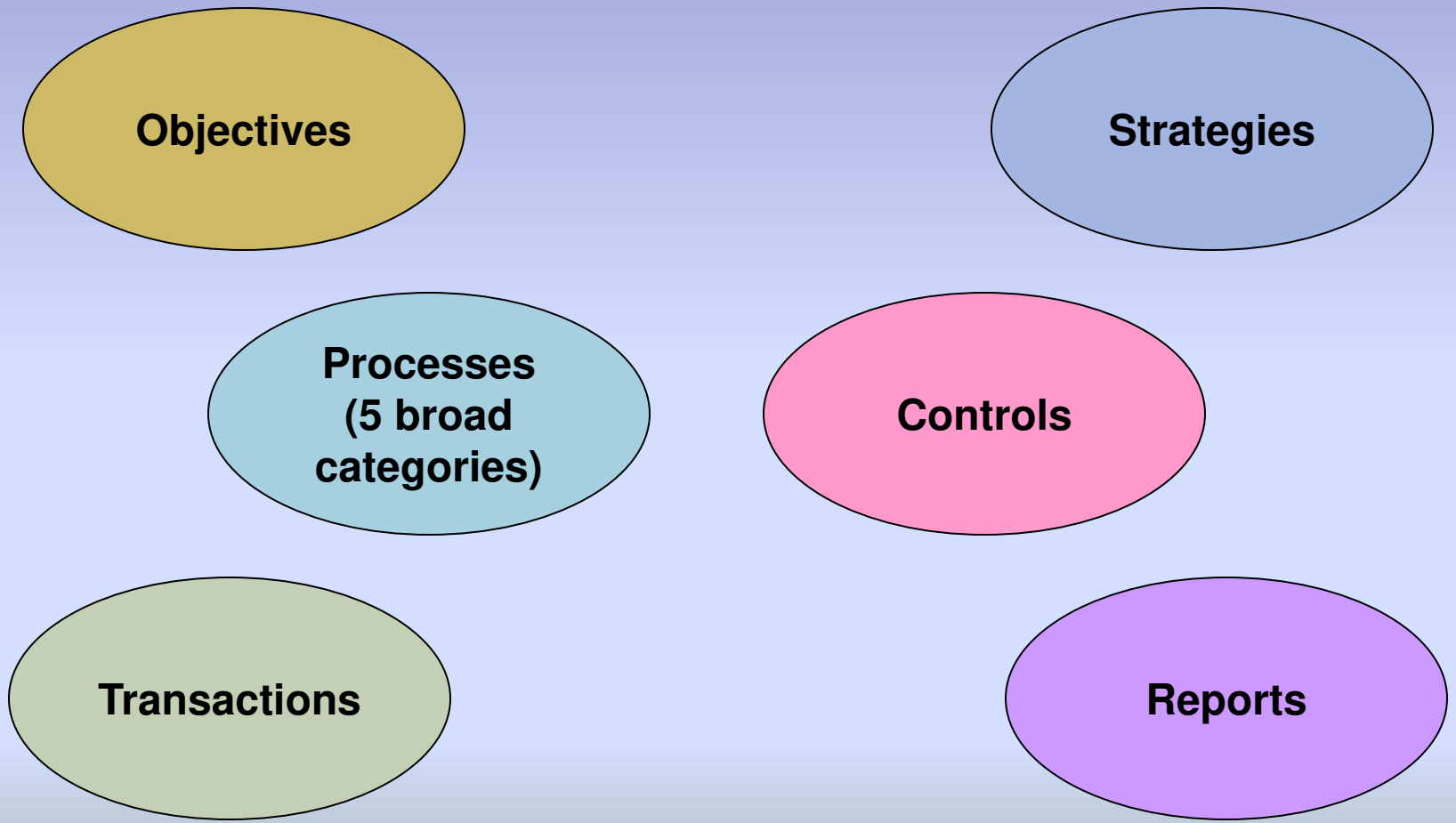
Thought Question:

How would your concerns about the inventory account differ for a salmon farm in Alaska versus an NBA team?

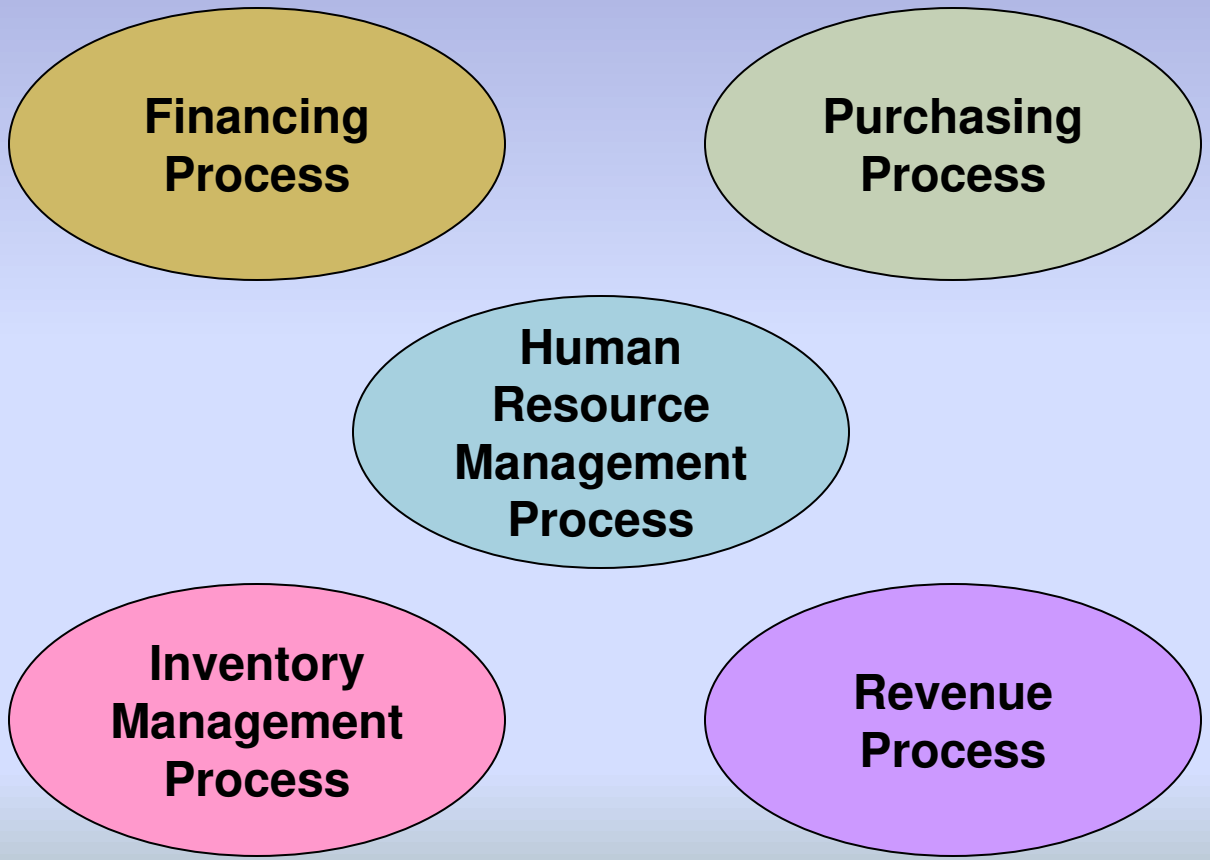
A Model of Business

Business organizations exist to create value for their stakeholders. Due to the way resources are invested and managed in the modern business world, a system of **corporate governance** is necessary, through which managers are overseen and supervised.

A Model of Business



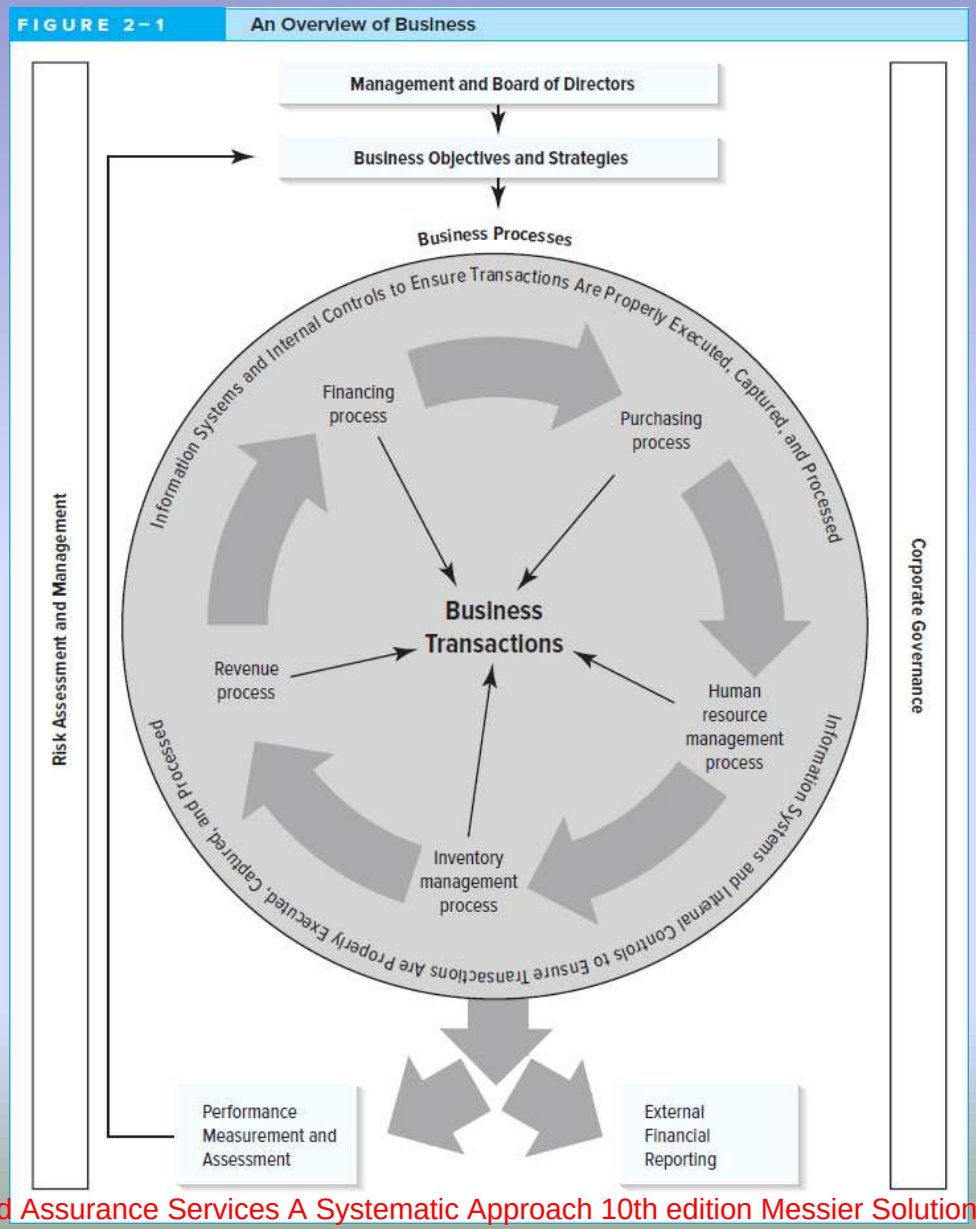
A Model of Business Processes: Five Components



An Overview of Business

LO# 7

Figure 2-1 An Overview of Business



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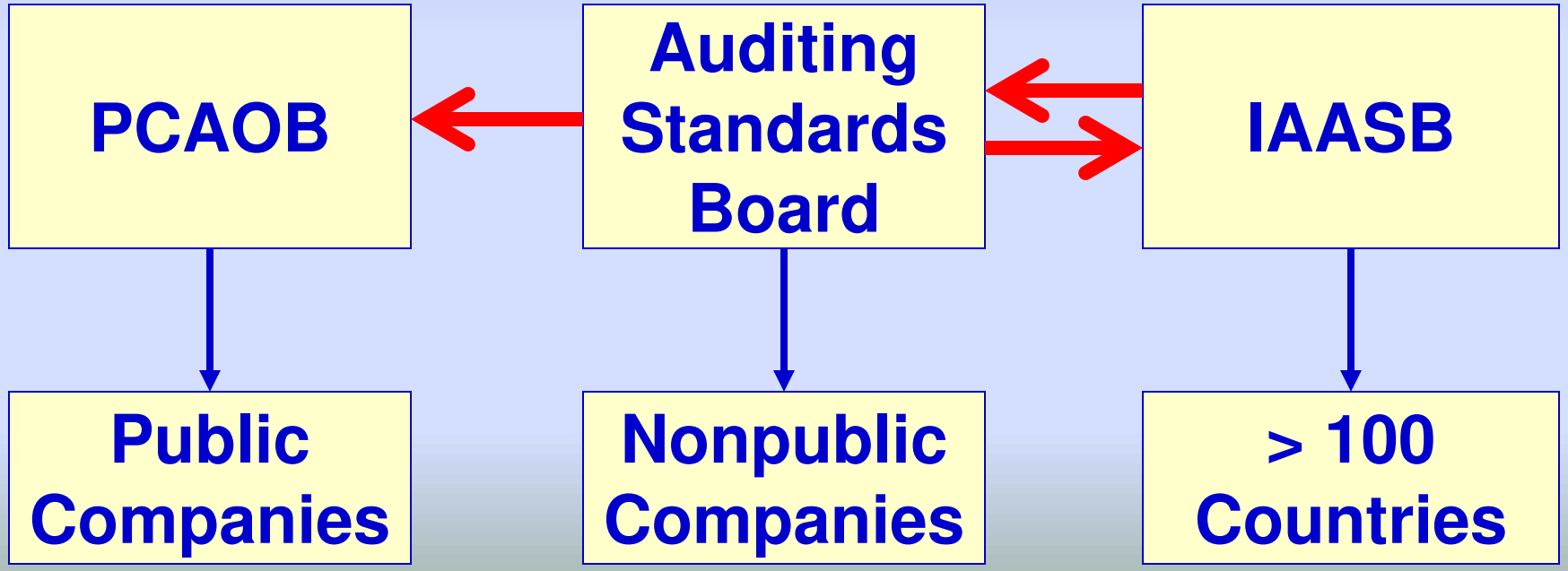
LO# 8

Organizations That Affect the Public Accounting Profession

- Securities and Exchange Commission (SEC)
- Public Company Accounting Oversight Board (PCAOB)
- Financial Accounting Standards Board (FASB)
- American Institute of Certified Public Accountants (AICPA)
- International Auditing and Assurance Standards Board (IAASB)
- International Accounting Standards Board (IASB)

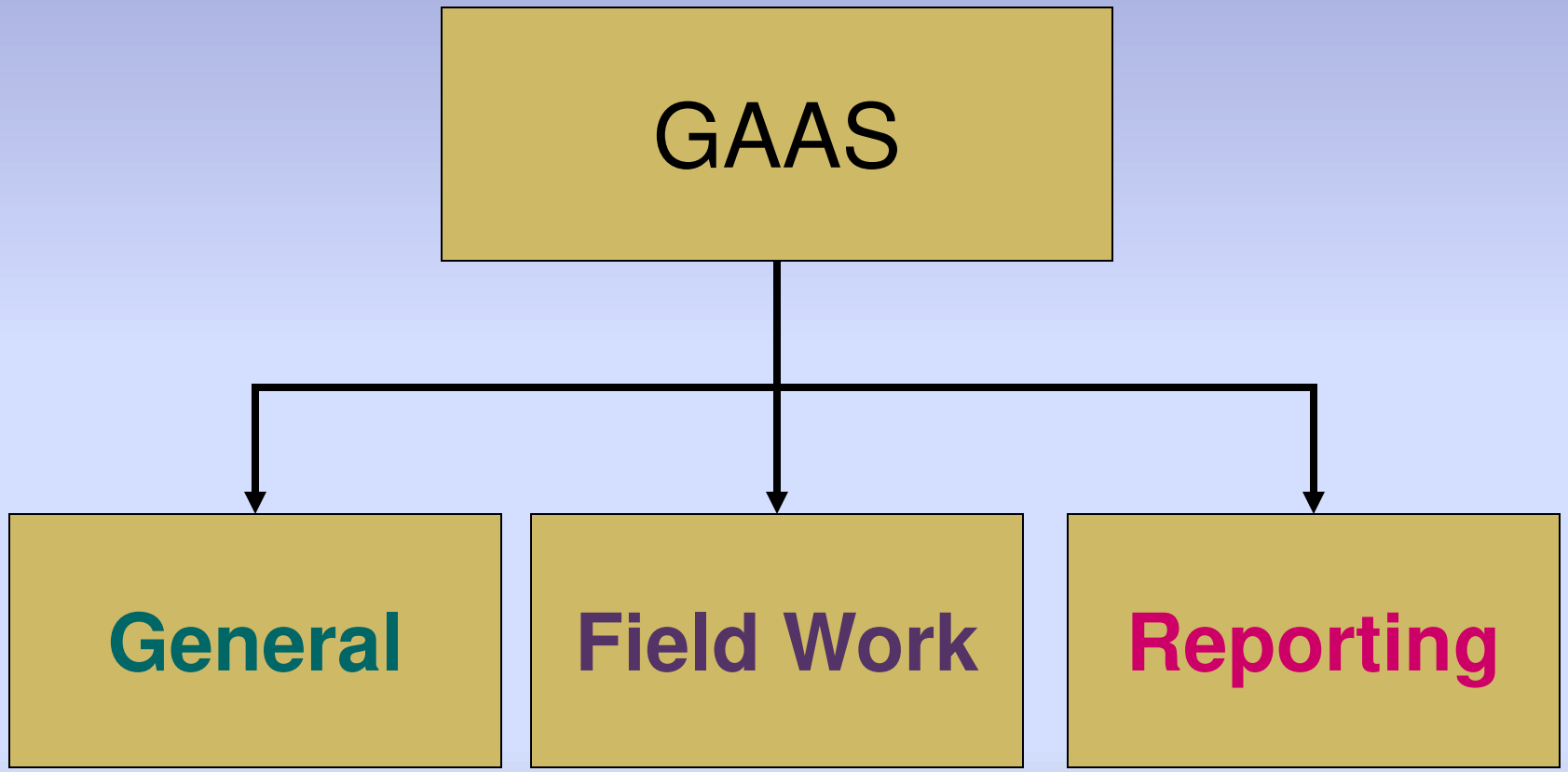
Auditing Standards

Auditing standards serve as guidelines for and measures of the quality of the auditor's performance.



LO# 9, 10

The 10 Generally Accepted Auditing Standards (PCAOB)



General Standards

Adequate Technical Training & Proficiency

Independence

Due Professional Care

LO# 9, 10

Standards of Field Work

Adequate Planning & Supervised Assistants

Obtain Sufficient Understanding of Internal Controls

Obtain Sufficient Appropriate Evidential Matter

Standards of Reporting

GAAP

Consistency

Disclosures

Opinion

GAAS - PCAOB

EXHIBIT 2–2 **Generally Accepted Auditing Standards (PCAOB)**

General Standards

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient appropriate evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

LO# 9, 10

Principles Underlying an Audit - ASB

Purpose:

To express an opinion on the financial statements prepared by management, whose responsibility is to prepare the financial statements and to provide the auditor with information necessary to conduct the audit.

Responsibilities:

Have competence and capability; comply with ethical requirements; maintain professional skepticism; exercise professional judgment.

Performance:

Sufficient appropriate audit evidence supporting reasonable (not absolute) assurance that the financial statements are free of material misstatement.

Reporting:

Express an opinion, in the form of a written report, based on an evaluation of the audit evidence obtained; or state that an opinion cannot be expressed.

Statements on Auditing Standards (SAS)—Interpretations of GAAS

GAAS and SAS are considered to be minimum standards of performance for auditors.

PCAOB adopted GAAS and SAS existing in 2003, and modifies that existing body by issuing standards called Auditing Standards (AS).

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Statements on Auditing Standards (SAS)—Interpretations of GAAS

SAS are classified by two numbering categories: SAS and AU numbers. The SAS number applies to the order in which the standards are issued and are thus chronological. The AU codification organizes the SAS according to topical content.

Statements on Auditing Standards (SAS)—Interpretations of GAAS

For example, SAS No. 39, "Audit Sampling," is found under AU 350 because the AU 300s relate to the standards of fieldwork on evidence collection and evaluation.

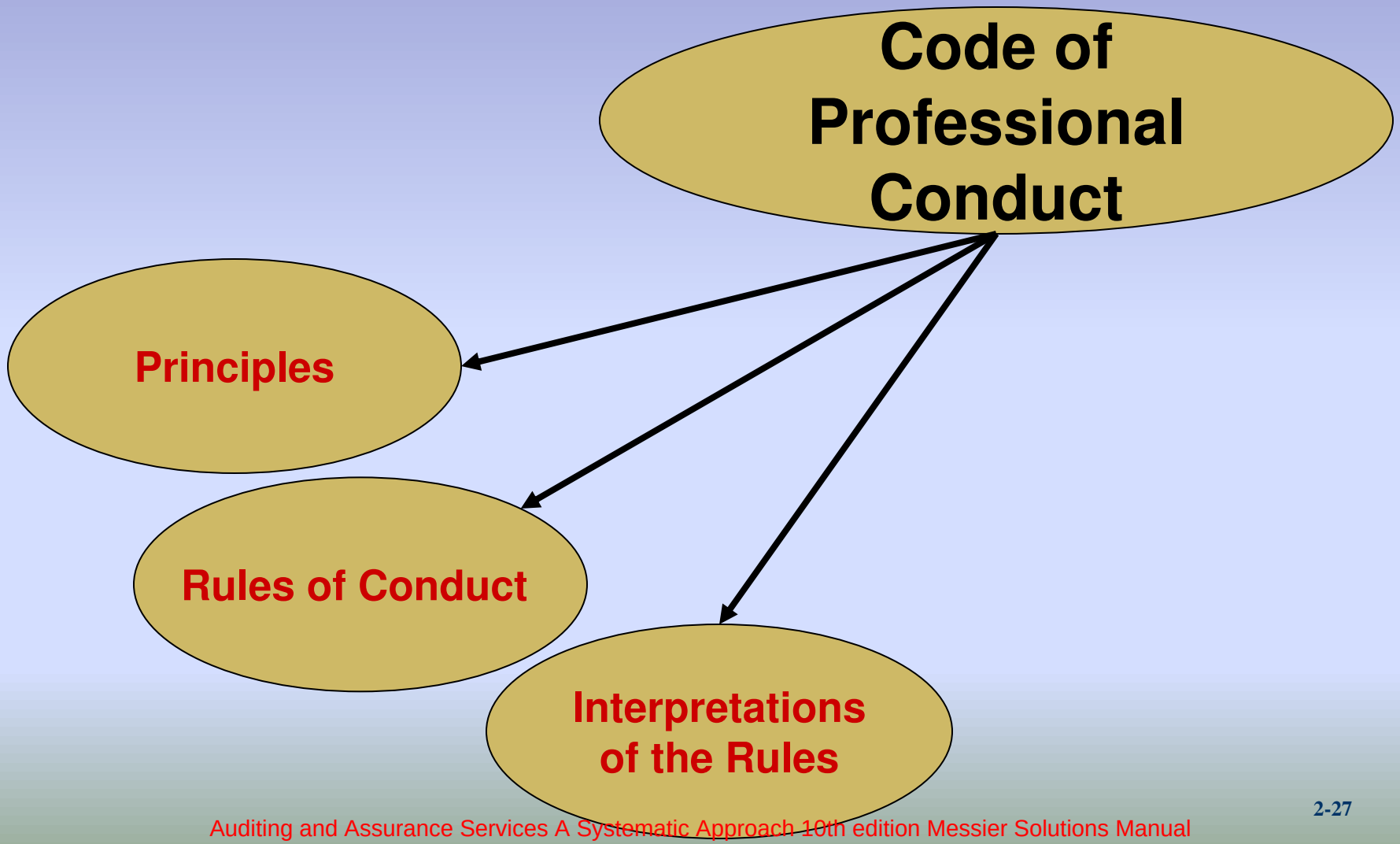
AU Section	Topical Content
AU-C 200	General Principles and Responsibilities
AU-C 300-499	Risk Assessment and Response to Assessed Risks
AU-C 500	Audit Evidence
AU-C 600	Using the Work of Others
AU-C 700	Audit Conclusions and Reporting
AU-C 800-999	Special Considerations

Ethics, Independence, and the Code of Professional Conduct

Ethics refers to a system or code of conduct based on moral duties and obligations that indicate how we should behave.

Professionalism refers to the conduct, aims, or qualities that characterize a profession or professional person. All professions operate under some type of code of ethics or code of conduct.

Ethics, Independence, and the Code of Professional Conduct



End of Chapter 2