# *Principles of Auditing and Other Assurance Services 21st edition Whittington Solutions Manual*

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Principles of Auditing and Other Assurance Services 21st edition Whittington Solutions Manual

# CHAPTER 2

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# Professional Standards

**Brief Topical Outline**

A. Auditing Standards Overall

1. Three sets of auditing standards (PowerPoint 2-2)
   — AICPA (Auditing Standards Board) for nonpublic companies in US.
   — PCAOB for public companies in US
   — International Auditing Standards with differing levels of authority in various countries

2. Authority of PCAOB, AICPA, and State Boards of Accountancy (PowerPoints 2-3 to 2-4)
3. Generally accepted auditing standards (GAAS)
   — Purpose - contrast with GAAP
   — AICPA Principles (PowerPoints 2-5 to 2-10)
   — The GAAS hierarchy (PowerPoint 2-11)

B. Auditors' responsibility for detecting misstatements

1. Responsibility for errors and fraud (PowerPoints 2-12 to 2-13)
2. Responsibility for identifying client noncompliance with laws (PowerPoint 2-14)

C. The auditors' standard report for public companies (PowerPoint 2-15)

1. Opinion paragraph (PowerPoints 2-16 to 2-17)
2. Basis of Opinion (PowerPoint 2-18)
3. Critical Audit Matters (PowerPoint 2-19)

D. The auditors' standard report for nonpublic companies (PowerPoint 2-20)
1. Introductory paragraph (PowerPoint 2-21)
2. Management responsibilities section (PowerPoint 2-22)
3. Auditors' responsibilities section (PowerPoints 2-23 to 2-24)
4. Opinion paragraph (PowerPoint 2-25)
5. Revision of report being considered

E. Other types of auditors' reports (PowerPoint 2-26)

F. Attestation standards (PowerPoint 2-27)

1. Relationship to other professional standards.

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G. Quality control in CPA firms

1. Quality Control Standards Committee
2. Elements of quality control (PowerPoints 2-28 to 2-34)
3. Quality control procedures (PowerPoint 2-35)

H. Regulation of Accounting Firms (PowerPoint 2-36)

1. Public Company Accounting Oversight Board (PowerPoint 2-37)
2. AICPA
3. Peer reviews (PowerPoint 2-38)
   — What is reviewed?
   — Who performs the review?
   — How is the review conducted?
   — The report
4. Inspections (PowerPoint 2-39)
   — Selection of high-risk engagements (although beginning in 2017 certain other audits were randomly selected)
   — Focuses on high-risk aspects of selected engagement
   — When issues are found, PCAOB staff attempts to relate to quality control system defect

I. International standards

1. International Financial Reporting Standards (IFRS)
   — Relationship to U.S. standards (PowerPoint 2-40)
2. International audit report (PowerPoint 2-41)

**Comments and Observations**

We start the discussion of this chapter with a survey of the organizations that regulate the accounting profession. Next, we describe generally accepted auditing standards. We go through the principles underlying GAAS. We do not ask that they memorize the principles verbatim, but that they know the basic ideas embodied in each principle. We also stress the need for professional judgment in applying the generally accepted auditing standards. For example, how much audit evidence is "sufficient"?

Next, we discuss the auditors' responsibility with respect to errors, fraud, and client noncompliance with laws. We emphasize the AU-C 240 (PCAOB AS 2401) requirement to assess the risk of material misstatement due to fraud. Also, it is important at this point to distinguish between auditor responsibility for identifying noncompliance with illegal acts having a direct effect on the financial statement amounts (and related disclosures) versus other illegal acts. This area is of particular interest to students, many of whom believe that audits should detect all illegal acts. You may wish to use tax evasion as an example of an illegal act with a direct effect on the financial statements—it results in improper financial statement amounts. As examples of other illegal acts without a direct effect on financial statement amounts you may use violations of laws and regulations relating to (1) occupational safety and health, (2) insider securities trading, (3) environmental protection, and (4) antitrust. Case 2-39 requires the students to make a judgment regarding the appropriate course of action by a CPA firm that has discovered that one of its large clients has engaged in certain illegal activities. Students usually are divided in their opinions regarding the action that should be taken by the CPA firm.

We next cover the standard audit report for public entities—the technical term for public entities is *issuers* in that they issue securities under the various securities acts. We highlight major elements of the report. In discussing the phrase “accounting principles generally accepted in the United States of America” in the auditors' report, we discuss the FASB *Codification*. The new requirement for inclusion

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of Critical Audit Matters is very interesting. It allows us to discuss difficult audit issues that are faced in an audit.

Following this discussion, we describe the audit report for nonpublic (nonissuer) companies. The AICPA is currently in the process of revising this report to make it similar to the PCAOB and international audit report.

Next, we review the nature of other reports that may be issued—qualified, adverse, disclaimer of opinion, and unmodified reports with emphasis of matter (and other matter) paragraphs. Then, we contrast the audit report for nonpublic companies with the report used for public companies, and lead a general discussion of the attestation standards and their relationship to GAAS.

In presenting the related topics of quality control and peer review, we start with a discussion of the regulatory environment for CPA firms. Next, we discuss the elements of quality control. If time is available, we spend additional time discussing the manner in which a peer review is performed. We also describe the regulation of auditors since establishment of the Public Company Accounting Oversight Board. Finally, we contrast the PCAOB inspections with peer reviews.

We conclude our discussion of this chapter with a brief discussion of international auditing standards, and the international audit report.

**Suggested Team Exercise**

We often use Case 2-38 on errors, fraud, and illegal acts, allowing students 10-15 minutes to discuss the issues in teams of three or four, and then select one team member to lead a discussion for the class. The case forces students to distinguish between fraudulent financial reporting and misappropriation of assets, as well as direct and indirect effect illegal acts. Also, as indicated earlier, Case 2-39 is helpful in this area.

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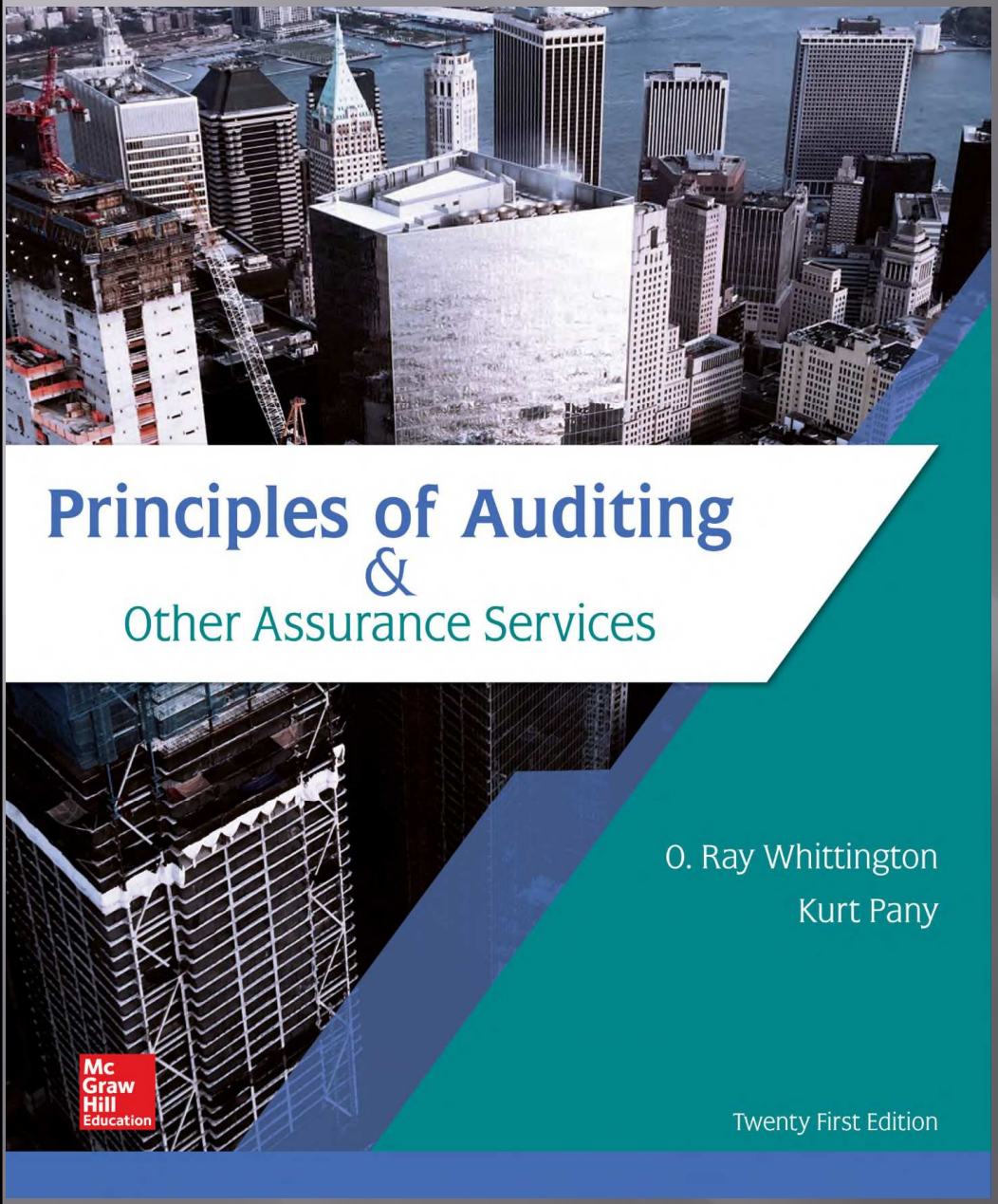


# Chapter 02

# Professional Standards

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# Three Sets of Auditing Standards

Three sets of auditing standards

- **AICPA** (Auditing Standards Board) for nonpublic companies in US.
- **PCAOB** for public companies in US
- **International Auditing Standards** with differing levels of authority in the various countries

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# Authority of Organizations

- **Public Company Accounting Oversight Board**
  - Auditing, Attestation, Quality Control, Independence, Ethical Standards for audits of public companies
  - Registers and regulates auditors of public companies
- **American Institute of Certified Public Accountants**
  - Auditing, Attestation, Quality Control, Independence, Ethical, Accounting and Review Standards for engagements involving nonpublic companies
  - Coordinates peer review programs for firms nonpublic attest practice
- **State Boards of Accountancy**
  - License CPAs and CPA firms to practice in their jurisdictions

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# Regulation of the Public Accounting Profession Figure 2.1

| Regulatory Bodies | Authority of Regulatory Bodies: Integrated Audits for Public Companies | Authority of Regulatory Bodies: Audits for Nonpublic Companies |
|---|---|---|
| **Public Company Accounting Oversight Board (PCAOB)** | 1. Establishes standards* for the audits of public companies:<br>• Auditing<br>• Quality control<br>• Independence<br>• Ethical behavior<br>2. PCAOB standards have authority based on federal legislation.<br>3. Registers CPA firms to audit public companies and may revoke a firm's registration or bar an individual CPA from participating in public company audits.<br>4. Performs inspections of the public company audit practices of registered CPA firms. | No standard-setting or regulatory responsibilities regarding CPA services for nonpublic companies. |
| **American Institute of Certified Public Accountants (AICPA)** | No standard-setting or regulatory responsibilities regarding public company audits.** | 1. Establishes standards for:<br>• Auditing<br>• Attestation<br>• Accounting and review<br>• Quality control<br>• Independence<br>• Ethical behavior<br>2. AICPA standards have authority based on their general acceptance by state boards of accountancy, other legislative organizations, and the courts.<br>3. Firms may subject themselves to AICPA regulation by voluntarily joining one or both of the AICPA sections: (1) the Private Companies Practice Section (PCPS), or (2) the Center for Public Company Audit Firms. Both sections have voluntary peer review programs.<br>4. The AICPA Center for Public Company Audit Firms' peer review program covers the nonpublic practices of firms whose public company practices are inspected by the PCAOB.<br>5. The individual membership requirements of the AICPA require members to practice in a firm that participates in a practice review program. |
| **State Boards of Accountancy** | 1. License CPAs and CPA firms to practice public accountancy in their states or jurisdictions and can revoke the right to practice in those jurisdictions.<br>2. In their jurisdictions, state boards have regulatory responsibility for both public and nonpublic practice.<br>3. State boards adopt AICPA and PCAOB standards but may supplement them with their own requirements. | |

*The PCAOB adopted AICPA professional standards issued through April 16, 2003, as its interim standards. In addition, the SEC has oversight responsibility for the PCAOB and all standards must be approved and issued by the SEC.
**Technically, the AICPA general ethics requirements also would apply to an AICPA member performing services for public companies.

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# Principles Underling a GAAS Audit 1/6

- Purpose of an audit
- Premise of an audit
- Personal responsibilities of the auditor
- Auditor actions in performing the audit
- Reporting the results of an audit

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# Principles Underling a GAAS Audit 2/6

- **Purpose of an audit**—Provide an opinion that financial statements are in accordance with the applicable financial reporting framework.
  - In the U.S. the framework is ordinarily GAAP.
  - The applicable framework corresponds to the "suitable criteria" of an attest engagement.

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# Principles Underling a GAAS Audit 3/6

- **Premise of an audit**—Management (and those charged with governance) have responsibility to:
  - Prepare financial statements in accordance with applicable financial reporting framework.
  - Provide auditors with needed information and unrestricted access to those in the entity.

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# Principles Underling a GAAS Audit 4/6

- **Personal responsibility of the auditor**—Appropriate competence and capabilities to perform audit in accordance with standards, including maintaining professional skepticism and exercising professional judgment throughout the audit.
  - Professional skepticism—A questioning mind and a critical assessment of audit evidence.

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# Principles Underling a GAAS Audit 5/6

- **Auditor actions in performing the audit**
  - Obtain reasonable assurance about whether financial statements are free from material error or fraud.
  - The auditor is unable to provide absolute assurance due to:
    - Nature of financial reporting.
    - Nature of audit procedures.
    - Need to conduct audit within a reasonable period of time.

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# Principles Underling a GAAS Audit 6/6

- **Reporting the results of an audit**—Express in a written report an opinion on findings (or statement that opinion cannot be expressed).
  - The opinion is on whether the financial statements are in accordance, in all material respects, with the applicable financial reporting framework.

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# The GAAS Hierarchy Figure 2.4

| Category | Status | Audit Guidance |
|---|---|---|
| 1. **Standards** | Basically must be applied, but also consider the Figure 2.3 responsibility levels (e.g., unconditional v. presumptively mandatory). | *Statements on Auditing Standards (SASs)* Other standards that apply for PCAOB and government audits, etc. |
| 2. **Interpretive Publications*** | Recommendations on the application of SASs; the auditor should consider them. | Auditing interpretations of GAAS<br>Audit guidance in *AICPA Audit and Accounting Guides*<br>AICPA *Statements of Position—Auditing and Attestation* |
| 3. **Other Auditing Publications** | No authoritative status, but may help the auditor understand and apply the standards. | Various AICPA publications, including *Auditing Practice Releases, Technical Practice Aids, Audit Risk Alerts, Professional Issues Task Force Practice Alerts,* and other publications<br>Auditing articles in *Journal of Accountancy* and other professional journals<br>Others (e.g., continuing education program materials, textbooks, guidebooks, audit programs) |

*These are documents issued under authority of the Auditing Standards Board after all its members have been provided an opportunity to comment.

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# Auditor Responsibility for the Detection of Errors and Fraud (1/2)

- Obtain information to assess inherent risks and fraud risks
  - Information about the company and its environment
  - Discussion among audit team members
  - Inquiries of management and others
  - Risk assessment analytical procedures, including those involving revenue
- Assess the risk of errors and fraud that may cause the financial statements to contain a material misstatement.

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# Auditor Responsibility for the Detection of Errors and Fraud (2/2)

- Based on that assessment, plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by errors or fraud, will be detected.
- Exercise due care in planning, performing and evaluating the results of audit procedures, and the proper degree of professional skepticism to achieve reasonable assurance that material misstatements due to error or fraud will be detected.

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# Auditor Responsibility for Identifying Noncompliance with Laws and Regulations

- Noncompliance with laws and regulations that could have a direct and material effect on financial statement amounts and disclosures—same as for errors and fraud. An audit obtains reasonable assurance of detecting noncompliance with these laws and regulations.
- Other Laws and regulations (no direct effect on financial statement amounts):
  - Specific procedures:
    - Inquire of management as to compliance
    - Inspect correspondence with licensing or regulatory authorities
  - Be aware of possible noncompliance.
  - If information comes to the auditor's attention, apply audit procedures directed at determining whether noncompliance has occurred. An audit does not provide assurance that noncompliance with these laws will be detected.

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# Auditors' Standard Report – Public Clients

- Includes the words "Registered" and "Independent" in the title.
- Must be addressed to shareholders and board of directors (additional parties are allowable).
- References auditing standards of the PCAOB.
- Provides a discussion of auditor and management responsibilities.
- Includes a paragraph indicating that the auditors have also issued a report on the client's internal control over financial reporting, or is a combined report on both the financial statements and internal control.
- Includes a Critical Audit Matters Section.
- Includes statement on year audit firm began serving the client.
- Signed with name of CPA firm not individual partner
- Includes the City of the office with responsibility for the audit
- Dated no earlier than the date on which the auditors obtained sufficient appropriate audit evidence to support their opinion

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# Opinion Paragraph

***Opinion on the Financial Statements***

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X7 and 20X6, the related statements of income, comprehensive income, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X7, and the related notes [and schedules] (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 20X7 and 20X6, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X7, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with standards of the Public Company Accounting Oversight Board (United States) ("PCAOB") the Company's internal control over financial reporting as of December 31, 20X7, based on *Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)* and our report dated February 9, 20X8 expressed an unqualified opinion.

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# Basis of Opinion

***Basis for Opinion***

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

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