

Solution to auditing and assurance service: 1, 12, b, 3

[Finance](#)



SOLUTIONS FOR REVIEW CHECKPOINTS 1. 1Business risk is the collective risk faced by a company that engages in business. It encompasses all threats to and organization's goals and objectives. It includes the chance that customers will buy from competitors, that product lines will become obsolete, that taxes will increase, that government contracts will be lost, or that employees will go on strike. 1. 2The conditions of complexity, remoteness, time-sensitivity, and consequences increase demands by outside users for relevant, reliable (useful) information.

They cannot produce the information for themselves because of these conditions. Company managers and accountants produce the information. 1. 3Information risk, in contrast to business risk, is the risk (probability) that the information (mainly financial) disseminated by a company will be materially false or misleading. This risk creates the demand for objective outsiders to provide assurance to decision makers. 1. 4Students can refer to the AAA and AICPA definitions in Chapter 1. Some instructors may want to extend the consideration of definitions to include the internal and governmental definitions (located in Module D).

In response to "What do auditors do?," students can refer to Exhibit 1. 2 and respond in terms of: (1) obtaining and evaluating evidence about assertions management makes about economic actions and events, (2) ascertaining the degree of correspondence between the assertions and the appropriate reporting framework, and (3) providing an audit report (opinion). Students can also respond more generally in terms of "lending credibility" to financial statements presented by management (attestation). 1. An attest engagement is: "An engagement in which a practitioner is engaged to issue <https://assignbuster.com/solution-to-auditing-and-assurance-service-112b-3/>

or does issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. " To attest means to lend credibility or to vouch for the truth or accuracy of the statements that one party makes to another. The attest function is a term often applied to the activities of independent CPAs when acting as auditors of financial statements. 1. Assurance engagements are independent professional services that improve the quality of information, or its context, for decision makers. Since information (financial statements) are prepared by managers of an entity who have authority and responsibility for financial success or failure, an outsider may be skeptical that the information is objective, free from bias, fully informative, and free from material error, intentional or inadvertent. The services of an independent-CPA auditor helps resolve those doubts because the auditor's success depends upon his independent, objective, and competent assessment of the information (e. . . , the conformity of the financial statements with the appropriate reporting framework). The CPA's role is to lend credibility to the information; hence the outsider will likely seek his independent opinion. 1. 7CPAs serve as independent intermediaries who lend credibility to information. Hence, assurance services are natural extensions of the well-regarded audit and attest services. CPAs can use their expertise in internal control and measurement methods. Assurance services are natural extensions of attestation services, which earlier evolved from financial statement audit services.

Attestation and audit services are highly structured and intended to be useful for large groups of decision makers (e. g. , investors, lenders). On the

other hand, assurance services are more customized and intended to be useful to smaller, targeted groups of decision makers. In this sense, assurance services bear resemblance to consulting services. 1. 8 There are four major elements of the broad definition of assurance services:

Independence. CPAs want to preserve their attestation and audit reputations and competitive advantages by preserving integrity and objectivity when performing assurance services.

Professional Services. Virtually all work performed by CPAs is defined as “professional services” as long as it involves some element of judgment based in education and experience. Improving the Quality of Information or its Context. The emphasis is on “information”-- CPAs’ traditional stock in trade. CPAs can enhance quality by assuring users about the reliability and relevance of information, and these two features are closely related to the familiar credibility-lending products of attestation and audit services. “Context” is relevance in a different light.

For assurance services, improving the context of information refers to improving its usefulness when targeted to particular decision makers in the surroundings of particular decision problems. For Decision Makers. They are the “consumers” for assurance services, and they personify the consumer focus of new and different professional work. They may or may not be the “client” that pays the fee, and they may or may not be one of the parties to an assertion or other information. The decision makers are the beneficiaries of the assurance services. 1. Accountants record, classify, and summarize (report) a company’s assets, liabilities, capital, revenue, and expense in financial statements. Auditors gather evidence related to the assertions

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management makes in financial statements and render a report.

Accountants produce the financial statements; auditors audit them. 1.

10 There are three major classifications of ASB assertions with several assertions in each classification: Transaction Assertions: Occurrence assertion: The objective is to establish with evidence that transactions giving rise to assets, liabilities, sales and expenses actually occurred.

Key questions include “ Did the recorded sales transactions really occur? ”

Completeness and cutoff assertion: The objective is to establish with evidence that all transactions of the period are in the financial statements and all transactions that properly belong in the preceding or following accounting periods are excluded. Completeness also refers to proper inclusion in financial statements of all assets, liabilities, revenue, expense and related disclosures. Key questions related to completeness include: “ Are the financial statements (including footnotes) complete? and “ Were all the transactions recorded in the right period? ” Accuracy assertion: The objective is to establish with evidence that transactions have been recorded at the correct amount. Key questions relate to “ where the expenses recorded at the proper dollar amount? ” Classification assertion: The objective is to establish with evidence that transactions were posted to the correct accounts. Key questions relate to “ was this expense recorded in the appropriate account/” Balance Assertions:

Existence assertion: The objective is to establish with evidence that balance represents assets, liabilities, sales, and expenses that are real and in existence at the balance sheet date. Key questions relate to “ does this number truly represent assets that existed at the balance sheet date? ”

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Rights and obligations assertion: The objectives related to rights and obligations are to establish with evidence that assets are owned (or rights such as capitalized leases are shown) and liabilities are owed. Key questions related to this assertion include: “ Does the company really own the assets? ” and “ Are related legal responsibilities identified? ” Completeness assertion: The objective is to establish with evidence that all balances of the period are in the financial statements. Key questions related to completeness include: “ Are the financial statements (including footnotes) complete? ” Valuation assertion: The objective is to establish with evidence that balances have been valued correctly. Key questions include “ Are the accounts valued correctly? ” and “ Are expenses allocated to the period(s) benefited? ” Presentation and Disclosure assertion:

Occurrence assertion: The objective is to establish with evidence that transactions giving rise to assets, liabilities, sales and expenses actually occurred. Key questions include “ are we properly presenting and disclosing transactions that occurred during this period. Rights and obligations

assertion: The objectives related to establishing with evidence the proper presentation of assets, liabilities, revenues and expenses to which the company has a legal right or a legal obligation Key questions related to this assertion include: “ Has the company properly presented the assets in its possession? ” and “ Are related legal responsibilities identified and properly disclosed? ” Completeness assertion: The objective is to establish with evidence that all balances of the period are presented and/or disclosed in the financial statements. Key questions related to completeness include: “ Are the financial statements (including footnotes) complete? ” Accuracy and

valuation assertion: The objectives are to establish with evidence that balances presented and disclosed in the financial statements have been recorded accurately and have been valued correctly.

Key questions include “ Are the accounts valued correctly? ” and “ Are expenses allocated to the period(s) benefited? ” Classification and

understandability assertion: The objective is to establish with evidence that presentation and disclosures are properly classified on the financial

statements and that financial statements including footnotes are

understandable to the financial statement users. Key questions relate to “ Is this account properly presented in the correct financial statement category”

and “ are the footnote disclosures presented to promote an understanding of the nature of the account” . 11The ASB’s assertions are important to auditors

because they are the focal points for audit procedures. Furthermore, audit procedures are the means to answer the key questions posed by

management’s assertions. The ASB assertions are in more detail than the PCAOB assertions and are categorized into transaction assertions, balance

assertions, and presentation and disclosure assertions. They include the

following additional assertions: cutoff, accuracy, valuation, classification, and understandability. Exhibit 1. 4 explains the difference between ASB and

PCAOB assertions. . 12Holding a belief that a potential conflict of interests

always exists causes auditors to perform procedures to search for errors or frauds that would have a material effect on financial statements. This tends

to make audits more extensive for the auditor and more expensive for the

client. The situation is not a desirable one in the vast majority of audits

where no errors or frauds exist. However, errors and financial reporting

frauds have happened too often. Users of financial statements and audit reports expect auditors to detect material misstatements. . 13Some examples of assurance engagements include: • Internet Website certification (CPA WebTrust) • Accounts receivable review and cash enhancement • Third-party reimbursement maximization • Rental property operations review • Customer satisfaction surveys • Benchmarking/best practices • Evaluation of investment management policies • Fraud and illegal acts prevention and deterrence • Information systems security reviews (SysTrust) • Internal audit strategic review . 14Major areas of public accounting services: • Assurance services (including audit services and other attestation engagements) • Tax consulting services • Consulting services 1.

15Operational auditing is the study of business operations for the purpose of making recommendations about the economic and efficient use of resources, effective achievement of business objectives, and compliance with company policies. The AICPA views operational auditing as a type of management advisory service offered by public accounting firms. 1. 6The elements of expanded-scope auditing include: (1) financial and compliance audits, (2) economy and efficiency audits, and (3) program results audits. 1.

17Compliance auditing involves a study of an organization's policies, procedures, and performance in following laws, rules, and regulations. An example is a school's policies, procedures, and performance in determining eligibility for a free meal program. 1. 18Other kinds of auditors include IRS agents/auditors, state and federal bank examiners, state insurance department auditors, and fraud auditors. 1. 9The purpose of continuing education is to ensure that CPAs in practice maintain their expertise at a sufficiently high level in light of evolving business conditions and new

regulations. For CPAs in public practice, 120 hours of continuing education is required every three years, with no less than 20 hours in any one year. For CPAs not in public practice, the general requirement is 120 or fewer (90 in some states) every three years. 1. 20Everything cannot be learned in the classroom, and some on-the-job experience is helpful before a person is foisted off on the public as a licensed professional.

Also, the experience weeds out some persons who do not want to take the trouble to be involved in accounting work. 1. 21State boards administer the state accountancy laws. State boards make physical arrangements to give the CPA examination, collect the examinations, receive the grades from the AICPA grading activity, and notify candidates whether they passed or failed. After satisfying state requirements for education and experience, successful candidates are awarded the CPA certificate by a state board. At the same time, new CPAs must pay a fee to obtain a state license to practice.

Thereafter, state boards of accountancy regulate the behavior of CPAs under their jurisdiction (enforcing state rules of conduct) and supervise the continuing education requirements. 1. 22After becoming a CPA licensed in one state, a person can obtain a CPA certificate and license in another state. The process is known as reciprocity. CPAs can file the proper application with another state board of accountancy, meet the state's requirements, and obtain another CPA certificate. Many CPAs hold certificates and licenses in several states. From a global perspective, individuals must be licensed in each country.

Similar to CPAs in the United States, “Chartered Accountants” (CAs) practice in Australia, Canada, Great Britain, and India. Efforts are currently underway through NASBA to streamline the reciprocity process so that CPAs can practice across state lines without having to have 50 different licenses.

SOLUTIONS FOR MULTIPLE CHOICE-QUESTIONS 1. 23a. Incorrect This is an attestation to the prize promoter’s claims. b. Incorrect This is an audit engagement to give an opinion on financial statements. c. Incorrect This is an assurance engagement on newspaper’s circulation data. . Incorrect This is an assurance engagement on the performance of golf balls. e. Correct Since attestation and audit engagements are subsets of assurance engagements, all are assurance engagements. 1. 24a. Correct This statement characterizes professional skepticism. b. Incorrect “Exclusively an auditor” is not an idea that seems to speak of “skepticism.” c. Incorrect “Professional obligations” is not an idea that seems to speak of “skepticism.” d. Incorrect This is more an assumption of necessity than of skepticism. 1. 25a.

Incorrect While work on a forecast is covered by the attestation standards, the auditors should give assurance or a disclaimer. b. Correct This is the basic definition of attestation--giving a report on reliability of an assertion one party makes to another. c. Incorrect Tax work is not an attestation service. d. Incorrect Litigation and expert witness services are not attestation services. 1. 26a. Incorrect The objective of environmental auditing is to help achieve and maintain compliance with environmental laws and regulations and to help identify and correct unregulated environmental hazards b.

Incorrect The objective of financial auditing is to obtain assurance on the conformity of financial statements with generally accepted accounting

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principles. c. Incorrect The objective of compliance auditing is the entity's compliance with laws and regulations. d. Correct Operational auditing refers to the study of business operations for the purpose of making recommendations about the economic and efficient use of resources, effective achievement of business objectives, and compliance with company policies. 1. 27a.

Incorrect While not the primary objective of an operational audit, auditors should still be concerned about compliance with financial accounting standards. b. Correct This statement is part of the basic definition of operational auditing. c. Incorrect An operational audit does not focus on the financial statements. d. Incorrect Analytical tools and skills are an important part of financial auditing. 1. 28a. Correct The proper reference is to the appropriate reporting framework. b. Incorrect The AICPA does not refer only to the FASB for the appropriate reporting framework. c.

Incorrect The reference to the SEC is wrong. d. Incorrect This is an abstract of the AAA definition. 1. 29d. Correct While "complexity," "remoteness," and "consequences" are good answers, "skepticism," or potential conflict of interest, generally drives the demand for audited financial statements. 1. 30d. Correct Sarbanes-Oxley prohibits the provision of all of the services listed in answers a, b, and c, therefore, d (all of the above) is the best response. 1. 31a. Incorrect Auditors do not reduce business risk. b. Correct Auditors give some assurance that the information risk is low. c.

Incorrect Complexity creates demand for accounting services, but is not an audit objective. d. Incorrect Auditors only indirectly control the timeliness of

financial statements. 1. 32d. CorrectAnswers a, b, and c refer to a financial statement audit, an internal controls attestation engagement, and an operational audit, respectively. Compliance refers to following laws, rules, regulations, and policies. 1. 33d. CorrectWhile answers a, b, and c are true, experience, education, and successful completion of the Uniform CPA are all necessary to be licensed as a CPA. 1. 34d. CorrectThe mission of the U. S. GovernmentAccountabilityOffice is to ensure that public officials are using public funds efficiently, effectively, and economically. 1. 35b, d CorrectThe two categories of performance audits are economy and efficiency audit and program audits. 1. 36c. CorrectReview of credit ratings of customers gives indirect evidence of the collectibility (valuation) of accounts receivable. 1. 37a. IncorrectRhonda's representations are not sufficient evidence to support assertions made in the financial statements. b. IncorrectDespite Rhonda's representations, Jones must gather additional evidence to corroborate Rhonda's assertions. . IncorrectRhonda's representations are a form of evidence (albeit weak) that should neither be disregarded, nor blindly regarded without professional skepticism. d. CorrectRhonda's assertions need corroboration. 1. 38a. IncorrectAlthough there is a high level of risk associated with client acceptance, this phrase was created by the authors. b. CorrectInformation risk is the probability that the information circulated by a company will be false or misleading. c. IncorrectMoral hazard is the risk that the existence of a contract will change the behavior of one or both parties to the contract. d.

IncorrectBusiness risk is the probability an entity will fail to meet its objectives and, ultimately, fail. 1. 39a. CorrectCompleteness includes cutoff
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which refers to accounting for revenue, expense, and other transactions in the proper period (neither postponing some recordings to the next period nor accelerating next-period transactions into the current-year accounts). 1. 40d.

CorrectThe objective related to rights and obligations is to establish with evidence that amounts reported as assets of the company represent its property rights and that the amounts reported as liabilities represent its obligations. . 41b. CorrectManagement's existence assertion states that reported assets, liabilities, and equities actually exist. 1. 42a. IncorrectUnder Sarbanes-Oxley, professional service firms are prevented from acting in a managerial decision making role for an audit client. b. IncorrectUnder Sarbanes-Oxley, professional service firms are prevented from auditing the firm's own work on an audit client. c. IncorrectUnder Sarbanes-Oxley, professional service firms may only provide tax consulting service to an audit client with the audit committee's approval. d.

CorrectSarbanes-Oxley prevents professional service firms from engaging in any of the above listed capacities. 1. 43 d. CorrectReciprocity refers to the process through which CPAs licensed in one state can obtain a CPA certificate and license in another state. 1. 44a. CorrectAuditing is a subset of attestation engagements that focuses on the certification of financial statements. b. IncorrectAuditing is a subset of attestation that provides higher assurance than that provided by an attestation engagement. c. IncorrectConsulting engagements focus on providing clients with advice and decision support. d.

IncorrectAssurance engagements are designed to improve the quality of information, or its context, for decision makers. 1. 45d. CorrectAlthough <https://assignbuster.com/solution-to-auditing-and-assurance-service-112b-3/>

auditing is a subset of attestation, and attestation is a subset of assurance, the focus of the engagements tends to be very specific. 1. 46d.

CorrectCredibility, advancement, and monetary rewards are all reasons to become certified. SOLUTIONS FOR EXERCISES AND PROBLEMS 47. Audit, Attestation, and Assurance Services Students may encounter some difficulty with this matching because the Special Committee on Assurance Services listed many things that heretofore ave been considered “ attestation services” (long before assurance services were invented). Maybe this is a good vehicle for discussing the considerable overlap between attestation services (attestation standards) and assurance services. • Real estate demand studies -- Assurance service (listed by SCAS but not in the textbook chapter) • Ballot for awards show -- Assurance service (listed by SCAS but not in the textbook chapter) [But PwC attested to the Academy Awards ballot results long before assurance services were invented] Utility rate applications -- Attestation service (or maybe a consulting service; I’m somewhat surprised the SCAS did not list it as an assurance service.) • Newspaper circulation audits --Assurance service (listed by SCAS but not in the textbook chapter) [But this work has appeared in prior years in examples of attestation services] • Third-party reimbursement maximization -- Assurance service (listed by SCAS and listed in the textbook chapter) • Annual financial report to stockholders -- Audit service Rental property operations review -- Assurance service (listed by SCAS and listed in the textbook chapter) • Examination of financial forecasts and projections -- Attestation service (but also listed by SCAS as an assurance service) • Customer satisfaction surveys-- Assurance service (listed by SCAS and listed in the textbook chapter) • Compliance with contractual requirements -- <https://assignbuster.com/solution-to-auditing-and-assurance-service-112b-3/>

Attestation service (but also listed by SCAS as an assurance service) •
 Benchmarking/best practices -- Assurance service (listed by SCAS and listed in the textbook chapter) Evaluation of investment management policies -- Assurance service (listed by SCAS and listed in the textbook chapter) •
 Information systems security reviews -- Assurance service (listed by SCAS and listed in the textbook chapter) • Productivity statistics -- Attestation service (but also listed by SCAS as an assurance service under various descriptions) • Internal audit strategic review -- Assurance service (listed by SCAS and listed in the textbook chapter) • Financial statements submitted to a bank loan officer -- Audit service

1. 49 ASB Assertions PCAOB Assertion | Corresponding ASB assertion | Nature of assertion | | Existence or Occurrence | Existence | Balance | | | Occurrence | Transactions | | | Disclosures | | Rights and Obligations | Rights and Obligations | Balances | | | | Disclosures | | Completeness | Completeness | Transactions | | | Balances | | | Disclosures | | | Cutoff Transactions | | Valuation and Allocation | Accuracy | Transactions | | | Disclosures | | | Valuation | Balances | | | | Disclosures | | Presentation and Disclosure | Classification | Transactions | | | | Disclosures | | | Understandability | Disclosures |

1. 52 Identification of Audits and Auditors The responses to this matching type of question are ambiguous. The engagement examples are real examples of external, internal and governmental audit situations. You might point out to students that the distinctions among compliance, economy and efficiency and program results audits are not always clear. The “ solution” is shown below in matrix form, showing some engagement numbers in two or three cells. The required schedule follows.

Type of Audit	Financial Statement	Economy, Efficiency	Program	Auditor	Compliance	Results
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Independent CPA | 2, 10 | | | | Internal Auditor | | 6, 8 | 4, 8 | | |
 Governmental (GAO) | | | 1, 3 | 1, 3, 9 | | IRS Auditor | | 5 | | | | Bank Examiner
 | | 7 | | | | Proprietary school's training expenses | Economy and Efficiency
 Program Results | Governmental (GAO) | | Advertising agency financial
 statements | Financial statement | Independent CPAs | | Dept. of Defense
 launch vehicle | Economy and Efficiency or Program Results | Governmental
 (GAO) | | Municipal services | Economy and Efficiency | Internal auditors | |
 Tax shelters | Compliance | IRS auditors | | Test pilot reporting | Compliance |
 Internal auditors | | Bank solvency | Compliance | Bank examiners | |
 Materials inspection by manufacturer | Compliance or Economy and
 Efficiency | Internal auditors | | States' reporting chemical use data | Program
 goal | Governmental (GAO) | | Sports complex forecast | Financial statement |
 Independent CPAs |

SOLUTIONS FOR REVIEW CHECKPOINTS 2. 1For 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 <https://assignbuster.com/solution-to-auditing-and-assurance-service-112b-3/>

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

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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. 4Independence 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. 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. 6Professional 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.

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

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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. 4 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. 5 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. 17A 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. 18Four 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. 19The 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. 20Public 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. 21The purpose served by the attestation standards is to guide work in attestation areas and engagements other than audits of financial statements.

2. 22The 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. 23A 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: . 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 24. In <https://assignbuster.com/solution-to-auditing-and-assurance-service-112b-3/>

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. 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. 26The 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. 7The 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. 28a. CorrectGathering audit evidence is a component of the performance principle. b. IncorrectWhile reasonable assurance is related to gathering audit evidence, this is not one of the categories of principles c. IncorrectThe reporting principle relates to the contents of the auditors' report d.

IncorrectThe responsibilities principle relates to the personal integrity and professional qualifications of auditors. 2. 29a. IncorrectThis practice relates to accountants' competence and capabilities, not due care. b. IncorrectThis practice relates to the reporting principle. c. IncorrectSufficiency of evidence relates to the performance principle and not due care. d. CorrectThese practices are a part of due care. 2. 30a. IncorrectGAAS relates to the conduct of audit engagements and not overall professional services. b. CorrectStandards within a system of quality control are firm- (rather than auditor-) related. c. IncorrectGAAP relates to accounting and financial reporting, rather than auditing practices. d.

IncorrectInternational auditing standards govern the conduct of audits conducted across international borders. 2. 31a. IncorrectRelying more extensively on external evidence is related to the appropriateness (or quality) of evidence. b. IncorrectFocusing on items with more significant financial effects on the financial statements is related to materiality. c. CorrectProfessional skepticism is characterized by appropriate questioning and a critical assessment of audit evidence. d. IncorrectFinancial interests are most closely related to auditors' independence. 2. 32a. CorrectAuditors study internal control to determine the nature, timing, and extent of substantive tests. b.

IncorrectConsulting suggestions are secondary objectives in an audit. c. IncorrectInformation about the entity's internal control is, at best, indirect evidence about assertions in the financial statements. d.

IncorrectInformation about the entity's internal control provides auditors with little opportunity to learn about changes in accounting principles. 2. 33a.

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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. 34a. 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. 35a. 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. 36a.

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.

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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 <https://assignbuster.com/solution-to-auditing-and-assurance-service-112b-3/>

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. 40a. 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. 41d. 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. 42b. Correct Government auditing standards are issued by the Government Accountability Office (GAO). Governmental accounting standards are issued by the Governmental Accounting Standards Board. 2. 43a. 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 <https://assignbuster.com/solution-to-auditing-and-assurance-service-112b-3/>

engagements, including audit engagements for not-for-profit organizations.

d. Incorrect Since (a) is correct, (d) cannot be correct. 2. 4NOTE 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. 45a.

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. 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 <https://assignbuster.com/solution-to-auditing-and-assurance-service-112b-3/>

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. 48Time 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.

55PrinciplesCase Study| | | | Responsibilities | | | | | | 1.

Auditors are responsible for appropriate competence and | | 1. It was inappropriate for Holmes to hire the two students to | | capabilities to perform the audit. | | 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 | | 2. To satisfy the independence requirement, Holmes must be | | requirements. | | 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. The fact that Holmes merely accepted the financial statements | | | without questioning any evidence demonstrates lack of professional| | 3. Auditors are responsible for maintaining professional | | skepticism (as well as a lack of good professional judgment). | | skepticism
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and exercising professional judgment throughout the planning and performance of the audit. Performance 1. The auditor must adequately plan the work and must properly supervise any assistants. 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.

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 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 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

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auditor's findings, or | | should indicate that no opinion can be expressed as to the fair | | states that an opinion cannot be expressed, in the form of a written | | presentation of the financial statements in accordance with | | report. The opinion states whether the financial statements are | | generally accepted accounting principles. | prepared, in all material respects, in accordance with the | | | appropriate financial reporting framework. | | | |

| 2. 57System 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 SOLUTIONS FOR REVIEW

CHECKPOINTS 12. Management prepares a report on the effectiveness of

internal control over financial reporting. The auditors prepare reports on (1) the entity's financial statement and other disclosures and (2) the

effectiveness of the entity's internal control over financial reporting. These can be presented as two separate reports or a combined report. 2.

Management's report on internal control over financial reporting consists of the following major components: • A statement indicating that management

is responsible for establishing and maintaining adequate internal control over financial reporting. • A statement identifying the framework used by management to assess the effectiveness of the entity's internal control.

Management's opinion on the effectiveness of the entity's internal control, including an explicit statement as to whether the internal control over

financial reporting is effective. • A statement that the registered accounting firm auditing the financial statements (auditor) has issued an attestation

report on the entity's internal control over financial reporting. 12. 3The

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auditors' report serves to communicate to users three specific statements with respect to the financial statements, the conduct of the audit, and the entity in general. First, the report indicates whether the financial statements are presented in conformity with GAAP. Second, auditors use their report to indicate any unusual aspects of the audit examination.

Third, even if the financial statements are fairly presented and no problems were noted in the conduct of the audit, the auditors can use the report to communicate information useful to decision makers that may not appear on the face of the financial statements. 12. 4Nine important elements of the auditors' standard report are: 1. Title. The title should contain the word independent, as in "Independent Registered Public Accounting Firm" or "Independent Auditors". 2. Address. The report shall be addressed to the client, which occasionally may be different from the auditee. 3. Notice of Audit. A sentence should identify the financial statements and indicate that they were audited. This appears in the introductory paragraph. 4. Responsibilities.

The report should state management's responsibility for the financial statements and the auditors' responsibility for the report. These statements are also in the introductory paragraph. 5. Description of the Audit. The second paragraph (scope paragraph) should declare that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB) and describe the principal characteristics of an audit, including a statement of belief that the audit provided a reasonable basis for the opinion. 6. Opinion. The report shall express an opinion (opinion paragraph) regarding conformity of the financial

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statements with accounting principles generally accepted in the United States of America. 7. Internal Control.

The report should reference the auditors' examination, report, and opinion on the client's internal control over financial reporting. 8. Signature. The auditors (partner of the audit team) shall sign the report, manually or otherwise. 9. Date. The report shall be dated using the date