AUD

1

Audit Reports

Module

NOTES

1 Professional Standards

The Auditing and Attestation section tests audits of issuers, nonissuers, governmental entities, not-for-profit entities, and employee benefit plans. In addition to audits, this section also tests other types of engagements that an accountant may be called upon to perform, such as accounting and review service engagements and attestation and assurance engagements. Each engagement requires the accountant to follow the applicable ethical guideline(s) and standard(s) for the engagement. For example, an audit engagement requires the auditor to perform the audit in accordance with generally accepted auditing standards (GAAS). These engagements and applicable standards will be covered in more detail in later modules.

Below is an overview of standards and guidelines that will be tested in this section:

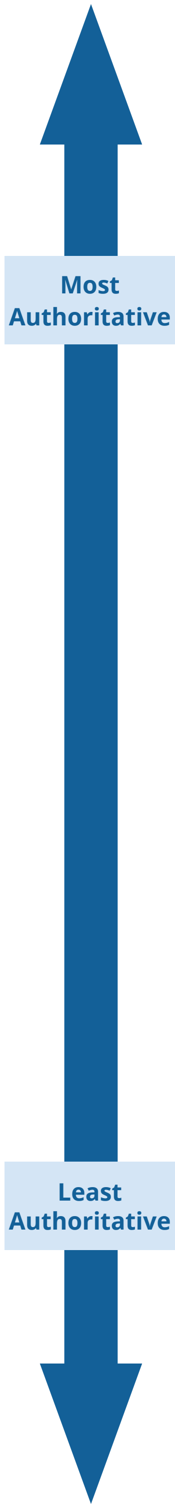
Professional Standards and Guidelines

Standard/ Guideline	*Section Reference*	*Standard-Setting Body*	*Description*	*Applies to:*
Audits				
Statements on Auditing Standards (SAS)	AU-C	AICPA Auditing Standards Board	SAS provide generally accepted auditing standards for the audits of **nonissuers**. In addition, SAS provide guidance for other services, such as review of interim financial information and letters to underwriters.	• Audits of annual historical financial statements: nonissuers • Special reports: nonissuers • Interim financial statements (where the annual financial statements have been audited): nonissuers
Public Company Accounting Oversight Board Auditing Standards (PCAOB AS)	PCAOB AS	Public Company Accounting Oversight Board	PCAOB AS provide generally accepted auditing standards for the audits of **issuers**. In addition, PCAOB AS provide guidance for other services, such as review of interim financial information and letters to underwriters.	• Audits of annual historical financial statements: issuers • Special reports: issuers • Interim financial statements: issuers
Generally Accepted Government Auditing Standards (GAGAS)	GAGAS	Governmental Accountability Office	GAGAS provide guidance for audits of **government** organizations, programs, activities, and of entities that receive government funds.	Financial or performance audits of government organizations, programs, activities, and of entities that receive government funds.

Standard/ Guideline	*Section Reference*	*Standard-Setting Body*	*Description*	*Applies to:*
Other Engagements				
Statements on Standards for Attestation Engagements (SSAE)	AT-C	AICPA	SSAE provide guidance for attestation engagements.	Examination, a review, or agreed-upon procedures report on a subject matter, or an assertion about a subject matter, that is the responsibility of another party.
Statements on Standards for Accounting and Review Services (SSARS)	AR-C	AICPA Accounting and Review Services Committee	SSARS provide guidance for **unaudited** financial statements or unaudited financial information of **nonissuers**.	• Preparation, compilation, and reviews of historical financial statements: nonissuers • Preparation or compilation of pro forma financial information and forecasts: nonissuers
Guidelines				
Code of Professional Conduct	ET	AICPA	The AICPA Code of Professional Conduct provides **members** with guidelines for **behavior** in the conduct of their professional affairs. In addition, it provides assurance to the public that the profession intends to maintain high standards and to enforce compliance with these standards by its members.	Members of the AICPA
Statements on Quality Control Standards (SQCS)	QC	AICPA	SQCS provides guidance to **CPA firms** about a quality control system. A quality control system consists of policies and procedures designed, implemented, and maintained to ensure that the firm complies with professional standards and appropriate legal and regulatory requirements, and that any reports issued are appropriate in the circumstances.	CPA firms providing auditing, attestation, and accounting and review services.

2 Auditing Guidance: The GAAS Hierarchy

There are three levels of audit guidance:



1. SAS (Nonissuers) and PCAOB AS (Issuers)

The auditor should:

- Use professional judgment in applying the SAS or PCAOB AS to a particular engagement.
- Be prepared to justify any departures from presumptively mandatory requirements.

Specific language is used within the standards to clarify the auditor's level of responsibility:

- **"Must"** or **"is required"** indicates an unconditional requirement, which must be followed in all cases in which the requirement is relevant.
- **"Should"** indicates a presumptively mandatory requirement, which must be followed in all cases in which the requirement is relevant, except in rare circumstances when departure from the requirement is permitted if there is appropriate justification, performance of sufficient alternative procedures, and thorough documentation.
- **"May," "might,"** and **"could"** indicate explanatory material that does not impose a professional requirement for performance.

2. Interpretive Publications

Interpretive publications are recommendations regarding how SASs should be applied in specific situations. They are not considered to be auditing standards.

The auditor should:

- Consider the guidance provided by these publications in performing an audit.
- Be able to explain any departures, and how compliance with standards was otherwise achieved.

Examples include: Auditing interpretations of GAAS, exhibits to GAAS, auditing guidance provide in AICPA Audit and Accounting Guides, and AICPA Auditing Statements of Position (SOP).

3. Other Auditing Publications

Other auditing publications have no authoritative status but may be helpful to the auditor.

The auditor should:

- Consider the guidance provided by these publications in performing an audit.
- Be able to explain any departures, and how compliance with standards was otherwise achieved.

Examples include: Auditing articles in the Journal of Accountancy (or other professional journal), auditing articles in the AICPA CPA Letter, continuing professional education materials, textbooks, and other auditing publications.

Question 1	**MCQ-02298**

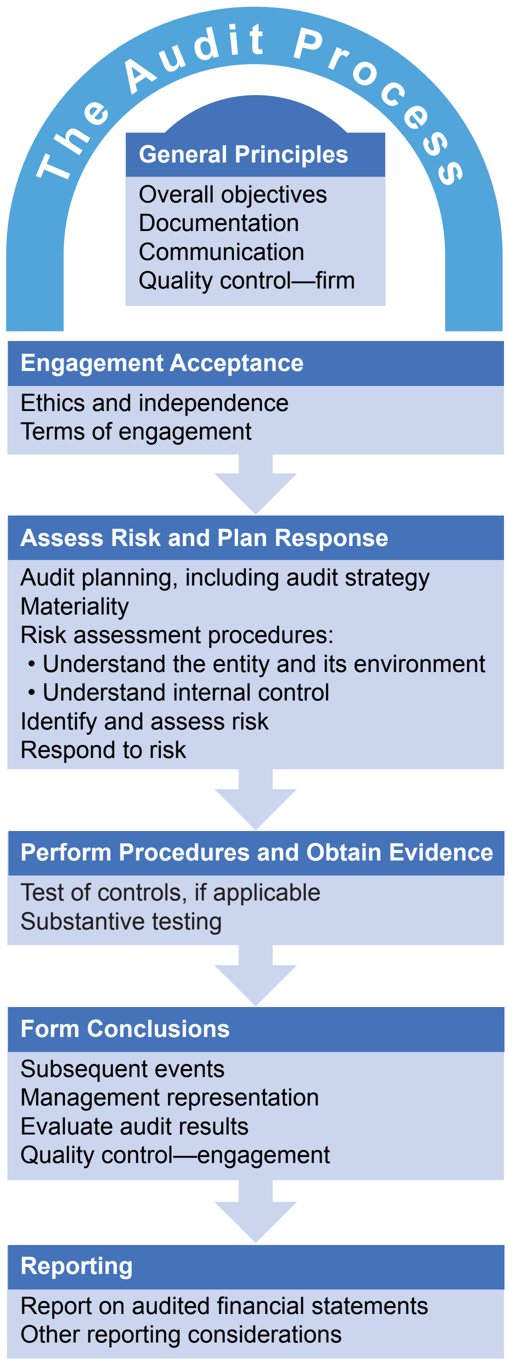
Which of the following provides the most authoritative guidance for the auditor of a nonissuer?

- **a.** An AICPA audit and accounting guide that provides specific guidance with respect to the accounting practices in the client's industry.
- **b.** A Journal of Accountancy article discussing implementation of a new standard.
- **c.** General guidance provided by a Statement on Auditing Standards.
- **d.** Specific guidance provided by an interpretation of a Statement on Auditing Standards.

Module 2

Audit Engagements

1 Audit Process Overview



2 The Independent Audit Function: The Basics

The purpose of an audit is to provide financial statement users with an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the *applicable financial reporting framework*.

Pass Key

The *applicable financial reporting framework* is the financial reporting framework that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation. Acceptable financial reporting frameworks include general purpose frameworks designed to meet the needs of a wide range of users (e.g., U.S. GAAP and International Financial Reporting Standards [*IFRSs*]), and special purpose frameworks.

The auditor's report gives credibility to the financial statements. The auditors, as a group independent of management, have an objective view and can report on a company's activities without bias or conflict of interest. Without a report from an independent auditor, a company's financial statements would be meaningless, because the public would have little faith in financial statements issued by the inherently biased company.

The financial statements of an enterprise are prepared by the management of the enterprise, not by the independent auditor. Further, the financial statements are the product and property of the enterprise; the independent auditor merely audits and expresses an opinion on them.

2.1 Management Responsibilities

An audit is conducted on the premise that management and, when appropriate, those charged with governance are responsible for:

1. the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework;
2. the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement due to error or fraud; and
3. providing the auditor with access to information and persons within the entity needed to complete the audit.

Pass Key

The preparation and fair presentation of the financial statements requires:

1. identification of the applicable financial reporting framework;
2. preparation and fair presentation of the financial statements in accordance with the framework; and
3. inclusion of an adequate description of the framework in the financial statements.

2.2 Auditor Responsibilities

The auditor is responsible for expressing an opinion on the financial statements based on the audit. The auditor is also responsible for:

1. maintaining professional skepticism;
2. complying with relevant ethical requirements;
3. exercising professional judgment throughout the planning and performance of the audit;
4. obtaining sufficient appropriate audit evidence; and
5. complying with generally accepted auditing standards (GAAS).

2.2.1 Professional Skepticism

The auditor should plan and perform the audit with professional skepticism. Professional skepticism is the recognition that circumstances may exist that cause the financial statements to be materially misstated. Professional skepticism is necessary to the critical assessment of audit evidence. Auditors should be alert for:

- Audit evidence that contradicts other audit evidence obtained.
- Information that calls into question the reliability of documents and responses to inquiries that may be used as audit evidence.
- Conditions that indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by GAAS.

Pass Key

The auditor should neither assume that management is dishonest nor assume unquestioned honesty. A belief that management is honest and has integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive evidence.

2.2.2 Ethical Requirements

The auditor should comply with ethical requirements related to financial statement audit engagements, including *independence in both fact and appearance.* Ethical requirements include the AICPA Code of Professional Conduct and the rules of the state boards of accountancy and applicable regulatory agencies that are more restrictive.

Pass Key

The auditor must be independent of an entity when performing an engagement in accordance with GAAS unless: a) GAAS provides otherwise, or b) the auditor is required by law or regulation to accept the engagement and report on the financial statements.

2.2.3 Professional Judgment

The auditor should exercise professional judgment in planning and performing an audit. Professional judgment is necessary because an audit requires interpretation of ethical requirements and GAAS, as well as informed decisions based on the application of knowledge and experience.

In an audit, professional judgment is necessary when making decisions about:

- Materiality
- Audit risk
- The nature, extent, and timing of audit procedures
- Evaluating whether sufficient, appropriate evidence has been obtained
- Evaluating management's judgments in applying the applicable financial reporting framework
- Drawing conclusions based on the audit evidence obtained

2.2.4 Sufficient Appropriate Audit Evidence and Audit Risk

To obtain reasonable assurance, the auditor should obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

2.2.5 Compliance With GAAS

The auditor should not represent compliance with GAAS in the auditor's report unless the auditor has complied with all GAAS relevant to the audit. If the objective of a relevant GAAS section cannot be achieved, the auditor should consider whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with GAAS, to modify the auditor's opinion or withdraw from the engagement.

In certain audit engagements, the auditor may be required to comply with other auditing requirements in addition to GAAS. GAAS do not override laws or regulations that govern an audit of financial statements. The auditor may conduct the audit in accordance with both GAAS and:

- auditing standards issued by the PCAOB;
- International Standards on Auditing (ISAs);
- government auditing standards (GAGAS); or
- auditing standards of a specific jurisdiction or country.

2.3 Reasonable Assurance and Inherent Limitations of an Audit

In order to express an opinion, the auditor obtains reasonable assurance about whether the financial statements are free from material misstatement, whether due to error or fraud.

Reasonable assurance is a high, but not absolute, level of assurance. In order to obtain reasonable assurance, the auditor must:

1. plan the work and properly supervise any assistants;
2. determine and apply appropriate materiality levels;
3. identify and assess risks of material misstatement, whether due to fraud or error; and
4. obtain sufficient appropriate audit evidence.

The auditor is unable to obtain absolute assurance that the financial statements are free from material misstatement because of the following inherent limitations:

- **The Nature of Financial Reporting:** Some financial statement items are subject to an inherent level of variability because they involve judgment by management or because they involve subjective decisions or assessments or a degree of uncertainty (e.g., accounting estimates).
- **The Nature of Audit Procedures:** There are practical and legal limits on an auditor's ability to obtain audit evidence, including:
  - The possibility that management or others may not provide, intentionally or unintentionally, the complete information that is needed for the preparation and presentation of the financial statements or that is requested by the auditor.
  - Fraud may be concealed in such a way that it is difficult to detect with audit procedures.
  - An audit is neither an investigation into a wrongdoing nor does the auditor have specific legal powers.
- **Timeliness of Financial Reporting and the Balance Between Cost and Benefit:** There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and will achieve a balance between benefit and cost, recognizing that it is impracticable to address all information that may exist. Therefore, it is necessary for the auditor to:
  - plan the audit so that it is performed effectively;
  - direct efforts to areas most expected to contain risks of material misstatement; and
  - use testing and other means of examining populations for misstatement.

3 Determine the Nature and Scope of the Engagement

The following should be considered as the auditor, the audit committee, and management determine the appropriate nature and scope of the engagement:

- An auditor may be hired to perform an audit for a single period or multiple periods.
- An audit may be on the complete financial statement; single financial statement; or specific elements, accounts, or items of a financial statement.
- Many audit firms are hired to perform tax services in addition to audit services.

3.1 Nonissuers

When auditing nonissuers, the auditor must determine if an audit is the most appropriate engagement, or whether a review, compilation, or preparation may be more appropriate. If an audit is needed, nonissuers have the choice of:

- a financial statement audit only (where one opinion is rendered on the fairness of the financial statements); or
- an integrated audit (where two opinions are rendered: one opinion on the fairness of the financial statements and one opinion on the operating effectiveness of internal controls over financial reporting).

3.2 Issuers

When auditing issuers, the auditor must perform an integrated audit of the client's financial statements and internal controls over financial reporting (covered later).

4 Overall Objectives of Audit Engagements

4.1 Objectives of the Financial Statement Audit

The overall objectives of the auditor when conducting a financial statement audit (which apply to audits of issuers, nonissuers, and governmental entities) are:

1. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to error or fraud, which enables the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and
2. To report on the financial statements and communicate as required by GAAS based on the auditor's findings.

4.2 Objectives of the Audit of Internal Control Over Financial Reporting

As mentioned previously, issuers are required to have an integrated audit of financial statements and internal control over financial reporting. In some cases, nonissuers and governmental entities may also have an audit of internal control over financial reporting. The overall objectives of the auditor when conducting an audit of internal over financial reporting are:

1. Express an opinion on the effectiveness of the company's internal control over financial reporting; and
2. Plan and perform the audit to obtain appropriate evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment.

Audits of internal control over financial reporting must be integrated with an audit of the financial statements.

Question 1 **MCQ-02820**

Which of the following is *not* an example of the application of professional skepticism?

- **a.** Designing additional auditing procedures to obtain more reliable evidence in support of a particular financial statement assertion.
- **b.** Obtaining corroboration of management's explanations through consultation with a specialist.
- **c.** Inquiring of prior year engagement personnel regarding their assessment of management's honesty and integrity.
- **d.** Using third-party confirmations to provide support for management's representations.