



Auditing & Attestation 1

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AUDITED FINANCIAL STATEMENTS—THE BASICS

I. THE INDEPENDENT AUDIT FUNCTION

A. WHAT IS AN AUDIT?

An audit consists of a methodical review and objective examination of an enterprise's financial statements. *The objective of the auditor's examination is to express an opinion on the financial statements.* This expression takes the form of an audit report.

B. RESPONSIBILITIES

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. The expression of an opinion by the independent auditor is known as the "audit function."

1. Company's Management = Financial Statements
2. Auditors = Expression of Opinion

C. THE AUDIT FUNCTION ADDS "CREDIBILITY"

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.

D. AN EXAMINATION IS MADE OF A COMPANY'S FINANCIAL STATEMENTS

1. The auditor carries out this examination by following the ten Generally Accepted Auditing Standards (GAAS) and all of the official pronouncements that explain and interpret GAAS.
2. The auditor must be:
 - a. Independent
 - b. Expert
 - (1) As to accounting (knowledge of GAAP)
 - (2) As to auditing (knowledge of GAAS)
 - (3) As to industry (particular business)
3. The audit should be planned and performed with an attitude of "professional skepticism," whereby the auditor neither assumes management is dishonest nor assumes unquestioned honesty.

E. THE AUDITOR MUST THEN REPORT HIS OR HER FINDINGS BASED UPON THE EVIDENCE EXAMINED

1. The primary assertion is whether the statements are "presented fairly" in accordance with GAAP (Generally Accepted Accounting Principles).
 - a. This decision as to fair presentation is a judgment call by the auditor. The American Institute of Certified Public Accountants (AICPA) defines *fair presentation* as follows: the financial statements reflect the underlying transactions of the company in a manner that represents the financial statements within a range of acceptable limits.
 - b. GAAP sources are further discussed in the Appendix.
2. Most audits are performed not only for the primary benefit of the stockholders, but also for any other interested outside parties.

PROFESSIONAL STANDARDS

I. AUDITING STANDARDS

A. GENERALLY ACCEPTED AUDITING STANDARDS



SAS

The auditor is responsible for the performance of a properly planned and executed audit. The criteria for such an audit are the ten generally accepted auditing standards (GAAS). Statements on Auditing Standards (SASs) are interpretations of GAAS issued by the Auditing Standards Board (ASB) of the AICPA. Note that compliance with GAAS is mandatory on all audit engagements.

B. GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS



GAGAS

Audits of government organizations, programs, activities, and of entities that receive government funds should be conducted in accordance with generally accepted government auditing standards (GAGAS), as covered later in the course.

C. THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD



PCAOB

The Public Company Accounting Oversight Board (PCAOB) was established pursuant to the Sarbanes-Oxley Act of 2002. The PCAOB establishes auditing and related professional practice standards to be used in the preparation and issuance of audit reports for "issuers."

1. "Issuers" consist of entities subject to the rules of the SEC (primarily public companies).
2. The PCAOB is comprised of five full-time, financially literate members.
 - a. Two members must be (or have been) CPAs, and the other three must not be (or must not have been) CPAs.
 - b. A CPA can only act as the Chair of the Board if he or she has not practiced as a CPA for the past five years.
 - c. No members of the Board can receive payments from a public accounting firm (other than fixed continuing payments, such as retirement payments).
3. Public accounting firms must register with the PCAOB in order to audit a public company. Registered firms are subject to Board inspection, disciplinary proceedings, and sanctions.
4. PCAOB Standards
 - a. The PCAOB adopted, on an initial, interim basis, ASB standards, but continues to review each standard to evaluate whether it should be modified, repealed, replaced, or permanently adopted. At present, the PCAOB has issued five of its own auditing standards, which replace ASB Standards for audits of issuers. These standards will be covered throughout the course.



Be sure to visit the Becker website for possible updates to this area.

- b. Note that the ASB retains the authority to set performance and reporting standards for audits of financial statements of nonissuers.

II. STANDARDS FOR ENGAGEMENTS OTHER THAN AUDITS

An audit is merely one type of engagement an accountant may be called upon to perform. Each type of engagement has a different set of applicable professional standards, and the requirements, responsibilities, and limitations vary with the nature and scope of the engagement. Below is an overview of these various sets of standards.

A. STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS

SSAE

Statements on Standards for Attestation Engagements (SSAE) are issued by senior technical bodies of the AICPA. These standards apply to attest engagements, covered later in the course.

B. STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES

SSARS

The Accounting and Review Services Committee was established by the AICPA to regulate standards for privately held companies not seeking audited statements. Statements on Standards for Accounting and Review Services (SSARS) are issued by this committee, and they are applicable to unaudited financial statements or unaudited financial information of a nonpublic entity. SSARS are covered later in the course.

C. STATEMENTS ON STANDARDS FOR CONSULTING SERVICES

SSCS

Statements for Standards for Consulting Services (SSCSs) are issued by the Management Advisory Services Executive Committee, and they provide standards for a broad range of consulting services.

D. STATEMENTS ON STANDARDS FOR TAX SERVICES

SSTS

Statements on Standards for Tax Services provide guidelines for tax preparation services.

III. OTHER GUIDELINES

A. CODE OF PROFESSIONAL CONDUCT

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. The Code of Professional Conduct applies to all services performed in the practice of public accounting. (*Note:* The Code of Professional Conduct is tested as part of the Regulation exam and is reviewed in the Regulation course.)

B. THE SECURITIES AND EXCHANGE COMMISSION (SEC)

1. The Securities Acts of 1933 and 1934 have given this governmental commission the authority to set guidelines for publicly traded companies.
 - a. The SEC publishes their regulations in the Accounting Series Releases and in Regulation S-K.
 - b. Final standards adopted by the PCAOB do not become effective unless and until they are approved by the SEC.

C. THE SARBANES-OXLEY ACT

Under the Sarbanes-Oxley Act:

1. Auditors report to and are overseen by the issuer's audit committee.
2. All services (both audit and non-audit) must be preapproved by the audit committee.
3. A second partner review is required for every public company audit report.
4. Severe penalties apply to those who destroy records (or willfully fail to maintain them for at least seven years), commit securities fraud, or fail to report fraud.
 - a. The statute of limitations for the discovery of fraud was extended by this Act, and protections were provided for corporate "whistleblowers."
5. Anyone associated with a registered public accounting firm (e.g., individual accountants) can be held responsible if their actions contribute to a firm's violation of laws, rules, or professional standards.

The Sarbanes-Oxley Act also contains provisions related to auditor independence, which will be covered later in the course.

IV. AUDITING GUIDANCE: THE GAAS HIERARCHY

There are three levels of auditing guidance.

A. STATEMENTS ON AUDITING STANDARDS (SASs)

1. Auditors (who are AICPA members) are required to comply with SASs published by the Auditing Standards Board. The auditor should:
 - a. Use professional judgment in applying the SASs to a particular engagement.
 - b. Be prepared to justify any departures from presumptively mandatory requirements (see below).
2. SASs generally apply only in situations where auditing services are being rendered. However, a few SASs apply to other services, such as reviews of interim financial information and letters for underwriters.
3. Specific language is used within the SASs to clarify the auditor's level of responsibility.
 - a. The terms "**must**" or "**is required**" indicate an *unconditional requirement*, which must always be followed.
 - b. The term "**should**" indicates a *presumptively mandatory requirement*, which must always be considered; however, rare departures from the requirement are permitted as long as there is appropriate justification, performance of sufficient alternative procedures, and thorough documentation.
 - c. The terms "**may**," "**might**," and "**could**" indicate explanatory material that does not impose a professional requirement for performance.

B. INTERPRETIVE PUBLICATIONS

1. Interpretive publications are recommendations regarding how SASs should be applied in specific situations. They are not considered to be auditing standards. The auditor should:
 - a. Consider the guidance provided by these publications in performing an audit.
 - b. Be able to explain any departures, and how compliance with standards was otherwise achieved.
2. Interpretive publications include SAS Interpretations, appendices to the SASs, AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position.

C. OTHER AUDITING PUBLICATIONS

1. Other auditing publications have no authoritative status but may be helpful to the auditor.
2. Other auditing publications include auditing articles in the Journal of Accountancy (or other professional journal), auditing articles in the AICPA CPA Letter, continuing professional education materials, textbooks, etc.

V. GENERALLY ACCEPTED AUDITING STANDARDS

The ten Generally Accepted Auditing Standards comprise the foundation of auditing. These standards are qualitative in nature and set minimum requirements for the profession. Auditing standards differ from auditing procedures in that "procedures" relate to acts to be performed, whereas "standards" deal with measures of audit quality and the objectives to be achieved in an audit. Auditing standards (as distinct from auditing procedures) concern themselves not only with the auditor's professional qualities, but also with the judgment exercised in the performance of the examination and in the auditor's report.

A. THE GENERAL STANDARDS



1. Training

"The auditor must have adequate technical training and proficiency to perform the audit."

Comment: The auditor must have the education in accounting, the practical experience in auditing, and knowledge of the particular industry being audited.



2. Independence

"The auditor must maintain independence in mental attitude in all matters relating to the audit."

Comment: This standard is often called the cornerstone of the profession since it is necessary to add credibility to what we do. It is defined as independence in fact and appearance. The auditor is judicially impartial.

a. Independence in Fact and in Appearance

The auditor must be independent in fact and in appearance. Auditors must leave no doubt as to their independence in the mind of the general public. Activities or relationships that even suggest or imply a possible lack of independence must be avoided by the auditor.

For example, assume the auditor owns an insignificant amount of the client's common stock, and the auditor can in no way influence corporate policy. Thus, in fact, the auditor is independent. However, the appearance of independence is nonetheless impaired. Any direct ownership of a company, no matter how small, will impair independence. (An indirect financial interest that is immaterial does not impair independence.)

b. Sarbanes-Oxley

Under the Sarbanes-Oxley Act of 2002, an accounting firm may not provide audit services to a public company if a top official of that company is also a previous employee of the accounting firm who worked on the audit during the last year.





3. Professional Care

"The auditor must exercise due professional care in the planning and performance of the audit and the preparation of the report."

Due professional care imposes a responsibility upon each person within an independent auditor's organization to observe the standards of fieldwork and reporting. The auditor will be held to exercise the same components of professional care as a reasonable auditor would exercise, which include good faith, integrity, and diligence, but due professional care does not imply infallibility. Due professional care is concerned with what the auditor does and how well it is done. The exercise of due professional care implies that the auditor will obtain sufficient appropriate audit evidence to limit audit risk to a low level. The high level of assurance expected to be obtained is referred to as "reasonable assurance"; absolute assurance is not possible.

Due professional care also requires the auditor to exercise professional skepticism. *Professional skepticism* can be defined as the maintenance of an objective attitude throughout the audit, including a questioning mind and a critical assessment of audit evidence. The auditor neither presumes management dishonesty nor presumes unquestioned management honesty. The auditor needs to exercise professional skepticism throughout the audit process, from engagement planning through conducting fieldwork.

Comment: Often called the "average auditor" concept. The auditor should do what the average auditor would do and never less, including review of work performed by assistants and maintaining an attitude of professional skepticism. Evidence of "due professional care" is indicated by critical management reviews of work performed at every level of supervision.

**STANDARDS OF
FIELDWORK****B. THE STANDARDS OF FIELDWORK****1. Planning and Supervision**

"The auditor must adequately plan the work and must properly supervise any assistants."

Comment: Audit programs are designed to enumerate appropriate action, and all work of staff auditors should be reviewed by a qualified auditor.

**2. Internal Control, Entity, and Environment**

"The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, extent, and timing of further audit procedures."

Comment: Appropriate internal controls provide the auditor with confidence that material misstatements will be prevented or detected on a timely basis.

- a. Strong controls imply the auditor will require less evidence.
- b. Weak controls imply the auditor will require more evidence.

**3. Evidence**

"The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit."

Comment: All specific audit work is performed in order to gather evidence. Virtually no specific audit evidence is required. The auditor applies his or her judgment.

