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CHAPTER 2

Professional Standards

LEARNING OBJECTIVES

	Review Checkpoints	Multiple Choice	Exercises and Problems
1. Understand the development and source of generally accepted auditing standards.	1, 2, 3, 4	47, 48	52 (*), 53
2. Describe the fundamental principle of *responsibilities* and how this principle relates to the characteristics and qualifications of auditors.	5, 6, 7	27, 29, 35, 39, 40	54, 55, 56, 57, 62 (*), 64 (*), 65 (*), 66 (*), 67 (*), 68 (*)
3. Describe the fundamental principle of *performance* and identify major activities performed in an audit.	8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18	26, 30, 31, 32, 33, 34, 36, 37, 42, 43, 44, 45	58, 59, 60, 61, 62 (*), 64 (*), 65 (*), 66 (*), 67 (*), 68 (*)
4. Understand the fundamental principle of *reporting* and identify the basic contents of the auditors' report.	19, 20	41, 49, 50, 51	63, 64 (*), 65 (*), 66 (*), 67 (*), 68 (*)
5. Understand the role of a system of quality control and monitoring efforts in enabling public accounting firms to meet appropriate levels of professional quality.	21, 22, 23, 24, 25	28, 38, 46	52 (*), 69, 70, 71

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(*) indicates that an item corresponds to multiple learning objectives

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SOLUTIONS FOR REVIEW CHECKPOINTS

2.1 **Generally accepted auditing standards** are auditing standards that identify necessary qualifications and characteristics of auditors and guide the conduct of the audit examination.

The purpose of generally accepted auditing standards is to meet the following objectives of an audit examination:

- To obtain reasonable assurance about whether the financial statements as a whole are free of material misstatement, whether due to error or fraud.
- To issue a report on the financial statements

2.2 Currently, the PCAOB is responsible for developing standards for the audits of issuers, while the AICPA is responsible for developing standards for the audits of non-issuers.

2.3 The AICPA (through the Auditing Standards Board) has responsibility for setting standards for the audits of non-issuers. This is done through the issuance of *Statements on Auditing Standards.*

The PCAOB has responsibility for setting standards for the audits of issuers. This is done through the PCAOB's issuance of *Auditing Standards.*

While the SEC does not have responsibility for setting auditing standards *per se,* all PCAOB standards must be approved by the SEC.

2.4 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 (or state that an opinion cannot be expressed) as to whether the financial statements are presented fairly in accordance with the applicable financial reporting framework.

2.5 **Independence 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.

2.6 **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.

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2.7 **Professional 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.

2.8 **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 entity's financial statements.

The audit team provides reasonable assurance by considering various risks relating to the likelihood of material misstatements and performing audit procedures to control this risk to an acceptably low level.

2.9 An **audit plan** is a list of audit procedures that are performed to gather sufficient appropriate evidence on which auditors base their opinion on the financial statements.

Audit plans are prepared during the planning stages of the audit.

2.10 An **interim date** is a date between the beginning of the year and the year-end. Performing audit procedures prior to the interim date allows the audit team to spread work over a longer period of time and focus efforts on the time period between the interim date and year-end, to allow the audit to be completed on a more timely basis.

2.11 **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.

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2.12 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 further audit procedures. A secondary purpose is because of auditors' responsibilities for reporting on client's internal controls.

2.13 As the client's internal control is more effective (a lower 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).

2.14 **Audit evidence** is defined as the information used by auditors in arriving at the conclusion on which the audit opinion is based.

2.15 *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.

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2.16 **Relevance** refers to the nature of information provided by the audit evidence; that is, what assertion(s) related to the account balance or class of transactions does the evidence support? **Reliability** refers to the extent of trust that auditors can place in evidence and is primarily influenced by the source of the evidence.

The appropriateness of audit evidence is related to both relevance and reliability; that is, as evidence is more relevant and reliable, it is considered to have a higher level of appropriateness.

2.17 The source of evidence affects its reliability as follows (from most to least reliable): (1) evidence directly obtained by auditors, (2) evidence obtained from external sources, and (3) evidence obtained from internal sources.

2.18 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, more transactions or components of an account balance should be examined.

2.19 A **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.

2.20 Four types of opinions and their conclusions:

Type	Conclusion
Unmodified 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.

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2.21 A **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:

1. Leadership responsibilities for quality within the firm ("tone at the top")
2. Relevant ethical requirements
3. Acceptance and continuance of client relationships and specific engagements
4. Human resources
5. Engagement performance
6. Monitoring

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2.22 In 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.

2.23 Procedures used by firms to monitor their quality control standards include:

- Reviews of selected administrative and personnel records.
- Reviews of engagement documentation, reports, and the client's financial statements.
- Discussions with firm personnel
- Assessments of the (1) appropriateness of the firm's guidance materials and professional aids, (2) compliance with policies and procedures on independence, (3) effectiveness of continuing professional education, and (4) decisions regarding the acceptance and continuance of client relationships and specific engagements.

2.24 The PCAOB's monitoring role for firms providing auditing services to issuers includes registering public accounting firms and conducting inspections of registered public accounting firms.

2.25 The frequency of PCAOB inspections depends upon the number of audits conducted by member firms. For firms performing audits for more than 100 issuers, inspections are required on an annual basis. For those performing audits for 100 or fewer issuers, inspections are conducted every three years.

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SOLUTIONS FOR MULTIPLE-CHOICE QUESTIONS

2.26

a.	Correct	Gathering audit evidence is a component of the performance principle.
b.	Incorrect	While reasonable assurance is related to gathering audit evidence, this is not one of the categories of principles
c.	Incorrect	The reporting principle relates to the contents of the auditors' report
d.	Incorrect	The responsibilities principle relates to the personal integrity and professional qualifications of auditors.

2.27 ***NOTE TO INSTRUCTOR****: Since this question asks students to identify the concept that is not related to the ethical requirements of auditors, the response labeled "correct" is not related to the ethical requirement of auditors and those labeled "incorrect" are related to the ethical requirements of auditors.*

a.	Incorrect	Due care is related to the ethical requirements of auditors.
b.	Incorrect	Both independence in fact and independence in appearance are related to the ethical requirements of auditors.
c.	Incorrect	Both independence in fact and independence in appearance are related to the ethical requirements of auditors.
d.	Correct	While professional judgment is part of the responsibilities principle, it is not related to the ethical requirements of auditors.

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2.28

a.	Incorrect	GAAS relates to the conduct of audit engagements and not overall professional services.
b.	Correct	Standards within a system of quality control are firm- (rather than auditor-) related.
c.	Incorrect	Generally accepted accounting principles are not an element related to professional services.
d.	Incorrect	International auditing standards govern the conduct of audits conducted across international borders.

2.29

a.	Incorrect	Relying more extensively on external evidence is related to the appropriateness (or quality) of evidence.
b.	Incorrect	Focusing on items with more significant financial effects on the financial statements is related to materiality.
c.	Correct	Professional skepticism is characterized by appropriate questioning and a critical assessment of audit evidence.
d.	Incorrect	Financial interests are most closely related to auditors' independence.

2.30

a.	Correct	Auditors study internal control to determine the nature, timing, and extent of further audit procedures.
b.	Incorrect	Consulting suggestions are secondary objectives in an audit.
c.	Incorrect	Information about the entity's internal control is, at best, indirect evidence about assertions in the financial statements.
d.	Incorrect	Information about the entity's internal control provides auditors with little opportunity to learn about changes in accounting principles.

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2.31

a.	Incorrect	External evidence is considered to be more reliable than the inquiry of management in choice (b).
b.	Correct	Inquiry of management is a form of internal evidence, which is the least reliable form of evidence.
c.	Incorrect	Auditor-prepared evidence is considered to be the most reliable form of evidence.
d.	Incorrect	Because the entity's legal counsel is an external party, this form of evidence is more reliable than the inquiry of management in choice (b).

2.32

a.	Incorrect	Inquiry of management is the least reliable form of evidence.
b.	Incorrect	Although external evidence is considered to be highly reliable, auditors' personal knowledge (choice d) provides the most reliable form of evidence
c.	Incorrect	While auditor evaluation of client procedures is a reliable form of evidence, this would not be relevant to verifying the existence of newly-acquired equipment.
d.	Correct	Auditors' personal knowledge through physical observation provides the most reliable form of evidence; in addition, unlike evaluation of client procedures (choice c), this relates directly to verifying the existence of newly-acquired equipment.

2.33

a.	Incorrect	Inquiry of client personnel is internal evidence, which is the least reliable form of evidence.

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b.	Incorrect	Prenumbered client purchase orders are an internal form of evidence, which is the least reliable form of evidence
c.	Incorrect	While sales invoices are documents created by external parties, the fact that these documents were received from client personnel reduces their reliability.
d.	Correct	Because the statements were received directly from outside parties, this is a more reliable form of evidence than internal forms of evidence (choices a and b) or external evidence received indirectly by the auditor (choice *c*).

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2.34

a.	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 closely related to planning and supervision.
c.	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 closely related to planning and supervision

2.35 ***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 include independence in fact.
b.	Incorrect	Due care requires the skills and knowledge of others in the auditors' profession, which would include professional skepticism.
c.	Incorrect	Due care refers to the performance of a "prudent" auditor.
d.	Correct	Reasonable assurance is related to the auditors' responsibility for detecting misstatements and procedures performed during the examination, not the concept of due care.

2.36

a.	Incorrect	Internal documents are a relatively low quality of evidence.
b.	Incorrect	Because these representations were received from an internal source (the president of the entity), they are a relatively low quality of evidence.
c.	Incorrect	While 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.

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2.37

a.	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 further audit procedures on an engagement.

2.38

a.	Incorrect	While receiving independence confirmations with respect to clients would be important in deciding to accept or continue clients, this element is more closely related to relevant ethical requirements (choice d).
b.	Incorrect	Receiving independence confirmations is not related to engagement performance.
c.	Incorrect	Receiving independence confirmations is not related to monitoring.
d.	Correct	Independence confirmations would ensure that all firm personnel are independent with respect to that firm's clients, which is related to the "Relevant

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Ethical Requirements" element of a system of quality control. It would not relate to acceptance and continuance of client relationships and specific engagements (*a*), engagement performance (*b*), or monitoring (*c*).

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2.39

a.	Incorrect	The responsibility to issue a report is related to the reporting principle.
b.	Incorrect	The requirement to gather sufficient, appropriate evidence is related to the performance principle.
c.	Correct	The auditors' compliance with independence and due care is related to the responsibilities principle.
d.	Incorrect	The responsibility to plan an audit and properly supervise assistants is related to the performance principle.

2.40

a.	Correct	Consultation with an appraiser 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 engagements, including audit engagements for not-for-profit organizations.
d.	Incorrect	Because consulting an appraiser is consistent with exercising due care (choice *a*), this cannot be correct.

2.41 ***NOTE 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 first paragraph of the Basis for Opinion section.
b.	Correct	Auditors provide reasonable (but not absolute) assurance in an audit engagement (this is noted in the second paragraph of the Basis for Opinion section of the auditors' report).
c.	Incorrect	A description of the audit engagement is provided in the second paragraph of the Basis for Opinion section of the auditors' report.
d.	Incorrect	The auditors' opinion on internal control over financial reporting is provided in the second paragraph of the Opinion section of the auditors' report.

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2.42

a.	Incorrect	The concept of absolute assurance requires auditors to identify and detect all material misstatements.
b.	Incorrect	Professional judgment relates to the application of training, knowledge, and experience in making informed decisions. It does not specifically relate to detecting material misstatements.
c.	Incorrect	The reliability of audit evidence relates to the sufficiency and appropriateness of evidence. While more reliable evidence will reduce the likelihood that material misstatements will not be detected, it does not, in itself, ensure that a GAAS audit will detect all material misstatements.
d.	Correct	Reasonable assurance recognizes that an audit conducted under GAAS may fail to detect all material misstatements.

2.43

a.	Incorrect	The fact that the source of the evidence is internal would result in evidence being less reliable than external evidence (choice c).
b.	Incorrect	The fact that the source of the evidence is internal and evidence is developed under less effective internal control would result in evidence being less reliable than external evidence and environments with more effective internal control (choice c).

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c.	Correct	Evidence is most reliable when the source of the evidence is external and when the evidence is developed under more effective internal control.
d.	Incorrect	The fact that the evidence is developed under less effective internal control would result in evidence being less reliable than when developed under more effective internal controls (choice *c*).

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2.44

a.	Incorrect	The decision to physically inspect investment securities rather than obtain an external confirmation relates to the source of evidence, which affects the reliability of evidence.
b.	Correct	The aging of accounts receivable will evaluate valuation, which is not directly evaluated through confirmation. Therefore, aging provides relevant evidence with respect to the valuation assertion.
c.	Incorrect	The number of accounts confirmed by the auditor is related to the sufficiency of evidence, not the appropriateness of evidence (or relevance and reliability).
d.	Incorrect	The decision to confirm a larger number of accounts following year-end relates to the timing of audit procedures, not the appropriateness of evidence (or relevance and reliability).

2.45 ***NOTE TO INSTRUCTOR****: Since this question asks students to identify the statement that is not true with respect to the performance principle, the response labeled "correct" is not true and those labeled "incorrect" are true.*

a.	Correct	Written audit plans are required in both initial and continuing audits.
b.	Incorrect	Materiality should be considered in planning the audit, performing the audit, and evaluating the effects of misstatements on the entity's financial statements.
c.	Incorrect	The effectiveness of the entity's internal control is an important consideration in the audit team's assessment of the risk of material misstatement.
d.	Incorrect	In order to be appropriate, evidence must be both relevant and reliable.

2.46

a.	Incorrect	Annual inspections are only required for audit firms that audit more than 100 issuers.
b.	Correct	In a PCAOB inspection, a sample of audits as well as the firm's system of quality control are reviewed by the inspection team.
c.	Incorrect	While the deficiencies noted in sampled audit engagements are publicly disclosed, information regarding deficiencies in the firm's quality control are not publicly disclosed unless the firm fails to address those deficiencies within one year.
d.	Incorrect	All firms auditing issuers must have a PCAOB inspection. If a firm audits 100 or fewer issuers, it has an inspection every three years rather than every year.

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2.47

a.	Correct	Audit procedures are particular and specialized actions that auditors take to obtain evidence during a specific engagement.
b.	Incorrect	Auditing standards do not apply to specific engagements, but are quality guides that apply to all audits.
c.	Incorrect	Interpretive publications provide guidance to auditors on the application of generally accepted auditing standards in specific situation.
d.	Incorrect	Statements on Auditing Standards are pronouncements issued by the Auditing Standards Board that apply to all audits of nonissuers.

2.48

a.	Incorrect	The PCAOB does develop Auditing Standards, but these relate to the audit of issuers.
b.	Correct	The PCAOB develops Auditing Standards for the audit of issuers.
c.	Incorrect	The Auditing Standards Board develops Statements on Auditing Standards.
d.	Incorrect	The Auditing Standards Board develops *Statements on Auditing Standards*.

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2.49

a.	Incorrect	The description of the audit examination (including a reference to PCAOB standards) is included in the second paragraph of the Basis for Opinion section.
b.	Incorrect	The auditors' conclusion with respect to the financial statements is included in the first paragraph of the Opinion section.
c.	Correct	The responsibility of auditors and management in the financial reporting process is included in the first paragraph of the Basis for Opinion section.
d.	Incorrect	The auditors' conclusion with respect to internal control is included in the second paragraph of the Opinion section.

2.50

a.	Correct	An adverse opinion is issued for material and pervasive departures from GAAP.
b.	Incorrect	A disclaimer of opinion would be issued only when auditors felt they were unable to reach a conclusion with respect to the fairness of the entity's financial statements.
c.	Incorrect	A qualified opinion concludes that, with the exception of a specific matter, the entity's financial statements are presented according to GAAP.
d.	Incorrect	An unmodified opinion concludes that the entity's financial statements are presented according to GAAP.

2.51

a.	Incorrect	The communication principle is not one of the fundamental principles.
b.	Incorrect	The performance principle relates to the conduct of the audit examination.
c.	Correct	The reporting principle is related to the contents of the auditors' report, which expresses an opinion on the entity's financial statements (or indicates that an opinion cannot be expressed).
d.	Incorrect	The responsibilities principle relates to the characteristics and qualifications of the auditors.

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SOLUTIONS FOR EXERCISES AND PROBLEMS

2.52 **AICPA and PCAOB Responsibilities**

a. The AICPA (through the Auditing Standards Board) has responsibility for setting standards for the audits of nonissuers. This is done through the issuance of *Statements on Auditing Standards.*

b. The PCAOB has responsibility for setting standards for the audits of issuers. This is done through the PCAOB's issuance of *Auditing Standards.*

c. While the SEC does not have responsibility for setting auditing standards *per se,* all PCAOB standards must be approved by the SEC.

d. The audits of issuers are governed by *Auditing Standards* issued by the PCAOB that have been approved by the SEC.

e. The audits of nonissuers are governed by *Statements on Auditing Standards* issued by the AICPA.

f. The AICPA (for nonissuers) and PCAOB (for issuers) examine documentation related to previous audit engagements and evaluate the audit firms' systems of quality control. These evaluations are referred to as peer reviews (AICPA) and inspections (PCAOB)

2.53 **Professional Guidance**

a. SAS
b. AS
c. N
d. SAS
e. B
f. AS
g. B
h. AS

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2.54 **Independence**

a. Auditors should not follow clients' suggestions about the conduct of an audit unless the suggestions clearly do not conflict with their professional competence, judgment, honesty, independence, or ethical standards. Where there is no disagreement about the results to be accomplished and the client's suggestions represent good ideas, auditors can consider these suggestions. Within professional bounds, mutual agreement with the client is acceptable. Auditors must never agree to any arrangement that violates generally accepted auditing standards or the AICPA's Code of Professional Conduct.

b. The reasons that would not support dividing the assignment of audit work solely according to assets, liabilities and income and expenses include the following:

1. Work should be assigned to staff members by considering the degree of difficulty in relation to the technical competence and experience of individual staff members.

2. Sequence of work performed on an examination should be in accordance with an overall audit plan.

3. It is impossible to segregate work areas by major captions because often a close relationship exists among a number of accounts in more than one category. For example, interest and dividend income are normally based on an asset (investments) and interest expense is normally based on a liability (long-term debt).

4. Often a single form of audit documentation is desirable to provide evidence with respect to balances in accounts of various types, such as an insurance analysis supporting premium disbursements, the insurance expense portion, and the prepaid insurance balance.

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5. Duplication of staff effort would be more likely to occur if assignments were made on such a basis.

6. Frequently, the scope of work regarding a single account requires simultaneous participation by the staff, such as in the observation of inventories.

Many audit operations are not susceptible to division by category, as for example studying and evaluating internal control, testing transactions, and preparing the report.

c. The audit staff member whose uncle owns the advertising agency should not be assigned to examine the client's advertising account. The firm is responsible for avoiding relationships which might suggest a conflict of interest. Regardless of whether this staff member could be independent and unbiased in such a situation (independence in fact), external parties will likely be influenced in their thinking by the fact that the uncle is the owner of the advertising agency (the staff member would not have independence in appearance). Even if a problem of ethics were not involved, it would be unwise for the firm to assign this staff member because the client's attitude could change significantly and the firm's position would be jeopardized if difficulties later arose in connection with the contract. Any situation in which bias exists or might arise should be avoided.

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2.55 **Independence**

a. Independence in fact relates to the auditors' "state of mind" and reflects an unbiased and impartial perspective with respect to the financial statements and other information they audit. Independence in appearance relates to others' (particularly financial statement users') perceptions of the auditors' independence.

b. The two general types of relationships that compromise auditors' independence are financial relationships (owning shares of stock or having an outstanding loan to or from a client) and managerial relationships (acting in a decision-making capacity on behalf of a client or providing advice on systems or information that will be audited).

c.

1. While auditors might still be independent in fact with respect to the audit of the client, the large revenues resulting from these services create a financial interest that many users would find to be troubling. For example, consider the possibility that clients might use the revenues from these services as a bargaining tool with auditors if an issue arises during the audit engagement.

2. This would clearly pose a compromise to auditors' independence and would not be permitted under current guidelines. The issues in this case are (1) the fact that the auditor is directly involved with the engagement and (2) the executive-level position occupied by his or her spouse with a client.

3. This introduces a similar issue to (2), but would be less likely to compromise the auditors' independence. The major differences in this scenario are (1) the auditor is not directly involved with the engagement, (2) the level of position held by the auditor's relative is not at the executive level, and (3) the relationship between the auditor and other individual is not as close. Professional standards would likely not conclude that this situation would compromise the auditor's independence.

4. This represents a direct financial interest in a client. The issue is whether the fact that the staff member is not a part of the engagement team compromises his or her independence. While professional guidelines would not conclude that this situation compromises the independence of the staff member, many firms have adopted the practice of not permitting any of their professional staff to hold financial interests in their audit clients.

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2.56 **Professional Skepticism**

a. Professional skepticism refers to a state of mind that is characterized by appropriate questioning and a critical assessment of audit evidence.

b. Auditors are required to maintain professional skepticism throughout the audit, including during the following stages: (1) engagement planning, (2) risk assessment, (3) audit evidence, and (4) reporting.

c.

1. The strong relationships and friendships that have developed between the firm personnel and client's officers may lead to an increased level of trust that would reduce the likelihood of questioning and critically assessing audit evidence.

2. The time pressure resulting from other workload demands and deadlines related to other engagements may result in a desire to complete the audit more promptly and reduce the extent to which the firm personnel question and critically assess audit evidence.

3. The client's wishes to reduce or limit the audit fee may make firm personnel less likely to question and critically assess audit evidence, since doing so would increase the costs incurred during the audit without a corresponding increase in revenues.

2.57 **Responsibilities Principle**

a. Ethical requirements. Martin should consider any potential impacts of the family relationship of one of its staff accountants with the Chief Financial Officer on its ability to maintain independence in fact and independence in appearance. The important role that the Chief Financial Officer plays in the financial reporting process makes potential relationships with this individual particularly sensitive.

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b. Competence and capabilities. The fact that Phillip, Inc. is in an industry in which Martin does not have significant experience (manufacturing) and is larger in size than most of Martin's clients raises potential concerns with respect to Martin's ability to appropriately conduct the audit of Phillip.

c. Professional skepticism and professional judgement. Martin appears to exhibit appropriate professional judgment and skepticism by verifying the reason for the change in auditors by contacting Phillip's former auditors, rather than just accepting Phillip's response to Martin's inquiries about the reason for the change.

d. Competence and capabilities. Martin's concerns about its inability to conduct an appropriate observation of Phillip's inventories (which are highly material to the financial statements) raises additional issues related to Martin's competence and capabilities beyond the industry and size of Phillip.

e. Professional skepticism and professional judgment. If Martin's proposal is accepted and Martin accepts the engagement, it should not rely on Phillip's representation that no transfers of inventory have occurred between locations without some form of verification and additional testing. Appropriate professional skepticism would suggest that other means of addressing this issue should be considered.

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f. Ethical requirements. While ensuring that firm personnel are independent in fact and in appearance with respect to Phillip, Martin should consider this issue prior to submitting a proposal rather than after doing so (assuming that the proposal is accepted).

2.58 **Responsibilities Principle: Planning**

One initial issue that is raised in this scenario is the fact that the firm is very small (one person with two assistants) and does not appear to do a meaningful amount of audit work (the problem description identifies the firm as primarily "compiling clients' monthly statements and preparing income tax returns"). In addition, the scenario notes that it would be considered a challenge to accept new audit clients. As a result, one possible response might question this firm's ability to conduct the proposed audit, regardless of some of the timing issues that are present in the President's request.

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.

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2.59 **Performance Principle: Evidence**

a. **Sufficiency** refers to the quantity of evidence, which is the number of transactions or components of an account balance of class of transactions examined by the audit team. As it relates to evidence, the term appropriate refers to the quality of evidence. **Appropriateness** is affected by the information the evidence provides to the audit team (relevance) as well as the extent to which the audit team can trust the evidence (reliability).

b. **Relevance** refers to the nature of information provided by the audit evidence (the assertion or assertions supported by the evidence). **Reliability** refers to the extent of trust the audit team can place in the evidence.

Relevance and reliability both affect the appropriateness of audit evidence; as the relevance and reliability of evidence increases, the appropriateness of evidence increases.

c. The source of evidence has in important effect on its reliability. The three sources of evidence (from most to least reliable) are:

1. Evidence directly obtained by the auditor.
2. Evidence obtained from external sources.
3. Evidence obtained from internal sources.

d. As the entity's internal control is more effective, auditors would assess lower levels of the risk of material misstatement. This would allow them to permit a higher level of detection risk, which means that they could gather less sufficient and less appropriate evidence.

In contrast, as the entity's internal control is less effective, auditors would assess higher levels of the risk of material misstatement. This would require auditors to control detection risk to lower levels, which means that they would be required to gather more sufficient and more appropriate evidence.

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2.60 **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 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.

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2.61 **Performance Principle**

a. Risk assessment (Evaluating the effectiveness of the client's internal control is used to assess control risk. Control risk, along with the inherent risk, forms the basis for the auditors' assessment of the risk of material misstatement).

b. Planning and supervision (Obtaining an understanding of the client's industry is performed in the planning stages of the audit examination).

c. The concept of *reasonable assurance* acknowledges that auditors cannot reduce the risk of failing to detect a material misstatement to zero. In addition, the concept of reasonable assurance is also related to the *risk of material misstatement* and *audit evidence*, since the risk of material misstatement and audit evidence will be used to limit the failure to detect a material misstatement to an appropriate (low) level. However, these processes cannot be relied upon to reduce this risk to zero.

d. Audit evidence (Obtaining confirmations from the client's customers is an example of a substantive procedure that provides external evidence, which is a highly reliable form of evidence).

e. Planning and supervision (Preparing a written audit plan is done in the planning stages of the audit examination).

f. This statement may relate to the *audit evidence* element, as it affects the type of audit evidence that is obtained during the examination. In addition, because auditors are required to design substantive procedures to provide *reasonable assurance* (but not absolute assurance), this statement is also related to reasonable assurance. Finally, the fact that auditors are concerned with misstatements that have a significant effect on financial statement users' decisions indicates that this statement is related to the *materiality* element.

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g. This statement considers the significance of a misstatement, or *materiality*. In addition, the likelihood that the account balance contains a material misstatement is inherent risk, which is evaluated during the *risk assessment* stage of the audit.

h. The concept of *reasonable assurance* acknowledges that auditors cannot provide absolute assurance because of mistakes and misinterpretations in evaluating evidence.

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2.62 **Responsibilities and Performance Principles**

a. While auditors typically cannot influence the susceptibility of accounts to misstatements or the effectiveness of the entity's internal control (both of which comprise the risk of material misstatement), this risk needs to be considered in order to determine the nature, timing, and extent of further audit procedures.

b. This statement is correct; if internal control is less effective, auditors are required to gather more sufficient and more appropriate evidence. However, in addition to the number of transactions and reliability of evidence, auditors should also consider the relevance of the evidence they gather and the extent to which that evidence supports the assertions of interest.

c. Auditors are not required to provide absolute assurance as to the fairness of the financial statements, which is what is being suggested in this statement. While it is true that a great deal of time and effort is necessary in an audit engagement, auditors are only required to provide reasonable assurance with respect to the ability to detect material misstatements.

d. This statement relates to the concept of materiality and is appropriate. However, it is important to note that the consideration of materiality in an audit is highly complex and requires an extremely high level of professional judgment.

e. While physical inspection of the stock certificates will provide more reliable evidence than confirming the certificates held with the custodian, it may not be necessary for auditors to conduct such an inspection. In many cases, a less reliable, but still effective procedure such as confirmation with the custodian would be appropriate.

2.63 **Reporting Principle**

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a. The purpose of the auditors' opinion and report is to express an opinion (or indicate that an opinion cannot be expressed) as to whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

b. *NOTE TO INSTRUCTOR: The following response assumes that no additional reporting language is necessary (i.e., auditors issue the standard report) and that the auditors issue a separate report on the entity's internal control over financial reporting rather than a combined report.*

The major sections in the auditors' report for an issuer, as well as the major contents of these paragraphs, are:

1. Opinion on the Financial Statements Section:

- Identifies the financial statements and years examined examined by the audit team
- Expresses an opinion on the fairness of the financial statements
- Identifies the auditors' opinion and references the auditors' report on internal control over financial reporting

2. Basis for Opinion Section:

- Summarizes management's and the audit team's responsibility for the financial statements
- Indicates an audit was performed in accordance with PCAOB standards

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- Provides a brief overview of an audit examination.
- Indicates that the audit provides a reasonable basis for the opinion.

3. Critical Audit Matter Section:

- Identifies matters that relate to material accounts and disclosures that involved challenging, subjective, or complex judgments.
- Indicates that the identified matters do not affect the opinion on the financial statements.

c. An *unmodified opinion* indicates that the financial statements are presented in conformity with GAAP.

A *qualified opinion* indicates that that *except for* a relatively isolated (usually limited) matter, the entity's financial statements are presented in conformity with GAAP.

An *adverse opinion* concludes that the entity's financial statements are not presented in conformity with GAAP.

A *disclaimer of opinion* indicates that an opinion cannot be expressed on the entity's financial statements.

d. In the opinion paragraph of the auditors' report, the phrase "in all material respects" indicates that materiality has been considered by the auditors in evaluating the conformity of the financial statements with GAAP.

2.64 **Fundamental Principles**

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a. Responsibilities
b. Performance
c. Responsibilities
d. Reporting
e. Performance
f. Performance
g. Responsibilities
h. Reporting
i. Performance
j. Responsibilities

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2.65 **Comprehensive Principles Case Study**

Responsibilities

1.	Auditors are responsible for appropriate competence and capabilities to perform the audit.	1.	It was inappropriate for Holmes to hire the two students to conduct the audit. The examination must be conducted by persons with proper education and experience in the field of auditing. Inexperienced persons can assist, if they are supervised.
2.	Auditors are responsible for complying with relevant ethical requirements.	2.	To satisfy the independence requirement, Holmes must be 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.	Auditors are responsible for maintaining professional skepticism and exercising professional judgment throughout the planning and performance of the audit.	3.	The fact that Holmes merely accepted the financial statements without questioning any evidence demonstrates lack of professional skepticism (as well as a lack of good professional judgment).

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Performance

1.	The auditor must adequately plan the work and must properly supervise any assistants.	1. This element recognizes that early appointment of auditors has 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.	2. 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 entity and its environment.	3. Holmes did not study 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 about whether material misstatements exist.	4. No evidence was obtained 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.

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Reporting

1.	Based on evaluation of the evidence obtained, the auditor expresses, in the form of a written report, an opinion in accordance with the auditor's findings or states that an opinion cannot be expressed. The opinion states whether the financial statements are presented fairly, in all material respects, in accordance with the appropriate financial reporting framework.	1. Because a proper examination was not conducted, the report should indicate that no opinion can be expressed as to the fair presentation of the financial statements in accordance with generally accepted accounting principles.

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2.66 **Fundamental Principles (Comprehensive)**

a. This situation is related to the competence and capabilities element of the responsibilities principle. In this case, auditors can accept this engagement assuming that they take appropriate measures to obtain the knowledge necessary to perform the audit and understand important issues affecting this client. It is important to note that the existence of industry-specific accounting issues will require auditors to obtain the knowledge necessary to complete the engagement.

b. This situation is related to the reporting principle, which addresses the conformity of the financial statements with GAAP. If the client elects to treat these leases as operating leases in violation of GAAP, auditors should issue either a qualified or adverse opinion, depending upon the materiality of the departure from GAAP.

c. This situation is related to the performance principle, which indicates that the audit should be properly planned. In this case, auditors should evaluate whether the client's deadline will allow an audit to be properly planned and conducted according to generally accepted auditing standards. The fact that this would be an initial audit makes this possibility even more questionable than usual.

d. This situation is related to the performance principle, which requires auditors to obtain sufficient appropriate audit evidence. Given the low level of control risk, auditors would then proceed to perform the necessary auditing procedures, which provide the basis for their opinion on the client's financial statements. In this case, confirming a smaller number of customer accounts would be appropriate.

e. This situation is related to the responsibilities principle, which requires auditors to be independent. In this particular case, the fact that one of the partner's husband is an officer of the prospective client would likely result in the firm declining this particular engagement because of a lack of independence.

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f. This situation is related to the reporting principle. Auditors should insist upon disclosure of the potential litigation and, if the client refuses, issue either a qualified opinion or adverse opinion, depending upon the materiality of the omission of the disclosures. In addition, the auditors' report should provide information regarding the omitted disclosures.

g. This situation is related to the performance principle, which requires auditors to assess the risk of material misstatement, which includes obtaining an understanding of the entity and its internal control. Once this understanding has been obtained, auditors would then proceed to perform the necessary substantive audit procedures.

h. This situation is related to the performance principle, which requires proper planning and supervision. An important element of supervision is critical review of work performed by persons at various levels within the firm. Because the supervisor's review of the work performed by the assistant indicates that the work supports the opinion on the financial statements, no further actions are necessary.

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2.67 **Fundamental Principles (Comprehensive)**

a. Responsibilities: Auditors must consider financial relationships with prospective clients in evaluating their independence, which is related to complying with relevant ethical requirements.

b. Responsibilities: The critical assessment of evidence relates to professional skepticism, which is a component of the responsibilities principle.

c. Performance: The consideration of internal control is related to assessing the risk of material misstatement, which is a component of the performance principle.

d. Performance: Determining amounts that would influence the judgment of financial statement users is most closely related to the concept of materiality, which is a component of the performance principle.

e. Reporting: This is an appropriate form of report that could be issued by auditors if a significant scope limitation exists. The reporting principle notes that the auditors may indicate that an opinion cannot be expressed.

f. Responsibilities: Educational and experience requirements provide auditors with appropriate competence and capabilities, which is a component of the responsibilities principle.

g. Performance: The performance principle focuses on the requirement that auditors provide reasonable (and not absolute) assurance.

h. Responsibilities: Possessing the skills and knowledge of others in the profession characterizes due care, which is a component of the responsibilities principle.

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i. Performance: The preparation of a written audit plan is part of the requirement for planning the audit and supervising assistants, which is a component of the performance principle.

j. Reporting: The issuance of a qualified opinion because of a departure from GAAP is an example of the auditors' responsibility for expressing an opinion on the financial statements under the reporting principle.

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2.68 **Fundamental Principles (Comprehensive)**

a. While university-level training is important, it is also necessary that professionals continue their education throughout their careers, as accounting and auditing standards will change. In this particular case, the staff member would need to stay abreast of current developments in order to meet the competence and capabilities element of the responsibilities principle.

b. Auditors need to be both independent in fact and independent in appearance. While a small financial investment might not impair the auditors' actual state of mind (independence in fact), it is unlikely that financial statement users will perceive the auditor to be independent (independence in appearance). Professional standards would not consider the auditor independent in this case, as no direct financial interests in clients are permitted.

c. Professional skepticism represents a state of mind that is characterized by *appropriate* questioning and a critical assessment of audit evidence. When employing professional skepticism, auditors will not simply accept all evidence provided and assume that clients are unquestionably honest. However, the statement that "[y]ou really have to question everything the client tells you" is a bit exaggerative and goes beyond the concept of professional skepticism.

d. It is correct that internal evidence is generally of lower quality than external evidence. However, the necessary quality of evidence depends upon the risk of material misstatement and the effectiveness of the client's internal control. In this case, the staff auditor's statement that internal evidence is obtained because of time and cost considerations is not appropriate, unless the risk of material misstatement permits lower quality of evidence because of other reasons.

e. While appropriate planning will allow audits to be conducted on a timely basis, it is not appropriate for auditors to ignore transactions and events between the interim date (in this case, November 1) and the client's fiscal year end. Some testing would need to be performed following the year end for transactions occurring between November 1 and December 31.

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f. While the primary purpose of evaluating internal control is to determine the nature, timing, and extent of further audit procedures, auditors must still conduct some study of internal control to ensure that the condition of the client's internal control has not changed from prior years. If it has, the substantive tests performed by auditors may no longer be appropriate. In addition, for issuers, auditors are required to study internal control and report on the effectiveness of the client's internal controls.

g. For departures from GAAP, the choice among opinions would be between a qualified opinion (for less material departures) and an adverse opinion (for more material departures).

h. While the concept of materiality does consider dollar amounts and their effects on users' decisions, qualitative factors also need to be considered when assessing materiality. For example, a small dollar amount (in absolute terms) may influence an entity's ability to meet its earnings expectations or report higher earnings than in previous years. Situations such as this need to be considered as well as the absolute dollar amount of an item in assessing materiality.

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2.69 **System 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 client relationships and specific engagements
h. Leadership responsibilities for quality within the firm
i. Engagement performance

2.70 **Evaluating Quality Control**

a. PCAOB inspections involve a review of a sample of engagements conducted by a firm as well as an evaluation of that firm's system of quality control.

b. PCAOB inspections are conducted for firms that audit public clients; the frequency of PCAOB inspections is either annually (for firms auditing more than 100 issuers) or every three years (for firms auditing 100 or fewer issuers).

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2.71 **Internet Exercise: Public Company Accounting Oversight Board Inspection Reports**

NOTE TO INSTRUCTOR: If the PCAOB modifies the format of its inspection report, this solution may no longer be appropriate. The following represents the format of the PCAOB inspection reports as of Spring 2022.

a. The major information contained in PCAOB inspection reports includes the following:

- **Overview of Inspection and Historical Data**: Provides a summary (three years of data for annually inspected firms) of the following background information for engagements reviewed:
  - Number of audits reviewed
  - Method of selection (risk-based vs. random vs. target team selections)
  - Role of firm in audit (principal auditor vs. other)
  - Type of audit (integrated financial statements and internal control over financial reporting vs. financial statement audit only)

- **Part I.A Deficiencies Identified:** Provides a summary of data (three years of data for annual inspected firms) of the following:
  - Number of deficiencies identified
  - Types of audits in which deficiencies were observed (integrated financial statement and internal control over financial reporting vs. financial statement audit only)
  - Most frequent types of deficiencies
  - Audit areas most frequently reviewed
  - Audit areas with most frequent deficiencies
  - Audit standards associated with identified deficiencies
  - Deficiencies classified by industry sector and revenue range of client.
  - Audit deficiencies identified by the PCAOB inspection in current year (on an audit-by-audit basis)

- **Part I.B. Other Instances of Non-Compliance with PCAOB Standards or Rules** (situations in which deficiencies do not relate to sufficiency or appropriateness of audit evidence, but represent non-compliance with PCAOB standards or rules.

- **Part II: Observations Related to Quality Control** While this information is not provided in the portion of the report available to the "public" (via the PCAOB's website), these results will be made public by the PCAOB if the firm does not satisfactorily address deficiencies within one year of the date of the report.

- **Appendix A: Firm's Response to the Draft Inspection Report**

b – e. The answers here will depend up on the report selected by the student. It is important to emphasize that even the largest and most sophisticated firms have audit deficiencies. One interesting exercise is to randomly assign your students to reports (ensuring that all Big Four firms are covered) and compare the types and magnitude of deficiencies identified. In addition, having students evaluate whether the firm's response is appropriate in the circumstances is an interesting classroom exercise.

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