

# AUDITING AND ATTESTATION

## CHAPTER 1

### PROFESSIONAL STANDARDS, AUDIT PROCESS, AND AUDIT PLANNING

#### Magic Memory Outline<sup>®</sup>

I. OVERVIEW OF PROFESSIONAL STANDARDS	1-25
A. Exam Coverage.....	
B. Professional Standards.....	
C. AICPA Professional Standards.....	
1. Statements on Auditing Standards (SAS; AU).....	
a. SAS Interpretive Publications.....	
(1) Interpretations of the SASs.....	
(2) Appendixes to the Auditing Standards .....	
(3) AICPA Audit and Industry Guides .....	
(4) AICPA Auditing Statements of Position .....	
b. Other Auditing Publications .....	
c. AICPA Clarity Project .....	
(1) Objective.....	
(2) Further Developments .....	
2. Statements on Standards for Accounting and Review Services (SSARS; AR).....	
a. Contents .....	
b. Interpretive Publications.....	
3. Statements on Standards for Attestation Engagements (SSAE; AT) .....	
a. Reference .....	
b. Interpretive Publications.....	
4. Statements on Quality Control Standards (SQCS; QC) .....	
5. Standards for Performing and Reporting on Peer Reviews (PR).....	
6. Other AICPA Standards .....	
a. Standards for Consulting Services (CS).....	
b. Standards for Valuation Services (VS).....	
c. Statements on Responsibilities in Personal Financial Planning Practice (PFP)...	
d. Statements on Standards for Tax Services (TS).....	
D. SEC Regulations and PCAOB.....	
E. Government Auditing Standards (Yellow Book) .....	
F. Meaning of Terms in Professional Standards.....	
1. Unconditional Responsibility/Requirement.....	
2. Presumptively Mandatory Responsibility/Requirement .....	
3. Responsibility to Consider.....	

G. Attestation Versus Audit .....	
1. Attestation .....	
2. Audit.....	
3. Generally Accepted Auditing Standards .....	
4. Attestation Standards.....	
5. Comparison of GAAS and Attestation Standards .....	
H. GAAS Acronym: <b>TIP SAS ACDO</b> .....	
1. General Standards - <b>TIP</b> .....	
2. Standards of Fieldwork - <b>SAS</b> .....	
3. Reporting Standards - <b>ACDO</b> .....	
4. Audit Risk Versus Assurance (Inverse Relationship) .....	
II. CPA FIRM QUALITY CONTROL .....	1-32
A. Quality Control Standards .....	
1. System of Quality Control.....	
2. Documentation of System .....	
3. Communication of System .....	
4. Effect of Control System Deficiencies .....	
B. Quality Control Elements.....	
1. Leadership .....	
2. Relevant Ethical Requirements .....	
a. AICPA Fundamental Principles of Professional Ethics .....	
b. Maintaining Independence .....	
3. Acceptance and Continuation of Clients and Engagements.....	
4. Human Resources.....	
a. Recruitment and Hiring.....	
b. Competencies and Professional Development .....	
c. Professional Development.....	
d. Performance Evaluation, Compensation, and Advancement .....	
e. Engagement Partner Competence.....	
5. Engagement Performance.....	
a. Consistency in Quality of Engagement Performance .....	
b. Engagement Supervision.....	
c. Review of Work Performed .....	
d. Engagement Documentation .....	
e. Engagement Quality Control Review.....	
6. Monitoring.....	
C. Internal Monitoring Versus Peer Review .....	
D. Peer Review Program.....	
1. AICPA Peer Review Program.....	
a. Quality Control.....	
b. Peer Review.....	
c. Remedial Action.....	

2.	Types of Peer Reviews .....	
a.	System Reviews.....	
b.	Engagement Reviews.....	
3.	Administering Entity .....	
4.	Review Team .....	
5.	Standards for Performing and Reporting on Peer Reviews .....	
6.	Peer Review Report Grades.....	
7.	Sample System Review Report With Rating of <i>Pass</i> .....	
III.	AUDIT PROCESS OVERVIEW .....	1-38
A.	General and Preliminary Fieldwork.....	
B.	Fieldwork: Evidence Gathering.....	
C.	Report and Opinion .....	
IV.	AUDIT ACCEPTANCE AND CONTINUATION PROCEDURES .....	1-38
A.	Auditability.....	
B.	Environmental Factors.....	
C.	Communication Between Predecessor and Successor Auditors.....	
1.	Fraud.....	
2.	Integrity.....	
3.	Reason for Change.....	
4.	Disagreement .....	
D.	Additional Communication with Predecessor Auditor.....	
E.	Predecessor Responsibility .....	
F.	Problem Situations and Evaluating Their Impact.....	
V.	PRELIMINARY PLANNING .....	1-40
A.	Pre-Engagement Planning .....	
1.	Establish Overall Audit Strategy .....	
a.	Characteristics of the Engagement .....	
b.	Reporting Objectives .....	
c.	Important Overall Factors.....	
2.	Analytical Procedures.....	
3.	Involvement of Professionals with IT Skills .....	
4.	Develop Audit Plan/Program.....	
5.	Planning Communications with Management and Those Charged with Governance .....	
a.	Management .....	
b.	Those Charged with Governance.....	
c.	Audit Committee or Other Subgroup of Those Charged with Governance .....	
d.	Matters to Communicate .....	
e.	Form of Communication and Restricted Use .....	

B. Understanding With Client/Engagement Letter .....	
1. Requirements.....	
a. Objectives of the Engagement.....	
b. Management’s Responsibilities.....	
c. Auditor’s Responsibilities .....	
d. Limitations of the Engagement .....	
2. Components of an Engagement Letter .....	
a. Typical Matters.....	
b. Additional Matters That May Be Addressed.....	
3. Client Representation Letter.....	
C. Objectives and Responsibilities for Integrated Audit (PCAOB).....	
1. Objective of Integrated Audit.....	
2. Additional Management Responsibilities .....	
3. Additional Auditor’s Responsibilities.....	
VI. RISK ASSESSMENT AND FURTHER TESTING	1-45
A. Understand Entity and Environment, Including Internal Controls.....	
B. Obtain Sufficient Appropriate Evidence (Tests of Controls and Substantive Testing).....	
C. Completion of the Audit.....	
VII. REPORTING	1-46
A. Standard Unmodified Report.....	
B. Departures from the Standard Report.....	

# AUDITING AND ATTESTATION

## CHAPTER 1

### PROFESSIONAL STANDARDS, AUDIT PROCESS, AND AUDIT PLANNING

#### I. OVERVIEW OF PROFESSIONAL STANDARDS

##### A. Exam Coverage

This section of the exam tests the candidate's knowledge of professional standards, auditing procedures, and auditing standards generally accepted in the United States of America (GAAS). This section also tests skills needed to conduct attestation engagements, reviews, and compilations.

##### B. Professional Standards

The table below summarizes the major professional standards that are addressed on this part of the CPA exam. The text following the table describes each set of standards in more detail.

The far-right column refers to the prefix used in the AICPA's electronic database of professional standards. International audit standards are discussed in Chapter 8.

<b>SUMMARY OF MAJOR PROFESSIONAL STANDARDS</b>		
<b>AICPA PROFESSIONAL STANDARDS</b> These standards can be accessed on the AICPA's web site at <a href="http://www.aicpa.org">www.aicpa.org</a> . When preparing for the CPA exam, candidates can obtain a free six-month online subscription. Information is available at <a href="http://www.cpa-exam.org">www.cpa-exam.org</a> , and access can be requested at <a href="http://www.nasba.org/NASBAWeb.nsf/ENCD">www.nasba.org/NASBAWeb.nsf/ENCD</a> .		
Audits of Financial Statements—Non-issuers (i.e., private companies not subject to SEC and PCAOB regulations)	Statements on Auditing Standards (SAS)	AU
Reviews & Compilations of Financial Statements—Nonpublic Entities	Statements on Standards for Accounting and Review Services (SSARS)	AR
Attest Services Not Addressed by Other Standards	Statements on Standards for Attestation Engagements (SSAE)	AT
Professional Responsibilities of CPAs, Including Those in Public Practice, Industry, Government, and Education	Code of Professional Conduct (See Chapter 8)	ET
Quality Control for CPA Firms	Statements on Quality Control Standards (SQCS)	QC
AICPA Peer Review Program	Standards for Performing and Reporting on Peer Reviews	PR
<b>STANDARDS FOR PUBLIC COMPANY ENGAGEMENTS</b>		
Audits of Financial Statements and Internal Control—Issuers (entities filing with the U.S. Securities and Exchange Commission)	Public Company Accounting Oversight Board available at <a href="http://www.pcaobus.org">www.pcaobus.org</a>	PCAOB

<b>STANDARDS FOR INTERNATIONAL AUDITS</b>		
Audits of Entities in Countries That Recognize or Require Standards Issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC)	International Standards on Auditing available at <a href="http://www.ifac.org">www.ifac.org</a>	ISA
<b>STANDARDS FOR GOVERNMENTAL AUDITS</b>		
Audits of Governments and Other Entities Receiving Federal Financial Assistance	Government Auditing Standards (“The Yellow Book”) available at <a href="http://www.gao.gov">www.gao.gov</a>	GAGAS

### **C. AICPA Professional Standards**

**1. Statements on Auditing Standards (SAS; AU):** These pronouncements are issued by the Auditing Standards Board (ASB) of the AICPA. SASs usually provide detailed implementations of the general concepts reflected in generally accepted auditing standards (GAAS). These statements relate to specific topics and audit procedures. SASs are intended to clarify the meaning of GAAS. The AICPA issues a Codification of SASs by topic rather than by sequence of adoption. The Codification is part of the AICPA Professional Standards, and is referred to as “U.S. Auditing Standards.” These standards are discussed in all chapters of this text.

During research tasks on the CPA exam, you will be required to correctly identify the prefix, section number, and paragraph number (such as AU 311.05). The prefix is “AU.” Section numbers consist of either two or three digits, sometimes followed by a capital letter (e.g., 311 or 337A). Paragraphs contain two or three digits.

**a. SAS Interpretive Publications:** Interpretative publications are not auditing standards but are issued under the authority of the ASB. They are recommendations on the application of the SASs in specific circumstances, including engagements for entities in specialized industries. The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance. Interpretative publications include:

**(1) Interpretations of the SASs:** Interpretations are issued by the Audit Issues Task Force of the Auditing Standards Board to provide timely guidance on the application of pronouncements of that Board. Interpretations are reviewed by the Auditing Standards Board. In the codification of professional standards, SAS interpretations have 4-digit numbers beginning with the number 9 followed by three digits for the related AU section. For example, interpretations of AU section 311 are numbered 9311.

**(2) Appendixes to the Auditing Standards:** Generally, these are not tested.

**(3) AICPA Audit and Industry Guides:** Again, the CPA exam does not usually test rules and applications of particular industries.

**(4) AICPA Auditing Statements of Position:** These may be reflected in the CPA exam and the Rigos text incorporates relevant statements in our text.

**b. Other Auditing Publications:** Other auditing publications have little or no authoritative status. However, they may help the auditor understand and apply auditing standards. If an auditor applies the auditing guidance included in another auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. In determining whether another auditing publication is appropriate, the auditor may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying the auditing standards and the degree to which the issuer or author is recognized as an authority in auditing matters.

Other auditing publications include AICPA auditing publications not referred to above; auditing articles in the *Journal of Accountancy* and other professional journals; continuing professional education programs and other instruction materials, textbooks, guide books, audit programs, and checklists; and other auditing publications from state CPA societies, other organizations, and individuals.

**c. AICPA Clarity Project:** The AICPA has completed the process to redraft and replace most of the existing audit standards with new standards, effective for audits of financial statements for periods ending on or after December 15, 2012. These new standards are testable on exams beginning July, 2013, and this edition is accordingly so updated.

**(1) Objective:** The project is designed to make the audit standards easier to read, understand, and apply. The U.S. standards are also being modified to converge with International Standards on Auditing. The vast majority of changes do not alter the material to be tested on the CPA exam; most of the audit concepts and practices will remain similar to prior standards. However, a significant change is that the “general,” “fieldwork,” and “reporting” standards (acronym **TIP SAS ACDO**, introduced in this chapter) will be replaced by a new framework consisting of an overall objective for the auditor and individual objectives for each section of the audit standards. CPA candidates should expect the new and/or amended standards to gradually be tested in July 2013.

**(2) Further Developments:** This edition of the Rigos textbook incorporates the new standards in various places where terminology is changed or introduced, or where major changes in practice have been approved through issuance of final standards. Additional changes to the audit standards are expected to occur as the AICPA completes the integration of U.S. standards to those of the International Standards on Auditing (ISAs).

**2. Statements on Standards for Accounting and Review Services (SSARS; AR):** These pronouncements are issued by the AICPA Accounting and Review Services Committee (ARSC).

**a. Contents:** They provide standards for review and compilation (unaudited) services provided to non-public entities. Their references in the codification of AICPA Professional Standards begin with the prefix “AR” followed by a two- or three-digit section number, followed by a two- or three-digit paragraph number (e.g., AR 200.32). Chapter 7 discusses the details of these standards.

**b. Interpretive Publications:** As with the SASs discussed above, a variety of interpretive publications exist for the SSARS. These publications include Interpretations of the SSARS, appendixes to the SSARS, AICPA guides, and AICPA Statements of Position (if relevant

to compilations or reviews). Interpretive publications are not as authoritative as the SSARS, but CPAs should be aware of them and may need to justify departures.

**3. Statements on Standards for Attestation Engagements (SSAE; AT):** These statements direct the conduct of attest services applied to other than traditional financial statements. They apply to attest services not addressed by the SASs or SSARS and rendered by a CPA in the practice of public accounting.

**a. Reference:** Their references in the codification of AICPA Professional Standards begin with the prefix “AT” followed by a two- or three-digit section number, followed by a two- or three-digit paragraph number (e.g., AT 101.26). For material provided in an appendix to the attestation standards, the paragraph number will be preceded by a capital letter referring to the appendix (e.g., AT 801.A68). Chapter 7 discusses the details of these standards.

**b. Interpretive Publications:** As with the SASs and SSARSs discussed above, a variety of interpretive publications exist for the SSAEs. These publications include Interpretations of the SSAEs, appendixes to the SSAEs, AICPA guides, and AICPA Statements of Position (if relevant to attestation engagements). Interpretive publications are not as authoritative as the SSAEs, but CPAs should be aware of them and may need to justify departures.

**4. Statements on Quality Control Standards (SQCS; QC):** These standards are issued by the Auditing Standards Board. Firms that are enrolled in an Institute-approved practice-monitoring program must adhere to the quality control standards. Their references in the codification of AICPA Professional Standards begin with the prefix “QC” followed by a two-digit section number, followed by a two- or three-digit paragraph number (e.g., QC 10.107). These standards are discussed in more detail later in this chapter.

**5. Standards for Performing and Reporting on Peer Reviews (PR):** These standards provide guidance for administering, planning, performing, and reporting on peer reviews of CPA firms (and individual CPAs) enrolled in the AICPA Peer Review Program. Their references in the codification of AICPA Professional Standards begin with the prefix “PR” followed by a three-digit section number, followed by a two- or three-digit paragraph number (e.g., PR 100.17). These standards are discussed later in this chapter.

**6. Other AICPA Standards:** Committees of the AICPA issue various other standards to assist CPAs in conducting non-attest services. These standards include:

**a. Standards for Consulting Services (CS):** These standards are issued by the AICPA Consulting Services Executive Committee. They provide guidance for consulting services provided by CPAs.

**b. Standards for Valuation Services (VS):** These standards are issued by the AICPA Consulting Services Executive Committee. They provide guidance for valuation services provided by CPAs.

**c. Statements on Responsibilities in Personal Financial Planning Practice (PFP):** These standards are approved by the Personal Financial Planning Executive Committee of the AICPA.

**d. Statements on Standards for Tax Services (TS):** These standards are approved by the Tax Executive Committee of the AICPA.

#### **D. SEC Regulations and PCAOB**

Audits of “issuers,” or publicly held companies, are subject to Securities and Exchange Commission (SEC) requirements, including the provisions of the Sarbanes-Oxley Act. The Act created the Public Company Accounting Oversight Board (PCAOB), which establishes auditing standards subject to approval by the SEC. The SEC has a three-part mission which is to protect investors, maintain fair, orderly, and efficient public markets, and facilitate capital formation.

For audits of publicly-traded companies, the PCAOB standards override any conflicting standards issued by the AICPA. In research tasks, PCAOB standards are referenced with the prefix “PCAOB” followed by a one- or two-digit standard number, followed by a paragraph number of up to three digits (e.g., PCAOB AS 4, Par. 51). These standards are discussed throughout the chapters.

#### **E. Government Auditing Standards (Yellow Book)**

These standards are issued by the U.S. General Accounting Office (GAO) and must be followed for audits of both governmental and non-governmental entities receiving federal government financial assistance. More information is provided in Chapter 7.

#### **F. Meaning of Terms in Professional Standards**

The language used in the auditing standards is sometimes ambiguous. The following definitions help CPAs understand the meaning of terms as they apply to auditor responsibilities/requirements.

**1. Unconditional Responsibility/Requirement:** The words “must,” “shall,” and “is required” indicate unconditional responsibilities. If the circumstance applies to an audit, the auditor is always required to comply. PCAOB standards use the term “unconditional responsibility,” whereas AICPA quality control standards use the term “unconditional requirements.”

**2. Presumptively Mandatory Responsibility/Requirement:** The word “should” indicates responsibilities that are presumptively mandatory. The auditor must comply except in rare cases when the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. PCAOB standards use the term “presumptively mandatory responsibility,” whereas AICPA quality control standards use the term “presumptively mandatory requirements.”

**3. Responsibility to Consider:** The words “may,” “might,” “could,” and other similar terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor’s attention and understanding. How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances consistent with the objectives of the standard.

#### **G. Attestation Versus Audit**

**1. Attestation:** An attestation is a type of engagement in which an attester (“auditor” – “practitioner” – “accountant”) provides a report as to whether an assertion (made by an assertor – “management”) has been prepared in conformity with the appropriate criteria. The purpose is to ascertain the degree of correspondence between those assertions and established criteria and to

communicate the results to interested users. Attestations include financial statement audits, reporting on forecasts, projections, pro-forma information, effectiveness of internal control, or the client's compliance with specified laws and regulations, or contracts, or grants. However, the Attestation Standards apply only to situations not addressed by other professional standards. (Details are provided in Chapter 7.)

**2. Audit:** An audit is a type of attest function in which an auditor provides an independent opinion (positive assurance) about whether management (asserter) has prepared financial statements in conformity with an applicable financial reporting framework (criteria). Appropriate reporting frameworks include U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS).

**3. Generally Accepted Auditing Standards (GAAS):** These are the minimum standards required of an auditor in the execution of an audit engagement. GAAS provide a measure of audit quality and the objectives to be achieved in an audit. Expressed in a more operational sense, these ten generally accepted auditing standards are general guidelines used by the profession and the auditor when exercising professional judgment in the conduct of an audit. The standards are intended to provide guidance to the process of auditing. The ultimate legal question is whether the auditor adhered to reasonable standards under the circumstances.

*Auditing procedures* differ from *auditing standards*. Auditing procedures are acts that the auditor performs during the course of an audit to comply with auditing standards.

**4. Attestation Standards:** These standards are similar to GAAS, but they establish a broad framework for and set reasonable boundaries around a variety of attest services increasingly demanded of the accounting profession. Attestation standards provide guidance to improve the consistency and quality of attest engagements. The CPA is using their auditing and reporting skills in evaluating management performance variables beside management prepared financial statements.

### 5. Comparison of GAAS and Attestation Standards

Generally Accepted Auditing Standards (AU)	Attestation Standards (AT)
<b>General Standards</b>	
<ol style="list-style-type: none"> <li>1. The auditor must have adequate technical training and proficiency to perform the audit.</li> <li>2. The auditor must maintain independence in mental attitude in all matters relating to the audit.</li> <li>3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.</li> </ol>	<ol style="list-style-type: none"> <li>1. The practitioner must have adequate technical training and proficiency to perform in the attestation engagement.</li> <li>2. The practitioner must have adequate knowledge of the subject matter.</li> <li>3. The practitioner must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users.</li> <li>4. The practitioner must maintain independence in mental attitude in all matters relating to the engagement.</li> <li>5. The practitioner must exercise due professional care in the planning and performance of the engagement and the preparation of the report.</li> </ol>

Generally Accepted Auditing Standards (AU)	Attestation Standards (AT)
<b>Fieldwork Standards</b>	
<ol style="list-style-type: none"> <li>1. The auditor must adequately plan the work and must properly supervise any assistants.</li> <li>2. 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, timing, and extent of further audit procedures.</li> <li>3. 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.</li> </ol>	<ol style="list-style-type: none"> <li>1. The practitioner must adequately plan the work and must properly supervise any assistants.</li> <li>2. The practitioner must obtain sufficient evidence to provide a reasonable basis for the conclusion that is expressed in the report.</li> </ol>
<b>Reporting Standards</b>	
<ol style="list-style-type: none"> <li>1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles.</li> <li>2. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.</li> <li>3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.</li> <li>4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.</li> </ol>	<ol style="list-style-type: none"> <li>1. The practitioner must identify the subject matter or the assertion being reported on and state the character of the engagement in the report.</li> <li>2. The practitioner must state the practitioner's conclusion about the subject matter or the assertion in relation to the criteria against which the subject matter was evaluated.</li> <li>3. The practitioner must state all of the practitioner's significant reservations about the engagement, the subject matter, and, if applicable, the assertion related thereto in the report.</li> <li>4. The practitioner must state in the report that the report is intended solely for the information and use of the specified parties under the following circumstances: <ul style="list-style-type: none"> <li>• When the criteria used to evaluate the subject matter are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria</li> <li>• When the criteria used to evaluate the subject matter are available only to specified parties</li> <li>• When reporting on subject matter and a written assertion has not been provided by the responsible party</li> <li>• When the report is on an attestation engagement to apply agreed-upon procedures to the subject matter.</li> </ul> </li> </ol>

## H. GAAS Acronym: TIP SAS ACDO

An acronym to help you memorize the ten elements of generally accepted auditing standards is:

### T I P S A S A C D O

**T** -- Technical training and proficiency of auditor

**I** -- Independence in fact and in appearance

**P** -- Professional Care in performing the audit

**S** -- Supervision of assistants and planning of the engagement

**A** -- Assess risk of material misstatement

**S** -- Sufficient appropriate evidence (tests of controls & substantive procedures)

**A** -- According to GAAP

**C** -- Consistent application

**D** -- Disclosures adequate

**O** -- Opinion expressed

**1. General Standards - TIP:** The general standards address the emotional, ethical and personal characteristics that all auditors should possess in order to properly discharge their professional responsibilities.

**2. Standards of Fieldwork - SAS:** The second group of standards is concerned with planning, risk assessment, and audit evidence. The fieldwork standards apply to subjects such as the supervision of personnel, the planning of audit work, assessment of risks that the financial statements will be materially misstated, and the nature, timing, and extent of audit procedures.

**3. Reporting Standards - ACDO:** The final group of standards concerns the nature and required content of the auditor's report. It requires that consistent application of controlling accounting principles be applied. An unmodified opinion of "fairly represents" is desirable.

**4. Audit Risk Versus Assurance (Inverse Relationship):** Reasonable assurance is the degree of confidence that an auditor should obtain to allow expression of an opinion on the financial statements. The auditor must obtain sufficient appropriate audit evidence to reduce audit risk to a low level, which means that there is a high, but not absolute, level of assurance about whether the financial statements are free of material misstatement. The nature of audit evidence and the characteristics of fraud prevent auditors from obtaining absolute assurance. Accordingly, an auditor who exercises due professional care may not detect a material misstatement.

## II. CPA FIRM QUALITY CONTROL

Quality control standards relate to the conduct of a firm's audit and/or attest practice as a whole, while generally accepted auditing standards and attestation standards relate to the conduct of individual audit and attestation engagements. Thus, generally accepted auditing standards and attestation standards are both related to quality control standards.

Firms that are enrolled in an AICPA-approved practice-monitoring program must adhere to Statements on Quality Control Standards (SQCS), issued by the AICPA's Auditing Standards Board. Firms that conduct audits of listed companies must comply with PCAOB quality standards.

### **A. Quality Control Standards**

Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control*, supersedes previous quality control standards and is effective January 1, 2009.

**1. System of Quality Control:** Firms must establish a system of quality control designed to provide reasonable assurance that the firm and its personnel comply with professional standards as well as with legal and regulatory requirements. The system applies to all audit, attestation, review, and compilation engagements.

**2. Documentation of System:** The firm's quality control policies and procedures must be documented. The extent of documentation depends on the size, structure, and type of work performed by the firm. Large multi-office firms would usually have more extensive documentation than small single-office firms.

**3. Communication of System:** The firm should communicate quality control system to personnel either orally or in writing. An effective communication would (a) describe the quality control objectives, policies, and procedures, (b) convey the idea that each individual is responsible for quality, and (c) emphasize that each individual should provide the firm with feedback on the quality control system.

**4. Effect of Control System Deficiencies:** Deficiencies in or instances of noncompliance with a firm's quality control policies and procedures do not, by themselves, indicate that a particular audit or attest engagement was not performed in accordance with professional standards. However, such deficiencies increase the likelihood that individual engagements will fail to comply with professional standards.

### **B. Quality Control Elements**

The firm's system of quality control must include the following components:

**1. Leadership:** Responsibilities for quality within the firm begins with the "tone at the top," which influences the firm's internal culture. Firm leadership must make it clear that the quality of work overrides commercial considerations and assign responsibility for quality control to personnel having appropriate experience and authority. An overarching commitment to quality must also be reflected in the firm's systems for performance evaluation, compensation, incentives, and advancement.

**2. Relevant Ethical Requirements:** The firm must establish policies and procedures to provide reasonable assurance that ethical requirements are met.

**a. AICPA Fundamental Principles of Professional Ethics:** Policies and procedures for ethical requirements should be designed to address the AICPA's fundamental principles of professional ethics: responsibilities, the public interest, integrity, objectivity and independence, due care, and scope and nature of services.

**b. Maintaining Independence:** Because of its importance, independence should be addressed specifically. Policies and procedures should address the independence requirements of the AICPA Code of Professional Conduct as well as the familiarity threat that may impair independence when the same senior personnel conduct an audit or attest engagement over long periods of time. Policies and procedures must provide for prompt notification and correction of any independence violations. In addition, all firm personnel subject to independence requirements must provide a confirmation (written or in electronic form) at least annually of compliance with independence requirements.

**3. Acceptance and Continuation of Clients and Engagements:** The firm must have policies and procedures for acceptance and continuation of client relationships as well as individual engagements. (See later section in this chapter for more details). In addition, significant issues related to client/engagement acceptance and continuation must be documented.

**4. Human Resources:** A firm's quality control system depends heavily on the proficiency of its personnel. The quality of a firm's work ultimately depends on the capabilities, competence, and commitment to ethical principles of personnel who perform, supervise, and review the work. Accordingly, policies and procedures should be established to provide reasonable assurance in the following areas:

**a. Recruitment and Hiring:** Personnel are hired who possess the appropriate characteristics to enable them to perform competently and with integrity.

**b. Competencies and Professional Development:** The firm is responsible for assessing the capabilities and competencies to ensure that personnel have the degree of technical training, proficiency, and other competencies required in the circumstances for each engagement.

**c. Professional Development:** Personnel should be encouraged to participate in appropriate professional development activities to fulfill assigned responsibilities, comply with requirements of the AICPA and other regulatory agencies, and encourage passing the Uniform CPA Examination. Capabilities and competencies may be developed through professional education, training, and work experience. In addition, the competence of less experienced personnel may be enhanced through appropriate supervision, mentoring, and teamwork.

**d. Performance Evaluation, Compensation, and Advancement:** Performance quality and adherence to ethical principles should be incorporated into the firm's policies and procedures for performance evaluation, compensation, and advancement.

**e. Engagement Partner Competence:** Because of the importance of the engagement partner to overall work performance, the firm should provide policies and procedures to provide reasonable assurance regarding the competence of the engagement partner. Appropriate competence depends on the specific client and engagement and may be obtained through prior work in public accounting or through relevant industry, governmental, and academic experiences. In addition, competence may be enhanced through appropriate continuing professional education or other training. Required competencies include:

- Understanding of the role of a system of quality control and the AICPA Code of Professional Conduct
- Understanding of the service to be performed
- Technical proficiency
- Familiarity with the industry
- Professional judgment
- Understanding the organization's information technology systems

**5. Engagement Performance:** To provide reasonable assurance that engagements consistently comply with professional standards and other legal requirements, policies and procedures should address the following areas:

**a. Consistency in Quality of Engagement Performance:** Consistency in quality is often enhanced through use of standardized procedure manuals, software tools, checklists, questionnaires, work programs, and other guidance materials.

**b. Engagement Supervision:** Policies are typically used to monitor the progress of engagements, modify engagement plans as needed, assign appropriate personnel, ensure that significant issues are addressed appropriately, and facilitate consultation with more experienced team members.

**c. Review of Work Performed:** Qualified team members should review the work of other team members on a timely basis to ensure that the work meets professional standards and that appropriate conclusions are reached.

**d. Engagement Documentation:** Policies should ensure that engagement documentation requirements are met (see details in Chapter 2).

**e. Engagement Quality Control Review:** Firms must establish criteria for performing an objective quality control review of individual engagements. Each engagement review should be conducted by one or more partners or other qualified individuals who were not part of the engagement team (often referred to as an *engagement quality reviewer*, *second partner*, or *concurring partner*). The review may be conducted during or after completion of fieldwork, but should be completed in enough time to allow resolution of any significant issues before release of the firm's report. The review should include:

- Reviewing selected engagement documentation
- Objectively evaluating the significant judgments and conclusions of the engagement team
- Reading the financial statements or other subject matter
- Considering the appropriateness of the report
- Discussing significant findings and issues with the engagement partner

**6. Monitoring:** Monitoring provides reasonable assurance to the firm and its engagement partners that the firm's system of quality control is adequately designed and operating effectively (similar to procedures described in Chapter 3). Monitoring procedures may include engagement quality control reviews as well as inspection of documentation for a sample of completed engagements. The monitoring function must be under the responsibility of a person having appropriate objectivity and authority. The firm must evaluate deficiencies and recommendations for remedial action, and a system must exist for addressing complaints/allegations of non-compliance. The results of monitoring should be communicated to firm leaders, engagement partners, and other relevant parties at least annually.

### **C. Internal Monitoring Versus Peer Review**

Monitoring consists of quality review activities performed inside a firm, whereas a peer review consists of similar activities performed by outsiders. Some of the activities are likely to be the same for both types of reviews. Therefore, a peer review conducted under standards established by the AICPA (see below) may substitute for internal inspection of engagement working papers, reports, and clients' financial statements. This option may be particularly useful for smaller CPA firms, which often lack sufficient numbers of experienced personnel to conduct independent internal monitoring.

## **D. Peer Review Program**

Members of the AICPA who are engaged in the practice of public accounting in the United States or its territories are required to be practicing in a firm that is enrolled in an approved practice-monitoring program or, if practicing in a firm not eligible to enroll, are themselves enrolled in such a program. Enrollment is required if the firm or individual performs engagements covered by:

- Statements on Auditing Standards (SASs)
- Statements on Standards for Accounting and Review Services (SSARS)
- Statements on Standards for Attestation Engagements (SSAEs)
- Government Auditing Standards (the Yellow Book), issued by the U.S. Government Accountability Office (GAO)
- Audits of non-SEC issuers performed pursuant to the standards of the Public Company Accounting Oversight Board (PCAOB) (*Note: Reviews for listed companies are performed by the PCAOB and, therefore, are not covered by the AICPA Peer Review Program*).

**1. AICPA Peer Review Program:** The goal of the AICPA Peer Review Program is to promote the quality of services provided by CPA firms, advance the public interest, and enhance significance of AICPA membership. Firms (and individuals) in the AICPA peer review program must

**a. Quality Control:** Establish and maintain appropriate quality control policies and procedures

**b. Peer Review:** Obtain independent peer reviews at least once every three years

**c. Remedial Action:** Take remedial, corrective actions as needed

### **2. Types of Peer Reviews:**

**a. System Reviews:** Firms which perform audit/examination engagements under the SASs, Government Auditing Standards or examinations of prospective financial statements under the SSAEs have peer reviews called system reviews.

**b. Engagement Reviews:** Firms which perform only review or compilation services under SSARS and/or services under the SSAEs not included in system reviews have peer reviews called engagement reviews.

**3. Administering Entity:** Peer reviews should be carried out under the supervision of a state CPA society, group of state CPA societies, the AICPA Peer Review Board's National Peer Review Committee (National PRC), or other entity approved by the AICPA Peer Review Board to administer peer reviews.

**4. Review Team:** A review team may be formed by a CPA firm engaged by the firm under review (a firm-on-firm review) or an association of CPA firms authorized by the board to assist its members in forming review teams (an association-formed review team). For Engagement Reviews, review teams may consist of a committee-appointed review team (called a CART review) formed by the administering entity.

All review team members must be independent of the firm under review, be members of the AICPA, have current accounting/auditing experience in a supervisory capacity (typically manager or partner), have at least five years' recent accounting/auditing experience in public accounting, and be associated with a firm that has received a report with a peer review rating of *pass*. The team captain must meet additional requirements.

**5. Standards for Performing and Reporting on Peer Reviews:** These standards describe how peer reviews should be conducted and peer review reports should be prepared under the AICPA Peer Review Program. Their numbers in the Codification begin with “PR”.

**6. Peer Review Report Grades:** Each peer review results in one of the following three overall conclusions about a firm’s system of quality control:

- Pass
- Pass with deficiency
- Fail

**7. Sample System Review Report With Rating of *Pass***

*[Firm letterhead for a firm-on-firm review; team captain’s firm letterhead for an association-formed review team.]*

**SYSTEM REVIEW REPORT**

August 31, 20XX

To the Partners *[or other appropriate terminology]* of Able, Baker & Co.  
and the Peer Review Committee of the *[name of administering entity]*

We have reviewed the system of quality control for the accounting and auditing practice of Able, Baker & Co. (the firm) in effect for the year ended June 30, 20XX. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to express an opinion on the design of the system of quality control and the firm’s compliance therewith based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a System Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

In our opinion, the system of quality control for the accounting and auditing practice of Able, Baker & Co. in effect for the year ended June 30, 20XX, has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)* or *fail*. Able, Baker & Co. has received a peer review rating of *pass*.

*[Name of team captain’s firm]*

### III. AUDIT PROCESS OVERVIEW

The overall audit process is illustrated below. Each of these audit steps is discussed in detail in this and subsequent chapters.

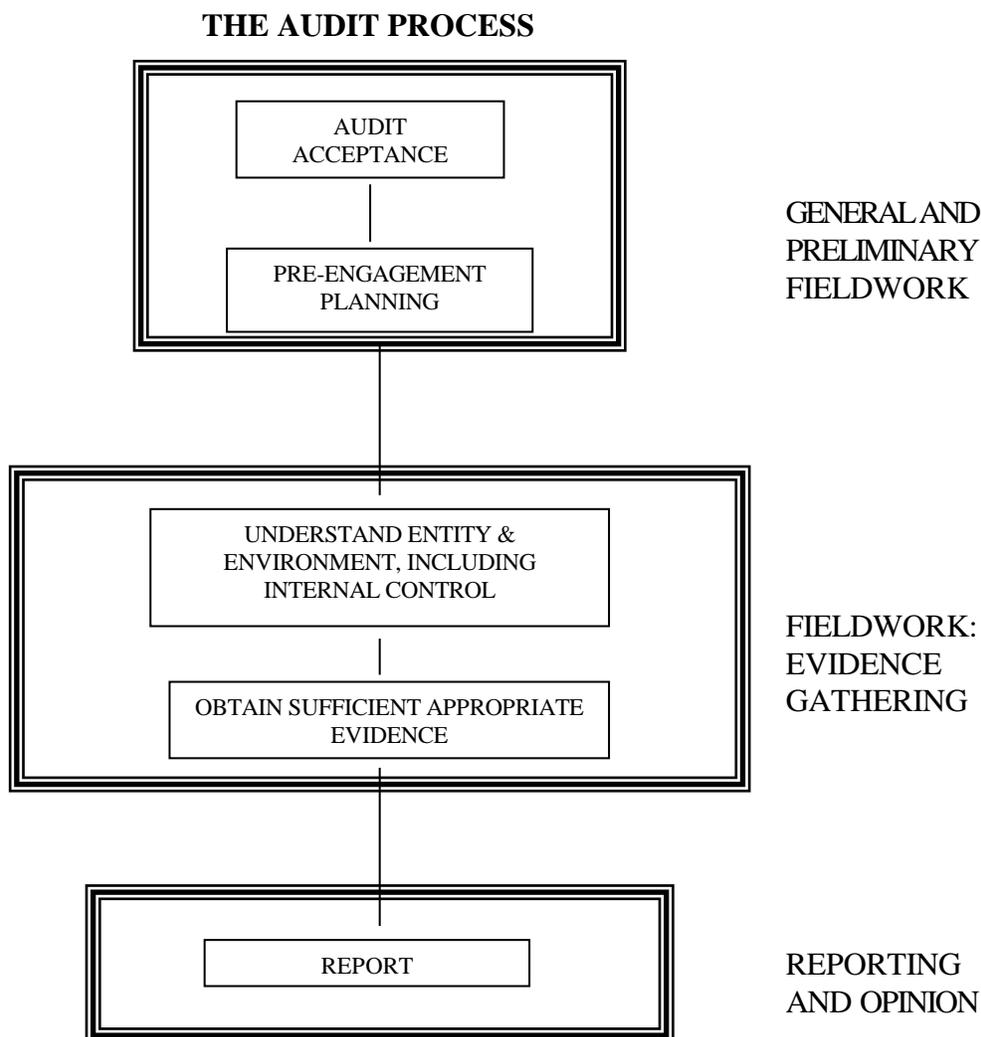


Figure 1-1

### IV. AUDIT ACCEPTANCE AND CONTINUATION PROCEDURES

The auditor must decide whether to accept a new client or to continue to audit an existing client. CPA firms are required by quality control standards (see earlier section in this chapter) to have procedures in place to determine acceptability of client relationships and engagements. Although this section of the chapter focuses on audit clients, similar issues must be considered for non-audit services.

Before accepting a client or engagement, a CPA firm must establish that it has personnel with appropriate capabilities and competence and other needed resources. This evaluation includes consideration of factors such as industry information, regulatory requirements, special accounting issues, and prior experience with the client. In addition, the firm must verify that it can comply

with legal and ethical requirements (including independence). Additional factors related to the client are described below.

### **A. Auditability**

The auditability of a client must be evaluated. Auditability may be adversely impacted by problems such as:

- Inability to obtain sufficient appropriate evidence.
- Significant client-imposed limits on the nature, timing or extent of audit procedures (i.e., scope limitations).
- Problems regarding the timing of key audit procedures such as observing the count of physical inventories.
- Inadequate or incomplete client accounting records.

### **B. Environmental Factors**

These audit-related factors could be combined with four key environmental factors which influence the auditability of a client. These include:

- Integrity of the client, including reputation of key managers, principal owners, related parties, and those charged with governance.
- Control consciousness of client.
- Presence of competent, trustworthy employees.
- Presence or absence of unique industry or economic risk factors.

### **C. Communication Between Predecessor and Successor Auditors**

A successor auditor must communicate with the predecessor auditor before accepting an audit engagement. To perform the communication, the successor first must obtain permission from the client; otherwise, the predecessor cannot disclose confidential information. If the client refuses, the successor auditor should inquire about the reasons and consider the implications for whether to accept the engagement. The communication may be oral or written, but any oral communications must be documented.

The successor auditor should inquire of the predecessor about at least the following four **FIRD** concerns:

1. **Fraud**: Communications to audit committees or another with equivalent authority and responsibility regarding fraud, illegal acts by clients, and internal-control-related matters.
2. **Integrity**: Information that might bear on the integrity of management.
3. **Reason for Change**: The predecessor auditor's understanding about the reasons for the change of auditors.

**4. Disagreement:** Disagreements with management as to accounting principles, auditing procedures, or other significant auditor-client matters. Questions here may be important, particularly if management and the auditor's positions were adverse and the amount at issue was large.

#### **D. Additional Communication with Predecessor Auditor**

The successor auditor should also consider inquiring about other areas of audit significance, such as the following. These communications may take place after the engagement has been accepted.

- Permission to review the prior year audit documentation.
- Any inadequacies in the client's financial data.
- Any accounting services needed prior to audit report.
- Any particular problem areas that required extra time.
- The amount of cooperation received from the client.

#### **E. Predecessor Responsibility**

The predecessor auditor is required to respond promptly and fully to the successor's inquiries unless he indicates that the response is limited. The predecessor accountant may use his or her judgment to decide which audit documentation, if any, to make available to the successor.

#### **F. Problem Situations and Evaluating Their Impact**

The predecessor auditor may indicate various problems experienced with the client, such as disputes concerning audit procedures or fees or application of accounting principles. If there is an ongoing dispute or legal problem with the client, the predecessor auditor may state that no information will be provided. In such situations, the successor auditor will want to make further investigation if any other problem situations are present. This analysis should be made before deciding to accept the client.

### **V. PRELIMINARY PLANNING**

#### **A. Pre-Engagement Planning**

##### **1. Establish Overall Audit Strategy:**

**a. Characteristics of the Engagement:** The auditor should establish the scope of work to be performed, which is influenced by the basis of reporting (e.g., U.S. GAAP), industry-specific reporting requirements, and entity locations.

**b. Reporting Objectives:** The auditor should determine the reporting objectives (see B. below), which will affect the timing and deadlines for the audit work and communications.

**c. Important Overall Factors:** The auditor should identify key factors that will influence the audit team's work, including:

- Materiality levels
- Preliminary identification of high-risk areas
- Preliminary identification of material locations and account balances
- Preliminary plan regarding possible testing of internal controls
- Identification of recent developments that may affect the audit (e.g., entity-specific, industry, or financial reporting)

**2. Analytical Procedures:** Analytical procedures must be applied during the planning and overall review stages of all audits. There are no specific procedures which must be performed. It is up to the auditor's professional judgment to determine which analytical procedures are appropriate in each audit situation. Analytical procedures may include comparing current year balances and ratios to prior years. The purpose is to assist in assessing the risk of material misstatement and planning the necessary nature, timing and extent of further tests. Analytical procedures should build the auditor's understanding of the client's business and of relevant transactions and events of audit significance. The procedures should also help to identify unusual transactions. See Chapter 2 for more details.

**3. Involvement of Professionals with IT Skills:** The auditor should consider whether the engagement will require use of professionals who possess informational technology (IT) skills. Further details are provided in Chapter 5.

**4. Develop Audit Plan/Program:** The auditor should document the planned audit procedures to be used, including when they will be performed. Further details are provided in Chapter 2.

**5. Planning Communications with Management and Those Charged with Governance:** To establish clear two-way communication with those charged with governance, the auditor should communicate certain matters not only to management but also to those charged with governance.

**a. Management:** The person(s) with decision-making and administrative responsibility for carrying out the entity's operations.

**b. Those Charged with Governance:** The person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and overall obligations for accountability of the entity.

**c. Audit Committee or Other Subgroup of Those Charged With Governance:** The audit standards require auditors to communicate many matters with the audit committee or other subgroup of those charged with governance. When complying with these standards, the auditor should determine whether it is also necessary to communicate with the entire governing body.

**d. Matters to Communicate:**

- Expected general content and form of communications
- Auditor's and management's responsibilities (see responsibilities in the engagement letter section, below)
- Planned scope and timing of the audit
- Significant findings or issues from the audit, uncorrected misstatements, corrected misstatements, and written representations requested by the auditor (discussed in Chapter 5)
- Fraud, illegal acts, internal control matters, auditing fair values, other information in documents containing audited financial statements, and compliance auditing considerations (discussed throughout this audit textbook)

**e. Form of Communication and Restricted Use:** Communications may be oral or in writing, but the auditor should consider whether oral communication is adequate. When communicating in writing, the auditor should restrict the communication to use by those charged with governance and, if appropriate, management.

**B. Understanding With Client/Engagement Letter**

The auditor should reach an understanding with the client regarding the services to be performed for each engagement. Such an understanding reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other party. The auditor should document the understanding through a written communication (usually called an "engagement letter"). If an understanding is not reached, the auditor should decline to accept the engagement.

**1. Requirements:** The understanding with the client should include:

**a. Objectives of the Engagement:** To detail for the client that the purpose is to express an opinion on the financial statements in conformity with GAAP. This is especially critical for a new audit client or for an initial audit of a continuing client.

**b. Management's Responsibilities:** To clearly communicate to the client that management is responsible for the financial statements, the system of internal controls, compliance with laws and regulations, providing the auditor with access to accounting records and other information, adjusting the financial statements to correct material misstatements, and providing the auditor with a representation letter (see Chapter 5).

**c. Auditor's Responsibilities:** To clarify that the auditor is responsible for conducting the auditing in accordance with GAAS and for expressing an opinion on the financial statements or explaining why an opinion cannot be expressed. The auditor is also responsible for communicating to the audit committee or its equivalent any reportable conditions that come to his or her attention.

**d. Limitations of the Engagement:** To disclose to the client that an audit provides reasonable rather than absolute assurance that the financial statements are free of material misstatement, whether caused by error or fraud; that an audit is not designed to detect error or fraud that is immaterial; and that an audit is not designed to provide assurance on internal control or to identify reportable conditions.

## 2. Components of an Engagement Letter

### a. Typical Matters:

- Objective of audit is to express an opinion on the financial statements
- Management is responsible for:
  - Financial statements
  - Selection and application of accounting policies
  - Establishing and maintaining effective internal control over financial reporting
  - Designing and implementing programs and controls to prevent and detect fraud
  - Identifying and ensuring compliance with laws and regulations
  - Making all financial records and related information available to the auditor
  - Adjusting the financial statements to correct material misstatements
  - Providing the auditor with a representation letter at the end of the engagement, including affirmation that the effects of any uncorrected misstatements are immaterial individually and in the aggregate.
- Description of auditor responsibility:

The auditor is responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that the auditor obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.
- Description of audit scope:

An audit includes obtaining an understanding of the entity and its environment, including its internal control, sufficient to assess the risks of material misstatement of the financial statements and to design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify significant deficiencies. However, the auditor is responsible for ensuring that those charged with governance are aware of any significant deficiencies that come to his or her attention.

**b. Additional Matters That May Be Addressed:**

- Obligations of the client's staff to prepare schedules and statements.
- Fee or basis for determining fee including additional fees resulting from increased scope of testing which may be required if internal control is inadequate.
- Frequency and details of fees and billing.
- Statement of necessity requiring client and attorney representation letters.
- Arrangements regarding predecessor auditor, and internal auditors, if applicable.
- Indication of date auditor expects to begin work and anticipated completion date.
- Any additional services the accountant will perform (such as tax return preparation or other regulatory requirements).
- Conditions under which others may be granted access to the audit documentation.

**3. Client Representation Letter:** Based upon the CPA's risk assessment, and issues that develop during the engagement, the auditor should draft a Representation Letter. This should be signed by the client's chief executive officer (CEO) and chief financial officer (CFO). Refusal of the CEO and CFO to sign normally precludes an unmodified opinion. See chapter 5.

**C. Objectives and Responsibilities for Integrated Audit (PCAOB)**

The Sarbanes-Oxley Act modifies the objectives of an audit and imposes additional responsibilities on the board of directors, management, and auditors of public companies. The board must direct the officers who manage the day-to-day corporate affairs. For an integrated audit of financial statements and internal control over financial reporting, the PCAOB has amended the objective and responsibilities as follows:

**1. Objective of Integrated Audit:** To express an opinion on both management's assessment of internal control over financial reporting and on the financial statements.

**2. Additional Management Responsibilities:** In addition to the responsibilities in a nonpublic company audit, management of a public company is responsible for establishing and maintaining effective internal control over financial reporting. This responsibility includes:

- Accepting responsibility for the effectiveness of the company's internal control over financial reporting.
- Evaluating the effectiveness of the company's internal control over financial reporting using suitable control criteria.
- Supporting the evaluation with sufficient evidence, including documentation.
- Presenting a written assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

**3. Additional Auditor's Responsibilities:** In an integrated audit, the auditor is required to obtain reasonable assurance about (1) whether the financial statements are free of material misstatement, whether caused by error or fraud, and (2) whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated in all material respects. If management has failed to meet its responsibilities (listed in #2 above), the auditor is required to communicate, in writing, to the management and the board audit committee that the examination of internal control over financial reporting cannot be satisfactorily completed and that the CPA is required to disclaim an opinion. The auditor is also responsible for communicating in writing various internal control matters to the audit committee, management, and the board of directors as described in Chapter 3.

## **VI. RISK ASSESSMENT AND FURTHER TESTING**

### **A. Understand Entity and Environment, Including Internal Controls**

Conceptually, the next step in the audit process is to gain an understanding of the entity and its environment (including internal controls). The auditor is interested in how the client assures accuracy in financial information reporting and protects the assets of the business. Good internal control may reduce the testing that the auditor finds necessary to substantiate the reported opinion covering the financial statements. On the other hand, the auditor may decide an audit is impossible because the client's internal controls are very poor. The auditor must assess the risk of material misstatement (RMM). RMM is the risk that a material misstatement (due to error or fraud) could occur and not be prevented or detected on a timely basis by the entity's control structure, policies or procedures. This part of the audit is addressed in Chapter 3.

### **B. Obtain Sufficient Appropriate Evidence (Tests of Controls and Substantive Testing)**

The next audit step is the process of gathering evidence to test the operating effectiveness of internal controls and to substantiate the amounts reported in the financial statements. The evidence gathering process is the most time-consuming part of the audit. In accordance with the third standard of fieldwork, the auditor must gather sufficient evidence to support the assertions reported on the financial statements. This part of the audit is addressed in Chapters 3, 4, and 5.

### **C. Completion of the Audit**

As detailed in Chapter 5, completing the audit includes a review of subsequent events and contingent liabilities. Analytical procedures are again used to evaluate the overall financial statements and to identify any areas where unusual fluctuations of balances may require disclosure or further audit work. Likely and known misstatements are evaluated individually and in the aggregate for materiality, and conclusions are drawn from the audit findings. Professional judgment must be exercised in evaluating management explanations. The auditor also makes required communications with management and others charged with entity governance.

## VII. REPORTING

The final step, based on the all the information available, is the formation of an opinion covering the financial statements. This includes issuing the audit report to the client.

### A. Standard Unmodified Report

In most instances, a standard, unmodified opinion is issued. The following language is for a single year, assuming that the audit is conducted according with U.S. GAAS and U.S. GAAP for a nonpublic company. Requirements for issuing a standard report are addressed in Chapter 6.

#### Independent Auditor's Report

To the Stockholders (or Board of Directors)  
Great Expectations, Inc.  
New York, NY

We have audited the balance sheet of Great Expectations, Inc., as of December 31, 20x8 and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management., as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 20X4 and 20X3, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X8, in conformity with U.S. generally accepted accounting principles.

Debit, Credit & Co., CPAs  
March 27, 20x9

### B. Departures from the Standard Report

Departures from the Standard Report occur when circumstances require modification to the standard unmodified report, or when a modified or adverse opinion or a disclaimer of opinion must be issued. These topics are covered in detail in Chapter 6.

# AUDITING AND ATTESTATION

## CHAPTER 1

### PROFESSIONAL STANDARDS, AUDIT PROCESS, AND AUDIT PLANNING

#### Question Map

- I. OVERVIEW OF PROFESSIONAL STANDARDS
  - AICPA Professional Standards
    - Statements on Auditing Standards – 2, 6, 25
    - Statements on Standards for Accounting and Review Services (SSARS) - 36
    - Statements on Standards for Attestation Engagements (SSAE) – 57
    - Standards for Consulting Services - 29
  - SEC Regulations and PCAOB – 56, 67
  - Meaning of Terms in Auditing Standards – 58, 59
  - Generally Accepted Auditing Standards – 4, 5, 24, 35
    - General Standards – **TIP** – 1, 12, 13, 20, 27, 28, 39, 43
    - Standards of Fieldwork – **SAS** – 3, 34
    - Reporting Standards – **ACDO** – 8, 9
    - Reasonable Assurance – 66
  - Attestation Standards – 50, 51, 52, 53, 54, 55
- II. CPA FIRM QUALITY CONTROL
  - System of Quality Control – 14, 26, 30, 32
  - Elements of Quality Control – 31
    - Leadership – 64
    - Relevant Ethical Requirements – 18
    - Acceptance and Continuation of Clients and Engagements (see section IV, below)
    - Human Resources – 16, 37, 65
    - Engagement Performance
    - Monitoring – 23
  - Quality Control Standards
  - AICPA Peer Review Program - 15
- III. AUDIT PROCESS OVERVIEW
- IV. AUDIT ACCEPTANCE AND CONTINUATION PROCEDURES – 19, 22, 60
  - Communication Between Predecessor and Successor Auditors – 40, 42, 45, 49, Task Number 1
  - Predecessor Responsibility – 41

V. PRELIMINARY PLANNING - 7

Pre-Engagement Planning – 11, 33, 44, 46, 47, 48

Understanding with Client/Engagement Letter – 38, 61, Task 2

Objectives and Responsibilities for Integrated Audit (PCAOB) – 62, 63

VI. RISK ASSESSMENT AND FURTHER TESTING

VII. REPORTING

# AUDITING AND ATTESTATION

## CHAPTER 1

### PROFESSIONAL STANDARDS, AUDIT PROCESS, AND AUDIT PLANNING

#### Multiple Choice Questions

1. The third general standard for an audit states that due care is to be exercised in the performance of the examination. This standard should be interpreted to mean that a CPA who undertakes an engagement assumes a duty to perform
  - a. With reasonable diligence and without fault or error.
  - b. As a professional who will assume responsibility for losses consequent upon error of judgment.
  - c. To the satisfaction of the client and third parties who may rely upon it.
  - d. As a professional possessing the degree of skill commonly possessed by others in the field.
2. Which of the following statements best describes the primary purpose of Statements on Auditing Standards?
  - a. They are guides intended to set forth auditing procedures which are applicable to a variety of situations.
  - b. They are procedural outlines which are intended to narrow the areas of inconsistency and divergence of auditor opinion.
  - c. They are authoritative statements, enforced through the code of professional ethics, and are intended to limit the degree of auditor judgment.
  - d. They are interpretations which are intended to clarify the meaning of “generally accepted auditing standards.”
3. Rogers & Co., CPAs, policies require that all members of the audit staff submit weekly time reports to the audit manager, who then prepares a weekly summary work report regarding variance from budget for partners’ review. This provides written evidence of Rogers & Co.’s professional concern regarding compliance with which of the following generally accepted auditing standards?
  - a. Quality control.
  - b. Due professional care.
  - c. Adequate review.
  - d. Adequate planning.
4. The “generally accepted auditing standards” are standards which
  - a. Are sufficiently established so that independent auditors generally agree on their existence.
  - b. Are generally accepted based upon a pronouncement of the Financial Accounting Standards Board.
  - c. Are generally accepted in response to the changing needs of the business community.
  - d. Are generally accepted as a consequence of approval of the AICPA membership.
5. Which of the following statements best describes the phrase “generally accepted auditing standards”?
  - a. They identify the policies and procedures for the conduct of the audit.
  - b. They define the nature and extent of the auditor’s responsibilities.
  - c. They provide guidance to the auditor with respect to planning the audit and writing the audit report.
  - d. They set forth a measure of the quality of the performance of audit procedures.

6. Auditing interpretations provide timely guidance on the application of pronouncements of the Auditing Standards Board and are

- a. Less authoritative than a pronouncement of the Auditing Standards Board.
- b. Equally authoritative as a pronouncement of the Auditing Standards Board.
- c. More authoritative than a pronouncement of the Auditing Standards Board.
- d. Nonauthoritative opinions, which are issued without consulting members of the Auditing Standards Board.

7. Early appointment of the independent auditor will enable

- a. A very thorough examination to be performed.
- b. A proper study and evaluation of internal control to be performed.
- c. Sufficient appropriate evidential matter to be obtained.
- d. A more efficient examination to be planned.

8. The fourth generally accepted auditing standard of reporting requires an auditor to render a report whenever an auditor's name is associated with financial statements. The overall purpose of the fourth standard of reporting is to require that reports

- a. Assure that the auditor is independent with respect to the financial statements under examination.
- b. State that the auditor's examination of the financial statements has been conducted in accordance with generally accepted auditing standards.
- c. Indicate the character of the auditor's examination and the degree of responsibility assumed.
- d. Express whether the accounting principles used in preparing the financial statements have been applied consistently in the period under examination.

9. The fourth reporting standard requires the auditor's report to contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. The objective of the fourth standard is to prevent

- a. The CPA from reporting on one basic financial statement and **not** the others.
- b. Misinterpretations regarding the degree of responsibility the auditor is assuming.
- c. The CPA from expressing different opinions on each of the basic financial statements.
- d. Management from reducing its final responsibility for the basic financial statements.

10. A CPA certificate is evidence of

- a. Recognition of independence.
- b. Basic competence at the time the certificate is granted.
- c. Culmination of the educational process.
- d. Membership in the AICPA.

11. Would the following factors ordinarily be considered in planning an audit engagement's personnel requirements?

	Opportunities for on-the-job <u>training</u>	Continuity and periodic rotation <u>of personnel</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

12. In determining independence with respect to any audit engagement, the ultimate decision as to whether or **not** the auditor is independent must be made by the

- a. Auditor.
- b. Client.
- c. Audit committee.
- d. Public.

13. A CPA, while performing an audit, strives to achieve independence in appearance in order to
- Reduce risk and liability.
  - Maintain public confidence in the profession.
  - Become independent in fact.
  - Comply with the generally accepted standards of fieldwork.
14. A basic objective of a CPA firm is to provide professional services that conform with professional standards. Reasonable assurance of achieving this basic objective is provided through
- Continuing professional education.
  - A system of quality control.
  - Compliance with generally accepted reporting standards.
  - A system of peer review.
15. Williams & Co., a large international CPA firm, is to have an “external peer review.” The peer review will most likely be performed by
- Employees and partners of Williams & Co. who are **not** associated with the particular audits being reviewed.
  - Audit review staff of the Securities and Exchange Commission.
  - Audit review staff of the American Institute of Certified Public Accountants.
  - Employees and partners of another CPA firm.
16. Within the context of quality control, the primary purpose of continuing professional education and training activities is to enable a CPA firm to provide personnel within the firm with
- Technical training that assures proficiency as an auditor.
  - Professional education that is required in order to perform with due professional care.
  - Knowledge required to fulfill assigned responsibilities and to progress within the firm.
  - Knowledge required to perform a peer review.
17. An individual just entering into an auditing career should obtain professional experience primarily in order to achieve a
- Positive quality control review.
  - Seasoned judgment.
  - Favorable peer review.
  - Specialty designation by the AICPA.
18. In pursuing a CPA firm’s quality control objectives, a CPA firm may maintain records indicating which partners or employees of the CPA firm were previously employed by the CPA firm’s clients. Which quality control element would this procedure be **most** likely to satisfy?
- Leadership.
  - Human resources.
  - Relevant ethical requirements.
  - Engagement performance.
19. In pursuing its quality control objectives with respect to acceptance of a client, a CPA firm is **LEAST** likely to
- Make inquiries of the proposed client’s legal counsel.
  - Review financial statements of the proposed client.
  - Make inquiries of previous auditors.
  - Review the personnel practices of the proposed client.
20. The third general standard for an audit states that due care is to be exercised in the performance of an audit. This standard is ordinarily interpreted to require
- Thorough review of the existing safeguards over access to assets and records.
  - Limited review of the indications of employee fraud and illegal acts.
  - Objective review of the adequacy of the technical training and proficiency of firm personnel.
  - Critical review of the judgment exercised at every level of supervision.

- 21.** Dickens, a CPA firm's personnel partner, periodically studies the CPA firm's personnel advancement experience to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. This is evidence of the CPA firm's adherence to prescribed
- Standards of due professional care.
  - Quality control standards.
  - Supervision and review standards.
  - Standards of fieldwork.
- 22.** A CPA establishes quality control policies and procedures for deciding whether to accept a new client or continue to perform services for a current client. The major purpose for establishing such policies and procedures is
- To enable the auditor to attest to the integrity or reliability of a client.
  - To comply with the client's quality control standards.
  - To lessen the exposure to litigation resulting from failure to detect fraud in client financial statements.
  - To minimize the likelihood of association with clients whose management lacks integrity.
- 23.** In connection with the element of monitoring, a CPA firm's system of quality control should ordinarily provide for the maintenance of
- A file of minutes of staff meetings.
  - Updated personnel files.
  - Documentation to demonstrate compliance with its policies and procedures.
  - Documentation to demonstrate compliance with peer review directives.
- 24.** The essence of the audit function is to
- Detect fraud.
  - Examine individual transactions so that the auditor may certify as to their validity.
  - Determine whether the client's financial statements are fairly stated.
  - Assure the consistent application of correct accounting procedures.
- 25.** The authoritative body designated to promulgate standards concerning an accountant's association with unaudited financial statements of an entity that is **not** required to file financial statements with an agency regulating the issuance of the entity's securities is the
- Financial Accounting Standards Board.
  - General Accounting Office.
  - Accounting and Review Services Committee.
  - Auditing Standards Board.
- 26.** One of a CPA firm's basic objectives is to provide professional services that conform with professional standards. Reasonable assurance of achieving this basic objective is provided through
- A system of quality control.
  - A system of peer review.
  - Continuing professional education.
  - Compliance with generally accepted reporting standards.
- 27.** The first general standard for an audit requires that an audit of financial statements is to be performed by a person or persons having
- Seasoned judgment in varying degrees of supervision and review.
  - Adequate technical training and proficiency.
  - Knowledge of the standards of fieldwork and reporting.
  - Independence with respect to the financial statements and supplementary disclosures.
- 28.** The exercise of due professional care requires that an auditor
- Examine all available corroborating evidence.
  - Critically review the judgment exercised at every level of supervision.
  - Reduce the risk of material misstatement below the maximum.
  - Attain the proper balance of professional experience and formal education.

**29.** On completing an audit of a nonpublic company, Larkin, CPA, was asked by the client to provide technical assistance in the implementation of a new computerized system. The set of pronouncements designed to guide Larkin in this engagement is the Statements on

- a. Auditing Standards.
- b. Standards for Consulting Services.
- c. Quality Control Standards.
- d. Standards for Accountants' Computer Services.

**30.** The nature and extent of a CPA firm's quality control policies and procedures depend on

The CPA firm's size	The nature of the CPA firm's practice	Cost-benefit considerations
a. Yes	Yes	Yes
b. Yes	Yes	No
c. Yes	No	Yes
d. No	Yes	Yes

**31.** Which of the following are elements of a CPA firm's quality control that should be considered in establishing quality control policies and procedures?

	Human Resources	Leadership	Monitoring
a.	Yes	Yes	No
b.	Yes	Yes	Yes
c.	No	Yes	Yes
d.	Yes	No	Yes

**32.** A CPA firm would be reasonably assured of meeting its responsibility to provide services that conform with professional standards by

- a. Adhering to generally accepted auditing standards.
- b. Having an appropriate system of quality control.
- c. Joining professional societies that enforce ethical conduct.
- d. Maintaining an attitude of independence in its engagements.

**33.** Which of the following procedures would an auditor most likely perform in planning a financial statement audit?

- a. Reviewing investment transactions of the audit period to determine whether related parties were created.
- b. Performing analytical procedures to identify areas that may represent specific risks.
- c. Reading the minutes of stockholder and director meetings to discover whether any unusual transactions have occurred.
- d. Obtaining a written representation letter from the client to emphasize management's responsibilities.

**34.** The audit work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the

- a. Audit has been performed by persons having adequate technical training and proficiency as auditors.
- b. Auditor's system of quality control has been maintained at a high level.
- c. Results are consistent with the conclusions to be presented in the auditor's report.
- d. Audit procedures performed are approved in the professional standards.

**35.** Which of the following best describes what is meant by the term generally accepted auditing standards?

- a. Procedures to be used to gather evidence to support financial statements.
- b. Measures of the quality of the auditor's performance.
- c. Pronouncements issued by the Auditing Standards Board.
- d. Rules acknowledged by the accounting profession because of their universal application.

36. Statements on Standards for Accounting and Review Services establish standards and procedures for which of the following engagements?

- a. Assisting in adjusting the books of account for a partnership.
- b. Reviewing interim financial data required to be filed with the SEC.
- c. Processing financial data for clients of other accounting firms.
- d. Compiling an individual's personal financial statement to be used to obtain a mortgage.

37. A CPA firm evaluates its personnel advancement experience to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. This is evidence of the firm's adherence to which of the following prescribed standards?

- a. Quality control.
- b. Leadership.
- c. Supervision and review.
- d. Professional development.

38. Which of the following statements would **least** likely appear in an auditor's engagement letter?

- a. Fees for our services are based on our regular per diem rates, plus travel and other out-of-pocket expenses.
- b. During the course of our audit we may observe opportunities for economy in, or improved controls over, your operations.
- c. Our engagement is subject to the risk that material errors or fraud, if they exist, will **not** be detected.
- d. After performing our preliminary analytical procedures we will discuss with you the other procedures we consider necessary to complete the engagement.

39. Which of the following standards requires a critical review of the work done and the judgment exercised by those assisting in an audit at every level of supervision?

- a. Proficiency.
- b. Audit risk.
- c. Inspection.
- d. Due care.

40. In an audit situation, communication between successor and predecessor auditors should be

- a. Authorized in an engagement letter.
- b. Acknowledged in a representation letter.
- c. Either written or oral.
- d. Written, but need not be included in the audit documentation.

41. What is the responsibility of a successor auditor with respect to communicating with the predecessor auditor in connection with a prospective new audit client?

- a. The successor auditor has **no** responsibility to contact the predecessor auditor.
- b. The successor auditor should obtain permission from the prospective client to contact the predecessor auditor.
- c. The successor auditor should contact the predecessor regardless of whether the prospective client authorizes contact.
- d. The successor auditor need **not** contact the predecessor if the successor is aware of all available relevant facts.

42. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding the predecessor's

- a. Opinion of any subsequent events occurring since the predecessor's audit report was issued.
- b. Understanding as to the reasons for the change of auditors.
- c. Awareness of the consistency in the application of GAAP between periods.
- d. Evaluation of all matters of continuing accounting significance.

- 43.** Because of the risk of material misstatement, an audit of financial statements in accordance with generally accepted auditing standards should be planned and performed with an attitude of
- Objective judgment.
  - Independent integrity.
  - Professional skepticism.
  - Impartial conservatism.
- 44.** Which of the following procedures would an auditor most likely include in the initial planning of a financial statement audit?
- Obtaining a written representation letter from the client's management.
  - Examining documents to detect illegal acts having a material effect on the financial statements.
  - Considering whether the client's accounting estimates are reasonable in the circumstances.
  - Determining the extent of involvement of the client's internal auditors.
- 45.** Hill, CPA, has been retained to audit the financial statements of Monday Co. Monday's predecessor auditor was Post, CPA, who has been notified by Monday that Post's services have been terminated. Under these circumstances, which party should initiate the communications between Hill and Post?
- Hill, the successor auditor.
  - Post, the predecessor auditor.
  - Monday's controller or CFO.
  - The chairman of Monday's board of directors.
- 46.** To obtain an understanding of a continuing client's business in planning an audit, an auditor most likely would
- Perform tests of details of transactions and balances.
  - Review prior-year documentation and the permanent file for the client.
  - Read specialized industry journals.
  - Reevaluate the client's internal control environment.
- 47.** Which of the following procedures would an auditor most likely perform in planning a financial statement audit?
- Inquiring of the client's legal counsel concerning pending litigation.
  - Comparing the financial statements to anticipated results.
  - Examining computer generated exception reports to verify the effectiveness of internal controls.
  - Searching for unauthorized transactions that may aid in detecting unrecorded liabilities.
- 48.** The element of the audit planning process most likely to be agreed upon with the client before implementation of the audit strategy is the determination of the
- Evidence to be gathered to provide a sufficient basis for the auditor's opinion.
  - Procedures to be undertaken to discover litigation, claims, and assessments.
  - Pending legal matters to be included in the inquiry of the client's attorney.
  - Timing of inventory observation procedures to be performed.
- 49.** A successor auditor most likely would make specific inquiries of the predecessor auditor regarding
- Specialized accounting principles of the client's industry.
  - The competency of the client's internal audit staff.
  - The uncertainty inherent in applying sampling procedures.
  - Disagreements with management as to auditing procedures.

- 50.** Which of the following statements best describes the phrase “attestation standards”?
- They provide guidance to improve the consistency and quality of a variety of attest services increasingly demanded of the accounting profession.
  - They identify the procedures to be used for obtaining evidence in an attestation engagement.
  - They define the nature and extent of the practitioner’s responsibilities when performing attest services.
  - They provide guidance to the practitioner with respect to planning the attestation engagement and writing the attestation report.
- 51.** The first general attestation standard requires that
- Attestation work shall be adequately planned and assistants, if any, shall be properly supervised.
  - Use of the attestation report is restricted to specified parties when the criteria used to evaluate the subject matter are available only to specified parties.
  - The engagement shall be performed by a practitioner having adequate technical training and proficiency in the attestation function.
  - Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report
- 52.** The exercise of due professional care in an attestation engagement requires that a practitioner
- Ensure that most of the work is performed by assistants so that the cost of the engagement to the client can be reduced.
  - Critically evaluate whether the evidence obtained is sufficient to provide a reasonable basis for the conclusion that is expressed in the report.
  - 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.
  - Is an expert in the subject matter of the engagement.
- 53.** The second standard of fieldwork for an attestation engagement requires the practitioner to
- Obtain a sufficient understanding of the entity and its environment, including its internal control, to plan the nature, timing, and extent of tests to be performed.
  - Have adequate technical training and proficiency in the attest function.
  - State all of the practitioner’s significant reservations about the engagement, the subject matter, and, if applicable, the assertion related thereto.
  - Obtain sufficient evidence to provide a reasonable basis for the conclusion that is expressed in the report.
- 54.** The work performed by each assistant in an attestation engagement should be reviewed to determine whether
- It was adequately performed.
  - The assistant maintained an independence in mental attitude.
  - The assistant had adequate technical training and proficiency in the attest function.
  - The work was adequately planned.
- 55.** Which of the following is a circumstance requiring an attestation report to state that use of the report is restricted to specified parties?
- The practitioner has significant reservations about the engagement or the subject matter.
  - The practitioner is not independent.
  - Insufficient evidence was obtained to provide a reasonable basis for a conclusion about the subject matter.
  - The criteria used to evaluate the subject matter are available only to specified parties.

**56.** The authoritative body designated to establish public company audit standards, subject to Securities and Exchange Commission approval, is the

- a. Public Company Accounting Oversight Board.
- b. General Accounting Office.
- c. Auditing Standards Board.
- d. Accounting and Review Services Committee.

**57.** Statements on Standards for Attestation Engagements establish standards and procedures for which of the following engagements?

- a. Reviewing financial statements of a nonpublic company.
- b. Consulting with a partnership on its income tax strategies.
- c. Reporting on a company's compliance with laws and regulations.
- d. Providing bookkeeping services for a sole proprietorship.

**58.** An auditor has an unconditional responsibility when which of the following words is used to describe an action or procedure in an audit standard?

	<u>Shall</u>	<u>Should</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

**59.** The word "might" when used in an audit standard means that the auditor

- a. Must implement the action or procedure unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard.
- b. Has no responsibility to consider implementing the action or procedure.

- c. Must implement the action or procedure in all cases in which the circumstances exist to which the requirement applies.
- d. Must use professional judgment to consider whether to implement the action or procedure.

**60.** In determining whether to accept a new audit client, a CPA is *least* likely to consider the

- a. Client's reputation in the business community.
- b. Adequacy and completeness of the client's accounting records.
- c. Need to exercise due professional care in the performance of the audit and the preparation of the report.
- d. Predecessor auditor's understanding about the reasons for the change of auditors.

**61.** In an audit of the financial statements of a nonpublic company, management is typically responsible for

- a. The fair presentation of the financial statements in accordance with generally accounting principles.
- b. Ensuring that the financial statements are free of all misstatements.
- c. Obtaining sufficient appropriate evidential matter to support the audit opinion.
- d. Presenting the auditor with a written assessment of the effectiveness of the company's internal control over financial reporting.

**62.** In addition to the responsibilities in an audit of only the financial statements, in an integrated audit of financial statements and internal control over financial reporting the auditor is responsible for obtaining reasonable assurance about whether

- a. The financial statements are free of material misstatement.
- b. Management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated in all material respects.
- c. Management has presented a written assessment of the effectiveness of the company's internal control over financial reporting.
- d. The auditor's understanding of the entity and its environment, including internal control, is sufficient for determining the nature, timing, and extent of further audit procedures.

**63.** In an integrated audit of financial statements and internal control over financial reporting, management is responsible for all of the following **except**

- a. Evaluating the effectiveness of the company's internal control over financial reporting using suitable control criteria.
- b. Presenting a written assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.
- c. Issuing an opinion about whether the written assessment of the effectiveness of the company's internal control is fairly stated in all material respects.
- d. Accepting responsibility for the effectiveness of the company's internal control over financial reporting.

**64.** Which of the following statements is NOT true according to Quality Control Standards?

- a. Responsibility for quality within the firm begins with the team members who work on engagements.
- b. The firm must have policies and procedures for acceptance and continuation of client relationships.
- c. All relevant firm personnel must provide a written confirmation of compliance with independence requirements at least annually.
- d. The monitoring function must be under the responsibility of a person having appropriate authority.

**65.** In which of the following situations is the engagement partner LEAST likely to be viewed as competent under a CPA firm's quality control system?

- a. An engagement partner whose recent experience has consisted primarily in providing tax services completes a relevant continuing professional education course before performing a compilation engagement.
- b. An engagement partner whose experience consists of performing review and compilation engagements becomes familiar with the industry in which the client operates and obtains continuing professional education relating to auditing before performing an audit.
- c. A professor teaches relevant tax knowledge and completes a rigorous self-study program before preparing client tax returns.
- d. An engagement supervisor whose experience has consisted primarily in auditing manufacturing companies completes a continuing professional education course on statistical sampling before performing an audit of a financial institution.

**66.** The auditor must obtain reasonable assurance about whether the financial statements are free of material misstatement. Which of the following statements about reasonable assurance is **not** true?

- a. Reasonable assurance means that the auditor has detected all material misstatements.
- b. The auditor is not responsible for error or fraud that is immaterial to the financial statements.
- c. Reasonable assurance is a high level of assurance.
- d. The auditor is responsible for both errors and fraud that might be material.

**67.** The SEC's mission is least likely to include:

- a. Protect investors capital investment.
- b. Ensure each listed corporation pays the shareholders a fair and reasonable return be it a cash or stock dividend annually.
- c. Maintain fair, orderly, and efficient capital markets.
- d. Facilitate capital formation.

# CHAPTER 1

## PROFESSIONAL STANDARDS, AUDIT PROCESS, AND AUDIT PLANNING

### Tasks

#### Task Number 1

 <b>Predecessor Inquiry</b>	<b>Authoritative Literature</b>	<b>Help</b>
--	---------------------------------	-------------

After interviewing several CPA firms and investigating their professional reputations and backgrounds, the Audit committee of the Board of Directors of Aragorn, Inc. decided to hire Mason, Drake & Street, CPAs, to perform Aragorn's annual audit. Mason, Drake & Street explained the need to make an inquiry to the predecessor auditor prior to undertaking the project and requested permission to do so. Aragorn's management agreed, and authorized the predecessor auditor to respond fully to Mason, Drake & Street's inquiries.

From the following list, choose the **two** most likely inquiries that Mason, Drake & Street would make of the predecessor auditor prior to accepting the engagement. Only **two** items can be chosen.

- (A)  The uncertainty inherent in applying sampling procedures
- (B)  Facts that might bear on future economic trends affecting the company
- (C)  Disagreements with management concerning accounting principles
- (D)  The predecessor's understanding of new accounting rules
- (E)  The form and content of the predecessor's engagement letter
- (F)  The predecessor's understanding about the reason for the change
- (G)  Management's responsibility for establishing and maintaining effective internal control over financial reporting
- (H)  The predecessor's detailed audit program

#### Task Number 2

 <b>Engagement Letter</b>	<b>Authoritative Literature</b>	<b>Help</b>
--	---------------------------------	-------------

Scribe & Draw, CPAs, is preparing an engagement letter for the annual financial statement audit of Uptown, a privately-owned company. Uptown's bank requires financial statements prepared in accordance with generally accepted accounting principles. Which section of the Professional Standards addresses the matters that Street & Drake would generally include in the engagement letter?

§  ¶

- AR
- AT
- AU
- BL
- ET
- PCAOB
- PR
- QC

#### **Exam Hints:**

- The two right-hand input boxes will not appear on the computer screen until a selection is made in the left-hand box.
- The exam software will provide examples of correctly formatted responses for the selection made in the left-hand box, regardless of whether that selection is correct. For example:  
AU§ 123.45, AU§1234A.567  
PCAOB AS 2 Par. 1, PCAOB AS 3 Par. 123

# AUDITING AND ATTESTATION

## CHAPTER 1

### PROFESSIONAL STANDARDS, AUDIT PROCESS, AND AUDIT PLANNING

#### Multiple Choice Answers

1. /d/ The only reasonable answer is D. Other conditions specify circumstances that the CPA cannot or should not be willing to meet in the conduct of the audit.
2. /d/ The primary purpose of Statements on Auditing Standards is to interpret and implement the ten GAAS. Answer B is incorrect in that it implies limiting auditor's judgment. Similarly Answer C is also incorrect. Answer A is close, except that SASs are stronger than guides, and in fact are requirements of audit procedures.
3. /d/ Answers A and C are related to professional standards, but are not part of the ten GAAS. Answers B and D are both GAAS, but B is related to the quality of work, and not to the planning and supervision standard addressed in the question. Thus the best answer is D.
4. /d/ The AICPA has the responsibility for regulating the conduct of the auditing profession. Answers A and C are general statements of the effect of GAAS. B is incorrect because FASB is responsible for accounting principles, not auditing standards.
5. /d/ The key to this answer lies in the fact that GAAS cover general conditions, conduct of fieldwork and reporting. Thus the best answer is that GAAS cover the overall quality of the audit performance. Other answers are too vague or only address a part of the overall coverage of the GAAS.
6. /a/ This answer requires that you know the purpose of SAS interpretations and their authoritative priority. They provide recommendations for the application of the SASs and are less authoritative than the SASs.
7. /d/ Again the best answer is required. Answer D is the only answer that would significantly change under the circumstances of an early audit appointment. Answers B and C are required by any audit, regardless of the time of appointment. Answer A contains vague and unspecific language which causes it to be incorrect.
8. /c/ The audit report is the opportunity for the auditor to indicate what work was performed on the client's financial statements, and the results of that work. Answer A is incorrect because a report does not assure independence. Answers B and D are not the best answers because they state an important part of the report, but not the purpose.
9. /b/ Third parties look to CPAs for assurance that they can trust the financial statements that are presented to them. It is important that these third parties understand what level of responsibility the CPA is assuming. Answers A and C are not correct because both are possible under the fourth reporting standard. Answer D is not the best answer because the report does nothing to affect management's ultimate responsibility for the statements.

10. /b/ The CPA certificate is usually granted after completion of education, exam, experience and an ethics examination. Thus, only Answer B is a valid part of this process. All other answers are wrong, or are not evidenced by the CPA certificate.
11. /a/ Answer A is correct because the two factors are both mentioned in the quality control standards as appropriate considerations when staffing an audit.
12. /a/ The key element to evaluating independence lies with the auditor himself, and his judgment about his own status. Other parties are secondary to the determination of independence.
13. /b/ Independence is the hallmark of the CPA profession. It is necessary to preserve public confidence in the auditing profession.
14. /b/ The wording is part of the preamble to the Statement on Quality Control Standards. Other answers are specific parts of the quality control standards or general statements not relevant to the statement.
15. /d/ Peer reviews are performed by other CPAs external to the auditing firm.
16. /c/ Statements on Quality Control Standards specify that CPE and training are directed toward developing the CPA's knowledge to do the job and to progress in the firm. Answer C is the most complete answer; answers A and B are subsets of C. Answer D, peer review, also is not an objective of quality standards.
17. /b/ The most general answer is seasoned judgment, which underlies many of the key audit decisions that must be made. (Note the repetition of interest in auditor's judgment.)
18. /c/ CPA firm employees who have previously worked for client firms may have relationships which would impair independence, which is part of relevant ethical requirements. Answer B is not the best answer because the control element of human resources relates more to the capabilities and competence of personnel than to independence.
19. /d/ In deciding to accept a client, Answers A, B and C all represent key contacts or review of materials of audit significance. Answer D is not customarily reviewed by an auditor.
20. /d/ Answer D is almost a direct quote from AU 230.02.
21. /b/ The procedures described are part of a system of Quality Control Standards. Answers A, C and D are generally accepted auditing standards.
22. /d/ A major purpose of policies to accept clients are based on the need to assure that clients have honesty and integrity. Association with clients lacking integrity can be harmful in actuality or reputation to the CPA. Answer A is wrong since the CPA does not attest to the integrity of the client. Answer B is incorrect because the CPA is concerned with the firm's, not the client's quality control standards. Answer C is possibly correct, but is not the most important—or direct—factor.

23. /c/ The best general answer with respect to Quality Control Standards is Answer C. Documentation of the elements of good quality control must be met. Other answers are secondary or the actual form of the documentation.
24. /c/ The audit function is to determine whether the client's financial statements taken as a whole are presented fairly in accordance with generally accepted accounting principles, and to report on the determination. Although the auditor is required to assess the risk of misstatements due to fraud (see Chapter 2), the emphasis is still on material misstatement in the financial statements.
25. /c/ The Accounting and Review Services Committee promulgates standards pertaining to a CPA's association with unaudited financial statements of an entity under the circumstances described in the fact pattern given.
26. /a/ A system of quality control is the basic means by which a CPA firm is able to achieve its goal of providing service that conforms to professional standards.
27. /b/ The first general standard requires auditors to have adequate technical training and proficiency (Refer to the acronym TIP, where T = Training of Auditor).
28. /b/ Answer B describes the requirement of due professional care - to critically review judgment exercised at all levels of supervision.
29. /b/ The fact pattern describes an engagement (to provide technical assistance in implementing a new computer system) that is covered by the Standards for Consulting Services. There are no Standards for Accountants' Computer Services.
30. /a/ Answer A is correct because each of the three elements - firm size, nature of the practice, and cost-benefit considerations are mentioned in AU 161.02 as affecting the nature and extent of quality control procedures.
31. /b/ All are elements of a CPA firm's quality control, as described in the quality control standards.
32. /b/ Having a system of quality control enables a CPA firm to be reasonably assured of providing services conforming with professional standards.
33. /b/ Performing analytical procedures to identify areas with special risk is an important part of planning an audit of financial statements (Answer B). Answers A, C, and D describe procedures performed later in the audit.
34. /c/ The work of an assistant is reviewed to determine if the results are consistent with conclusions to appear in the report to be issued.
35. /b/ Generally accepted auditing standards are best described by Answer B, in that such standards are measures of the quality of the auditor's performance.
36. /d/ Of the types of engagements listed, a compilation such as is described in Answer D, would be covered by standards given by Statements on Standards for Auditing and Review Services.
37. /a/ Criteria for advancement is included in human resources, which is one of the elements of quality control.

38. /d/ Answer D is correct because the auditor would not, and should not, discuss with the client the detailed audit procedures to be performed.
39. /d/ Due care refers to the required critical review of work performed and judgment exercised at all levels of supervision.
40. /c/ Communication between predecessor and successor auditors can be either written or oral. Answer A is incorrect because the authorization must come from the client and the communication should take place before the new auditor finally accepts the engagement in the engagement letter. Answer B is incorrect because the client representation letter comes at the end of fieldwork, long after the engagement was accepted. Answer D is a incorrect because the communication must be included in the audit documented, whether the communication is oral or in writing.
41. /b/ The first step in the communication process is to secure permission from the client to talk to the predecessor auditor. This is necessary in order for the predecessor auditor not to violate confidentiality of a client situation.
42. /b/ The primary purpose of the communication is to provide information that will assist in determining whether to accept the engagement. Thus, Answer B is the best choice.
43. /c/ Professional skepticism is the term used to describe the independent auditor's appropriate attitude toward management.
44. /d/ Per AU 311.04 (h), the extent of the involvement of the internal audit staff of the client has a considerable impact on the planning of the audit. Answer A, the representation letter, is obtained at the end of the fieldwork. Procedures given in Answers B and C are carried out during the performance phase of the audit, not during the planning phase.
45. /a/ Per AU 315.02, Hill, the successor auditor, has the responsibility to initiate communications with the predecessor, Post.
46. /b/ Tests of details are not part of planning an audit (Answer A). Reading specialized industry journals (Answer C) relates to gaining an understanding of the client's industry, not the client's business. The internal control evaluation (Answer D) is part of performing, not planning the audit.
47. /b/ Answer B is correct. The other procedures mentioned are performed later in the audit and are not part of the planning phase.
48. /d/ Answers A and B are matters for the auditor's judgment and are not discussed with the client. Answer C will not be discussed with the client until the audit is well under way.
49. /d/ Answer D is specifically mentioned in AU 315.06. The other answers are the responsibility of the successor auditor but would not be discussed with the predecessor auditor.
50. /a/ Answer A is specifically mentioned in the description of the attestation standards. Each of the other answers is too specific; they relate to the specific actions to be taken during an attestation engagement.

51. /c/ Answer C is the only general standard listed. Answers A and D are attestation fieldwork standards, and Answer B is a reporting standard.
52. /b/ Due professional care requires the practitioner to critically evaluate the work performed and conclusions reached throughout the engagement. Answer B is an example of due professional care. Answer A is not a requirement. Answer C is a required part of an audit rather than an attestation engagement. Answer D relates to the knowledge requirement rather than the exercise of due professional care.
53. /d/ Answer D describes the general requirement for gathering evidence during the fieldwork of an attestation engagement. Answer A is a required part of the fieldwork in an audit rather than an attestation engagement. Answer B is a general standard, and answer C is a reporting standard.
54. /a/ Answer A explicitly describes the purpose of reviewing the work of assistants. Answers B and C describe general standards. Answer D is also required in the first attestation fieldwork standard, but it is unrelated to the reason why assistant work is reviewed.
55. /d/ Answer D is explicitly cited in the fourth attestation reporting standard. Answers A and B are possible reasons why an attest engagement should not be accepted. Answer C would affect the attestation report, but it would not require restriction.
56. /a/ The PCAOB was established under the Sarbanes-Oxley Act to establish audit standards for audits of public companies, but its proposed standards require SEC approval.
57. /c/ The attestation standards provide a broad framework for and set reasonable boundaries around a variety of attest services that are not addressed by other sets of standards. Answer A is addressed by SSARS. Answers B and D are not attest services.
58. /b/ The words "must," "shall," and "is required" indicate unconditional responsibilities / requirements. The word "should" indicate responsibilities that are only suggestive, not mandatory.
59. /d/ The words "may," "might," "could," and other similar terms and phrases describe actions and procedures that auditors have a responsibility to consider. Consideration requires the exercise of professional judgment in the circumstances consistent with the objectives of the standard.
60. /c/ Answers A, B, and D are items specifically identified in the audit standards as items that an auditor should consider when deciding whether to accept a new audit client. Answer C describes a requirement that relates to the work performed in all audits.
61. /a/ Answer A explicitly states management's responsibility in a financial statement audit. Answer B is too restrictive; the financial statements do not need to be free of all misstatements to be fairly presented. Answer C describes one of the auditor's responsibilities. Answer D is a management responsibility in an integrated audit under the Sarbanes-Oxley Act, as described in PCAOB rules.

- 62. /b/** In an integrated audit, the auditor is required to obtain reasonable assurance about (1) whether the financial statements are free of material misstatement, whether caused by error or fraud, and (2) whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated in all material respects. Part (1) is a responsibility in any audit of financial statements, which rules out Answer A. Part (2) is an additional responsibility in an integrated audit under PCAOB rules, so Answer B is the correct answer. Answer C describes a management responsibility. Answer D is part of GAAS for all financial statement audits.
- 63. /c/** Answer C describes one of the auditor's responsibilities in an integrated audit under PCAOB rules. All of the other answers are part of management's responsibilities.
- 64. /a/** Quality Control Standards emphasize the importance of CPA firm leadership. Responsibility for quality within the firm begins with the "tone at the top," rather than with the team members who work on an engagement. The other answer options (b, c, and d) are specific requirements of SQCS No. 7.
- 65. /d/** Quality control standards require that personnel must have or obtain relevant capabilities and competencies before performing client services. Answer D is the best answer because a supervisor with experience in audits of manufacturing companies might lack the specialized knowledge and expertise needed to perform an audit of a financial institution. In addition, a statistical sampling class is probably insufficient training.
- 66. /a/** Under reasonable assurance, some risk remains that a material misstatement of the financial statements would be undetected.
- 67. /b/** Of the four alternatives given the SEC is least likely to ensure each listed corporation pays a fair and reasonable annual cash or stock dividend. A is incorrect because one of the SEC's missions is to protect an investor's capital investment. C is incorrect because one of the SEC's missions is to maintain fair, orderly, and efficient capital markets. D is incorrect because one of the SEC's mission is to facilitate capital formation.

## CHAPTER 1

### PROFESSIONAL STANDARDS, AUDIT PROCESS, AND AUDIT PLANNING

#### Task Answers

##### Task Number 1 Answer

- (C)  Disagreements with management concerning accounting principles  
(F)  The predecessor's understanding about the reason for the change

Prior to accepting the engagement, Mason, Drake & Street should communicate with the predecessor auditor regarding each of the following:

- Facts that might bear on the integrity of management
- Disagreements with management concerning accounting principles, auditing procedures, or other significant matters
- The predecessor's understanding about the reason for the change
- Any other information that may be of assistance in determining whether to accept the engagement

##### Task Number 2 Answer

Because Uptown is a nonissuer (presumably in the United States), Scribe & Draw will conduct the audit according to the AICPA's Statements on Auditing Standards, which are represented by AU in the authoritative literature.

