# Test 1 Book Notes – ACCT5314

# Chapter 1

**Attest services** occur when a practitioner is engaged to issue … a report on subject matter, or an assertion about subject matter, that is the responsibility of another party.

**Assurance services** are independent professional services that improve the quality of information, or its context, for decision makers.

## Three Fundamental Concepts: Materiality, Audit Risk, and Evidence

### Materiality

Definition – The magnitude of an omission of misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement. Reflects what the auditor perceives as the view of reasonable person who is relying on the financial statements.

### Audit Risk

Definition – The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. The risk that the auditor may unknowingly give a “Clean” opinion on financial statements that are materially misstated.

### Evidence relating to management’s assertions

Internal Controls are implemented to ensure appropriate capturing and recording of individual transactions, which are then collected into ending account balances.

The auditor’s job ultimately is to express an opinion on *whether the financial statements are fairly stated.*

Three Different Stages in a client’s accounting system to help determine whether the financial statements are fairly stated:

* The internal control put in place by the client to ensure proper handling of transactions (Evaluate and test the controls)
* The transactions that affect each account balance (Examine a sample of the transactions that happen during the period)
* The ending account balances themselves (examining a sample of the items that make up an ending account balance at year-end)

Audit Internal Control

* Reliability of financial reporting
* Effectiveness and efficiency of operations
* Compliance with applicable laws and regulations

# Chapter 2

## Internal Control Audits

* An audit of internal control is available but not required for private entities.
* Auditing standards require an integrated audit of internal control and financial statements.

## Compliance Audits

* A compliance audit determines the extent to which rules, policies, laws, covenants, or government regulations are followed by the entity being audited. E.g. Determine whether applicable rules and policies are being followed with respect to the granting of student loans.

## Operational Audits

* An operational audit involves a systematic review of part or all of an organization’s activities to evaluate whether resources are being used effectively and efficiently.
* The purpose of an operational audit is to assess performance, identify areas for improvement, and develop recommendations.
* Sometimes referred to as a performance audit or management audit.

## Forensic Audits

* A forensic audit’s purpose is the detection or deterrence of fraudulent activities.
* Examples
  + Business or employee fraud
  + Criminal investigations
  + Shareholder or partnership disputes
  + Business economic losses
  + Matrimonial disputes

## Services

* Attest Services
  + Attest to the nature and quantity of inventory stored in a client’s warehouse.
* Assurance Services
* Other Nonaudit Services
  + Tax Preparation and Planning Services
    - Assist with preparing and filing tax returns, provide advice on tax and estate planning, and provide representation on tax issues before the IRS or tax courts.
  + Management Advisory Services
    - Consulting activities that may involve providing advice and assistance concerning an entity’s organization, personnel, finances, operations, systems, or other activities. You can only perform this to non-audit clients.
  + Compilation and Review Services
    - Bookkeeping, payroll processing, and preparing financial statements.

## Organization and Composition

* Local Public Accounting Firms
  + Organized as proprietorships, general partnerships, or corporations.
* Regional, National, and International Accounting Firms
  + Structured as LLPs

## Government Regulation

* Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act
  + Transferred authority to set and enforce auditing standards for public company audits to the PCAOB.
  + Mandated that the SEC impose strict independence rules, prohibiting the provision of many types of nonaudit services to public company audit clients.
  + Rotate audit partners every 5 years
  + Requires an integrated audit (audit of both financial statements and internal control over financial reporting)
* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
  + Granting authority to PCAOB to inspect foreign audit firms that practice in the U.S. or that have U.S. clients and by exempting companies with under $75 million market capitalization from the requirement to submit to an audit of internal control over financial reporting.

## Business as the Primary Context of Auditing

* Essential Characteristics of a business
  + Corporate Governance
    - Consists of all the people, processes, and activities in place to help ensure proper stewardship over an entity’s assets.
    - Board of Directors
      * Body primarily responsible for management oversight in U.S. corporations.
    - Audit Committee
      * Consists of members of the board, oversees the internal and external auditing work done for the organization.
  + Objectives, Strategies, Processes, Risks, Controls, & Reporting
    - Process Categories / Cycles
      * Financial Process
        + Business obtains capital through borrowing or soliciting investments from owners and typically invests in assets such as land, buildings, and equipment in accordance with their strategies.
      * Purchasing Process
        + Acquisition of goods and services to support their operations.
      * Human Resource Management Process
        + Business organizations hire personnel to perform various functions in accordance with the enterprise’s mission and strategy. Usually begins with an employee performing a job and ends with payment being made to the employee.
      * Inventory Management Process
        + Cost accounting transactions to accumulate and allocate costs to inventory.
      * Revenue Process
        + Generate revenue thru sales of goods or services to customers and collect the proceeds of those sales in cash, either immediately or through collections or receivables.

## Securities and Exchange Commission (SEC)

* Federal government agency that administers the Securities Act of 1933, 1934, and SoX.
* Securities Act of 1933
  + Regulates disclosure of material information in a registration statement for an IPO
  + S forms, which are used for issuing the securities, contain the audited financial statements of the registrant.
* Securities Exchange Act of 1934
  + Regulates ongoing reporting by companies whose securities are listed and traded on a stock exchange or that possess assets greater than $1 million and equity securities held by 500 or more persons.
  + 10K, 10Q, and 8K.

## Public Company Accounting Oversight Board (PCAOB)

* A nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports.
* The PCAOB can impose sanctions to deter possible recurrence of rule violations and to enhance the quality and reliability of future audits.

## American Institute of Certified Public Accountants (AICPA)

* Promulgation of rules and standards that guide audit and related services provided to nonpublic companies, governmental entities such as states, counties, municipalities and school districts, and other entities such as universities and charities.
* Professional Rules & Standards
  + The Code of Professional Conduct
  + Quality control & peer review standards
  + Attestation Standards
  + Compilation and Review Standards

## Financial Accounting Standards Board (FASB)

* Privately funded body whose mission is to establish standards for financial accounting and reporting
* FASB Accounting Standards Codifcation (ASC), recognized as the source of GAAP by SEC, PCAOB, and AICPA.
* Emerging Issues Task Force (EITF)
  + Established to meet accountants’ needs for timely guidance on accounting practices and methods and to limit the number of issues requesting formal pronouncements from the FASB.

## International Auditing and Assurance Standards Board (IAASB)

* The global organization for the accountancy profession.
* Develop international standards on ethics, education, and public sector accounting standards.
* Issues International Standards on Auditing (ISA) and is the predominantly recognized international auditing standard setter outside of the U.S.

## International Accounting Standards Board (IASB)

* International counterpart to the FASB
* Predominately recognized accounting standards outside of the U.S.
* Responsible for the development and publication of International Financial Reporting Standards (IFRS), and for approving Interpretations of IFRS

## Auditing Standards

* Three Sets of Auditing Standards: ASB, PCAOB, and IAASB
  + ASB
    - PCAOB adopted the ASB standards that existed as of April 2003 and labeled them “interim standards of the PCAOB”
  + PCAOB
    - Adopted ASB standards. Required for all public company audits.
  + IAASB
    - Global accounting firms, which provide financial statement audits for nonpublic U.S. entities, U.S. public companies, and international companies around the world must adhere to ASB, PCAOB, and IAASB.

## The 10 Generally Accepted Auditing Standards

* ASB first issued the 10 generally accepted auditing standards (GAAS) in 1947.
* Three Categories: General Standards (3), Standards of Field Work (3), and Standards of Reporting (4)
* General Standards
  + The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor
  + In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
  + Due professional care is to be exercised in the performance of the audit and the preparation of the report
* Standards of Field Work
  + The work is to be adequately planned and assistants, if any, are to be properly supervised.
  + A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
  + Sufficient appropriate evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.
* Standards of Reporting
  + The report shall state whether the financial statements are presented in accordance with GAAP
  + The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period
  + Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report
  + The report shall 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. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor’s name is associated with financial statements, the report should contain a clear-cut indicator of the character of the auditor’s work, if any, and the degree of responsibility the auditor is taking.

## Three General Standards

* The three general standards deal with the auditor’s qualifications and the quality of his or her work.
* The auditor must have adequate training and proficiency gained through formal education, continuing education programs, and experience.
* The second general standard requires that the auditor maintain an attitude of independence on an engagement.
* Must be independent in fact but also appearance.
* Due professional care is the focus of the third general standard.
* Due care means that the auditor plans and performs his or her duties with the skill and care that is commonly expected of accounting professionals.

## Three Standards of Field Work

* Relate to the actual conduct of the audit
* Provide a conceptual background for the audit process
* First standard deals with planning and supervision. Proper planning leads to a more effective audit that is more likely to detect material misstatements and facilitates completing the engagement in a reasonable amount of time.
* The second standard requires that the auditor gain a sufficient understanding of the entity’s internal control to effectively plan the nature, timing, and extent of further audit procedures.
  + Nature – What procedures are performed
  + Timing – When the audit work is to be done
  + Extent – Refers to how much work is done
* Third standard requires sufficient and appropriate evidence.
  + Search for and evaluate the evidence regarding management’s assertions in the financial statements.

## Four Standards of Reporting

* Require that the auditor consider each of the following issues before rendering an audit report
  + Whether the financial statements are presented in accordance with GAAP
  + Whether those principles are consistently applied
  + Whether all appropriate disclosures have been made
  + What degree of responsibility the auditor is taking, as well as the character of the auditor’s work.

The ASB replaced the 10 GAAS with a more comprehensive and coherent description of “the principles underlying an audit conducted in accordance with GAAS.” Grouped into four categories:

* The purpose and premise of an audit
* Personal responsibility of the auditor
* Auditor actions in performing the audit
* Reporting

## Principles Underlying an Audit Conducted in Accordance with GAAS

* Purpose of an Audit and Premise upon which an Audit is Conducted
  + The purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. An auditor’s opinion enhances the degree of confidence that intended users can place in the financial statements
  + An audit in accordance with GAAS is conducted on the premise that management and, where appropriate, those charged with governance have responsibility
    - For the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
    - To provide the auditor with
      * All information, such as records, documentation, and other matters that are relevant to the preparation and fair presentation of the financial statements;
      * Any additional information that the auditor may request from management, and where appropriate, those charged with governance; and
      * Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.
* Responsibilities
  + Auditors are responsible for having appropriate competence and capabilities to perform the audit; complying with relevant ethical requirements; and maintaining professional skepticism and exercising professional judgment, throughout the planning and performance of the audit.
* Performance
  + To express an opinion, the auditor obtains reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
* To obtain reasonable assurance, which is a high, but not absolute, level of assurance, the auditor
  + Plans the work and properly supervises any assistants
  + Determines and applies appropriate materiality level or levels throughout the audit
  + Identifies and assesses risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity’s internal control.
  + Obtains sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks
* The audit or is unable to obtain absolute assurance that the financial statements are free from material misstatement because of inherent limitations, which arise from:
  + The nature of financial reporting;
  + The nature of audit procedures; and
  + The need for the audit to be conducted within a reasonable period of time and so as to achieve a balance between benefit and cost
* Reporting
  + Based on an evaluation of the audit evidence obtained, the auditor expresses, in the form of a written report, an opinion in accordance with the auditor’s findings, or states that an opinion cannot be expressed. The opinion states whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

Auditing Standards and the AU Codification

* Statements on Auditing Standards (SAS) are issued by the ASB
* The SAS are considered to be the minimum standards of performance for auditors
* The PCAOB adopted the ASB’s SAS as constituted at April 2003.
* Standards issued by the PCAOB are simply called “Auditing Standards” (AS)

## Definitions

Professional Skepticism – An attitude that includes a questioning mind and a critical assessment of audit evidence.

Ethics – Refers to a system or code of conduct based on moral duties and obligations that indicate how we should behave

Professionalism – The conduct, aims, or qualities that characterize a profession or professional person. The AICPA establishes guidance for acceptable behavior for auditors.

# Chapter 3

## Prospective Client Acceptance

* Requires that the client authorize you to speak to predecessor
* Make the following inquiries
  + Information that might bear on the integrity of management
  + Disagreements with management about accounting policies, auditing procedures, or other similarly significant matters
  + Communications to those charged with governance regarding fraud and noncompliance with laws or regulations by the entity
  + Communications to management and those charged with governance regarding significant deficiencies and material weaknesses in internal control
  + The predecessor auditor’s understanding about the reasons for the change of auditors
* Procedures for Evaluating a Prospective Client
  + Obtain and review available financial information (annual reports, interim financial statements, income tax returns, etc).
  + Inquire of third parties about any information concerning the integrity of the prospective client and its management. Such inquiries should be directed to the prospective client’s bankers and attorneys, credit agencies, and other members of the business community who may have such knowledge.
  + Communicate with the predecessor auditor about whether there were any disagreements about accounting principles, audit procedures, or similar significant matters
  + Consider whether the prospective client has any circumstances that will require special attention or that may represent unusual business or audit risks, such as litigation or going concern issues
  + Determine if the firm is independent of the client and able to provide the desired service
  + Determine if the firm has the necessary technical skills and knowledge of the industry to complete the engagement
  + Determine if acceptance of the client would violate any applicable regulatory agency requirements or the Code of Professional Conduct

## Preliminary Engagement Activities

* Three Preliminary Engagement Activities
  + Determining the audit engagement team requirements
  + Ensuring that the audit team and audit firm are in compliance with ethical and independence requirements, and
  + Establishing an understanding with the client
* Determine the Audit Engagement Team Requirements
  + The firm needs to ensure that their auditors have the proper degree of technical training and proficiency given the circumstances of the client
  + Some factors to consider
    - Engagement size and complexity
    - Level of risk
    - Any special expertise
    - Personnel availability
    - Timing of the work to be performed

## Assess Compliance with Ethical and Independence Requirements

* A Public Accounting firm should establish policies and procedures to ensure that persons at all organizational levels within the firm meet the profession’s ethical requirements, including maintaining independence in accordance with Rule 101 of the Code of Professional Conduct
* The firm should document compliance with this policy by having all personnel complete an annual independence questionnaire or report.
* E.g. Unpaid fees, having ownership or family involved with the company, no consulting services, etc.

## Establish an Understanding with the Client

* Establish an understanding with the client about the terms of the engagement
* Reduces the risk that either party may be misinterpret what is expected or required of the other party.
* Engagement Letter
  + Objectives of the engagement
  + Management’s responsibilities
  + Auditor’s responsibilities
  + Limitations of the engagement
* Three topics to discuss
  + The engagement letter
  + Using the work of the internal auditors
  + Role of the audit committee
* Engagement Letter
  + An engagement letter is used to formalize the arrangements reached between the auditor and the client. This letter serves are a contract, outlining the responsibilities of both parties and preventing misunderstandings between the two parties
  + May include
    - Arrangements involving the use of specialists or internal auditors
    - Any limitation of the liability of the auditor or client, such as indemnification to the auditor for liability arising from knowing misrepresentations to the auditor by management or alternative dispute resolution procedures
    - Additional services to be provided relating to regulatory requirements
    - Arrangements regarding other services (e.g. assurance, tax, or consulting services)

## Using Internal Auditors

* The auditor first needs to obtain an understanding of the internal audit function, including information about the activities that it performs.
* Determine whether any of these activities are relevant to the audit of the financial statements
* The internal auditors’ work may affect the nature, timing, and extent of the audit procedures performed by the independent auditor
* If the internal auditors are competent and objective, the independent auditor may use the internal auditors’ work in these areas to reduce the scope of audit work.
* The materiality of the account balance or class of transactions and its related audit risk may also determine how much the independent auditor can rely on the internal auditors’ work.
* You should always supervise, review, evaluate, and test their work.

## The Role of the Audit Committee

* An audit committee is a subcommittee of the board of directors that is responsible for the financial reporting and disclosure process.
* Under section 301 of SOX , the audit committee of a public company has the following requirements:
  + Each member of the audit committee must be a member of the board of directors and shall remain independent. “Independent” is defined as not receiving, other than for service on the audit committee, any consulting, advisory, or other compensatory fee and not being affiliated with the company
  + The audit committee is directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the company.
  + The audit committee must preapprove all audit and nonaudit services provided by the auditor
  + The audit committee must establish procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal control, and auditing
  + Each audit committee member must have the authority to engage independent counsel or other advisors, as determines necessary to carry on its duties

## Audit Plan and Strategy

* Engagement planning involves all the issues that auditor
* The audit plan is more detailed than the audit strategy. Auditor documents a description of the nature, timing, and extent of the planned audit procedures to be used in order to comply with auditing standards. How to conduct the audit in an effective and efficient manner.
* Additional Steps
  + Assess business risks
  + Establish materiality
  + Consider multilocations
  + Assess the need for specialists
  + Assess the possibility of illegal acts
  + Identify related parties
  + Consider additional value-added services

## Audit Plan & Strategy

* Assess Business Risks
  + Identify those business risks that may result in material misstatements.
  + How does the entity respond to those business risks and ensure that those responses have been adequately implemented?
* Establish Materiality
  + A matter of professional judgment
  + The auditor establishes a level of planning (or overall) materiality for evaluating the financial statements as a whole
  + Auditor also establishes tolerable misstatement – an amount of planning materiality that is allocated to specific accounts (i.e. A/R) or classes of transactions (i.e. sales transactions).
* Multilocations or Business Units
  + The auditor is to determine which locations or business units are to be audited and the extent of audit procedures to be performed at the selected locations or business units.
  + Related to AS 9
* Assess the Need for Specialists
  + Auditor’s specialist as an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence.
  + You should evaluate the competence and objectivity of the specialist, audit the inputs used by the specialist (e.g. census data for actuaries) and reconcile the output (e.g., an estimate should be found in the financial statements or disclosures), and review the specialist’s work for reasonableness, including the reasonableness of assumptions.
* Assess the Possibility of Illegal Acts
  + Illegal acts refers to violation of laws or governmental regulations.
  + Auditing standards distinguish between illegal acts that have direct and material effects on the financial statements and those that have material but indirect effects.
  + It is the auditor’s responsibility to detect illegal acts that have direct and material effect on the financial statements.
  + If it is found to of occurred, the auditor should consider its implications for other aspects of the audit, particularly the reliability of management representations. Inform the audit committee.
* Identify Related Parties
  + Affiliates of the enterprise; investments, trusts, pension, profit-sharing trusts, principal owners, management, immediate family, others who can influence management, etc.
  + How to find out
    - Review the minutes of the BOD and executive or operating committees for information about material transactions authorized or discussed at their meetings.
    - Review conflict-of-interest statements obtained by the company from management
    - Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships
    - Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of a reporting period
    - Review confirmations of loans receivables and payable for indications of guarantees. If guarantees are identified, determine their nature and the relationships of the guarantor to the entity.
* Consider Additional Value-Added Services
  + Provide strengths and weaknesses to BOD and management
  + Assurance services, risk assessment, business performance measurements, and electronic commerce.
* Document the Overall Audit Strategy, Audit Plan, and Prepare Audit Programs
  + Document decisions about the nature, timing, and extent of audit tests. The auditor records how the client is managing its risks (i.e., through internal control processes) and then documents the effects of the risk and controls on the planned audit procedures.

## Supervision of the Audit (AS13)

* The engagement partner has the overall responsibility for the engagement and its performance and should supervise the audit engagement team so that the work is performed as directed and supports the conclusions reached.
  + Inform engagement team members of their responsibilities, including
    - The objectives of the procedures that they are to perform;
    - The nature, timing, and extent of procedures they are to perform; and
    - Matters that could affect the procedures to be performed or the evaluation of the results of those procedures
  + Direct engagement team members to bring any significant accounting and auditing issues they identify to the attention of the engagement partner or other engagement team members performing supervisory activities so they can evaluate those issues and determine appropriate actions
  + Review the work of engagement team members to evaluate whether
    - The work was performed and documented;
    - The objectives of the procedures were achieved; and
    - The results of the work support the conclusions reached

## Types of Audit Tests

* Risk Assessment Procedures
* Tests of Control
* Substantive Procedures

## Risk Assessment Procedures

* Obtain an understanding of the entity and its environment, including its internal control. Inquiries of management and others, preliminary analytical procedures, and observation and inspection

## Test of Controls

* Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the relevant assertion level. E.g.
  + Inquiries of appropriate management, supervisory, and staff personnel
  + Inspection of documents, reports, and electronic files
  + Observation of the application of specific controls
  + Walkthroughs, which involve tracing a transaction from its origination to its inclusion in the financial statements through a combination of audit procedures including inquiry, observation, and inspection
  + Reperformance of the application of the control by the auditor

## Substantive Procedures

* Designed to detect material misstatements in a transaction class, account balance, and disclosure component of the financial statements.
  + Tests of Details
    - Categorized into two types:
      * Substantive Tests of Transactions
        + Test for errors or fraud in individual transactions
        + Gives evidence about occurrence, completeness, and accuracy assertions
      * Tests of Details of Account Balances and Disclosures
        + Items that are contained in the ending financial statement account balances and disclosures. Test A/R
        + Send confirmations to a sample of customers in order to gather evidence about the existence assertion
  + Substantive Analytical Procedures
    - Evaluation of financial information through analysis of plausible relationships (e.g., examination of trends and ratios) among both financial and nonfinancial data
    - Identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.
* Dual-Purpose Tests

## Qualitative Factors That May Affect Establishing & Evaluating Materiality

* Establish the preliminary judgment about materiality
  + Material misstatements in prior years
  + Potential for fraud or illegal acts
  + Small amounts may violate covenants in a loan agreement
  + Small amounts may affect the trend in earnings
  + Small amounts may cause entity to miss forecasted revenue or earnings
* Evaluating the materiality of unadjusted misstatements
  + Whether the misstatement masks a chance in earnings or trends
  + Whether the misstatement hides a failure to meet analysts’ consensus expectations
  + Whether the misstatement changes a loss into income or vice versa
  + Whether the misstatement concerns a segment or other portion of the business that has been portrayed as playing a significant role in the operations or profitability of the entity
  + Whether the misstatement affects compliance with regulatory requirements
  + Whether the misstatement affects compliance with loan covenants or other contractual requirements
  + Whether the misstatement increases management’s compensation
  + Whether the misstatement involves the concealment of an unlawful transaction
  + Whether the misstatement may result in a significant positive or negative market reaction
  + Whether small intentional misstatements are part of actions to “manage” earnings