

## ACC531: Auditing and Assurance Services

### Ch2. Professional Standards

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# Table of Contents

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- 1 Generally Accepted Auditing Standards (GAAS)
- 2 Fundamental Principle: Responsibilities
- 3 Fundamental Principle: Performance
- 4 Fundamental Principle: Reporting
- 5 Evaluating the Quality of Public Accounting Firms' Practices

## Opening Illustration: Can we drive a truck to Australia?



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- McKesson & Robbins (MR) claimed that they shipped goods to Australia by truck.
- It **artificially inflated** A/R, inventories, and revenues.
- Price Waterhouse (now PwC) was the auditor.
- PwC may have become too close to MR, having audited the company for 10+ years.
- PwC accepted MR's assertions about inventory and receivables without **verifying their existence**.
- In 1939, this scandal triggered the AICPA to develop auditing standards.<sup>1</sup>

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<sup>1</sup>Watch the video on YouTube.

# Generally Accepted Auditing Standards (GAAS)

## LO 1

Understand the development and source of Generally Accepted Auditing Standards (GAAS).

- Auditing standards set by \_\_\_\_\_ is referred to as \_\_\_\_\_.
- Auditing standards set by \_\_\_\_\_ is referred to as \_\_\_\_\_.

## Who sets the rules and standards for audits?

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- 1938: The SEC began an investigation into McKesson & Robbins.
- 1939-1972: \_\_\_\_\_<sup>2</sup> issued Statements on Auditing Procedures.
- 1972-Present: ASB issued Statements on Auditing Standards (SASs).
- 2002: The massive frauds at Enron and WorldCom.
- In response to these failures: Sarbanes-Oxley Act (SOX) was passed in 2002. It created [PCAOB](#).<sup>3</sup>
- \_\_\_\_\_ takes over the responsibility of issuing Auditing Standards for \_\_\_\_\_ (i.e., public companies).<sup>4</sup>
- \_\_\_\_\_ still has a role in the development of auditing standards for \_\_\_\_\_ (i.e., private companies).

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<sup>2</sup>Auditing Standards Board

<sup>3</sup>Public Company Accounting Oversight Board

<sup>4</sup>PCAOB's Auditing Standards are subject to the formal approval of the SEC.

## Who sets the rules and standards for audits?

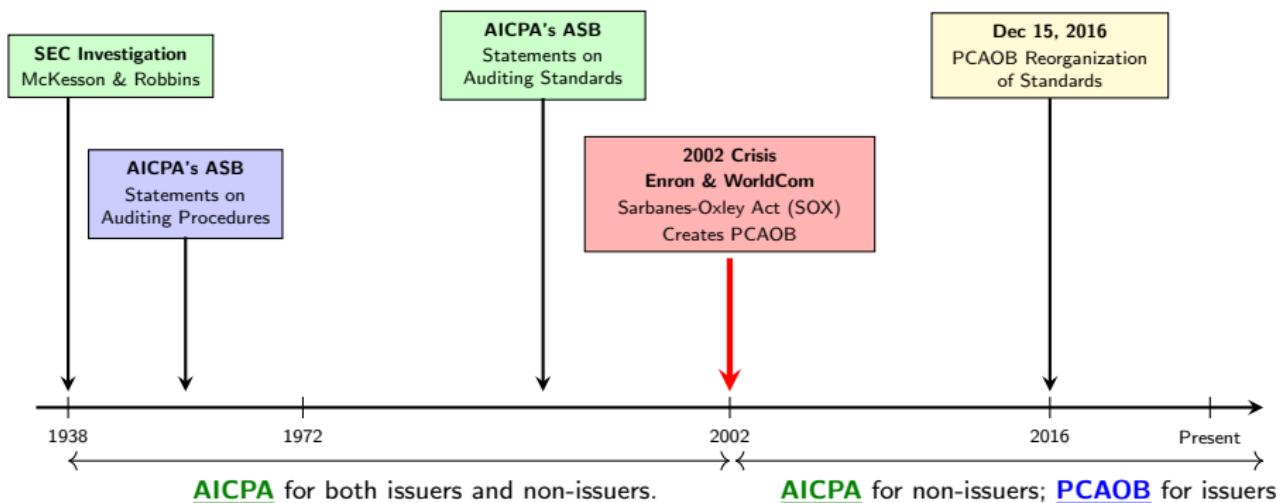
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- Until 2016: PCAOB standards consisted of a combination of Auditing Standards issued by PCAOB and standards issued by AICPA that had not been superseded by PCAOB standards.<sup>5</sup>
- Effective December 15, **2016**: **PCAOB** has **reorganized and combined** these standards into a single body of pronouncements.

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<sup>5</sup>They are referred to as Interim Auditing Standards.

# Who sets the rules and standards for audits?



# Generally Accepted Auditing Standards (GAAS)

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- GAAS is the relevant pronouncements of the \_\_\_\_\_.
- GAAS identify necessary qualifications and characteristics of auditors
- GAAS guide the conduct of the audit examination.
- The purpose of GAAS is to meet the objectives of an audit examination:
  - ▶ To obtain \_\_\_\_\_ about whether the F/S as a whole are free of \_\_\_\_\_, whether due to fraud or error.
  - ▶ To issue a \_\_\_\_\_ on the F/S.

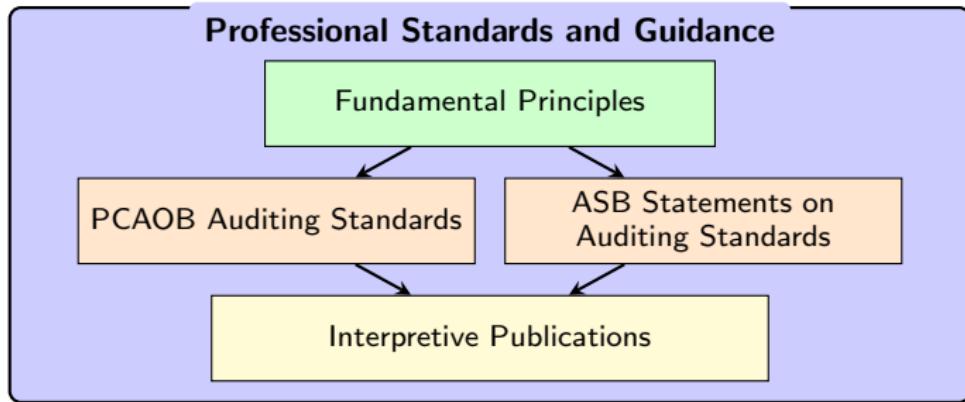
- The body of GAAS is based on three **fundamental principles**.<sup>6</sup>
  - ▶ \_\_\_\_\_ of the audit team.
  - ▶ \_\_\_\_\_ of the audit.
  - ▶ \_\_\_\_\_ the results of the engagement.

**RECALL:** Auditing: a process of \_\_\_\_\_ regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established criteria and to interested users.

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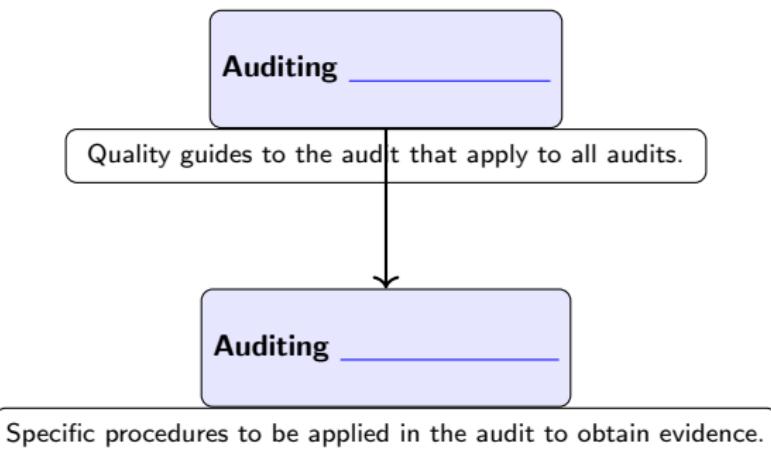
<sup>6</sup>This later part of the slide covers these three principles at the high level. Then they are covered throughout the semester.

- **Fundamental principles** - Guide general conduct of audit engagements
- **Auditing Standards** - Provide requirements supporting fundamental principles
- **Interpretive Publications** - Provide guidance on the application of GAAS<sup>7</sup>



<sup>7</sup>Examples include AICPA Audit and Accounting Guides and AICPA Auditing Statements of Position.

# Auditing Standards vs Auditing Procedures



**EX.** Auditing \_\_\_\_\_ indicate that auditors must determine that recorded accounts receivable are based on actual sales to customers. An audit \_\_\_\_\_ used to satisfy that standard is to **confirm** accounts receivable with the company's customers.

## Issuers vs Non-issuers

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	<b>Rule-making body</b>	<b>Standards</b>
<b>Issuers<sup>8</sup></b>	_____	Auditing Standards
<b>Non-issuers<sup>9</sup></b>	_____	Statements on Auditing Standards

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<sup>8</sup>Public companies

<sup>9</sup>Private companies

## Other Auditing Standards

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Other standards exist related to the audits of governmental and foreign entities. We do not cover them in this course.

# Table of Contents

---

- 1 Generally Accepted Auditing Standards (GAAS)
- 2 Fundamental Principle: Responsibilities
- 3 Fundamental Principle: Performance
- 4 Fundamental Principle: Reporting
- 5 Evaluating the Quality of Public Accounting Firms' Practices

### LO 2

Describe the fundamental principle of responsibilities and how this principle relates to the characteristics and qualifications of auditors.

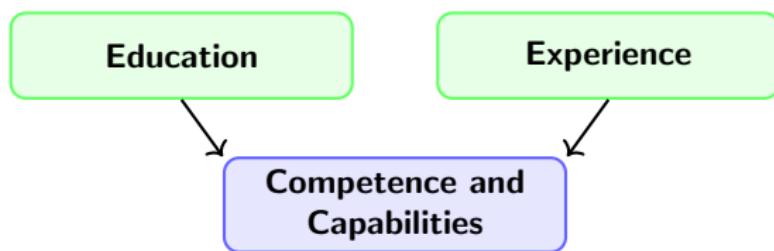
The responsibility principle relates to

- the **personal integrity** and
- **professional qualifications** of auditors.

Auditors are responsible for:

- ① Having appropriate \_\_\_\_\_ to perform the audit.
- ② Complying with relevant \_\_\_\_\_.
- ③ Maintaining \_\_\_\_\_ and exercising \_\_\_\_\_ through the planning and performance of the audit.

- Auditors must have appropriate **competence and capabilities** to perform the audit.



- The responsibility principle requires auditors to comply with appropriate **ethical requirements**.
- Two important requirements are:
  - ① **Independence** from the entity being audited.
  - ② **Due care** in the performance of the audit.



## Independence \_\_\_\_\_

- Auditors must maintain independence in mental attitude.
- Auditors are expected to be unbiased and impartial with respect to the F/S and information they audit.
- Independence allows auditors to form an opinion on the entity's F/S without being affected by influences that might compromise that opinion.

## Independence \_\_\_\_\_

- It is also important to ensure that auditors do appear to be independent.
- Examples of lack of independence in appearance:
  - ▶ The audit partner owns stocks of the entity.
  - ▶ The audit partner is a friend of the entity's CEO.
  - ▶ A son of the audit partner works for the entity.
- What about this? A friend of my partner works for the entity.
- There's no clear rule for this.

Auditors should be independent 1) **in fact** and 2) **in appearance**.

The followings may compromise independence:

- The auditor receives more fees from the entity through non-audit services than through audit services.
- The auditor has audited the entity for 100+ years.
- The client firm's CFO is a former employee of the auditor.

A detailed discussion of AICPA and SEC rules related to independence is provided in Module B of the textbook.

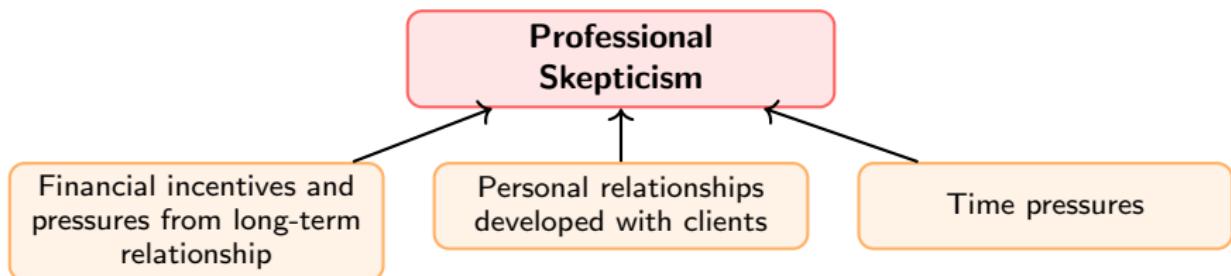
- Due care reflects the **level of performance** that would be exercised by a **reasonable auditors** in similar circumstances.
- Due care is related to the two dimensions of the responsibility principle:
  - ▶ Competence and capabilities (discussed earlier).
  - ▶ Professional skepticism and professional judgment (discussed later).

- Auditors should be professionally skeptical.<sup>10</sup>
- Auditors should evaluate and consider:
  - ▶ **Contradictory audit evidence** obtained through different procedures.
  - ▶ The **reliability** of documentary evidence.
  - ▶ The **reliability** of info obtained from MGT and those charged with governance of the entity (e.g., Board of Directors and Audit Committee).

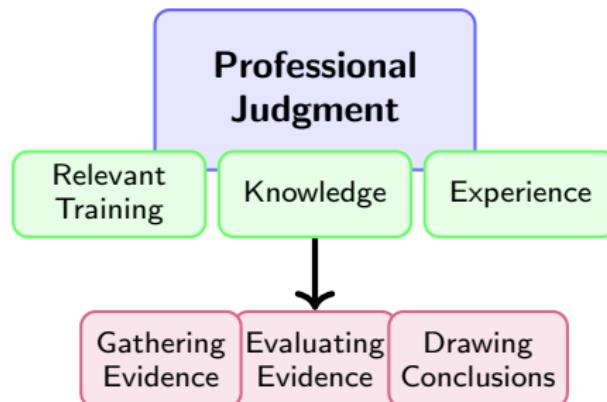
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<sup>10</sup> Professional skepticism: a state of mind that is characterized by appropriate **questioning** and a **critical assessment** of audit evidence, as discussed in Ch1.

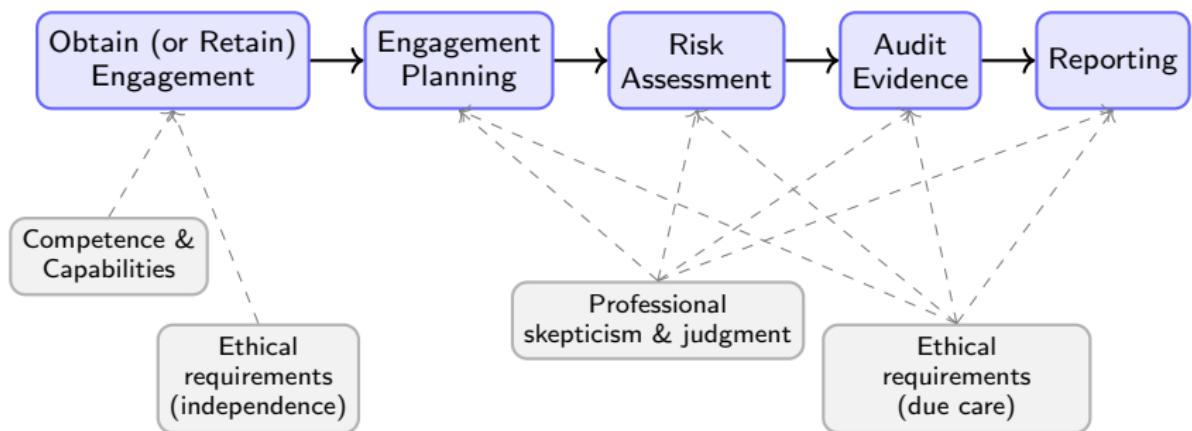
Auditors may lack professional skepticism due to:



- **Professional judgment** is the application of relevant training, knowledge, and experience in making informed decisions about appropriate courses of action during the audit engagement.
- **Professional judgment** is required as auditors 1) gather evidence; 2) evaluate the evidence; 3) draw conclusions based on the evidence.
- Particularly important when evaluating the reasonableness of the entity's accounting estimates (e.g., bad debt expense).



## < Stages of an Audit >



# Table of Contents

---

- 1 Generally Accepted Auditing Standards (GAAS)
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- 3 Fundamental Principle: Performance
- 4 Fundamental Principle: Reporting
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### LO 3

Describe the fundamental principle of performance and identify the major activities performed in an audit.

The **performance principle** states:

- To express an opinion, the auditor obtains \_\_\_\_\_ about whether the F/S as a whole are free of \_\_\_\_\_, whether due to fraud or error.

### **Reasonable assurance:**

- A high but not absolute level of assurance.
- Auditors are not “insurers” or “guarantors” regarding the fairness of the entity’s F/S.
- However, auditors should provide a high level of assurance (or confidence) regarding their work.<sup>11</sup>

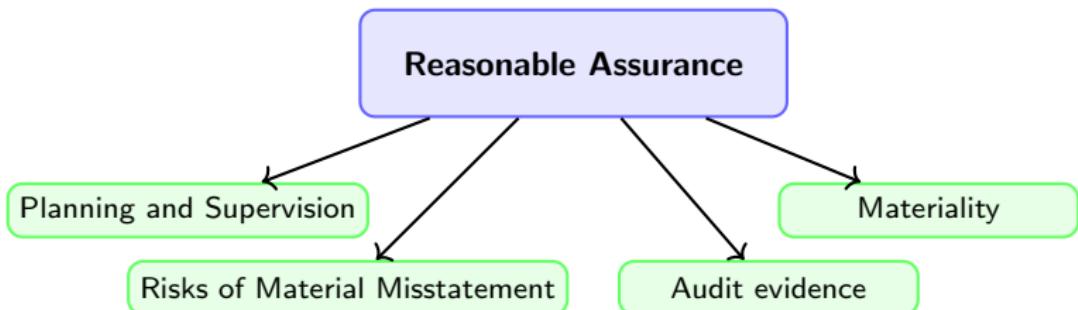
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<sup>11</sup>Even after high-quality audits, the F/S may still contain material misstatements.

## Fundamental Principle: Performance

To obtain **reasonable assurance**, the auditor

- \_\_\_\_\_ the work and properly supervises any assistants.<sup>12</sup>
- Determines and applies appropriate \_\_\_\_\_ level or levels throughout the audit.<sup>13</sup>
- Identifies and assesses \_\_\_\_\_, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's <sup>14</sup> \_\_\_\_\_.
- Obtains sufficient appropriate \_\_\_\_\_ about whether \_\_\_\_\_ exists, throughout designing & implementing appropriate responses to the assessed risks.<sup>15</sup>

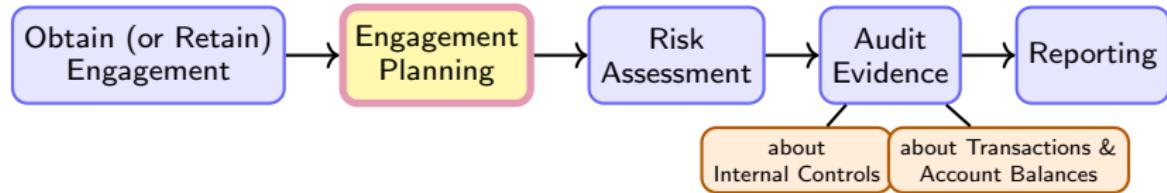


<sup>12</sup>Ch3.

<sup>13</sup>Ch3.

<sup>14</sup>Ch5.

<sup>15</sup>Ch3.



Once obtaining or retaining the engagement, the next step is planning, including:

- Preparing an \_\_\_\_\_ and supervising the audit work.
- Obtaining knowledge of the client's business and industry.
- Dealing with differences of opinion among the accounting firm's own personnel.

**Audit Plan:** A list of the \_\_\_\_\_ to be performed to gather sufficient appropriate \_\_\_\_\_ on which to base their opinion on the F/S.<sup>16</sup>

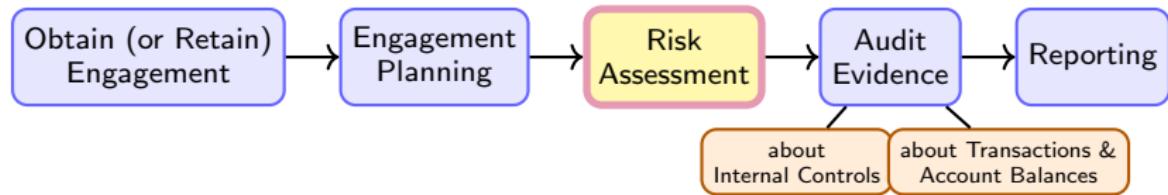
<sup>16</sup>Ch3.

Auditors should focus on matters that are important to F/S users.

- \$1,000,000 misstatement might be not material to Apple.
- \$1,000,000 misstatement must be material to a small company with \$2,000,000 in sales.
- **Materiality** is a relative, subjective concept.<sup>17</sup>

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<sup>17</sup> Ch 3.



Auditors need to evaluate the RMM in the F/S.

The risk assessment process requires an understanding of:

- the client's industry.
- the client's operating environment.
- the client's internal controls.

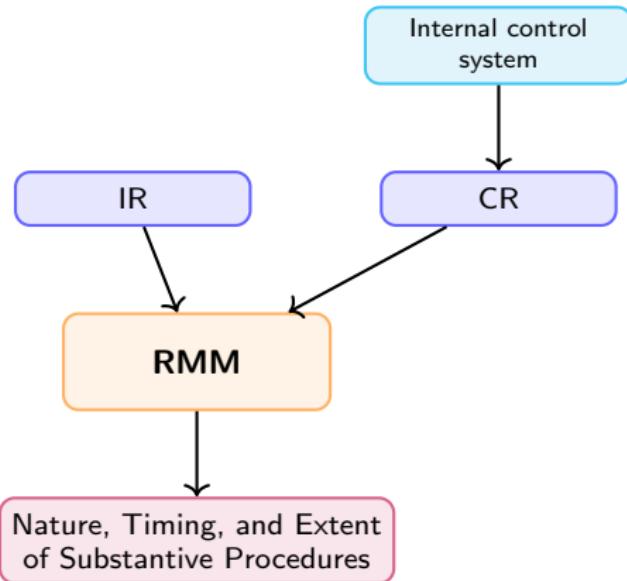
$$\text{RMM} = \text{CR} \times \text{IR}$$

- RMM: P [ the F/S includes MM prior to the audit ]
- IR: P [ MM will occur if no \_\_\_\_\_ are in place ]<sup>18</sup>
- CR: P [ MM will not be \_\_\_\_\_ by the client's internal controls ]<sup>19</sup>

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<sup>18</sup>Inherent risk (IR) is unavoidable. It's in nature of the business.

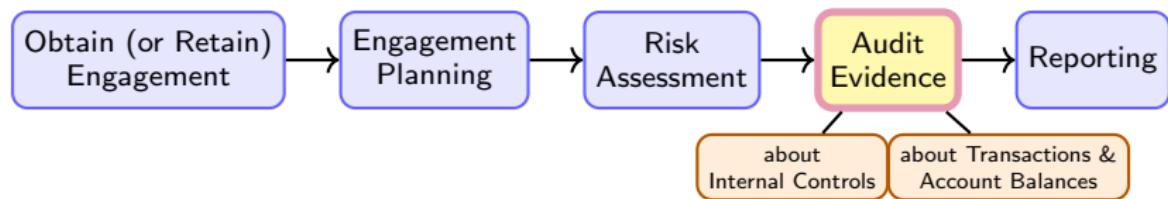
<sup>19</sup>Control risk (CR) can be managed through **effective internal controls**.



- Effective \_\_\_\_\_ can reduce CR and RMM.
- \_\_\_\_\_ ⇒ Auditors should obtain and evaluate more evidence.
- \_\_\_\_\_ ⇒ Auditors should use more effective substantive procedures.

## Failure of Silicon Valley Bank

The final element of the performance principle requires that audit team collects and evaluates **sufficient appropriate evidence** to provide a reasonable basis for their opinion.



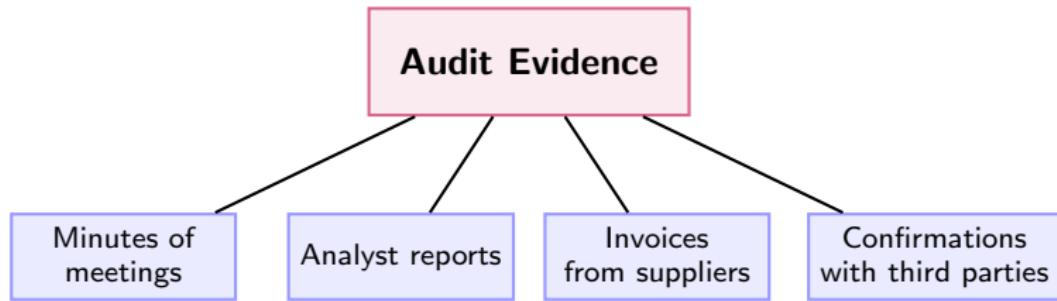
## Audit evidence<sup>20</sup>:

- The information that auditors use to form their opinion on the F/S.
- Auditors use **substantive procedures** to obtain audit evidence.

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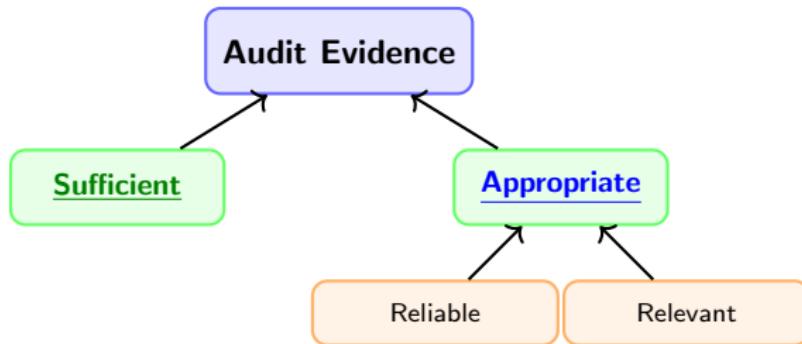
<sup>20</sup>Ch3.

Examples include:



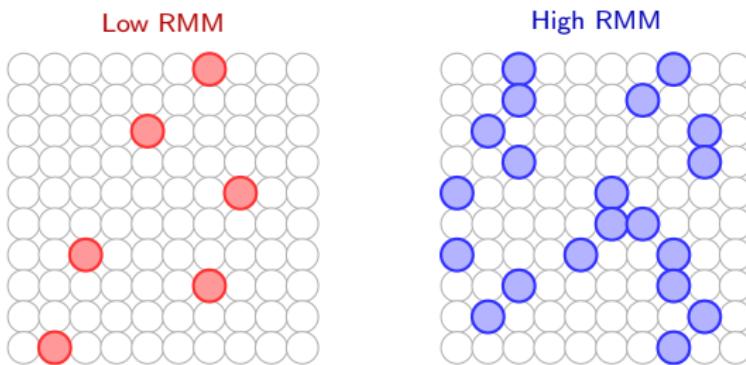
## Sufficient appropriate evidence:

- Sufficient in terms of quantity
- Appropriate in terms of quality (reliability and relevance)



## "Sufficient"

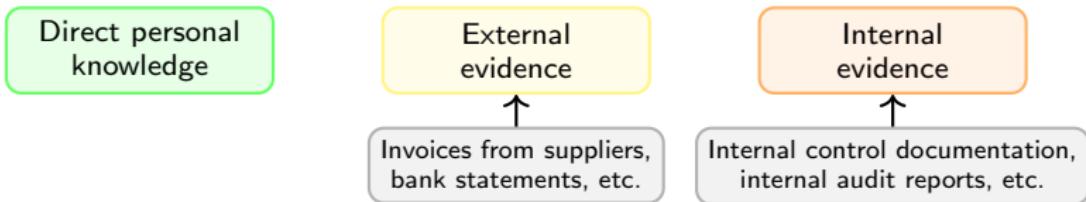
- Auditors do not audit all of the transactions and components.
- Auditors examine a \_\_\_\_\_ of them.



- \_\_\_\_\_ ⇒ Auditors should obtain and evaluate more evidence.

## "Reliable"

- **High RMM** ⇒ Auditors should obtain **more reliable** evidence.
- From most to least reliable:



- Evidence created by sources outside the entity is more reliable when received from directly from the external source than when received from sources internal to the entity (**direct external evidence** vs. **external-internal evidence**).
- Evidence obtained from entities with more effective \_\_\_\_\_ is more reliable.
- Evidence obtained from \_\_\_\_\_ is more reliable.

### "Relevant"

- Audit evidence should be relevant to the \_\_\_\_\_.
- Audit evidence relevant to one audit objective is not necessarily relevant to another audit objective.
- For example, when auditors **confirm the existence of accounts receivable** with customers, the evidence should be relevant to the audit objective of the \_\_\_\_\_ of accounts receivable.
- But it is not relevant to the audit objective of the \_\_\_\_\_ of the accounts receivable.

## **Audit Risk**

- Audit risk (AR) is the risk that the auditors will issue a **false audit opinion**.
- $AR = IR \times CR \times DR^{21}$
- High IR or CR (i.e., RMM)  $\Rightarrow$  DR should be lower to keep a reasonable AR.<sup>22</sup>
- To reduce AR, auditors reduce DR.
- That is, DR is **"set up"** by the auditor to lower the overall audit risk.

$$DR = \frac{AR}{IR \times CR} = \frac{AR}{RMM}$$

- To reduce DR, auditors obtain more \_\_\_\_\_.

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<sup>21</sup> IR: Inherent risk, CR: Control risk, DR: Detection risk (i.e., the risk that the auditors will fail to detect a MM when one exists).

<sup>22</sup> This topic is covered in Ch 4.

	Case 1	Case 2
<b>Target AR</b>	5%	5%
<b>IR</b>	30%	80%
<b>CR</b>	20%	70%
<b>RMM</b>	_____	_____
<b>DR</b>	_____	_____

Interpretation:

- With \_\_\_\_\_ RMM, auditors can accept a \_\_\_\_\_ DR.  $\Rightarrow$  \_\_\_\_\_ evidence needed.
- With \_\_\_\_\_ RMM, auditors must set a \_\_\_\_\_ DR.  $\Rightarrow$  \_\_\_\_\_ evidence needed.

# Table of Contents

---

- 1 Generally Accepted Auditing Standards (GAAS)
- 2 Fundamental Principle: Responsibilities
- 3 Fundamental Principle: Performance
- 4 Fundamental Principle: Reporting
- 5 Evaluating the Quality of Public Accounting Firms' Practices

### LO 4

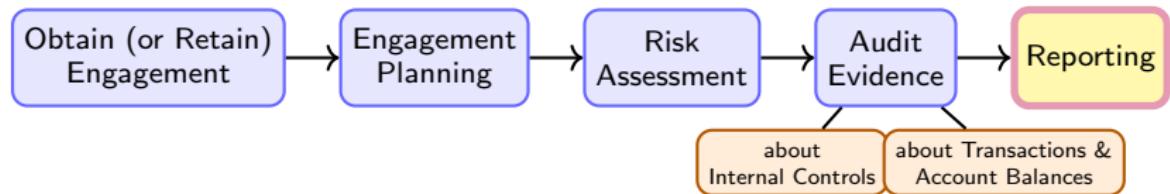
Describe the fundamental principle of reporting and identify the basic contents of the auditors' report.

Check audit reports of Crocs for years 2023, 2024, and 2025.  
What insights can you get?

## Fundamental Principle: Reporting

The ultimate objective of the audit is the report on the audit, which is guided by the fundamental principle of reporting:

*Based on evaluation of the evidence obtained, the auditor expresses in the form of a written report, an opinion in accordance with the auditor's findings, or states that an opinion cannot be expressed. The opinion states whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.*



## Types of Audit Opinions

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Opinion Type	Explanation
<b>Unqualified Opinion</b>	F/S are presented fairly, in all material respects, in accordance with GAAP.
<b>Qualified Opinion</b>	F/S are presented fairly, in all material respects, <b>except for a specific reservation.</b>
<b>Adverse Opinion</b>	F/S are <b>not</b> presented fairly, in all material respects, in accordance with GAAP.
<b>Disclaimer of Opinion</b>	An opinion cannot be expressed.

# Table of Contents

---

- 1 Generally Accepted Auditing Standards (GAAS)
- 2 Fundamental Principle: Responsibilities
- 3 Fundamental Principle: Performance
- 4 Fundamental Principle: Reporting
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## LO 5

Understand the role of a system of quality control and monitoring efforts in enabling public accounting firms to meet appropriate levels of professional quality.

Who is responsible for evaluating the quality of public accounting firms' practices?

