Planning the Audit

Generally Accepted Auditing Standards (GAAS)

GAAS represent measures of the quality of performance of the auditor & address

- Auditor's professional qualities
- Judgment exercised by the auditor in performing audit & preparing report

Consist of 10 standards divided into 3 categories

1) General standards
    - Qualifications of auditor
    - Quality of work
2) Standards of fieldwork
3) Standards of reporting

General Standards (3)

1) **Training and Proficiency**—The audit is to be preformed by a person or persons having adequate technical training and proficiency as an auditor.
2) **Independence**—In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3) **Professional Care**—Due professional care is to be exercised in the performance of the audit and the preparation of the report

Standards of Fieldwork (3)

1) **Planning and Supervision**—The work is to be adequately planned and assistants, if any, are to be properly supervised.
2) **Internal Control**—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.
3) **Evidence Matter—**Sufficient competent 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 (4)

1) **Generally Accepted Accounting Principles**—The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2) **Consistency—**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.
3) **Disclosures**—Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4) **Opinion—**The report shall either contain 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 indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

Summary of the 10 Generally Accepted Auditing Standards (GAAS)

T—Training and Proficiency

I—Independence

P—Professional Care

P—Planning and Supervision

I—Internal Control

E—Evidential Matter

G—Generally Accepted Accounting Principles

O—Opinion

D—Disclosures

C—Consistency

The Standards spell out TIP, PIE, and GODC (the reporting standards are ordered 1, 4, 3, 2 for GOD and a soft-c to sound like gods)

Accepting the Engagement

Compliance with General Standards

1) Training & proficiency results from education & auditing experience
2) Independence required in both fact & appearance
   - Independence in fact includes
   - Intellectual honesty
   - No direct financial interest in client
   - No material indirect financial interest
3) Due professional care
   - Observation of standards of fieldwork & reporting
   - Critical review at every level of supervision
   - Exercise professional skepticism
   - Obtain reasonable assurance

Understanding of Client's Operations, Business, & Industry

Auditor must have understanding or be able to obtain it prior to commencing the engagement

Avoid association with client whose management lacks integrity

Procedures prior to acceptance

- Review client's financial statements
- Make inquiries of third parties such as client's attorneys & creditors
- Communication with predecessor auditor

Communication with Predecessor Auditor

Successor must make inquiries of predecessor auditor before accepting engagement

- Successor initiates communication
- Requires permission of client
- Consider implications of client's refusal

Nature of inquiries

- Disagreements with management about audit procedures or accounting principles
- Communication with audit committee about fraud, illegal acts, or internal control
- Reason for change in auditor
- Integrity of management

Audit Committee

The client's audit committee is part of board of directors

- Directors that are not officers or employees
- Liaison between auditor & board of directors

Audit committee

- Oversees financial reporting and disclosure process
- Hires auditor
- Reviews audit plan
- Reviews results & financial statements
- Oversees adequacy of internal control

Auditor & audit committee agree on

- Timing, fees, & responsibilities of parties
- Overall audit plan

Communication during & after Audit

Communication about the audit

- The auditor's responsibilities under GAAS
- Selection of & changes to accounting policies (may be communicated by management)
- Management's process for estimating (may be communicated by management)
- Adjustments proposed by auditor
- Auditor's judgment about the quality of entity's accounting principles
- Auditor's responsibility for information in documents containing audited financial statements
- Disagreements with management
- Management's consulting other accountants about accounting matters
- Items discussed with management prior to being retained
- Difficulties encountered in performing the audit

Communication during & after Audit (continued)

Other communication

- Errors discovered by auditor & corrected by client
- Consequential fraud & illegal acts
- Fraud & illegal acts involving senior management
- Significant deficiencies in internal control not previously communicated

Engagement Letter

Includes clear understanding of nature of services and responsibility assumed

Understanding may be written, in the form of an engagement letter, or **ora**l and includes

- **O**bjectives of engagement
- **R**esponsibilities of management
- **A**uditor's responsibilities
- **L**imitations of engagement

Understanding will also indicate

- **F**inancial records and information will be made available
- **I**ndication of compliance with applicable laws and regulations
- **L**etter of representations at conclusion of fieldwork
- **E**stablishment and maintenance of internal control
- **S**tatements are the responsibility of management

Engagement Letter (continued)

An engagement letter may also address

- **F**ees to be charged by the auditor
- **I**mmaterial errors or fraud not expected to be found by audit
- **R**easonable assurance provided that statements are not materially misstated
- **M**aterial misstatements may not be detected

*The client opens its **files** to the CPA **firm**.*

Management's Responsibilities

The financial statements are the responsibility of management

By presenting financial statements, management is making various assertions

- **P**resentation & Disclosure (**P** & D)—components of the financial statements are properly classified, described, & disclosed
- **E**xistence or occurrence (**E** or O)—assets & liabilities of the entity exist as of a particular date & recorded transactions occurred during a given period
- **R**ights & obligations (**R** & O)—the assets are the rights of the entity & the liabilities are the obligations of the entity at a particular date
- **C**ompleteness (**C**)—all accounts & transactions that should be, are included in the financial statements
- **V**aluation (**V**)—asset, liability, equity, revenue, & expense components have been included in the financial statements at appropriate amounts

*The auditor must **perceive (PERCV)** the assertions to design a good audit program.*

Planning Considerations & Procedures

Audit planning—developing strategy for scope & conduct of audit based on

- Size & complexity of entity
- Auditor’s experience with entity
- Auditor’s knowledge of entity’s business

Planning considerations

- Entity’s accounting policies
- Materiality levels
- Audit risk & planned assessed level of control risk
- Entity’s business environment
- Methods of processing accounting information
- Items on financial statements prone to adjustment
- Conditions affecting audit tests
- Reports to be issued

Planning procedures

- Determine involvement of consultants, specialists, & internal auditors
- Read current year's interim financial statements
- Coordinate assistance of entity personnel
- Discuss with firm personnel responsible for non-audit services matters affecting the audit
- Review correspondence files, prior year's working papers, permanent files, financial statements, & auditor's report
- Inquire about current business developments affecting entity
- Discuss type, scope, & timing of audit with management, board of directors, or audit committee
- Consider effects of recent pronouncements
- Establish timing of audit work
- Establish & coordinate staffing
- Compare financial statements to anticipated results
- Perform analytical procedures to identify risk areas
- Assess materiality and audit risk

Materiality

Recognizes relative importance of items to fair presentation of financial statements

- Items may be material due to high dollar amount (Quantitative)
- Items may be material due to nonmonetary significance (Qualitative)

Materiality can be measured in relation to

- Financial statements taken as a whole
- A transaction

Materiality is matter of professional judgment

- Must plan audit to obtain reasonable assurance that financial statements are not misstated
- Misstatements could be material individually or collectively
- Materiality measurement based on smallest aggregate level

Audit Risk (AR)

AR is risk that material errors or fraud exists resulting in an inappropriate audit report

- Auditor uses judgment in establishing acceptable level of AR
- Lower acceptable level of AR achieved through obtaining more evidential matter

AR consists of inherent risk (IR), control risk (CR), & detection risk (DR)

IR acknowledges that certain items are more susceptible to risk

- May be due to complexity of transactions or calculations, ease of theft, or lack of available objective information
- IR is beyond control of auditor & generally beyond control of entity

CR acknowledges that misstatements may not be prevented or detected by entity's internal control

- Entity's internal control may be poorly designed or poorly executed
- CR is beyond control of auditor but within control of entity

Audit Risk (continued)

DR acknowledges that auditor may not detect material misstatement

- Auditor may not properly plan audit procedures
- DR is within control of auditor

Components of Audit Risk

	Increases risk	*Decreases risk*
Inherent risk	Declining industry Lack of working capital High rate of obsolescence	More profitable than industry average Low management turnover
Control risk	Ineffective internal controls Weak management oversight	Effective internal controls Strong management oversight
Detection risk	Decrease substantive testing Perform tests early in year	Increase substantive testing Select more effective tests Perform tests near year-end

Audit Risk Model

$AR = IR \times CR \times DR$

To apply model

Establish acceptable level of audit risk

Measure inherent risk based on internal & external factors

Establish planned assessed level of control risk based on discussing internal control with management

- May set control risk at maximum level
- If control risk set below maximum, must perform tests of controls to verify assessment

Compute necessary level of detection risk

$DR = AR \div (IR \times CR)$

Determine if planned nature, timing, & extent substantive tests are adequate to provide appropriate level of detection risk

Material Misstatements

Definition of Misstatement

A misstatement may refer to any of the following:

- A difference between the amount, classification, or presentation of a reported financial statement element, account, or item and the amount, classification, or presentation that would have been reported under generally accepted accounting principles.
- The omission of a financial statement element, account, or item.
- A financial statement disclosure that is not presented in accordance with generally accepted accounting principles.
- The omission of information required to be disclosed in accordance with generally accepted accounting principles.

Evaluation of Misstatements

Misstatements should not just be evaluated quantitatively, but qualitatively, such as

1) Misstatements that affect trends of profitability.
2) Misstatements that change losses into income.
3) Misstatements that affect segment information.
4) Misstatements that affect compliance with legal and contractual requirements.

Misstatements in a sample are likely to indicate greater misstatement in the population as a whole. The use of estimates in accounting increases the risk of material misstatements.

Consideration of Fraud in a Financial Statement Audit

Prevention & detection of fraud is management's responsibility

- Auditor provides reasonable assurance that financial statements are not materially mis-stated
- Absolute assurance prevented by fact that perpetrator generally conceals actions to make detection difficult

Types of Fraud

2 types of fraud can result in material misstatement of financial statements

- Fraudulent financial reporting—intentional misstatements or omissions
- Misappropriations of assets (defalcations)—embezzlement, stealing, or misuse of funds

Fraud most often committed when there is

- Pressure or incentive
- Opportunity

Steps in Consideration of Fraud

- Staff discussion of the risk of material misstatement
- Obtain information needed to identify risks of material misstatement
- Identify risks that may result in a material misstatement due to fraud
- Assess the identified risks after considering programs and controls
- Respond to the results of the assessment
- Evaluate audit evidence
- Communicate about fraud
- Document consideration of fraud

Throughout the engagement, the audit team should exercise **professional skepticism** regarding the possibility of fraud.

Fraud Risk Factors

Existence of certain factors lead auditor to conclude high risk of **fraudulent financial reporting**

Management characteristics

- Compensation tied to aggressive results
- Excessive interest in stock prices & earnings
- Commitments made to analysts regarding achieving unrealistic forecasts
- Pursuit of minimizing earnings for tax purposes

Management's attitude toward internal control

- Management dominated by single person or small group
- Controls not adequately monitored
- Known weaknesses not corrected timely
- Unrealistic goals set for operating personnel
- Use of ineffective accounting, technology, or internal audit staff

Fraud Risk Factors (continued)

Other management related factors

- High turnover
- Strained relationship with auditor

Industry conditions

- New accounting rules or requirements impairing profitability
- High degree of competition
- Declining industry
- Volatile industry

Fraud Risk Factors (continued)

Operating characteristics & financial instability of entity

- Negative cash flows
- Need for capital
- Use of estimates that are unusually subjective or subject to change
- Related party transactions outside the ordinary course of business
- Significant or unusual transactions near year-end
- Overly complex structure
- Unusual growth or profitability
- Vulnerable to changes in interest rates
- Difficult debt covenants
- Overly aggressive incentive programs
- Threat of bankruptcy, foreclosure, or takeover
- Pending transaction that will be adversely affected by poor results

Fraud Risk Factors (continued)

Existence of other factors lead auditor to conclude high risk of **misappropriation of assets**

Characteristics indicating lack of adequate control over susceptible assets

- Operations not subject to proper oversight
- Inadequate screening of applicants for positions with access to assets
- Inadequate recordkeeping
- Insufficient segregation of duties with lack of independent checks
- Inappropriate system for authorizing & approving transactions
- Inadequate physical safeguards over assets
- Untimely or inappropriate documentation of transactions
- No requirement for vacations among employees performing key functions

Other factors increase general risk of material misstatement of financial statements due to fraud

- Low employee morale
- Employees financially stressed
- Adverse relationship between employees & management or entity

Assessing Risk of Fraud

Risk of material misstatement due to fraud part of audit risk

- Auditor must consider existence of risk factors when designing audit procedures
- Risk factors not necessarily indicative of existence of fraud
- Factors are considered individually & collectively

Auditor should make inquiries of management regarding

- Management's understanding of risk of fraud in entity
- Management's knowledge of fraud

Auditor may become aware of risk factors when

- Deciding on acceptance of the engagement
- Planning the engagement
- Obtaining an understanding of internal control
- Performing fieldwork

Effects of Assessment

Upon assessment of risk of fraud, auditor may

- Determine planned audit procedures are sufficient
- Decide to modify planned procedures

Modifications may include

- Applying greater degree of skepticism
- Assigning higher level personnel to engagement
- Evaluating management's accounting decisions more carefully
- Increasing assessment of control risk to maximum

When modification not practical, auditor may withdraw from engagement

Performance of Audit Procedures

Misstatement in financial statements may be detected during performance of audit procedures

Auditor should evaluate whether misstatement indicates possibility of fraud

- May be immaterial & insignificant
- May be immaterial but significant due to level of parties involved
- May be material
- May not be able to determine materiality

When misstatement that indicates possibility of fraud is either material or materiality cannot be determined

- Discuss with appropriate level of management
- Attempt to obtain additional evidence
- Suggest, perhaps, that client see attorney
- Consider withdrawing from engagement

Documentation

Assessment of risk of material misstatement due to fraud in planning engagement should be documented, including

- Risk factors identified
- Auditor's response to risk factors
- Further response indicated by detection of risk factors during audit

Actions Resulting from Evidence of Fraud

Upon detecting evidence of fraud, auditor should

- Notify appropriate level of management
- Inform audit committee whenever senior management involved or whenever material fraud is committed by anyone within the organization
- Disclose to third parties only to comply with legal or regulatory requirements, in response to inquiries of a successor auditor, in response to a subpoena, or in accordance with requirements for audits of entities receiving governmental financial assistance

Responsibility to Detect & Report Illegal Acts

Illegal acts may have a direct effect on financial statements or only an indirect effect

Auditor provides reasonable assurance regarding illegal acts having a direct effect on financial statements

Auditor provides no assurance regarding illegal acts having an indirect effect on financial statements

- More difficult to detect by auditor
- No assurance that such illegal acts will be detected
- No assurance that resulting contingent liabilities will be disclosed

If auditor becomes aware of possibility of illegal acts with indirect effect, procedures should be applied to determine if illegal act occurred

Responsibility to Detect & Report Illegal Acts (continued)

When auditor aware of a possible illegal act by client, auditor should

- Obtain an understanding of the nature & circumstances
- Evaluate effect on financial statements

Circumstances may require modification of opinion

- Qualified or adverse opinion, depending on materiality, if illegal act with material effect on financial statements not properly reported or disclosed
- Disclaimer if client prevents auditor from obtaining sufficient evidence to evaluate occurrence

Refusal by client to accept a modified opinion may result in withdrawal from the engagement

Assurance Provided by Auditor

	Not material	*Material*
Errors	No assurance	Reasonable assurance
Fraud	No assurance	Reasonable assurance
Illegal acts with direct effect on financial statements	No assurance	Reasonable assurance
Illegal acts with indirect effect on financial statements	No assurance	No assurance

Private Securities Litigation Reform Act of 1995

Imposes requirements to include audit tests to detect (**RIG**)

- **R**elated party transactions
- **I**llegal acts
- **G**oing concern doubts

Requires quick notice of illegal acts unless clearly inconsequential.

- Auditor must inform board of directors within 1 business day.
- Board must notify SEC by next business day.
- Auditor must resign or notify SEC within 1 business day after that, if board fails to notify SEC and provide auditor with proof of notice.

Sarbanes-Oxley Act

Several requirements have been established for accounting firms auditing public companies that report to the SEC

- All such firms must register with the Public Company Accounting Oversight Board.
- Workpapers must be retained for 7 years.
- A second partner must review all audit reports.
- The Board will conduct peer review every year for firms issuing more than 100 audit reports annually.
- Firms issuing under 100 audit reports must have peer review every 3 years.
- Firms are prohibited from performing most non-audit services for audit clients (except tax services approved by the client's audit committee).
- The partner-in-charge on an audit must be changed every 5 years.
- A firm is barred for 1 year from auditing a client if after a firm member becomes the CEO, CFO, CAO, Controller, or equivalent of the client.

Quality Control

CPA firms should establish quality controls to ensure compliance with professional standards

Nature & extent of quality control policies & procedures will depend on

- Size of firm & number of offices
- Knowledge & experience of personnel & authority allowed to personnel
- Nature & complexity of firm's practice
- Cost-benefit considerations

Policies & procedures should relate to

- Hiring, assigning, & advancement of personnel & professional development
- Accepting & continuing only client's with reasonable assurance of avoiding those whose management lacks integrity
- Maintaining independence, integrity, & objectivity in carrying out professional responsibilities
- Planning, supervising, documenting, & otherwise performing engagements with reasonable assurance of meeting professional standards & regulatory requirements
- Monitoring activities to evaluate effectiveness of quality control policies & procedures