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AUDITING AND ATTESTATION

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OVERVIEW OF AN ATTEST FUNCTION

The Attest Function

- A. In an attest engagement a CPA is engaged to issue or does issue an examination, a review, or agreed-upon procedures report on subject matter, or an assertion about subject matter, that is the responsibility of another party.
- B. To perform an attest engagement there must be suitable criteria to judge the fairness of the information being reported on.
- C. The attestation standards establish three forms of CPA attestation engagements—examinations, reviews, and the performance of agreed-upon procedures.
 - 1. An **examination** referred to as an audit when it involves financial statements, normally results in a positive opinion, the highest form of assurance about whether the information follows the criteria.
 - 2. A **review** is substantially less in scope than an audit and provides negative assurance (“nothing came to our attention”) rather than positive assurance.
 - 3. For the third form of attestation engagement, a CPA and a specified party that wishes to use the information may mutually decide on specific **agreed-upon procedures** that the CPA will perform. Agreed-upon procedures engagements result in a report that describes the procedures performed and related findings
- D. **Statements on Standards for Attestation Engagements** provide guidance on how to perform attestation engagements.
- E. **Statements on Standards for Accounting and Review Services** provide guidance for work done for a nonpublic company that is less than an audit.
- F. An **independent audit** is made up of two separate steps.
 - 1. First step is the examination of a set of financial statements that have been produced by the management of the reporting entity.
 - a. Purpose of examination is to gather sufficient, appropriate evidence on which to form an opinion as to the fair presentation of the statements in accordance with generally accepted accounting principles.
 - b. Auditor attempts to corroborate these assertions in order to provide reasonable assurance that no material misstatements exist in any of the assertions.
 - (1) The term “**material**” means anything of a size or type that would influence the judgment of a reasonable person relying on the information. A preliminary judgment of the size component of materiality is set at the beginning of an audit but is continuously reassessed as new information is gathered.
 - (2) A **misstatement** is an **error** (an unintentional mistake), **fraud** (an intentional manipulation of the assets or the records).
 - 2. Second step is the report of the findings to outside parties, primarily to stockholders and other parties outside of the reporting entity. The report is intended to add credibility to the financial information being distributed.
- G. All of the auditor’s work must follow **generally accepted auditing standards** (GAAS) which are currently established by means of **Statements of Auditing Standards** that are produced by the Auditing Standards Board. If the audit is of a public company, the audit must

be performed in accordance with auditing standards adopted or issued by the **Public Company Accounting Oversight Board (PCAOB)**.

H. There are ten basic generally accepted auditing standards that provide the basis for an auditing engagement.

1. General Standards

- a. The auditor must have adequate **training** and proficiency to perform the audit. The auditor should have sufficient education and experience in (1) auditing, (2) accounting, and (3) the industry in which the client operates in order to make the decisions necessary to evaluate whether any material misstatements exist in any of the management's assertions.
- b. The auditor must maintain **independence** in all matters related to the audit.
 - (1) Independence in mental attitude cannot be regulated. However, to encourage independence in fact and to maintain the appearance of independence, the auditor can have no **direct financial interest** in the client. "Direct" includes the auditor and members of immediate family. "Financial interest" is ownership of equity shares, other client financial instruments, or any other potential financial benefit.
 - (2) In addition, there can be no material **indirect financial interest** such as ownership through a mutual fund.
 - (3) To ensure independence, auditor cannot render an opinion on statements of one year until all fees from the prior year audit have been paid.
 - (4) To emphasize independence from management, auditor is usually appointed by audit committee of the board of directors.
 - (5) Independence may be impaired by performing consulting services, especially those that involve making management decisions.
- c. The auditor must exercise **due professional care** in performance of the audit and preparation of the report.
 - (1) Auditor must do at least what any average auditor would do and never less.

2. Standards of Fieldwork

- a. The auditor must adequately **plan** the work and must properly **supervise** any assistants.
 - (1) Audit program is developed before substantive testing to ensure that adequate planning has occurred.
 - (2) All evidence is recorded on working papers that are reviewed by qualified personnel to ensure supervision. Even a partner other than the partner in charge of the engagement should review the working papers.
- b. 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, to design the nature, timing and extent of further audit procedures.
 - (1) Assessment is made of material misstatement. If that risk is high, the auditor will have to gather more evidence than anticipated or a better quality of evidence.

- c. 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.
 - (1) Evidence gathering is sometimes called **substantive testing**. Any testing that confirms the ending balance of an account is known as a test of a balance. Evidence gathered to support an account by looking at the various transactions that have affected it during the period is called a test of details.
 - (2) The actual amount and quality of evidence to be gathered depends on the judgment of the auditor.

3. Standards of Reporting

- a. The auditor must state in the auditor's report whether the financial statements are presented in accordance with **generally accepted accounting principles** (GAAP). (This assurance is stated explicitly.)
 - (1) The determination of what specific generally accepted accounting principle (GAAP) applies to a situation can be difficult because various sources can give conflicting guidelines. A **GAAP Hierarchy** has been established with five levels of authority. The higher levels have highest priority. In the top level (for businesses) are FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins.
- b. 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.
- c. When the auditor determines that informative **disclosures** are not adequate, the auditor must so state in the auditor's report. (Assurance of adequate disclosure is implied.)
- d. 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.

PROBLEMS AND SOLUTIONS

OVERVIEW OF AUDIT FUNCTION

1. Because of the attest function, financial statements are the responsibility of the independent auditor. (True or False?)

Answer – *Financial statements are the responsibility of the management of the reporting entity. The independent auditor examines and reports on these financial statements. (False)*

2. In an audit, the independent auditor attempts to corroborate assertions made by the company's management in connection with each account, class of transactions, and disclosures found in a set of financial statements. (True or False?)

Answer – *The assertions to be corroborated by the independent auditor vary for account balances, classes of transactions, and disclosures. (True)*

3. An independent auditor seeks to provide reasonable assurance that no material misstatements exist in any of the assertions made by management. (True or False?)

Answer – *The role of the independent auditor is to gain sufficient, appropriate evidence so as to provide reasonable (not perfect) assurance that material misstatements do not exist in any of the assertions made by management. (True)*

4. The term “materiality” refers to any factor of a size or type that would impact an outside decision-maker's decision about a set of financial statements. (True or False?)

Answer – *A material item is anything that—because of either its size or its type—would influence the judgment of a reasonable person relying on the information being presented. (True)*

5. A misstatement is either due to error or fraud. (True or False?)

Answer – *A misstatement is an error (an unintentional mistake), or fraud (an intentional manipulation of the assets or the records. (True)*

6. The spouse of an auditor holds a small number of shares in a company. The auditor is not independent as to that particular company. (True or False?)

Answer – *To maintain the appearance of independence, independence is assumed to be lacking if the auditor has either a direct financial interest or a material indirect financial interest in the reporting company. Ownership of the shares by the spouse is considered a direct financial interest and would be prohibited. (True)*

7. According to generally accepted auditing standards, the standard audit report explicitly states that the financial statements are in accordance with generally accepted accounting principles applied on a consistent basis. (True or False?)

Answer – *The standard audit report must specify that the statements are in accordance with generally accepted accounting principles. However, consistency is not mentioned unless a problem exists. Thus, consistency is implied in the standard audit report. (False)*

8. Auditing standards for audits of public companies are issued by the Auditing Standards Board. (True or False?)

Answer – *The AICPA Auditing Standards Board issues auditing standards for audits of nonpublic companies. The Public Company Accounting Oversight Board issues auditing standards for audits of public companies. (False)*