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# AUDITING

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I. THE INDEPENDENT AUDIT FUNCTION

A. The Purpose of an Audit

The purpose of an audit is to provide financial statement users with an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

**PASS KEY**

The *applicable financial reporting framework* is the financial reporting framework that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation. Acceptable financial reporting frameworks include general purpose frameworks designed to meet the needs of a wide range of users (e.g., U.S. GAAP and International Financial Reporting Standards [IFRSs]), and special purpose frameworks (discussed in lecture A-2).

B. Audit Function Adds “Credibility”

The auditor’s report gives credibility to the financial statements. The auditors, as a group independent of management, have an objective view and can report on a company’s activities without bias or conflict of interest. Without a report from an independent auditor, a company’s financial statements would be meaningless, because the public would have little faith in financial statements issued by the inherently biased company.

C. Responsibilities

The financial statements of an enterprise are prepared by the management of the enterprise, not by the independent auditor. Further, the financial statements are the product and property of the enterprise; the independent auditor merely audits and expresses an opinion on them.

1. Management Responsibilities

An audit is conducted on the premise that management and, when appropriate, those charged with governance, are responsible for:

a. the *preparation and fair presentation* of the financial statements in accordance with the applicable financial reporting framework;
b. the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement due to error or fraud; and

c. providing the auditor with access to information and persons within the entity needed to complete the audit.

**PASS KEY**

The preparation and fair presentation of the financial statements requires:

1. identification of the applicable financial reporting framework;
2. preparation and fair presentation of the financial statements in accordance with the framework; and
3. inclusion of an adequate description of the framework in the financial statements.

**2. Auditor Responsibilities**

The auditor is responsible for expressing an opinion on the financial statements based on the audit. The auditor is also responsible for having appropriate competence and capabilities to perform the audit, complying with relevant ethical requirements, maintaining professional skepticism, and exercising professional judgment throughout the planning and performance of the audit.

**D. Performance**

In order to express an opinion, the auditor obtains reasonable assurance about whether the financial statements are free from material misstatement, whether due to error or fraud.

1. **Reasonable Assurance**

   Reasonable assurance is a high, but not absolute, level of assurance. In order to obtain reasonable assurance, the auditor must:

   a. plan the work and properly supervise any assistants;
   b. determine and apply appropriate materiality levels;
   c. identify and assess risks of material misstatement, whether due to fraud or error; and
   d. obtain sufficient appropriate audit evidence.

2. **Inherent Limitations of an Audit**

   The auditor is unable to obtain absolute assurance that the financial statements are free from material misstatement because of the following inherent limitations:

   a. **The Nature of Financial Reporting**

      Some financial statement items are subject to an inherent level of variability because they involve judgment by management or because they involve subjective decisions or assessments or a degree of uncertainty (e.g., accounting estimates).

   b. **The Nature of Audit Procedures**

      There are practical and legal limits on an auditor's ability to obtain audit evidence, including:

      (1) The possibility that management or others may not provide, intentionally or unintentionally, the complete information that is needed for the preparation and presentation of the financial statements or that is requested by the auditor.

      (2) Fraud may be concealed in such a way that it is difficult to detect with audit procedures.
(3) An audit is neither an investigation into a wrongdoing nor does the auditor have specific legal powers.

c. **Timeliness of Financial Reporting and the Balance Between Cost and Benefit**

There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and will achieve a balance between benefit and cost, recognizing that it is impracticable to address all information that may exist. Therefore, it is necessary for the auditor to:

(1) plan the audit so that it is performed effectively;

(2) direct efforts to areas most expected to contain risks of material misstatement; and

(3) use testing and other means of examining populations for misstatement.
I. **AUDITING STANDARDS**

A. **Generally Accepted Auditing Standards**

   The auditor is responsible for the performance of a properly planned and executed audit in accordance with generally accepted auditing standards (GAAS). Note that compliance with GAAS is mandatory on all audit engagements.

   Generally accepted auditing standards for the audits of nonissuers are issued by the AICPA’s Auditing Standards Board (ASB) in the form of Statements on Auditing Standards (SAS). The ASB’s Statements on Auditing Standards are outlined in Section AU of the AICPA Professional Standards.

   **PASS KEY**

   To address concerns about the clarity, length, and complexity of its standards, and to converge its standards with the International Standards on Auditing (ISAs), the ASB redrafted all of its SASs. These clarified SASs were issued by the ASB in late 2011 and are effective for audits of financial statements for periods ending on or after December 15, 2012. The clarified SASs are outlined in Section AU-C of the AICPA Professional Standards, to avoid confusion with the existing AU sections, which remain effective through 2013. The AU-C identifier will revert to AU in 2014. These Becker audit materials are based on the clarified SAS, which are testable on the CPA Exam starting on July 1, 2013.

B. **Generally Accepted Government Auditing Standards**

   Audits of government organizations, programs, activities, and of entities that receive government funds should be conducted in accordance with generally accepted government auditing standards (GAGAS), as covered later in the course.

C. **Public Company Accounting Oversight Board**

   The Public Company Accounting Oversight Board (PCAOB) was established pursuant to the Sarbanes-Oxley Act of 2002. The PCAOB establishes auditing and related professional practice standards to be used in the preparation and issuance of audit reports for issuers.

   1. Issuers consist of entities subject to the rules of the SEC (primarily public companies).
   2. The PCAOB is comprised of five full-time, financially literate members.
      a. Two members must be (or have been) CPAs, and the other three must not be (or must not have been) CPAs.
      b. A CPA can only act as the Chair of the Board if he or she has not practiced as a CPA for the past five years.
      c. No members of the Board can receive payments from a public accounting firm (other than fixed continuing payments, such as retirement payments).
   3. Public accounting firms must register with the PCAOB in order to audit a public company. Registered firms are subject to Board inspection, disciplinary proceedings, and sanctions.
4. PCAOB Auditing Standards (AS)
   a. The PCAOB adopted, on an initial, interim basis, ASB standards, but continues to review each standard to evaluate whether it should be modified, repealed, replaced, or permanently adopted. The PCAOB has issued several of its own Auditing Standards (AS), which replace ASB Standards for audits of issuers. These Auditing Standards will be covered throughout the course.
   b. Note that the ASB retains the authority to set performance and reporting standards for audits of financial statements of nonissuers.

D. International Standards on Auditing
   The International Auditing and Assurance Standards Board (IAASB), a standard setting board of the International Federation of Accountants (IFAC), establishes International Standards on Auditing (ISA). The IFAC is a worldwide organization that establishes and promotes adherence to high-quality professional standards and works toward the international convergence of such standards. ISAs issued by the IAASB do not override the local laws and regulations or national standards that govern the audits of historical financial statements in particular countries. Over 100 countries are using or are in the process of adopting or incorporating the ISAs into their national auditing standards or are using the ISAs as a basis for preparing national auditing standards.

II. STANDARDS FOR ENGAGEMENTS OTHER THAN AUDITS
   An audit is merely one type of engagement an accountant may be called upon to perform. Each type of engagement has a different set of applicable professional standards, and the requirements, responsibilities, and limitations vary with the nature and scope of the engagement. Below is an overview of standards for engagements other than audits that will be tested on the Auditing and Attestation section of the CPA exam.

A. Statements on Standards for Attestation Engagements
   Statements on Standards for Attestation Engagements (SSAE) are issued by the AICPA. These standards apply to attest engagements, covered later in the course. The SSAEs are outlined in Section AT of the AICPA Professional Standards.

B. Statements on Standards for Accounting and Review Services
   The Accounting and Review Services Committee was established by the AICPA to establish standards for privately-held (nonissuer) companies not seeking audited statements. Statements on Standards for Accounting and Review Services (SSARS) are issued by this Committee, and they are applicable to unaudited financial statements or unaudited financial information of a nonpublic entity. SSARS are covered later in the course. The SSARS are outlined in Section AR of the AICPA Professional Standards.