Modern Auditing Assurance Services and the Integrity of Financial Reporting 8th Edition Boynton Solutions Manual
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CHAPTER 2

FINANCIAL STATEMENT AUDITS AND AUDITORS' RESPONSIBILITIES

Learning Check

2.1 The ultimate objective of accounting is the communication of relevant and reliable financial data that will be useful for decision making. Accounting methods involve identifying the events and transactions that affect the entity. Once identified, these items are measured, recorded, classified, and summarized in the accounting records and reported in accordance with generally accepted accounting principles (GAAP). The accounting process is carried out by an entity's employees, and ultimate responsibility for the financial statements lies with the entity's management.

The primary objective of an audit is to add credibility to management's financial statements. The typical audit performed in accordance with generally accepted auditing standards (GAAS) involves obtaining and evaluating evidence concerning management's financial statements. Auditing culminates in the issuance of an audit report that contains the auditor's opinion on whether the financial statements do in fact present fairly the entity's financial position, results of operations, and cash flows in conformity with GAAP. The auditor is responsible for forming and expressing an opinion on the entity’s financial statements.

2.2 Verifiability is primarily concerned with the availability of evidence. In an audit the auditor needs to obtain evidence to support conclusions about the fair presentation of financial position, results of operations, and cash flows. However, financial statements contain elements, such as an allowance for doubtful accounts, which may not be precise. In verifying the financial statements the auditor:

a. Only looks for misstatements that may be material, or significant, to financial statement users.

b. Cannot perform a 100 % audit. The auditor cannot verify everything. Hence the audit is subject to the uncertainty associated with sampling.

c. The audit cannot add precision to estimates that are inherently imprecise.

2.3 (1) The independent auditor must have a relationship with management that is based on mutual respect and a high degree of candor. Management is responsible for maintaining an audit trail that supports the financial statements. If management attempts to conceal evidence, it increases the probability that the auditor may not find material misstatements. Nevertheless the auditor

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cannot over rely on management and must approach management's representations with an appropriate degree of professional skepticism.

(2) The board of directors and its audit committee is responsible for appointing auditors of public companies. The audit committee should also establish procedures for receiving complaints regarding internal controls and auditing. The audit committee plays an important role in strengthening the auditor's ability to apply appropriate professional skepticism in an audit.

2.4 The entity's being audited is often referred to as the "client" because the entity pays the auditor's fees. However, the auditor should also represent the public interest and the interests of financial statement users, creditors and investors. The auditor should be independent, neutral and unbiased in performing an audit.

2.5 The ASB, or Auditing Standards Board, is an arm of the Auditing Standards Division of the AICPA. It is the AICPA's senior technical committee authorized to issue pronouncements on auditing standards, and its 19 members are all members of the AICPA.

2.6 SASs, or Statements on Auditing Standards, are the pronouncements of the Auditing Standards Board. They explain the nature and extent of an auditor's responsibility and offer guidance to an auditor in performing the audit. Before issuance, each SAS is exposed for public comment and extensively discussed at open meetings of the ASB. The approval of two-thirds of the Board is required for issuance. They are accessible as individual publications of the AICPA, via a loose-leaf service entitled Professional Standards, Volume 1, in annual bound volumes, and in electronic format on CD – ROM.

2.7 Section 103 of the Sarbanes-Oxley Act of 2002 directs the PCAOB to establish, among other things, auditing and related attestation standards to be followed by public accounting firms when auditing public companies. The PCAOB's rulemaking process results in the adoption of rules that are then submitted to the Securities and Exchange Commission for approval. PCAOB rules do not take effect unless approved by the Commission.

2.8 a. The three categories of the generally accepted auditing standards are (1) general standards, (2) standards of fieldwork, and (3) standards of reporting.

b. Of the general standards, the first relates to adequate technical training and proficiency, the second to independence in mental attitude, and the third to due professional care.

Of the standards of fieldwork, the first relates to adequate planning and proper supervision, the second to understanding the internal control structure, and the third to obtaining sufficient competent evidential matter.

Of the standards of reporting, the first relates to identifying GAAP as the criteria used to evaluate management's financial statements, the second to consistency in the application of GAAP, the third to the adequacy of informative disclosures, and the fourth to expressing an opinion on the financial statements taken as a whole or stating that an opinion cannot be expressed.

c. The PCAOB has recognized the existing generally accepted auditing standards, although it reserve the right to set new auditing standards for public companies.

2.9 a. Reasonable assurance is not a guarantee that the financial statements are free of material misstatements. Rather it provides a high level of assurance that the financial statements are free of material misstatement based on the work of the auditor.

b. The limitations associated with reasonable assurance include the fact that economic factors prevent the auditor from examining all the evidence supporting the financial statements. The auditor must exercise skill and judgment in deciding what evidence to look at, when to look at it, how much to look at, and who in the audit team should evaluate the evidence. Further, the financial statements themselves are not "exact" but they include estimates that cannot precisely be determined.

2.10 a. The auditor has a responsibility to plan and perform an audit to provide reasonable assurance that the financial statements are free of material misstatement, including fraud. The auditor must (1) assess the risk of fraud including both fraudulent financial reporting and misappropriation of assets, (2) design and audit to respond to those risks, and (3) carry out the audit plan and design with due professional care. The auditor must also evaluate evidence with an appropriate level of professional skepticism.

b. If fraud is discovered during the audit, even minor or immaterial fraud, it should be reported to management at least one level above the level where the fraud occurred. The auditor would normally report to the board of directors or its audit committee and fraud involving senior management or any material fraud. The auditor is normally precluded by ethical and legal obligation from disclosing fraud outside the client entity. However, the auditor may be required to do so in the following situations:

- In response to a court subpoena.
- To the SEC when the auditor has withdrawn or been dismissed from the engagement, or when the auditor has reported fraud to the audit committee or board of directors and the committee or board fails to take appropriate action.
- To a successor auditor who makes inquiries in accordance with professional standards.
- To a funding or other agency in accordance with audit requirement for entities that receive governmental financial assistance.

2.11 a. The auditor's responsibility for misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as for errors or fraud. That is, the auditor should plan an audit to detect such illegal acts and implement the plan with due professional care. However, the auditor addresses the discovery of disclosure of indirect effect illegal acts in the context of SFAS No. 5 on contingent liabilities.

b. The auditor primary responsibility is for fair presentation in the financial statements. When illegal acts have a material effect on the financial statements they should be properly disclosed. In this way the auditor meets their responsibility to management, to the board of directors, and to parties outside the entity. If management does not properly disclose such illegal acts in accordance with GAAP, the auditor should express a qualified or adverse opinion if management does not revise the financial statements.

c. Under the Private Securities Litigation Reform Act of 1995 provide a safe harbor where the auditor is not liable for reporting illegal acts to the SEC if the following circumstance apply:

- The audit committee or board of directors of a publicly held company has been adequately informed with respect to illegal acts detected in the audit. Subsequently the auditor determines that the illegal acts have a material effect on the financial statements, and the senior management or board of directors has not taken appropriate remedial actions with respect to such illegal acts, and the failure to take remedial actions is reasonably expected to warrant departure from a standard audit report or warrant resignation by the auditor, then the auditor shall report these conclusion to the public company's board of directors.
- A public company whose board of directors receives the report referred to above must so inform the SEC not later than one business day after the receipt of such report and furnish the independent auditor with a copy of the notice provided to the SEC.
- If the independent auditor fails to receive a copy of the public company's notice to the SEC before the expiration of the required one business day period, the auditor shall within one additional day furnish to the SEC a copy of the report previously provided to the public company's board of directors. In such case the auditor may also wish to consider resigning from the engagement.

2.12 a. It is important to note that the auditor has a dual responsibility: (1) to report on management's assertion about internal controls and (2) to report on the effectiveness of the entity's system of internal control. The auditor's of a public company have a responsibility to report material weakness in the entity's system of internal control. The auditor firm of a public company has a responsibility to obtain reasonable assurance about whether a material weakness in the system of internal control exists as of the date of the balance sheet. (Note: The auditor has a responsibility to report significant deficiencies in the system of internal control to management and the audit committee, but not to the public. Only material weaknesses are reported to the public.)

b. The auditor of a private company has no responsibility to audit the system of internal control. As a result, material weaknesses in the system of internal control may be reported to management but not to the public. A private company can have a material weakness in the system of internal control, correct the financial statements, and obtain an unqualified opinion from the auditor on the financial statements. A private company will rarely have an opinion on the system of internal control.

2.13 The auditor should consider whether *substantial doubt* exists about an entities ability to continue as a going concern during the year following the date of the financial statements in every audit. If substantial doubt exists the auditor should evaluate the adequacy of disclosure about going concern. If disclosure is adequate, the auditor still needs to refer to the fact that the entity may not continue as a going concern in the auditor's report (See Appendix 2A for an example).

2.14 An unqualified opinion in not equivalent to a *clean bill of health* on the audit client. It only provides the financial statement user with reasonable assurance that the financial statements are free of material misstatement. The absence of reference to substantial doubt about going concern should not be viewed as providing assurance about an entity's ability to continue as a going concern.

2.15 a. The seven basic elements of the auditor's standard report are: (1) title, (2) addressee, (3) introductory paragraph, (4) scope paragraph, (5) opinion paragraph, (6) firm's signature, and (7) date.

b. The auditor's report is dated as of the last day of field work rather than the date on which the report is actually issued which may be several days to several weeks later. This is the date when the auditor finished collecting evidence to support an opinion on the financial statements.

2.16 The concluding paragraph of the auditor's standard report satisfies the first and fourth standards of reporting, respectively, by explicitly stating that the financial statements are presented fairly in conformity with generally accepted accounting principles and by expressing an opinion on the financial statements taken as a whole. The second and third standards of reporting (i.e., consistency in the application of GAAP and the adequacy of informative disclosures) are satisfied because these standards are presumed to be met unless the auditor's report states to the contrary.

2.17 a. The two categories of departures from the auditor's standard report are (1) standard report with explanatory language and (2) other types of opinions (a qualified opinion, an adverse opinion, and a disclaimer of opinion).

b. Three types of circumstances that require a departure from the auditor's standard report and the type or types of opinion appropriate for each are: (1) circumstances requiring explanatory language do exist - unqualified opinion; (2) financial statements contain a departure from GAAP - qualified opinion or adverse opinion; (3) auditor unable to obtain sufficient competent evidence (scope limitation) - qualified opinion or disclaimer of opinion.

2.18 The wording in the opinion paragraph that distinguishes the four types of opinions that may be expressed is as follows:

- Unqualified opinion - In our opinion, the financial statements referred to above present fairly ....
- Qualified opinion - In our opinion, except for the effects of (refer to matter leading to qualification described in explanatory paragraph), the financial statements referred to above present fairly ....
- Adverse opinion - In our opinion, because of the effects of (refer to effects of matter leading to adverse opinion described in explanatory paragraph), the financial statements referred to above do not present fairly ....

- Disclaimer of opinion - Since (refer to effects of matter described in explanatory paragraph that lead to disclaimer), we do not express an opinion on these financial statements.

2.19 a. The nine basic elements of the auditor's standard report on internal control over financial reporting are: (1) title, (2) addressee, (3) introductory paragraph, (4) scope paragraph, (5) definition paragraph, (6) inherent limitations paragraph, (7) opinion paragraph, (8) explanatory paragraph, and (9) signature and date.

b. The auditor's report is dated as of the last day of field work rather than the date on which the report is actually issued which may be several days to several weeks later. This is the date when the auditor finished collecting evidence to support an opinion on internal control over financial reporting.

c. The professional standards that govern the audit of management's assertion regarding the effectiveness of internal control over financial reporting are developed by the Public Companies Accounting Oversight Board, specifically PCAOB Audit Standard No. 2.

2.20 a. Internal control over financial reporting is defined as: "*A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.*"

b. A company may also have internal controls that relate to (1) compliance with laws and regulations or (2) effective and efficient utilization of assets. This report on internal controls only addresses internal control over financial reporting, and other controls are not covered by the scope of this type of audit.

2.21 The types of inherent limitations that prevent internal control over financial reporting from being effective include:

- Mistakes in judgment when applying internal control.
- Breakdowns and fatigue. Many aspects of internal control are human processes that may function inconsistently over time. They may function at a very high level but not work perfectly.
- Collusion between individuals may cause segregation of duties to break down, and internal controls may appear to function when they are not.
- Management override. Senior management may have authority that would cause otherwise functioning internal controls to break down. Auditors must assess the risk of management override, but that risk might not be reduced to zero.

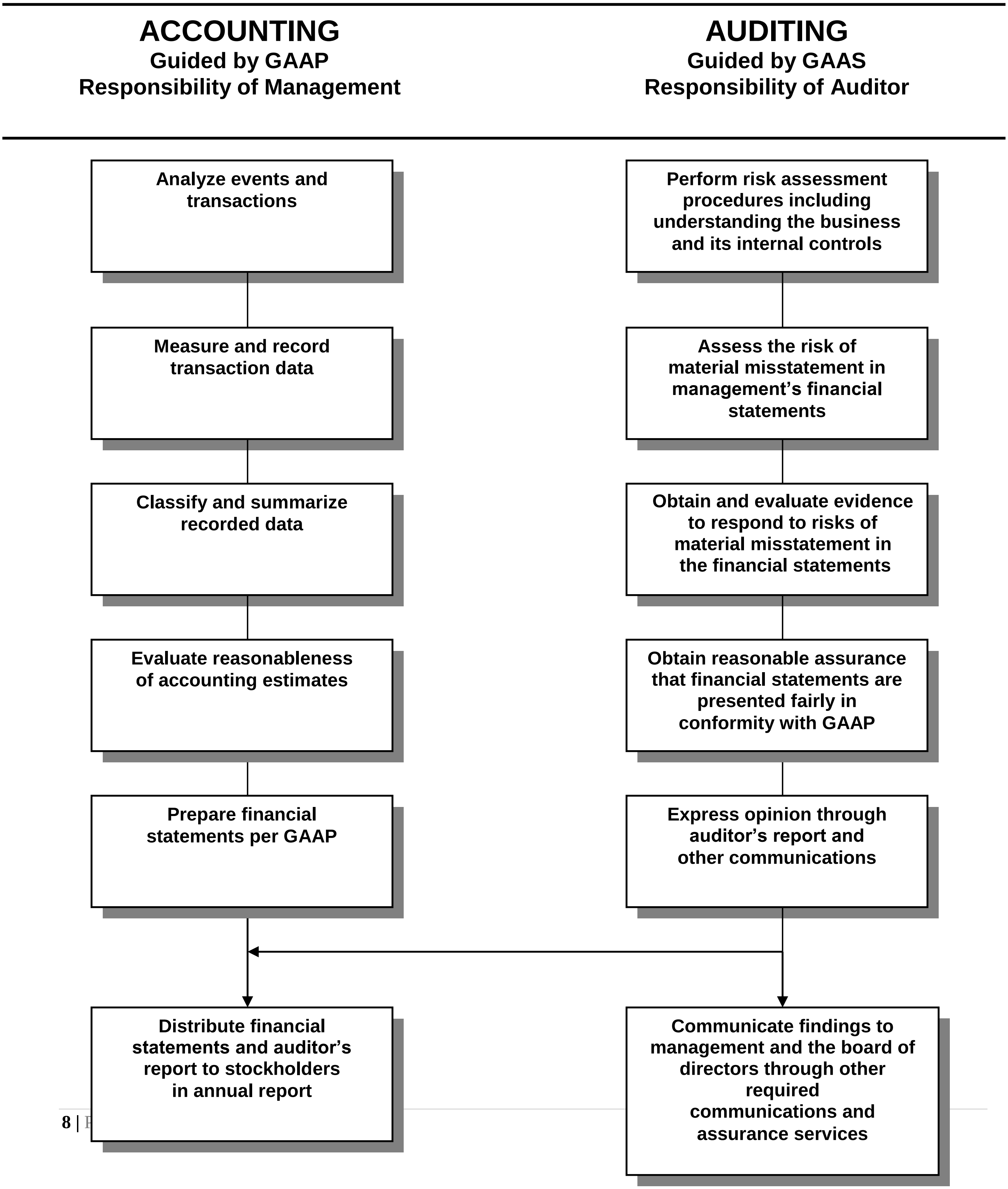
2.22 a. An auditor should issue an adverse opinion on the effectiveness of internal controls over financial reporting when a company has one or more material weaknesses. A material weakness exists when a deficiency in internal controls results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

b. The following is a common example of a circumstance imposed scope limitation. An auditor might identify a material weakness at an interim date, and the entity implements new controls to correct the deficiency. If the new controls are placed in operation near year-end, the auditor may not have sufficient time to determine that they actually are operating effectively at fiscal year-end. The auditor might consider three different responses to the circumstance imposed scope limitation. If the auditor considers it to be material, he or she would issue a qualified opinion. If the auditor considers it to be extremely material, he or she would issue a disclaimer of opinion. If the auditor has concerns about the integrity of management, the auditor will likely withdraw from the engagement. If management imposes a scope limitation: e.g, in a multi-location audit the entity imposes a restriction on visiting certain locations that are important to the scope of the audit the auditor should consider disclaiming opinion or withdrawing from the audit (if the auditor has concerns about the integrity of management).

c. The auditor might issue a adverse opinion on the effectiveness internal controls over financial reporting if a material weakness exists in internal controls. However, if the weakness results in a material misstatement in the financial statements, and management corrects the financial statements such that the present fairly the entity’s financial position, results of operations, and cash flows, the auditor will issue an unqualified opinion on the financial statements.

Comprehensive Questions

2.23 a.



b. This contention is incorrect. Management has the responsibility for the preparation of the financial statements. The auditor's responsibility is limited to making an audit of the statements and reporting the findings. In the course of the audit, the auditor may suggest adjustments in the financial statements. However, management is responsible for all decisions concerning the form and content of the statements.

c. Public companies hire auditors for several reasons. First, the SEC and many stock exchanges require financial statement audits and audits of internal controls over financial reporting. Second, many public companies also find that having an audit provides increased access to capital markets and their cost of capital is lower than it would be without an audit.

2.24 (Estimated time - 25 minutes)

Statement I

a. Each sentence of this statement is partially true:

   1. Test checking is used extensively on most audits.

   2. The auditor's judgment is involved in selecting the sample, either directly or through choice of statistical design.

   3. A system of 100 percent verification would detect errors and protect to some extent against fraud.

b. Areas of misconception, incompleteness, or fallacious reasoning included in this statement are the following:

   1. The auditor does not perform all parts of the audit on a test basis. For example, he or she reviews minutes for all meetings of the board of directors and examines all material contracts and agreements.

   2. The statement ignores the importance of the auditor's consideration and testing of internal control. This is the basis for determining the extent of procedures. If internal control is weak, he or she may examine every transaction during the transaction period. However, such an examination is not a perfect substitute for good internal control. A 100 percent verification may not detect sophisticated errors or frauds.

   3. Competent exercise of judgment is one of the auditor's skills. Deficiencies in the exercise of this skill are possible, but a 100 percent verification also may be performed improperly.

4. The historical experience of the auditing profession supports the conclusion that material misstatements are disclosed by test checking. If the sampling is statistically sound, it is further backed by the mathematical concepts of probability theory. A 100 percent verification does not add significantly to the auditor's degree of assurance. High accuracy and protection against fraud are better provided by good internal controls.

5. On most engagements the cost of checking every transaction would be excessive in terms of the benefits derived.

6. Finally, a 100 percent examination unduly delays completion of the audit and issuance of the audited financial statements.

Statement 2

a. This statement is untrue if the CPA is fulfilling his or her responsibilities.

b. It would be incorrect to assume the following:

   1. That the attest function has no value to the users of financial statements.
   2. That the auditor renders no service beyond the furnishing of an opinion.

Perhaps the best indication of the value of the auditor's report is that it is so often insisted upon by the users of financial statements. The auditor alerts users to improper or inadequate reporting by means of a qualified opinion. When the opinion is unqualified, the auditor increases the credibility which users may place upon the financial statements. It is likely that the quality of reporting is improved by the certainty of an audit and by the desire for an unqualified opinion.

The auditor fulfills a vital social role. An example is the auditor's contribution to the maintenance of orderly capital markets and improvement of the efficiency of the economy by reducing the risk premium that investors require in their return on investment.

In addition to rendering an opinion on financial statements, the auditor usually plays an important advisory role in their preparation. The auditor also furnishes advice to the client on control and other financial matters and makes general management suggestions.

2-25 (Estimated time - 10 minutes)

1. Student D is correct. It is the client's responsibility.
2. a. (1) The first sentence of this statement is partially true. It is important to read the footnotes to financial statements because they provide important supplementary information.

(2) Footnotes often pertain to complex matters and are presented in technical language. Certainly it must be acknowledged that sometimes they could be presented in a clearer form.

(3) To the extent the footnotes supplement disclosures in the body of the financial statements, they could reduce the auditor's exposure to third-party liability.

b. (1) The statement is clearly wrong in asserting that the footnotes can be used to correct or contradict financial statement presentation. Footnotes are an integral part of the financial statements. If there is contradiction or if the presentation is incomprehensible, this constitutes inadequate reporting and requires comment in the auditor's report.

(2) The statement fails to recognize that the need for accuracy and completeness sometimes overrides the desire for clarity.

(3) The statement incorrectly assigns the primary responsibility for the financial statements and footnotes to the auditor instead of to management. The auditor's relationship to the footnotes is the same as to the balance sheet and other financial statements. For both, the auditor's actions are governed by the same reporting responsibilities.

(4) Because footnotes are prepared by management, the auditor cannot control their content. Other advisors, e.g., legal counsel, will influence the wording of footnotes. The auditor should recommend improvements in presentation, but will only make an opinion exception if disclosure is inadequate or so unclear as to be misleading.

2.26 (Estimated time - 30 minutes)

a. Identification of Standard	**b. Statement of Standard**
1. Third general	Due professional care is to be exercised by the auditor in the performance of the audit and the preparation of the report.
2. First fieldwork	The work is to be adequately planned and assistants, if any, are to be properly supervised.
3. Second fieldwork	A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
4. First fieldwork	The work is to be adequately planned and assistants, if any, are to be properly supervised.
5. First general	The audit is to be performed by a person or persons

a. Identification of Standard	b. Statement of Standard
	having adequate technical training and proficiency as an auditor.
6. First reporting	The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
7. Second general	In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
8. Second reporting	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.
9. Third fieldwork	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.
10. Third reporting	Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
11. Fourth reporting	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 therefor 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 audit, if any, and the degree of responsibility the auditor is taking.

2.27 (Estimated time - 15 minutes)

a. To satisfy auditor's responsibilities to detect Smith's errors, fraud, and direct and material illegal acts, Reed should

- Assess the risk that Smith's errors, fraud, and direct and material illegal acts may cause its financial statements to contain a material misstatement.
- Design the audit to provide reasonable assurance of detecting errors, fraud, and direct and material illegal acts that are material to the financial statements.
- Exercise due care in planning, performing, and evaluating the results of audit procedures, and the proper degree of professional skepticism to achieve reasonable assurance that material errors, fraud, and direct and material illegal acts will be detected.

b. To satisfy an auditor's responsibilities to report Smith's errors, fraud, and direct and material illegal acts, Reed should

- Inform Smith's audit committee, or others having equivalent authority and responsibility, about material fraud of which Reed becomes aware.

- Express a qualified or an adverse opinion on the financial statements if they are materially affected by errors, fraud, and direct and material illegal acts and are not revised.

- Disclaim or qualify an opinion on the financial statements and communicate the findings to the audit committee or the board of directors if the scope of the audit has been restricted concerning possible errors, fraud, and direct and material illegal acts.

- Consider notification of outside parties concerning fraud or direct and material illegal acts in certain circumstances.

2.28 (Estimated time - 25 minutes)

a. An illegal act refers to such acts as the payment of bribes, the making of illegal political contributions, and the violation of other specific laws and governmental regulations that have a direct and material effect on the financial statements.

b. Two characteristics of illegal acts influence the auditor's responsibility for detection.

- The determination of whether an act is illegal is dependent on legal judgment that normally is beyond the auditor's professional competence.

- Illegal acts vary considerably in their relation to financial statements. Some laws and regulations such as income tax laws have a direct and material effect on the financial statements. However, other laws such as those pertaining to occupational safety and health and to environmental protection have only an indirect effect on the financial statements.

c. Disagree. The auditor's responsibilities differ for illegal acts that have a direct and material effect on the financial statements and all other illegal acts. The auditor's responsibilities for the first type of illegal acts are the same as for material errors and fraud (i.e., he or she should plan the audit to detect such acts.) Responsibilities for all other illegal acts are limited to applying auditing procedures to such acts that come to the auditor's attention.

d. Information that may provide evidence concerning possible illegal acts includes (1) unauthorized transactions, (2) investigations by governmental agencies, and (3) failure to file tax returns. The auditor should respond by discussing the matter with management, consulting with the client's legal counsel, and applying additional procedures to obtain an understanding of the act and its effects on the financial statements.

e. The effects on the audit report are the same as for fraud. When an illegal act having a material effect on the financial statements is not accounted for in conformity with GAAP, the auditor should express either a qualified opinion or an adverse opinion. If the auditor is unable to obtain sufficient evidence about an illegal act, there is a scope limitation, which should result in expressing either a qualified opinion or disclaimer of opinion. The auditor's reporting responsibilities to other parties is limited to communicating with the audit committee.

2.29 (Estimated time - 10 minutes)

a. GAAS is referenced in the scope paragraph. GAAP is referenced in the opinion paragraph.

b. GAAS are approved in two different ways. GAAS for auditors of public companies are approved by the PCAOB. GAAS for auditors of private companies are approved by the Auditing Standards Board (ASB), which is a part of the AICPA. When the PCAOB started it approved the GAAS that had previously been adopted by the ASB. They apply to all financial statement audits and deal with the quality of performance and the overall objectives to be achieved. GAAP represents the principles to be followed in the preparation of financial statements. GAAP includes adequate disclosure. Statements of the FASB and GASB are recognized as GAAP.

c. GAAP is the criteria for determining whether the financial statements present fairly, in all material respects. The auditor is also required by the first standard of reporting to state whether the financial statements are in conformity with GAAP.

d. The Statements on Auditing Standards and the PCAOB auditing standards explain the ten GAAS.

2.30 (Estimated time - 15 minutes)

	a. **Paragraph**	**Sentence Sequence**
1.	Scope	First
2.	Scope	Last
3.	Opinion	------
4.	Introductory	First
5.	Scope	Third
6.	Introductory	Third
7.	Scope	Second
8.	Scope	Fourth
9.	Introductory	Second

b. The primary purpose of each paragraph is:

- Introductory--distinguish between the responsibilities of management and the auditor.
- Scope--describe the nature and scope of the audit.
- Opinion—communicate the auditor’s conclusion and satisfy the standards of reporting.

2.31 (Estimated time - 15 minutes)

a. Departures from the auditor's standard report occur when (1) explanatory language is added to the standard report and (2) other than an unqualified opinion is expressed.

b. A change in an accounting principle made in conformity with GAAP results in adding explanatory language to the auditor's standard report in a paragraph following the opinion paragraph. There are no other changes in the standard report.

c. The auditor may express one of the following other types of opinions:

- A qualified opinion states that except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly... in conformity with GAAP.
- An adverse opinion states that the financial statements do not present fairly... in conformity with GAAP.
- A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.

d. There are three changes in the auditor's report when there is nonconformity with GAAP: (1) an explanatory paragraph is added before the opinion paragraph that explains the nonconformity with GAAP, (2) reference is made to the explanatory paragraph in the opinion paragraph, and (3) the wording of the opinion paragraph will say 'In our opinion, except for."

2.32 (Estimated time - 15 minutes)

a.

	Paragraph	**Sentence Sequence**
1.	Introductory	Second
2.	Scope	Last
3.	Inherent Limitations	Second
4.	Introductory	Last
5.	Scope	Second
6.	Definition	First
7.	Definition	Second
8.	Scope	Second
9.	Opinion	First
10.	Inherent Limitations	First

b. The primary purpose of each paragraph is:

- Introductory – identify assertion audited and distinguish between the primary responsibilities of management and the auditor.

- Scope – describe the nature and scope of the audit.

- Definition – describe the purpose of internal control over financial reporting.

- Inherent limitations – describe some basic inherent limitations of internal control over financial reporting.

- Opinion – Express two opinions: one on management's assertion about internal controls and the other on the effectiveness of the company's internal control over financial reporting.

- Explanatory – Communicate that the auditor also audited the Company's financial statements.

Cases

2.33 (Estimated time - 40 minutes)

Brief Description of Generally Accepted Auditing Standards	Holmes' Actions Resulting in Failure to Comply With Generally Accepted Auditing Standards
General Standards	
1. The audit is to be performed by a person or persons having adequate technical training and proficiency is an auditor.	It was inappropriate for Holmes to hire the two students to conduct the audit. The audit must be conducted by persons with proper education and experience in the field of auditing. Although a junior assistant has not completed his or her formal education, he or she may help in the conduct of the audit as long as there is proper supervision and review.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.	To satisfy the second general standard, Holmes must be without bias with respect to the client under audit. Holmes has an obligation for fairness to the owners, management, and creditors who may rely on the report. Because of the financial interest in whether the bank loan is granted to Ray, Holmes is independent in neither fact nor appearance with respect to the assignment undertaken.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.	This standard requires Holmes to perform the audit with due care, which imposes on Holmes and everyone in Holmes' organization a responsibility to observe the standards of fieldwork and reporting. Exercise of due care requires critical review at every level of supervision of the work done and the judgments exercised by those assisting in the audit. Holmes did not review the work or the judgments of the assistants and clearly failed to adhere to this standard.
Standards of Field Work	
1. The work is to be adequately planned and assistants, if any, are to be properly supervised.	This standard recognizes that early appointment of the auditor has advantages for the auditor and the client. Holmes accepted the engagement without considering the availability of competent staff. In addition, Holmes failed to supervise the assistants. The work performed was not adequately planned.

Brief Description of Generally Accepted Auditing Standards	Holmes' Actions Resulting in Failure to Comply With Generally Accepted Auditing Standards
2. A sufficient understanding of the internal controls is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.	Holmes did not obtain any understanding of the internal control structure. There appears to have been no audit at all. The work performed was more an accounting service than it was an auditing service.
3. 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 examination.	Holmes acquired no evidence that would support the financial statements. Holmes merely checked the mathematical accuracy of the records and summarized the accounts. Standard audit procedures and techniques were not performed.
Standards of Reporting	
1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.	Holmes' report made no reference to generally accepted accounting principles. Because Holmes did not conduct a proper audit, the report should state that no opinion can be expressed as to the fair presentation of the financial statements in accordance with generally accepted accounting principles.
2. 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.	Holmes' improper audit did not result in a determination of whether principles were consistently observed.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report	Management is primarily responsible for adequate disclosure in the financial statements, but when the statements do not contain adequate disclosures the auditor should make such disclosures in the auditor's report. In this case both the statements and the auditor's report lack adequate disclosures.
4. The report shall either contain an expression of opinion regarding the financial statements taken as a whole or an assertion to the	Although the Holmes report contains an expression of opinion, such opinion is not based on the results of a proper audit. Holmes should not express an opinion because he failed to conduct an audit in accordance with generally accepted auditing standards.

Brief Description of Generally Accepted Auditing Standards	Holmes' Actions Resulting in Failure to Comply With Generally Accepted Auditing Standards
effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clearcut indication of the character of the audit, if any, and the degree of responsibility the auditor is taking.	

2.34 (Estimated time - 30 minutes)

a. In conducting an ordinary audit, Hill & Associates should be aware of the possibility that fraud may exit. Defalcations, fraud, or deliberate misrepresentations may result in misstated financial statements. The ordinary audit leading to the expression of an opinion is not a guarantee that fraudulent activities will be detected.

Under GAAS, the auditor has the responsibility to plan the audit to detect errors or fraud that would have a material effect on the financial statements, and to exercise due skill and care in the conduct of the audit. Because the audit is based on the concept of selective testing of the data, there is the risk that material errors or fraud, if they exist, will not be discovered. Moreover, there is the risk that management override of controls and collusion by employees may limit the effectiveness of the auditor's examination.

b. When fraud exists, the auditor cannot issue an unqualified opinion because the auditor's standard report implicitly indicates the belief that the financial statements taken as a whole are not materially misstated as a result of errors or fraud.

When the auditor has obtained sufficient competent evidential matter concerning the fraud, he or she should express either a qualified or adverse opinion, depending on the materiality of the misstatement, because the financial statements are not in conformity with GAAP.

When the audit indicates the presence of fraud and the auditor remains uncertain about whether it may materially affect the financial statements, the auditor should qualify the opinion or disclaim an opinion on the financial statements because it is not known whether the financial statements are in conformity with GAAP.

Solution to Professional Simulations Chapter #2

(Estimated time - 30 to 45 minutes)

Situation	Research	Draft Report

The inability to obtain sufficient information about the foreign subsidiary is a material scope limitation. AU 508.22-26 explains how the auditor should evaluate a scope limitation when forming an opinion on the financial statements. These paragraphs are displayed below.

"Scope Limitations

.22 The auditor can determine that he or she is able to express an unqualified opinion only if the audit has been conducted in accordance with generally accepted auditing standards and if he or she has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the report. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.23 The auditor's decision to qualify his or her opinion or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the financial statements being audited. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.24 Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. Another common scope restriction involves accounting for long-term investments when the auditor has not been able to obtain audited financial statements of an investee. Restrictions on the application of these or other audit procedures to important elements of the financial statements require the auditor to decide whether he or she has examined sufficient competent evidential matter to permit him or her to express an unqualified or qualified opinion, or whether he or she should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.25 When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of evidential matter, the situation should be described in an explanatory paragraph preceding the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor's report. It is not appropriate for the scope of the audit to be explained in a note to the financial statements, since the description of the audit scope is the responsibility of the auditor and not that of the client. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]"

Situation	Research	Draft Report

REPORT OF INDEPENDENT
CERTIFIED PUBLIC ACCOUNTANTS

To the ToyCo Board of Directors,

We have audited the accompanying balance sheets of ToyCo, as of December 31, 20x2 and 20x1 and the related statements of income, and cash flows for each of the two years in the period ended December 31, 20x2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and schedule are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

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In our opinion, the balance sheets of ToyCo as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of ToyCo as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

Signature

Report Date

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