

CHAPTER 2: Financial Statement Audits and Auditors' Responsibilities

QUESTIONS

True/False

REQUIRED: For each of the following items, indicate whether it is (T) True or (F) False. For those marked "False," identify the error(s) and indicate the change or changes that are needed to make the statement true.

1. The primary objective of auditing is to add credibility to the financial statements prepared by management.
2. Auditing is not possible in the absence of verifiable data.
3. Compliance with "Statements on Auditing Standards" is mandatory for all auditors.
4. The training called for by the first general standard comes solely from practical experience.
5. The second general standard likens the auditor's role in an audit to the role of an attorney in a legal case.
6. No provisions exist for meeting the first reporting standard when a company uses a comprehensive basis of accounting other than GAAP.
7. The third general standard requires the auditor to act in good faith and not to be negligent in an audit.
8. The fourth reporting standard requires the auditor to express an opinion either on the financial statements taken as a whole or on selected major components of the financial statements.
9. In most cases, when disclosure in the financial statements is considered inadequate, the auditor's report must include the necessary disclosures.
10. The concepts of materiality and risk affect the application of auditing standards.
11. The auditing standards are more applicable to audits of public companies than to audits of nonpublic companies.
12. The main purpose of the audit committee is to monitor the competence of the external auditors during the course of the engagement.
13. Auditing procedures are the methods used and the acts performed by the auditor during an audit.
14. It is permissible under GAAS for the internal auditor to provide direct assistance to the independent auditor.
15. The internal auditor is responsible for the preparation of the financial statements.
16. The auditor's report should make explicit reference to the management responsibility for the financial statements.
17. In the opinion paragraph, reference is made to the listed financial statements, but their names are not repeated.

18. A disclaimer of opinion may be substituted for an adverse opinion.
19. The concept of reasonable assurance does not guarantee the accuracy of the financial statements.
20. In the case of a very material departure from GAAP, the best course of action is usually to disclaim an opinion.
21. Auditors are responsible for planning and performing an audit to obtain reasonable assurance that the financial statements are free of material misstatement.
22. SAS 82, *Consideration of Fraud in a Financial Statement Audit*, states that the auditor's interest specifically relates to fraudulent acts that cause material misstatements in financial statements.
23. When the auditor concludes that the financial statements are materially misstated and are not prepared in accordance with GAAP, the auditor should revise the financial statements.
24. SAS 82 essentially makes the audit report a guarantee.
25. SAS 54, *Illegal Acts by Clients*, indicates that 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.
26. The auditor's responsibility for illegal acts that have an indirect effect on the financial statements is restricted to information that comes to his or her attention.
27. An audit made in accordance with GAAS provides strong assurance that all illegal acts will be detected.
28. The payment of a bribe is an example of an error.
29. Fair presentation of financial statements in accordance with GAAP is not a guarantee of the continuation of an entity as a going concern.
30. If management concludes adequate disclosures in the financial statements concerning the entity's ability to continue as a going concern, the auditor would issue a qualified opinion on the financial statements with an additional paragraph explaining the going concern uncertainty.
31. The auditor of a public company is responsible for issuing more opinions than the auditor of private company.
32. The accounting profession is developing a narrower array of assurance services.
33. ASB refers to the Auditing Standards Board.
34. SAS refers to the Statements on Auditing Services.
35. The ASB has members that represent small and large practice units, state boards of accountancy, academic, government, and the public.
36. GAAS are applicable in each financial statement audit made by an independent auditor regardless of the entity's size, form of business organization, or type of industry.
37. The reader of a private company financial statement obtains reasonable assurance about the system of internal control over financial reporting.
38. The auditors report on internal control over financial reporting that goes to the public must report material weaknesses in internal controls.

Answers to True/False

1. T.
2. T.
3. F: Mandatory for all auditors who are members of the AICPA.
4. F: Such training also comes from formal education and continuing professional education.
5. F: **An attorney** should be **an arbitrator or a judge**.
6. F: Special provisions exist for meeting the standard when a company uses a comprehensive basis of accounting other than GAAP.
7. T.
8. F: **On selected major components of the financial statements** should be **state that an opinion cannot be expressed**.
9. T.
10. T.
11. F: **More** should be **equally**; **than to audits of** should be **and**.
12. F: **Monitor the competence** should be **strengthen the independence**.
13. T.
14. T.
15. F: **The internal auditor** should be **Management**.
16. T.
17. T.
18. F: **May** should be **cannot**.
19. T.
20. F: **Disclaim an** should be **issue an adverse**.
21. T.
22. T.
23. F: **revise the financial statements** should be **insist that the financial statements be revised by management**.
24. F: **Essentially makes** should be **does not make**.
25. T.
26. T.
27. F: **Strong** should be **no**.
28. F: **Error** should be **illegal act**.
29. T.
30. F: **A qualified** should be **an unqualified**.
31. T.
32. F: **Narrower** should be **wider**.
33. T.
34. F: **Services** should be **standards**
35. T.
36. T.
37. F: **Reasonable** should be **no**
38. T.

Multiple Choice

REQUIRED: Indicate the best answer choice for each of the following.

1. What level of assurance does the reader of a private company financial statement receive on the company's system of internal controls?
 - a. positive assurance
 - b. reasonable assurance
 - c. negative assurance
 - d. no assurance
 - e. limited assurance

2. How many different opinions must an auditor of a publicly held company issue?
 - a. 1
 - b. 2
 - c. 3
 - d. 4
 - e. 5

3. There are several paragraphs included in the auditor's standard report in internal control over financial reporting. Which paragraph defines internal control over financial reporting?
 - a. introductory paragraph
 - b. scope paragraph
 - c. inherent limitations paragraph
 - d. definition paragraph
 - e. explanatory paragraph

4. Statements on auditing standards (SAS's) are interpretations of?
 - a. generally accepted auditing standards
 - b. generally accepted accounting principles
 - c. generally accepted accounting policies
 - d. generally accepted auditing services
 - e. AICPA code of professional conduct

5. Auditing is based on the assumption that financial data are verifiable. Data are verifiable when two or more qualified individuals,
 - a. working together, can prove, beyond doubt, the accuracy of the data.
 - b. working independently, each reach essentially similar conclusions.

- c. working independently, can prove, beyond reasonable doubt, the truthfulness of the data.
 - d. working together, can agree upon the accuracy of the data.
 - e. working together, each reach essentially similar conclusions.
6. Which of the following organizations does the Auditing and Attest Standards Team belong to?
- a. IRS
 - b. FASB
 - c. AICPA
 - d. IMA
 - e. SEC
7. Which of the following best describes the relationship that should exist between the external auditor and the management of the client company?
- a. adversarial relationship
 - b. mutual trust and respect
 - c. advocacy of management's position
 - d. mutual caution and suspicion
 - e. skeptical vigilance
8. The primary purpose of the audit is to provide reasonable assurance that the financial statements are fairly presented in accordance with
- a. GAAS
 - b. GAAP
 - c. AICPA
 - d. FASB
 - e. SEC
9. Within the generally accepted auditing standards, the general standards relate primarily to:
- a. qualifications of the auditor and the quality of the auditor's work.
 - b. qualifications of the auditor.
 - c. the relationship between GAAS and generally accepted accounting principles.
 - d. the fairness of the financial statements.
 - e. the general distribution of audit reports.
10. The essence of the due care standard is that the auditor should not be guilty of:
- a. bias.
 - b. objectivity.
 - c. errors in judgment.
 - d. fraud.
 - e. negligence.
11. Which of the following is an incorrect statement concerning one of the field work standards?
- a. Audit planning includes the development of audit strategies.
 - b. Audit planning is aimed primarily at effectiveness, with little effect on efficiency.
 - c. Understanding of the internal control structure is necessary in order to plan the audit.
 - d. Proper supervision is essential because major portions of the audit are often executed by staff assistants with limited experience.
 - e. The auditor must have a reasonable basis, in the form of gathered evidence, for expressing an opinion.
12. Every independent audit engagement involves both auditing standards and auditing procedures. The

relationship between the two may be illustrated by how they apply from engagement to engagement. The best representation of this application is that, from one audit engagement to the next,

- | | Auditing
Standards | Auditing
Procedures |
|----|-----------------------|------------------------|
| a. | apply uniformly | apply uniformly. |
| b. | may vary | apply uniformly. |
| c. | apply uniformly | may vary. |
| d. | may vary | may vary. |
| e. | apply uniformly | are optional. |
13. The public companies accounting oversight board's (PCAOB) rule making process requires the adopted rules to be submitted to _____ for approval?
- IRS
 - FASB
 - AICPA
 - IMA
 - SEC
14. According to SAS 54, the auditor's responsibility for illegal acts having a direct and material effect on the determination of financial statement amounts is:
- greater than for errors or fraud.
 - the same as it is for errors or fraud.
 - less than it is for errors or fraud.
 - different for direct-effect illegal acts and other types of illegal acts.
 - restricted to information that comes to his attention.
15. If the client refuses to accept an audit report that is qualified due to the known existence of an illegal act, the auditor should:
- withdraw from the engagement and indicate the reasons to the audit committee in writing.
 - issue an adverse opinion if management agrees to fully disclose the matter.
 - withdraw from the engagement and indicate the reasons to the SEC or other regulatory body in writing.
 - issue a disclaimer of opinion instead.
 - issue an unqualified opinion if management agrees to fully disclose the matter.
16. Required auditor communication to the Audit Committee concerning illegal acts detected includes:
- all material items.
 - all that are not adequately addressed by management.
 - only those that have an effect on the audit report.
 - only those that constitute management fraud.
 - any such acts.
17. SAS 59 establishes auditor responsibility for evaluating whether there is any doubt about the entity's ability to continue as a going concern for a reasonable period of time. This reasonable period of time is defined as:
- at least one year past the date of the statements under audit.
 - at least one year past the date of the audit report.
 - not to exceed two years past the date of the audit report.
 - not to exceed one year past the date of the statements under audit.

- e. not to exceed one year past the date of the audit report.
18. When the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, and this fact is adequately disclosed in the notes to the financial statements, the auditor's report should express:
- a qualified opinion due to the uncertainty.
 - an unqualified opinion, with a fourth (explanatory) paragraph.
 - the standard unqualified opinion.
 - a disclaimer of opinion.
 - an adverse opinion.
19. Which of the following representations does an auditor make explicitly and which implicitly when issuing a standard unqualified opinion?

	Conformity with GAAP	Adequacy of disclosure	Consistency of accounting
a.	Explicitly	Explicitly	Implicitly
b.	Implicitly	Implicitly	Explicitly
c.	Explicitly	Implicitly	Implicitly
d.	Implicitly	Explicitly	Explicitly
e.	Explicitly	Implicitly	Explicitly

20. Which of the following would not be found in the introductory paragraph of the standard audit report?
- a reference to generally accepted auditing standards.
 - a list of specific financial statements audited.
 - a statement that the financial statements are the responsibility of management.
 - a statement that the auditor's responsibility is to express an opinion, based on the audit.
 - a reference to the entity audited.
21. The introductory paragraph in the standard audit report identifies all of the following except:
- the existence of the management responsibility letter.
 - the entity audited.
 - the dates of the statements.
 - the auditor's responsibility for the opinion.
 - management's responsibility for the statements.
22. The scope paragraph in the standard audit report uses all of the following terms except:
- generally accepted auditing standards.
 - conclusive basis.
 - materiality.
 - significant estimates.
 - examining evidence.
23. In the opinion paragraph of the standard audit report, the phrase "in our opinion," really means:
- "we certify..."
 - "we guarantee..."

- c. "we are certain..."
 - d. "we are reasonably satisfied..."
 - e. "we promise..."
24. The use of the phrase "present fairly, in all material respects" in the opinion paragraph is most closely associated with which of the following concepts from the scope paragraph?
- a. test basis
 - b. substantial guarantee
 - c. positive conclusion
 - d. basis for an opinion
 - e. significant estimates
25. In the standard audit report, the auditor's opinion on fairness pertains:
- a. only to the complete set of financial statements.
 - b. to individual accounts.
 - c. to each financial statement taken as a whole.
 - d. to major components of each financial statement.
 - e. only to material aspects of each financial statement.
26. When a user sees that a standard unqualified opinion has been expressed by an external auditor, he or she may correctly infer that:
- a. no material errors were found during the engagement.
 - b. no embezzlements remain undetected.
 - c. any system defects encountered during the engagement have been corrected to the auditor's satisfaction.
 - d. any differences between management and the auditor on material accounting matters have been resolved to the auditor's satisfaction.
 - e. any detected management fraud is immaterial.
27. A disclaimer of opinion really states that:
- a. no opinion can be formed.
 - b. no audit was attempted.
 - c. except for some minor errors the statements are fair.
 - d. the financial statements are wrong.
 - e. the audit was aborted.
28. If the financial statements contain a departure from GAAP, the auditor should express:
- a. an adverse opinion.
 - b. a qualified opinion.
 - c. a disclaimer of opinion.
 - d. either a disclaimer of opinion or a qualified opinion.
 - e. either a qualified opinion or an adverse opinion.
29. If an extremely material scope limitation exists, the auditor should express:
- a. an adverse opinion.
 - b. a qualified opinion.
 - c. a disclaimer of opinion.
 - d. either a disclaimer of opinion or a qualified opinion.
 - e. either a qualified opinion or an adverse opinion.

30. SAS 54 lists a number of items that may provide evidence concerning possible illegal acts. They include which one of the following?
- authorized transactions
 - investigations by governmental agencies
 - failure to file statements with the SEC
 - failure to amend tax returns
 - related party transactions
31. Which one of the following terms relates to the embezzling of receipts?
- manipulation
 - misrepresentation
 - misappropriation
 - misapplication
 - misleading
32. A significant aspect of conducting an audit with due professional care is the auditor's attitude of professional:
- pessimism
 - skepticism
 - optimism
 - courtesy
 - decorum
33. An auditor may be required to disclose fraud outside the client entity in each one of the following situations except:
- in response to a court subpoena.
 - to the SEC when the auditor has withdrawn from the engagement.
 - to a successor auditor who makes inquiries in accordance with professional standards.
 - to the GAO when the auditor has reported illegal acts to the audit committee.
 - to a funding agency in accordance with audit requirements for entities that receive governmental financial assistance.
34. Which one of the following is not an example of fraud?
- the falsification of accounting records
 - the intentional omission from the financial statements of transactions
 - the intentional misapplication of accounting principles relating to amounts
 - the stealing of assets
 - the payment of a bribe
35. Which one of the following is an indicator that may indicate an increased risk of illegal acts?
- failures to file income tax returns
 - authorized transactions
 - inquiries by governmental agencies
 - a substantial number of reclassifications
 - the presence of obsolete items in inventory
36. The auditors report on internal control over financial reporting that goes to the public must report material weaknesses in
- financial statement format
 - internal affairs
 - internal control

- d. management
 - e. supervision
37. It is important for the auditor to be independent, neutral, and _____ in performing an audit.
- a. unemotional
 - b. unbiased
 - c. unaware
 - d. silent
 - e. alone
38. Currently, there is a significant overlap between the rules of the PCAOB and the
- a. financial accounting standards board
 - b. statements on auditing standards
 - c. internal revenue service
 - d. financial information regulation organization
 - e. statements on financial information systems

Answers to Multiple Choice

- | | | |
|-------|-------|-------|
| 1. d | 15. a | 29. c |
| 2. c | 16. e | 30. b |
| 3. d | 17. d | 31. c |
| 4. a | 18. b | 32. b |
| 5. b | 19. c | 33. d |
| 6. c | 20. a | 34. e |
| 7. b | 21. a | 35. a |
| 8. b | 22. b | 36. c |
| 9. a | 23. d | 37. b |
| 10. e | 24. e | 38. b |
| 11. b | 25. c | |
| 12. c | 26. d | |
| 13. d | 27. a | |
| 14. b | 28. e | |

Matching 2-1 (5 minutes)

The ten generally accepted auditing standards are listed below in paraphrased form. Indicate the category to which each statement belongs by placing the following letters in the spaces provided:

- G: General,
- F: Field work, or

R: Reporting,

- _____ 1. An understanding of the internal control structure is to be obtained.
- _____ 2. The auditor should be unbiased during the examination.
- _____ 3. The financial statements should be in conformity with GAAP.
- _____ 4. The financial statements contain adequate disclosures.
- _____ 5. The auditor should have adequate technical training and proficiency as an auditor.
- _____ 6. Sufficient competent evidential matter is to be obtained.
- _____ 7. Due professional care is to be exercised by the auditor.
- _____ 8. The work should be adequately planned and assistants should be properly supervised.
- _____ 9. The report shall contain an expression of opinion.
- _____ 10. Circumstances in which GAAP have not been consistently observed should be identified.

Answers — Matching 2-1

- | | | | | |
|------|------|------|------|-------|
| 1. F | 3. R | 5. G | 7. G | 9. R |
| 2. G | 4. R | 6. F | 8. F | 10. R |

Matching 2-2 (10 minutes)

Words and phrases from the auditor’s standard report are given below. Indicate where the item should appear in the report by placing the following letters in the spaces provided:

- I: Introductory,
- S: Scope, or
- O: Opinion.

- | Item | |
|--|--|
| _____ 1. We have audited | |
| _____ 2. statements of income, retained earnings, and cash flows | |
| _____ 3. in accordance with GAAS | |
| _____ 4. in conformity with GAAP | |
| _____ 5. Our responsibility is to express an opinion | |

- _____ 6. responsibility of the Company's management
- _____ 7. statements are free of material misstatement
- _____ 8. results of its operations and its cash flows
- _____ 9. in all material respects
- _____ 10. examining, on a test basis,
- _____ 11. assessing the accounting principles used
- _____ 12. evaluating the overall financial statement presentation
- _____ 13. financial position of X Company
- _____ 14. supporting the amounts and disclosures in the financial statements
- _____ 15. a reasonable basis for our opinion

Answers — Matching 2-2

- | | | | | |
|------|------|------|-------|-------|
| 1. I | 4. O | 7. S | 10. S | 13. O |
| 2. I | 5. I | 8. O | 11. S | 14. S |
| 3. S | 6. I | 9. O | 12. S | 15. S |

Short Answer 2-1 (10 minutes)

The auditor's standard report on internal control over financial reporting includes an introductory paragraph. Identify the key elements within this introductory paragraph

Answers — Short Answer 2-1

1. Type of service performed("We have audited")
2. Management's assertion that it maintained an effective system of internal control was audited
3. Name of entity audited
4. Dates of the assertion regarding internal control
5. Management's responsibility for the assertion
6. Reference to COSO criteria for internal control
7. Auditor's responsibility for the opinion

Short Answer 2-2 (10 minutes)

During a financial statement audit, the auditor maintains professional relationships with four important groups. Briefly explain each of these relationships.

Answers — Short Answer 2-2

- (a) **Management** — From an auditing standpoint, management refers to the company officers, controller, and key supervisory personnel. During the course of an audit, there is extensive interaction between the auditor and management.

The auditor often requires confidential data about the entity while obtaining evidence, and it is therefore imperative to have a relationship based on mutual respect and trust. The approach the auditor should take towards management's assertions may be characterized as one of **professional skepticism**.

- (b) **Board of directors and audit committee** – A corporation's **board of directors** is responsible for ensuring that the firm is operated in the best interest of the stockholders. When the board is mostly made up of company officers, the auditor's relationship with the board and management is the same. When the board has some outside members, the board (or a designated **audit committee** composed exclusively or primarily of outside board members) can serve as an intermediary between the auditor and management.

Today, public company audit committees must have individuals with significant accounting knowledge.. Audit committee functions include:

- (1) Appointment, compensation and oversight of the public accounting firm to conduct the annual audit.
- (2) Establishing procedures for the receipt, retention, and treatment of complaints received by the company regarding internal controls and auditing.
- (3) Discussing the scope of the audit with the auditor.
- (4) Inviting direct auditor communication on major problems encountered during the course of the audit.
- (5) Reviewing the financial statements and the auditor's report with the auditor on completion of the engagement.

The audit committee also plays an important role in strengthening the auditor's ability to apply the appropriate professional skepticism in an engagement.

- (c) **Internal auditors** – An independent auditor normally has a close working relationship with the client's internal auditors, and has a direct interest in the work of internal auditors that pertains to the client's internal control structure. It is also permissible for internal auditors to provide *direct assistance* to the external auditor in performing a financial statement audit.

The *internal auditor's* work cannot be used as a *substitute* for the external auditor's work, but it can be an important *complement*. In determining the effect of such work on the audit, the independent auditor should:

- (1) consider the competence and objectivity of the internal auditor and
 - (2) evaluate the quality of the internal auditor's work.
- (d) **Stockholders** – Stockholders rely on audited financial statements for assurance that management has properly discharged its stewardship responsibility, and the auditor therefore has a serious responsibility to stockholders as the primary users of the audit report. During the course of an engagement, auditors are not likely to have direct personal contact with stockholders who are not officers, key employees, or directors of the client, but may attend the annual stockholders' meeting and answer stockholders' questions.

Short Answer 2-3 (10 minutes)

The second standard of field work requires the auditor to "understand the entity and its environment, including internal control." List the five different areas this standard requires the auditor to understand.

Answers — Short Answer 2-3

1. The entity's industry, regulatory, and other external factors.
2. The nature of the entity, including its application of accounting policies.
3. The entity's objectives and strategies and related business risks, as well as its risk assessment process.
4. The entity's measurement and review of financial performance.

5. The entity's system of internal control.

Short Answer 2-4 (10 minutes)

List the types of inherent limitations that prevent internal control over financial reporting from being effective.

Answers — Short Answer 2-4

1. Mistakes in judgment when applying internal control.
2. 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.
3. Collusion between individuals may cause segregation of duties to break down, and internal controls may appear to function when they are not.
4. Management override. Senior management may have authority that would cause otherwise functioning internal controls to break down.

Analysis 2-1 (15 minutes)

The following audit report was issued by the CPA firm of Wong and Lee on a basic set of financial statements:

(0) We have examined the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of (1) income and retained earnings for the year then ended. These financial statements are the responsibility of the Company's (2) board of directors. Our responsibility is to express an opinion on these financial statements based on our (3) examination.

We conducted our audit in accordance with (4) professional auditing standards. Those standards require that we (5) plan and perform the audit to obtain reasonable assurance about whether the financial statements (6) are fairly stated. An audit includes examining, (7) on a detailed basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes (8) judging the accounting practices used and significant (9) decisions made by management, as well as evaluating the (10) completeness of the financial statement presentation. We believe that our audit provides (11) reliable evidence for our opinion.

(12) We believe the financial statements referred to above (13) present fairly, in all respects, the financial position of X Company as of December 31, 19XX, and (14) the results of its operations and its cash flows for the year then ended (15) in conformity with promulgated accounting principles.

REQUIRED: If the wording of each numbered item is correct, enter OK. If the wording is incorrect, give the correct wording.

Answer (0) is given as an example.

(0) We have audited.

Answers — Analysis 2-1

- (1) income, retained earnings, and cash flows
- (2) management
- (3) audit
- (4) generally accepted auditing standards
- (5) OK
- (6) are free of material misstatement
- (7) on a test basis
- (8) assessing the accounting principles used

- (9) estimates made by management
- (10) overall financial statement presentation
- (11) a reasonable basis for our opinion
- (12) In our opinion, the financial . . .
- (13) present fairly, in all material respects,
- (14) OK
- (15) in conformity with generally accepted accounting principles.

Analysis 2-2 (8 minutes)

Identify the specific generally accepted auditing standard for each one of the following descriptions.

1. 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.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
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 audit.
4. Due professional care is to be exercised in the performance of the audit and the preparation of the report.
5. The work is to be adequately planned, and assistants, if any, are to be properly supervised.
6. 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.
7. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
8. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
9. 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.
10. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

Answers — Analysis 2-2

1. Fourth Standard of Reporting
2. Second General Standard
3. Third Standard of Field Work
4. Third General Standard
5. First Standard of Field Work
6. Second Standard of Reporting
7. First General Standard
8. Third Standard of Reporting
9. Second Standard of Field Work
10. First Standard of Reporting

Analysis 2-3 (10 minutes)

Data are **verifiable** when two or more qualified people, working independently, reach similar conclusions from an examination of the data. *Verifiability* is mainly concerned with the availability of evidence attesting to the validity of the information being considered.

What are the challenging aspects involved in verifying a client's allowance for doubtful accounts, the net realizable value of inventory and impairment test to fixed assets and goodwill?

Answers — Analysis 2-3

These are examples of how management and auditors must use judgment in determining how to apply generally accepted accounting principles. Determinations of the balances in these accounts require significant professional judgment. GAAP is inherently imprecise. Hence an audit cannot guarantee financial statement accuracy, and an audit cannot increase the precision of an accounting estimate. Audits can only provide a high level of assurance, reasonable assurance, that the financial statements are presented fairly in all material respects.

Analysis 2-4 (8 minutes)

The auditor's standard report on internal control over financial reporting has six main paragraphs. Listed below are excerpts from each of the six main paragraphs. Identify which paragraph each statement is from.

1. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements.
2. We have also audited, in accordance with the standards of the Public Companies Accounting Oversight Board (United States), the balance sheet of XYZ Co. as of December 31, 2005 and related statements of income, cash flows, and equity for the years then ended...
3. ...management's assessment that XYZ Co. maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects...
4. We have audited management's assessments....
5. A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting...
6. We conduct our audit in accordance with auditing and related professional practice standards established by the standards of the Public Companies Accounting Oversight Board (United States).

Answers — Analysis 2-4

1. Inherent Limitations Paragraph
2. Explanatory Paragraph
3. Opinion Paragraph
4. Introductory Paragraph
5. Definition Paragraph
6. Scope Paragraph