CHAPTER 1

Introduction and Overview of Audit and Assurance

Learning Objectives

1. Differentiate among assurance, attestation, and auditing services.

2. Describe the different types of assurance services.

3. Explain the demand for audit and assurance services.

4. Discuss the different roles of the financial statement preparer and the auditor.

5. Identify the roles of different regulators and organizations that affect the audit profession.

6. Explain the concepts of reasonable assurance, materiality, and the nature of an unqualified/unmodified report on the audit of financial statements.

7. Explain the concept of reasonable assurance and the nature of an unqualified report on internal controls over financial reporting.

8. Discuss the audit expectation gap.

ANSWERS TO MULTIPLE-CHOICE QUESTIONS

1. C

LO 1, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: None, AICPA AC: Risk Assessment, Analysis and Management, Section: Assurance, Attestation, and Audit Services

2. A

LO 2, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: None, AICPA AC: Risk Assessment, Analysis and Management, Section: Different Assurance Services

3. B

LO 2, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: None, AICPA AC: Risk Assessment, Analysis and Management, Section: Different Assurance Services

4. C

LO 2, BT: C, Difficulty: Medium, TOT: 2 min., AACSB: None, AICPA AC: Risk Assessment, Analysis and Management, Section: Different Assurance Services

5. C

LO 3, BT: C, Difficulty: Medium, TOT: 2 min., AACSB: None, AICPA AC: Risk Assessment, Analysis and Management, Section: Demand for Audit and Assurance Services

6. B

LO 4, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: None, AICPA AC: Risk Assessment, Analysis and Management, Section: Preparers and Auditors

7. A

LO 5, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: None, AICPA AC: Reporting, Section: The Role of Regulators and Regulations

8. D

LO 5, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: None, AICPA BC: Governance Perspective, Section: The Role of Regulators and Regulations

9. D

LO 6, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: None, AICPA AC: Risk Assessment, Analysis and Management, Section: Audit Report on Financial Statements

10. C

LO 6, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: None, AICPA AC: Reporting, Section: Audit Report on the Financial Statements

11. B

LO 7, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: None, AICPA AC: Reporting, Section: Audit Report on Internal Controls over Financial Reporting

12. B

LO 8, BT: C, Difficulty: Medium, TOT: 2 min., AACSB: None, AICPA PC: Professional Behavior, Section: The Audit Expectation Gap

ANSWERS TO REVIEW QUESTIONS

**R1.1** An assurance service is any service provided by an independent practitioner that improves the quality of information, or its context, for decision makers. An independent practitioner can verify that the information meets relevant criteria, which provides assurance to users who intend to use the information for decision making. An assurance engagement has three parties: the assurance provider (auditor/practitioner), the party responsible for providing the information (client), and the intended users of the information (investors/lenders/others who rely on the information).

LO 1, BT: C, Difficulty: Easy, TOT: 5 min., AACSB: None, AICPA AC: Risk Assessment, Analysis and Management, Section: Assurance, Attestation, and Audit Services

**R1.2** The criterion used in a financial statement audit to measure and evaluate subject matter is the applicable financial reporting framework used by the client. The most common framework used in the U.S. is Generally Accepted Accounting Principles (GAAP).

LO 1, BT: C, Difficulty: Easy, TOT: 5 min., AACSB: None, AICPA AC: Measurement Analysis and Interpretation, Section: Assurance, Attestation, and Audit Services

**R1.3** Financial statements are not guaranteed to be free from error or fraud due to several limitations. These limitations include the nature of financial reporting, the nature of audit procedures and the need for the audit to be conducted within a reasonable period of time and within a reasonable budget. The nature of financial reporting causes limitations because it includes management’s judgment when applying accounting standards and estimates. The nature of the audit procedures is a limitation because the auditors have to rely on management to provide all the necessary documentation needed for the audit. The auditor may arrive at an inappropriate conclusion if information is tampered with or excluded. The last limitation refers to the limited resources of time and money for an audit engagement. It would be impractical for auditors to examine every transaction. Therefore, auditors rely on sampling measures to provide an accurate representation of the population, and sampling cannot provide absolute assurance.

LO 2, BT: C, Difficulty: Medium, TOT: 15 min., AACSB: None, AICPA AC: Risk Assessment, Analysis and Management, Section: Different Assurance Services

**R1.4** Management and those charged with governance can request an operational audit to help improve the efficiency and effectiveness of a company’s operations. An organization’s internal audit department typically conducts operational audits.

LO 2, BT: C, Difficulty: Easy, TOT: 5 min., AACSB: None, AICPA BC: Governance Perspective, Section: Different Assurance Services

**R1.5** Investors are interested in the information that financial statements can provide about their investment. This includes, but is not limited to, information regarding the profitability of the company, return on investment, going concern/continuity of operations, and dividend distributions. An independent audit helps to ensure that the information in the financial statements is credible and of high quality.

LO 3, BT: C, Difficulty: Easy, TOT: 10 min., AACSB: None, AICPA BC: Governance Perspective, Section: Demand for Audit and Assurance Services

**R1.6** Both the preparer and the auditor have responsibilities regarding the company’s financial statements. Management (the preparer) is in charge of preparing the financial statements. This includes ensuring the information is presented fairly and in compliance with GAAP, or other applicable financial reporting framework. Management is responsible for designing, implementing, and maintaining internal control over financial reporting, as well as providing auditors with all the necessary documentation and personnel needed to complete the audit. Auditors are responsible for providing an opinion on whether the financial statements are presented fairly and in accordance with the applicable financial reporting framework. The three responsibilities of auditors are to conduct the audit in accordance with the appropriate audit standards, plan and perform the audit with professional skepticism, and exercise professional judgment.

LO 4, BT: C, Difficulty: Medium, TOT: 15 min., AACSB: None, AICPA AC: Reporting, Section: Preparers and Auditors

**R1.7** The SOX Act of 2002, which emphasized a need for better governance over financial reporting, created the Public Company Accounting Oversight Board (PCAOB). The PCAOB is a non-profit corporation established to oversee the audits of public companies. The U.S. Securities and Exchange Commission (SEC) is a federal government agency whose role is to enforce and interpret securities laws. The SEC approves each new auditing standard established by the PCAOB before it can be implemented. The SEC and PCAOB work closely together to ensure standards are in place for both public companies and auditors to safeguard investors.

LO 5, BT: C, Difficulty: Medium, TOT: 10 min., AACSB: None, AICPA AC: Reporting, Section: The Role of Regulators and Regulations

**R1.8** Some functions of the state boards of accountancy include issuing Certified Public Accountant (CPA) licenses, adopting and enforcing professional conduct rules for CPAs, enforcing continuing professional education requirements, and administering disciplinary actions. The National Association of State Boards of Accountancy (NASBA) is a professional organization that works to unite the interests of the 55 jurisdictions of state boards with regulative and legislative bodies.

LO 5, BT: AP, Difficulty: Easy, TOT: 10 min., AACSB: Analytic, AICPA PC: Professional Behavior, Section: The Role of Regulators and Regulations

**R1.9** The principles of Generally Accepted Audit Standards (GAAS) start with the purpose of an audit, which is to provide an opinion on whether a company’s financial statements are presented fairly and in accordance with GAAP. The next principle describes the premise upon which an audit is conducted. This outlines management’s responsibility to prepare the financial statements in accordance with the applicable framework, manage and maintain internal controls over financial reporting, and provide the auditor with access to all documentation relevant to conduct the audit. The next principle outlines the responsibilities of the auditor, which explicitly states auditors have to be competent, comply with auditing standards, maintain professional skepticism and exercise professional judgment during an audit. While performing an audit, an auditor must obtain reasonable assurance that the financial statements are free from material misstatement, but also recognize it is not an absolute assurance due to several limitations. The last principle states that auditors must report the results of the audit in a formalized written report.

LO 5, BT: C, Difficulty: Easy, TOT: 10 min., AACSB: None, AICPA AC: Reporting, Section: The Role of Regulators and Regulations

**R1.10** Audit reports for private and public companies are very similar in content. Both reports contain the essential components: a title with the word “independent,” an address to the shareholders/owners and board, identification of which financial statements were audited, an opinion on the outcome, a description of the responsibilities of the parties involved, a description of the conduct of an audit, a signature with the firm’s name and a date indicating the end of fieldwork. However, there are a few differences between the two. The title for an audit report of a public company includes the term “registered” indicating the firm is registered with the PCAOB. Audit reports for public companies state the auditor is required to be independent from the company in accordance with U.S. federal securities laws and with regulations of the SEC and PCAOB. The report for a public company includes a paragraph referencing the audit of the firm’s internal controls over financial reporting. Public companies are required to have two audits, one for financial statements and the other for Internal Control over Financial Reporting (ICFR); whereas private companies are not required to have an audit of ICFR. A report of a public company will indicate the audit was performed in accordance with the standards of the PCAOB, whereas a private company report will indicate the audit was conducted in accordance with GAAS (issued by the AICPA). Finally, auditors must provide a statement about auditor tenure at the bottom of the audit report for public companies and must also include a section for the discussion of critical audit matters (CAM). Neither of these features is required for an audit report for a private company client.

LO 6, BT: AN, Difficulty: Medium, TOT: 15 min., AACSB: Analytic, AICPA AC: Reporting, Section: Audit Report on Financial Statements

**R1.11** The components of an auditor’s report on internal controls over financial reporting include the title, address, opinion, reference to the financial statement audit, basis for opinion paragraph, scope paragraph, definition and limitations paragraph, signature and date. The title must include two important terms—“independent” and “registered”—signifying the auditor’s independence and that the firm is registered with the PCAOB. The report is addressed to the board and shareholders of the company. The opinion paragraph states that an audit of the company’s internal controls was conducted using the COSO *Internal Control-Integrated Framework* as the criteria, and then states whether or not the company maintained effective internal control. The next paragraph references the audit of the company’s financial statements since public companies require two audits. The basis for opinion paragraph briefly describes the responsibilities of management and the auditor and mentions that auditors are required to be independent from the company. The scope paragraph briefly describes how an audit of ICFR is conducted. The definition and inherent limitations paragraph defines ICFR for users unfamiliar with the terminology and emphasizes that internal controls will not be able to prevent or detect all misstatements or errors. The report is signed by the firm and dated to represent the end of the fieldwork.

LO 7, BT: C, Difficulty: Medium, TOT: 15 min., AACSB: None, AICPA AC: Reporting, Section: Audit Report on Internal Controls over Financial Reporting

**R1.12** The audit expectation gap occurs when the auditor’s professional responsibilities do not align with the financial statement users’ beliefs. This gap is created when the user has unrealistic expectations for the audit. Some examples of unrealistic expectations are as follows:

* the user may believe the auditor is providing absolute assurance instead of reasonable assurance,
* the user may believe the auditor is guaranteeing future viability of the company,
* the user may believe a favorable audit conclusion indicates complete accuracy instead of no material misstatements,
* the user may believe the auditor will find any and all fraud when that is simply impossible, and
* the user may believe the auditor has tested every transaction instead of a sample.

It is impossible for professional auditing standards to give users what they want because of inherent limitations with the conduct of an audit, such as the cost of an audit and completing the audit in a reasonable time frame.

Auditors sometimes do not meet professional standards because of time constraints in completing the audit (possibly being short staffed), not exercising enough professional skepticism, and not maintaining professional competence through continuing professional education.

LO 8, BT: AN, Difficulty: Medium, TOT: 10 min., AACSB: Analytic, AICPA AC: Risk Assessment, Analysis and Management, Section: The Audit Expectation Gap

SOLUTIONS TO ANALYSIS PROBLEMS

**AP1.1** Although internal and external audit are different professional fields, they share some similar responsibilities. Both fields follow rules and regulations made by their respective professional organizations, the Institute of Internal Auditors (IIA) and the American Institute of Certified Public Accountants (AICPA). Additionally, external auditors of public companies must adhere to regulations set forth by the PCAOB and SEC. Internal auditors are typically employees of the organization and therefore cannot have the same level of independence from the organization as an external auditor can. Nevertheless, internal auditors are required to maintain independence from management to ensure objectivity and an unbiased attitude. External auditors cannot be employees of the audit client, and they must adhere to strict independence guidelines to ensure there are no conflicts of interest in performing the audit engagement.

The most common role for internal auditors is to monitor internal controls and improve the effectiveness of controls, governance, and risk management strategies. Internal auditors report their results to those charged with governance and typically do not report findings to the public. The role of the external auditors is to express an opinion on the fair presentation of the client’s financial statements in accordance with the applicable financial reporting framework. For certain public company clients, external auditors also provide an opinion on the effectiveness of the client’s internal controls over financial reporting. The external auditors report their opinion(s) to those charged with governance, and for public company clients, to interested users outside of the client.

LO 1, 2 BT: AN, Difficulty: Easy, TOT: 15 min., AACSB: Analytic, Technology, AICPA AC: Research, Section: Assurance, Attestation, and Audit Services, Different Assurance Services

**AP1.2** Users demand audited financial statements for various reasons. If the accounting firm performing the audit is perceived as incompetent, not independent, or unethical, then the value of the audit service is lost. Users will not be confident that the information management presents in the financial statements is unbiased and reliable. If users think the financial statements are unreliable, then they may not invest in the company, do business with the company, or lend money to the company. Therefore, a company does not want to be associated with an accounting firm that has a poor reputation or that is in violation of professional standards. That is why clients dropped Arthur Andersen after charges were brought against the firm.

LO 3, BT: AP, Difficulty: Hard, TOT: 15 min., AACSB: Analytic, AICPA PC: Professional Behavior, Section: Demand for Audit and Assurance Services

**AP1.3** The solution will depend on the accounting firm chosen and the date of the analysis. However, the answers should show for the Big 4: greater geographic coverage, larger numbers of staff and broader range of skills offered, greater claims to specialization and industry coverage, more publications available (particularly from the international offices), more consistent and sophisticated marketing.

LO 3,4, BT: AN, Difficulty: Medium, TOT: 20 min., AACSB: Analytic, Technology, AICPA AC: Research, Section: Demand for Audit and Assurance Services, Preparers and Auditors

**AP1.4**

a. Financial statement audits are mandatory for public companies, so overall demand is largely fixed or determined by economic conditions affecting the number of companies. However, for organizations that are not required by legislation to have an audit, there are two opposing pressures in times of economic recession. First, cost-cutting would result in fewer audits. Second, organizations with less credible financial statements will face the most difficulty in borrowing during a credit squeeze. This suggests that demand for auditing will increase in difficult times, because an audit will increase the credibility of the financial statements and thus increase access to external financing.

b. Shifting from a mid-tier auditor to a Big 4 auditor would increase both costs and financial statement credibility for a company. Therefore, it can be argued that companies with greater need to reduce costs will shift “down” from Big 4 auditors to mid-tier auditors, but companies with greater need for credibility (and financial advice) will shift “up” from mid-tier auditors to Big 4 auditors.

LO 3, 4 BT: AP, Difficulty: Hard, TOT: 15 min., AACSB: Analytic, AICPA BC: Customer Perspective, Section: Demand for Audit and Assurance Services, Preparers and Auditors

**AP1.5** The solution will vary based on the states selected by the student to research. In general, most states require a bachelor’s degree and relevant accounting and business courses. Some states, such as Texas and Colorado, require an ethics course. Some states allow candidates to sit for the CPA exam after completing a bachelor’s degree with the relevant accounting courses, but a total of 150 hours of college credits are required to be licensed as a CPA. In addition to passing the CPA exam and meeting the education requirements, most states require 1-2 years of work experience in public accounting to be licensed.

LO 5, BT: AN, Difficulty: Basic, TOT: 20 min., AACSB: Technology, AICPA AC: Research, Section: The Role of Regulators and Regulations

**AP1.6** To be registered with the PCAOB, a firm must complete a 27-page application (Form 1) and pay the required fees. The purpose of Form 1 is to capture information about the firm including contact information, number of employees, types of clients serviced by the firm, any on-going or pending criminal or civil actions against the firm, quality control procedures, and names of issuers that the firm expects to provide audit services to in the current year. Form 1 is signed by a partner or authorized officer of the firm. The application fee is $500 for a firm that audits less than 50 issuers, $3,000 for a firm that audits 50-100 issuers, $29,000 for a firm that audits 101-1000 issuers, and $390,000 for a firm that audits 1001 or more issuers.

Once a firm is registered, annual fees are $100,000 for firms with more than 500 issuer audit clients and more than 10,0000 personnel, $25,000 for firms with more than 200 issuer clients and more than 1,000 personnel, and $500 for all other firms. Registered firms have to file an annual report with the PCAOB on Form 2. Form 2 captures any updated information related to the firm and its audit clients, affiliations with other firms, and on-going or pending criminal or civil actions against the firm.

Registered firms must abide by PCAOB regulations and consent to be inspected on a regular basis. Firms that audit 100 or more issuers per year are inspected annually. Firms that audit less than 100 issuers per year are inspected once every three years.

LO 5, BT: C, Difficulty: Basic, TOT: 20 min., AACSB: Technology, AICPA AC: Research, Section: The Role of Regulators and Regulations

**AP1.7**

1. 1
2. 4
3. 6
4. 9
5. 8
6. 5
7. 9
8. 7
9. 1
10. 2

LO 5, BT:C, Difficulty: Easy, TOT: 15 min, AACSB: Technology, AICPA AC: Research, Section: The Role of Regulators and Regulations

**AP1.8**

1. C
2. B
3. C
4. B
5. A
6. B
7. C
8. B
9. A
10. C

LO 6, 7 BT: C, Difficulty: Easy, TOT: 20 min, AACSB: Analytic, Technology, AICPA AC: Research, Reporting, Section: Audit Report on Financial Statements, Audit Report on Internal Controls over Financial Reporting

**AP1.9**

a. Answers may vary depending on which public company is selected to compare with the Amazon.com reports. Most likely both companies will have unqualified opinions on both the financial statements and internal controls.

b. All accounting firms follow the standard audit report formats provided by the ASB (for private company audits) and the PCAOB (for public company audits). Having a uniform report format promotes consistency in the profession and is easier for financial statement users to understand.

LO 6, 7, BT: AN, Difficulty: Easy, TOT: 20 min., AACSB: Analytic, Technology, AICPA AC: Research, Reporting, Section: Audit Report on Financial Statements, Audit Report on Internal Controls over Financial Reporting

**AP1.10**

Dear Kim,

I enjoyed eating dinner with you the other night, old friend. I am writing to you because you had a difficult time understanding the audit profession and a few of its important aspects. I will describe to you the concept of “reasonable assurance” and how it is determined, the “professional skepticism” that all auditors must practice, and why your perceptions are a great example of what is called the “expectations gap.”

As auditors of a company, we are required to give our opinion on the level of confidence we have in the reliability that the financial statements are free of material misstatement. This confidence level is called “reasonable assurance.” It is determined by using our professional judgment and by acquiring a significant amount of evidence to support this assurance. We cannot offer absolute assurance because there are several factors that make it impossible for us to detect every misstatement. First, we have a limited time to conduct the audit, therefore we cannot audit everything. We focus our time on the most impactful, or material, items on the financial statements. Second, there is a risk that management can collude to hide information or provide false information to us, but fraud is not a common occurrence. Finally, some items on the financial statements are subjective and can be very complex to audit. We cannot provide absolute assurance on an item that is subjective.

“Professional skepticism” is a concept that means auditors must have a state of awareness about the factors that could lead to material misstatement, be critical of the evidence and documents they receive from an organization’s management and have a questioning attitude overall. Although we are skeptical of management, this does not mean that we believe they are constantly trying to deceive us. There are many situations where we must rely on the information provided to us by the client’s management team.

The perceptions that you had during dinner about the audit profession are a perfect example of the “expectations gap.” We define the expectations gap as the difference between what the public believes auditors are providing and what the auditing profession is actually capable of doing. Now that you have read my explanations of reasonable assurance and professional skepticism, I hope I have provided you with a more realistic impression of my profession. Hope we can get together for dinner again soon!

Sincerely,

LO 4, 6, 8 BT: S, Difficulty: Medium, TOT: 30 min., AACSB: Analytic, Communication, AICPA PC: Communication, Section: Prepares and Auditors, Audit Report on Financial Statements, The Audit Expectations Gap

**AP1.11**

a. An audit is limited due to several factors. The nature of financial reporting causes a limitation of the audit. This refers to the subjectivity involved when a company is deciding which accounting methods or estimates to use. It can be difficult to audit an item that has been created based on judgment. Another limitation is the nature of audit procedures. Auditors select audit procedures that will detect *material* misstatements, as it is too costly to try and detect all misstatements. Also, auditors use sampling techniques when gathering evidence related to some financial statement items. A limitation of sampling is that the sample may not be representative of the population and the auditor will draw an incorrect conclusion. Finally, one of the bigger limitations auditors face is that of time. There is a need for an audit to be conducted within a reasonable period of time and at a reasonable cost. This time constraint on the audit can cause auditors to perhaps rush their work and not be as diligent as they would be otherwise.

b. When looking at the reports in figures 1.7, 1.8, and 1.10 in Chapter 1, you can see these limitations referenced. The reports mention the reasonableness of accounting estimates, which refers to the subjectivity limitation. Also, you see the word “material” in all three of these audit reports. Auditors are only concerned with material misstatements that could affect the decisions of financial statement users. Reasonable assurance is mentioned in every report. It is because of these limitations that auditors provide only reasonable assurance. Defined as a high, but not absolute, level of assurance, reasonable assurance means the auditor does not “guarantee” that the financial statements are 100% accurate. Finally, the audit reports in Illustrations 1.7 and 1.8 include the phrase “procedures included examining, on a test basis,” which refers to the limitation of using sampling. The auditor does not test all information~~,~~ ; therefore, sampling risk exists.

LO 2, 4, 6, 7, 8 BT: AN, Difficulty: Hard, TOT: 30 min., AACSB: Analytic, AICPA AC: Risk Assessment, Analysis and Management, Reporting, Section: Different Assurance Services, Preparers and Auditors, Audit Report on Financial Statements, Audit Report on Internal Controls over Financial Reporting, The Audit Expectation Gap

Cloud 9

a. A financial statement audit only focuses on determining if the financial statements are prepared according to the applicable financial reporting framework. A financial statement audit must be performed by an independent accounting firm under the supervision of a CPA. A compliance audit is performed to determine if an entity has followed rules, laws, or regulations with which it is required to conform. A compliance audit does not have to be performed by a CPA, but it must be performed by someone designated or approved by the body that enforces the rules, laws, or regulations. An operational audit focuses on the efficiency and effectiveness of an entity’s activities. Typically, an operational audit is performed by employees of the company, but it can also be outsourced. The individual(s) performing the audit does not have to be independent and does not have to be a CPA.

b. Reasonable assurance is a high level of assurance, but it is not absolute assurance. Absolute assurance implies a level of service that is akin to a guarantee or a certification. Because of the limitations of an audit (time constraints, subjectivity, and the nature of audit procedures), auditors can only provide reasonable assurance.

c. An audit is more in depth and broader in scope than a review. An audit also provides a higher level of assurance, reasonable assurance as compared to a review, which only provides limited assurance. Since Chip is considering purchasing Stotez shoes, he would likely require more assurance that the financial statements are fairly presented and the information in the financial statements is reliable.

d. Ron should consider the reputation of the firm and whether the firm has the expertise to conduct an audit of a company in the sports footwear industry. Since Ron’s company is small, he would most likely consider using a regional or mid-tier firm because their work is tailored to companies of his size.

LO 1, 2, 3, 4, 6, BT: AN, Difficulty: Medium, TOT: 30 min., AACSB: Analytic, AICPA AC: Reporting, Section: Assurance, Attestation, and Audit Services, Different Assurance Services, Demand for Audit and Assurance Services, Preparers and Auditors, Audit Report on Financial Statements