
Auditing - Lecture 2

Part I. Fundamentals of audit: CPA

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CPA - profession

- Use of the title certified public accountant (CPA) is regulated by national laws in every individual country through national authorized licensing departments. Although regulations for becoming a CPA usually differ from country to country however to become a CPA three major requirements must be met:
 - educational requirement
 - uniform CPA examination requirement
 - experience requirement
- To maintain the right to practice as independent auditors in most countries, CPAs must meet defined continuing education and licensing requirements. Therefore, it is common for accountants to be CPAs who do not practice as independent auditors.

CPA – firm (types)

- **Big-4** – Deloitte, PwC, EY, KPMG - have offices throughout the United States and throughout the world. The Big Four firms audit nearly all of the largest companies worldwide.
- **National firms** - RSM McGladrey, Grant Thornton, BDO Seidman, CBIZ/Mayer Hoffman McCann - these firms are large but considerably smaller than the Big-4. National firms perform the same services as the Big-4 and compete directly with them for clients. Each national firm is affiliated with firms in other countries and therefore has an international capability.
- **Regional and local large firms** - Crowe Horwath, BKD , Moss Adams Holthouse Carlin & Van Trigt - some have only one office and serve clients primarily within commuting distances, others have several offices in some some country or region and serve a larger radius of clients. Many of these firms also have internat. affiliations.
- **Local small firms** - more than 95 percent of all CPA firms have fewer than 25 professionals in a single-office firm. They perform audits primarily for smaller businesses and not-for-profit entities, although some have one or two clients with public ownership.

CPA – firm (services)

- Activities of CPA firms:
 - **Accounting and bookkeeping services** - many small clients with limited accounting staff rely on CPA firms to prepare their financial statements. Accounting and bookkeeping are the major source of revenue for most large CPA firms.
 - **Tax services** - CPA firms prepare corporate and individual tax returns for both audit and nonaudit clients. For many small firms, such services are far more important to their practice than auditing, as most of their revenue may be generated from tax services.
 - **Management consulting services** - Most CPA firms provide certain services that enable their clients to operate their businesses more effectively. These services range from simple suggestions for improving the client's accounting system to advice in risk management, mergers and acquisitions due diligence, business valuations, and actuarial benefit consulting.

Assurance and other services - framework

- All auditor services standards have as their basis the IFAC Code of Ethics and International Standards on Quality Control (ISQC)
 - **IFAC Code of Ethics** – contains 3 parts (A – Framework which applies to all professional accountants, B - Framework which applies to accountants in public practice, C - Framework which applies to employed accountants). It declares such fundamental principles as independence of audit and review engagements, integrity of client, objectivity, professional competence and due care, confidentiality, professional behavior of CPA professionals and firms. It also defines basic threats and safeguards for CPA professions and firms.
 - **International Standards on Quality Control (ISQC)** – sets a requirement for CPA firm to establish and maintain a system of quality control to provide it with reasonable assurance that: (a) the firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and (b) reports issued by the firm are appropriate in the circumstances.⁶

Assurance and other services - framework

- Engagement standards:
 - **International Standards on Auditing (ISAs)** - are to be applied, as appropriate, in the audit of historical financial information.
 - **International Standards on Review Engagements (ISREs)** - are to be applied in the review of historical fin. information.
 - **International Standards on Assurance Engagements (ISAEs)** - are to be applied in assurance engagements dealing with subject matters other than historical financial information.
 - **International Standards on Related Services (ISRSs)** - are to be applied to compilation engagements, engagements to apply agreed upon procedures to information, and other related services engagements as specified by the IAASB.

Assurance and other services - AE

- **Assurance engagement (AE)** - an engagement in which a practitioner (professional accountant or auditor) expresses a conclusion (in report form) that is designed to enhance the degree of confidence users have about the evaluation of the subject matter against identified criteria (common examples of AEL: financial statement audits and reviews and opinions on the effectiveness of internal controls).
- Elements of AE – there are 5 elements: (1) three-party relationship involving (a practitioner, a responsible party, intended users); (2) a subject matter; (3) suitable criteria; (4) evidence; (5) assurance report.

Assurance and other services - AE

- Assurance engagements (AE) and other related services
 - **Audit and review of historical financial information** – objective of audit is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. The expression of a conclusion by an auditor is designed to enhance the degree of confidence intended users can have about historical financial statements. A review of financial statements is similar to an audit in the way it requires terms of an engagement, planning, consideration of work performed by others, documentation, and paying attention to subsequent events.
 - **Related services** – a related service engagement is generally an examination of historical financial statements to develop a conclusion based on the criteria, but no audit opinion. In some instances, this kind of engagement could also be linked to information in other historical financial statements.

Audit process (phase I)

- **Phase I. Client acceptance** – objectives are to determine both acceptance of a client and acceptance by a client, to decide on acquiring a new client or continuation of relationship with an existing one and the type and amount of staff required. Procedures:
 - Evaluate the client's background and reasons for the audit
 - Determine whether the auditor is able to meet the ethical requirements
 - regarding the client
 - Determine need for other professionals
 - Communicate with predecessor auditor
 - Prepare client proposal
 - Select staff to perform the audit
 - Obtain an engagement letter

Audit process (phase II)

- **Phase II. Planning** – objectives are to determine the amount and type of evidence and review required to give the auditor assurance that there is no material misstatement of the financial statements.

Procedures:

- Perform audit procedures to understand the entity and its environment, including the entity's internal controls
- Assess the risks of material misstatements of the financial statements
- Determine materiality
- Perform tests of controls (ToC) providing evidence on quality of internal controls and based on them financial statements
- Prepare the planning memorandum and audit program, containing the auditor's response to the identified risks

Audit process (phase III)

- **Phase III. Testing and evidence** – objective is to test for evidence supporting internal controls and the fairness of the financial statements. Procedures:
 - Substantive tests of transactions
 - Analytical procedures
 - Tests of details of balances
 - Search for unrecorded liabilities

Audit process (phase IV)

- **Phase IV. Evaluating and evidence** – objective is to complete the audit procedures and issue an opinion. Procedures:
 - Evaluate governance evidence
 - Perform procedures to identify subsequent events
 - Review financial statements and other report material
 - Perform wrap-up procedures
 - Prepare Matters for Attention of Partners
 - Report to the board of directors
 - Prepare Audit report

Standard unqualified audit report

- **Standard unqualified audit report** - the **most common type** of audit report. It is used for more than 90 percent of all audit reports. US GAAS and ISA prescribe the use of **three-paragraph form**: introduction, scope, and opinion, where the final paragraph – opinion - states the auditor’s conclusion based on the results of the audit examination. This paragraph is so important that the entire audit report is frequently referred to as “**the auditor’s opinion**”. The opinion paragraph is stated as an **opinion** rather than as **statement of absolute fact or a guarantee**. The intent is to indicate that the conclusions are based on professional judgment.
- Conditions for standard unqualified audit report:
 - **completeness** - all statements (balance sheet, income statement, statement of change in equity and retained earnings, and statement of cash flows) are included in the financial statements.

Standard unqualified audit report

- ❑ **compliance** – US GAAS/SAS or ISA have been followed in all respects. This also means that adequate disclosures have been included in the footnotes and other parts of the financial statements.
- ❑ **pervasiveness of evidence** – sufficient appropriate evidence has been accumulated and presented in auditor's report.
- ❑ there are **no circumstances** requiring the addition of an explanatory paragraph or modification of the wording of the report.
- The standard unqualified audit report is sometimes called a **clean opinion** because there are no circumstances requiring a qualification or modification of the auditor's opinion. The standard unqualified report is the most common audit opinion. Sometimes circumstances beyond the client's or auditor's control prevent the issuance of a clean opinion. However, in most cases, companies make the appropriate changes to their accounting records to avoid a qualification or modification by the auditor.

Extended and/or modified unqualified audit report

- An auditor's report is considered to be modified in the two different situations:
 - matters that **do not affect the auditor's opinion** (which would mean adding of matter paragraph => issue of unqualified audit report with explanatory notes and/or modified wording)
 - matters that **do affect the auditor's opinion** (instances that call for either: (a) qualified opinion, (b) disclaimer of opinion, or (c) adverse opinion).
- **Causes of addition of an explanatory paragraph or a modification** in the wording of the standard unqualified report:
 - **Lack of consistent application of US GAAP or IFRS**
 - **Substantial doubt about going concern**
 - Auditor agrees with a **departure from promulgated accounting principles**
 - **Emphasis of a matter**
 - Reports involving **other auditors or experts**

Departures from unqualified audit report

- **Conditions requiring departures** (matters that do affect the auditor's opinion):
 - Scope of the audit has been restricted (**scope limitation**)
 - Financial statements have not been prepared in US GAAP or IFRS (**US GAAP/IFRS limitation**)
 - Auditor is not independent (**independence limitation**)
- **Materiality (extra condition)** - materiality is an essential consideration in determining the appropriate type of report for a given set of circumstances. For example, if a misstatement is **immaterial** relative to the financial statements, it is appropriate to issue an **unqualified report**. The situation is totally different when the amounts are of such significance that the financial statements are **materially** affected as a whole. In these circumstances, it is necessary to issue a **disclaimer of opinion or an adverse opinion**, depending on whether a scope limitation or GAAP departure is involved. In situations of **lesser materiality**, a **qualified opinion** is appropriate.

Decision-making process about type of audit report

- Making decision about **type of audit reports**:
 - Deciding whether any **condition** exists requiring a departure from a standard unqualified report
 - Deciding about **materiality level** for each condition
 - Deciding about the **appropriate type** of report for the condition, given the determined materiality level
 - **Writing** of audit report

Qualified audit report (opinion)

- **Qualified opinion report** - can result from a **limitation on the scope** of the audit or **failure to follow US GAAP or IFRS**. A qualified opinion report can be used only when the auditor concludes that the **overall financial statements are fairly stated** (a disclaimer or an adverse report must be used if the auditor believes that the condition being reported on is highly material) Therefore, the qualified opinion is considered **the least severe type of departure** from an unqualified report.
- A qualified report can take the form of **a qualification of both the scope and the opinion** or of the **opinion alone**. A scope and opinion qualification can be issued only when the auditor has been unable to **accumulate all of the evidence** required by generally accepted auditing standards. Therefore, this type of qualification is used when the auditor's scope has been restricted by the client or when circumstances exist that prevent the auditor from conducting a complete audit. The use of a qualification of the opinion alone is restricted to situations in which the **financial statements are not stated in accordance with US GAAP/IFRS**.

Adverse audit report (opinion)

- **An adverse opinion** - is used only when the auditor believes that the **overall financial statements are so materially misstated or misleading** that they **do not present fairly the financial position or results of operations and cash flows in conformity with US GAAP/IFRS**. The adverse opinion report can arise only when the auditor has knowledge, after an adequate investigation, of the **absence of conformity**. This is uncommon and thus the adverse opinion is rarely used.

Disclaimer

- **A disclaimer of opinion** - is issued when the auditor has been unable to satisfy himself or herself that **the overall financial statements are fairly presented**. The necessity for disclaiming an opinion may arise because of a **severe limitation on the scope of the audit or a nonindependent relationship** under the Code of Professional Conduct (AISPA or IFAC) between the auditor and the client. Either of these situations prevents the auditor from expressing an opinion on the financial statements as a whole. The auditor also has the **option to issue a disclaimer of opinion for a going concern problem**.
- The disclaimer is distinguished from an adverse opinion in that it can **arise only from a lack of knowledge by the auditor**, whereas to express an adverse opinion, the auditor must have knowledge that the financial statements are not fairly stated. Both disclaimers and adverse opinions are used only when the **condition is highly material**.

Recommended reading

- Arens et al. (2015) – chosen chapters will be uploaded to IS
 - Ch. 1 (1.4, 1.7), 2 (2.1-2.2, 2.9), 3 (whole)
- Hayes et al. (2014) – chosen chapters will be uploaded to IS
 - Ch. 1 (1.8-1.9), 2 (2.3), 4 (whole)
- ISQC