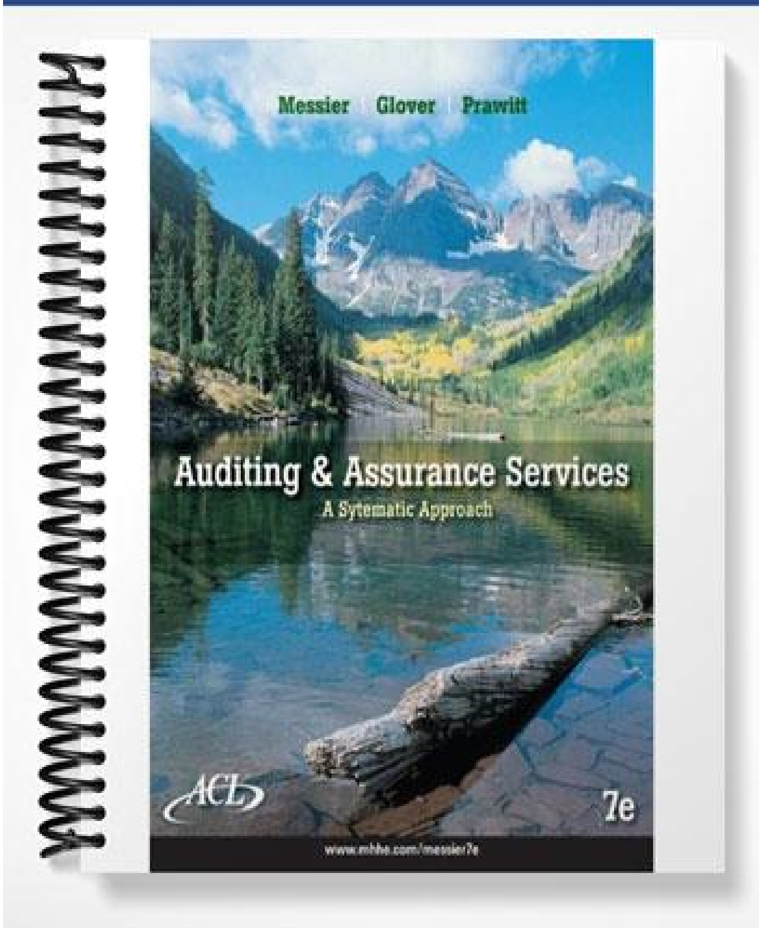
SOLUTIONS MANUAL



CHAPTER 2
THE FINANCIAL STATEMENT AUDITING ENVIRONMENT

Answers to Review Questions

2-1 During the late 1990s and early 2000s, accounting firms aggressively sought opportunities to expand their business in nonaudit services such as consulting. This expansion from their core audit practice, combined with allegations of auditors refusing to challenge management's actions, resulted in conflict between regulators and the accounting profession. Subsequent financial fiascos such as those at Enron, WorldCom, Tyco, and many others, caused investors to doubt the fundamental integrity of the financial reporting system. Under pressure to restore the public's confidence, Congress passed the Sarbanes-Oxley Act and created the PCAOB in 2002.

2-2 The accounting profession's expansion into new areas, combined with changes in the overall business environment, resulted in new regulations and guidelines. The scandals of the late 1990s and early 2000s brought into the question the profession's ability to self-regulate, resulting in new legislation. While these changes have caused pain and turmoil, they highlight the essential importance of auditing in our economic system. Ultimately, the "back to basics" emphasis, along with auditing firms' renewed focus on thorough and effective financial statement audits, will likely prove healthy for the U.S. financial reporting system and for the profession. Further, somewhat ironically, the SOX-mandated audit of internal control over financial reporting has brought significant new revenues to accounting firms.

2-3 The essential components of the high-level model of business offered in the chapter are: corporate governance, objectives, strategies, processes, controls, transactions, and financial statements. Corporate governance is carried out by management and the board of directors in order to ensure that business objectives are carried out and that company assets are safeguarded. To achieve its objectives, management must formulate strategies and implement various processes which are in turn carried out through business transactions. The entity's information and internal control systems must be designed to ensure that these transactions are properly executed, captured, and processed in order to produce accurate financial statements. It is important that the auditor obtain a firm understanding of these components in order to understand relevant risks and to plan the nature, timing, and extent of the audit so that it is efficient and effective.

2-4 The information system must maintain a record of all businesses transactions. It should be capable of producing accurate financial reports to summarize the effects of the entity's transactions. Among other things, internal control is required to ensure that a proper environment is established and that transactions are appropriately conducted and recorded by the information system and company employees. Effective internal control provides safeguards to ensure the (1) reliability of financial reporting, (2) compliance with laws and regulations, and (3) the effectiveness and efficiency of operations. Auditing standards require that the auditor obtain an understanding of the client's environment, including its internal control, in planning the nature, timing, and extent of testing.

2-5 The three categories of management assertions (balances, transactions, and disclosures) cover every aspect of what is needed for a transaction to be handled properly, for a financial statement account to be fairly stated, and for the financial statements to be presented appropriately and to contain adequate disclosures. The management assertions form the basis for planning and evaluating the evidence that the auditor must obtain about the fairness of the client's financial statements. They help the auditor ensure that "all the bases are covered" in the process of collecting and evaluating evidence to form an opinion on the fairness of the financial statements.

2-6 GAAS is composed of three categories of standards: *general standards*, *standards of fieldwork*, and *standards of reporting*. The ten GAAS and the SAS are minimum standards of performance because circumstances of individual engagements may require the auditor to perform audit work beyond that specified in GAAS and the SAS in order to appropriately issue an opinion that a set of financial statements is fairly presented. As a result, the auditor needs to use professional judgment in following all standards.

2-7 Independence is a fundamental principle for auditors. If an auditor is not independent of the client, users may lose confidence in the auditor's ability to report objectively and truthfully on the financial statements, and the auditor's work loses its value. From an agency perspective, if the principal (owner) knows that the auditor is not independent, the owner will not trust the auditor's work. Thus, the agent will not hire the auditor because the auditor's report will not be effective in reducing information risk from the perspective of the owner.

2-8 Management is responsible to prepare financial statements that fairly present the company's financial condition and operations in accordance with established accounting standards. Note that the auditor's opinion explicitly states that the financial statements are the responsibility of management. The auditor is responsible to issue an opinion in regards to the financial statements prepared by management. In order to issue this opinion, the auditor must plan and perform the audit in accordance with established standards to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. However, it is important to note that an auditor's unqualified opinion does not mean that errors or fraud do not exist but rather that there is reasonable assurance that they do not exist in material amounts.

2-9 Examples of compliance audits include (1) internal auditors determining whether corporate rules and policies are being followed by departments within the organization, (2) an examination of tax returns of individuals and companies by the Internal Revenue Service for compliance with the tax laws, and (3) an audit under the Single Audit Act of 1984 to determine whether an entity receiving federal assistance is in compliance with applicable laws and regulations.

Examples of operational audits include (1) an audit by the GAO of the Food and Drug

Administration to determine the efficiency and effectiveness of procedures for introducing new drugs to the market, (2) internal auditors examining the effectiveness and efficiency of funds being spent on the entity's computer resources, and (3) a university hiring an external auditor to examine the effectiveness and efficiency of student advisory services.

Examples of forensic audits include (1) an examination by an external auditor of cash disbursements for payments to unauthorized vendors, (2) assistance by an auditor to a law enforcement agency in tracing laundered monies by organized criminals, and (3) an independent auditor helping identify hidden assets as part of a divorce settlement.

Student answers will likely be less detailed but should capture the general idea of each type of audit.

2-10 Auditors can be classified under four types: (1) external auditors, (2) internal auditors, (3) government auditors, and (4) forensic auditors.

2-11 The AICPA issues the following standards:

- Statements on Auditing Standards
- Statements on Standards for Attestation Engagements
- Statements on Standards for Accounting and Review Services
- Statements on Quality Control Standards
- Standards for Performing and Reporting on Peer Reviews
- Statements on Standards for Consulting Services
- Statements on Standards for Tax Services

2-12 The PCAOB is a quasi-governmental organization overseen by the SEC. It was formed to provide governmental regulation of the standards used in conducting public company audits because of a perceived failure of the profession to adequately regulate itself.

2-13 The SEC has congressional authority from the original Securities Acts of 1933 and 1934 to establish accounting and auditing standards for publicly traded companies; however, in the past the SEC has largely delegated this authority to other bodies, including the FASB and the AICPA's Auditing Standards Board. The Sarbanes-Oxley Act of 2002 gave the SEC the mandate to actively regulate the public accounting profession by establishing and overseeing the PCAOB and its standard setting process relating to the audits of public companies. The SEC has authority to implement and oversee standards relating to all aspects of the audits of public companies, including standards relating to auditor independence (such as the requirement for audit firms to rotate audit partners off audit engagements every five years).

2-14 The documents most frequently encountered by auditors under the Securities Exchange Act of 1934 are forms *10K*, *10Q*, and *8K*. Forms *10K* and *10Q* are, respectively, annual and quarterly reports, which include the audited financial statements periodically filed with the SEC by a publicly traded entity. An *8K* is filed whenever a significant event occurs which may be of interest to investors, such as a change of independent auditors.

Answers to Multiple-Choice Questions

2-15	D	**2-20**	A
2-16	A	**2-21**	B
2-17	C	**2-22**	A
2-18	C	**2-23**	A
2-19	C		

Solutions to Problems

2-24

Brief Description of Generally Accepted Auditing Standards	**Sally Jones' Actions Resulting in Failure to Comply with Generally Accepted Auditing Standards**
<u>General Standards</u>:	
1. The auditor must have adequate technical training and proficiency to perform the audit.	1. It was inappropriate for Jones to hire the two students to conduct the audit. The examination must be conducted by persons with proper education and experience in the field of auditing. Although a junior assistant has not completed his formal education, he may help in the conduct of the examination as long as there is proper supervision and review.
2. The auditor must maintain independence in mental attitude in all matters relating to the audit.	2. To satisfy the second general standard, Jones must be without bias with respect to the client under audit. Jones 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 Boucher, Jones is not independent in either fact or appearance with respect to the assignment undertaken.

3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.	3. This standard requires Jones to plan and perform the audit with due care, which imposes on Jones and everyone in Jones's 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 examination. Jones did not review the work or the judgments of the assistants and clearly failed to adhere to this standard.
Standards of Fieldwork: 1. The auditor must adequately plan the work and must properly supervise any assistants.	 1. This standard recognizes that early appointment of the auditor has advantages for the auditor and the client. Jones accepted the engagement without considering the availability of competent staff. In addition, Jones failed to supervise the assistants. The work performed was not adequately planned.
2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.	2. Jones did not study the client or its environment, including internal control, nor did the assistants. There appears to have been no audit examination at all. The work performed was more an accounting service than it was an auditing service.
3. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.	3. Jones acquired little evidence that would support the fairness of the financial statements. Jones merely checked the mathematical accuracy of the records and summarized the accounts. Several standard audit procedures and techniques were neglected.

Standards of Reporting: 1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).	1. Jones's report made no reference to generally accepted accounting principles. Because Jones did not conduct a proper examination, the report should state that no opinion can be expressed as to the fair presentation of the financial statements in accordance with GAAP.
2. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.	2. Jones's improper examination would not enable her to determine whether accounting principles have been consistently applied.
3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.	3. Management is 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. Both the statements and the auditor's report lack adequate disclosures.
4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefore in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.	4. Although the Jones report contains an expression of opinion, such opinion is not based on the results of a proper audit examination. Jones should disclaim an opinion because she failed to conduct an examination in accordance with generally accepted auditing standards.

2-25

Situation	Applicable GAAS of Reporting	Discussion of Relationship of Client Situation to Standard of Reporting
a.	The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.	A change in accounting principle affects the consistent application of the accounting principle. If the change is material, the auditor should reference the change in accounting in an explanatory paragraph to the audit report.
b.	When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.	Information essential to a fair presentation in conformity with GAAP must be disclosed in the financial statements or the related footnotes. Assuming that the terms of loan agreements, such as restrictive covenants, are material, such information should be disclosed. If the client refuses to disclose such essential information, the auditor should disclose the information and qualify the audit report.
c.	The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).	The improper presentation of material amounts of minority interest in net income and retained earnings constitutes a departure from GAAP. The audit report should be qualified (or adverse) and the information should be disclosed by the auditor.

2-26

Item Number	Type of Audit	Type of Auditor
a.	Operational	Government
b.	Financial statement	External
c.	Compliance or operational or possibly internal control	Internal or external
d.	Forensic	Internal, external, or forensic

e.	Operational	Government, external, or internal
f.	Operational	Internal or external
g.	Compliance	Government
h.	Compliance or forensic	Government, external, or forensic

Solutions to Discussion Cases

2-27 Merry-Go-Round Part I.

a. E&Y is alleged to have violated all three general standards as well as one, and perhaps two, of the standards of fieldwork.
   - They violated the first general standard in the sense that it appeared that the staff assigned to the engagement did not have sufficient training or experience for the engagement.
   - E&Y's relationship with MGR's landlords and attorneys likely caused them to violate the second general standard, which requires independence in mental attitude.
   - The turnaround team's slow performance, the fact that the leader of the team took a vacation at a critical time, and the insufficient cost-cutting recommendations suggest that E&Y did not exercise due professional care, which would be in violation of the third general standard.
   - Poor staff assignments, the leader's vacation, and the use of inexperienced personnel all suggest that the engagement was not adequately planned and that assistants were not properly supervised, a violation of the first standard of fieldwork.
   - Finally, E&Y's inadequate recommendations suggests that they likely did not gather enough information about MGR's operations to allow them to implement an effective implementation strategy, which would be in violation of the third standard of fieldwork.

b. There are arguments both for and against having formal standards for CPAs who consult. Advantages include potential increase in public trust, some assurance that a minimal level of service quality would be attained, and perhaps more guidance for consultants (to allow them to perform more effective consulting engagements). The primary disadvantage would result from the fact that CPAs who consult compete with consulting firms comprised of non-CPAs. If standards were not thought out carefully, perhaps the standards would put CPAs at a disadvantage relative to non-CPAs in the sense that CPAs would be subject to standards that constrain their activities or perhaps result in their not being able to compete with non-CPAs in the area of fees. Note that CPAs face certain restrictions in providing consulting services to audit clients. These restrictions are covered in a later chapter.

2-28 Merry-Go-Round Part II.

a. In one sense, E&Y acted unethically. That is, they should have disclosed the nature of these relationships to MGR. In another sense, it is difficult to ascertain whether these relationships caused E&Y to act unethically. Specifically, was E&Y's advice affected by their relationship with the landlord? Is this relationship the reason that E&Y's cost-cutting suggestions did not go farther? These questions point out the importance of independence in fact and appearance, even when acting in a consulting capacity. Even if E&Y acted ethically, this relationship creates the appearance of impropriety.

b. As mentioned in Part a, the relationship with Rouse could have caused E&Y to hesitate to suggest that the stores for which Rouse was the landlord be closed for fear of losing business from Rouse. Their relationship with Swidler could have made E&Y feel that they could not lose the engagement under any circumstances, thereby possibly explaining their apparently lackadaisical attitude towards the engagement.

Solutions to Internet Assignments

2-29 **a.** According to its website, the AICPA's mission is to "provide members with the resources, information, and leadership that enable them to provide valuable services in the highest professional manner to benefit the public as well as employers and clients."

b. The SEC's website states that its mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." They go on to emphasize that their purpose is to promote and sustain economic growth. The site also mentions that the SEC promotes the disclosure of important market information, maintains fair dealing, protects against fraud, and enforces its authority.

c. During the 1920s many people began investing heavily in the stock market without fully thinking about the risk that they were taking upon themselves. As a result of poor investment choices and unreliable information, the stock market crashed in 1929. In an attempt to restore confidence in the capital markets, congress passed the Securities Act of 1933. One year later, the SEC was created by the Securities Exchange Act of 1934.

The PCAOB's website provides information on the board's organization, policies, and standards. It also indicates that the Board uses an expert advisory group to help the Board develop standards. Though many observers dispute this claim, the Board asserts that its standards are also developed in an open, public process to allow all parties of interest to comment. Section 103 of the Sarbanes-Oxley Act empowers the PCAOB to set auditing standards for audits of public companies.

2-30 A search of the GAO's homepage will identify recent audits conducted by this agency.