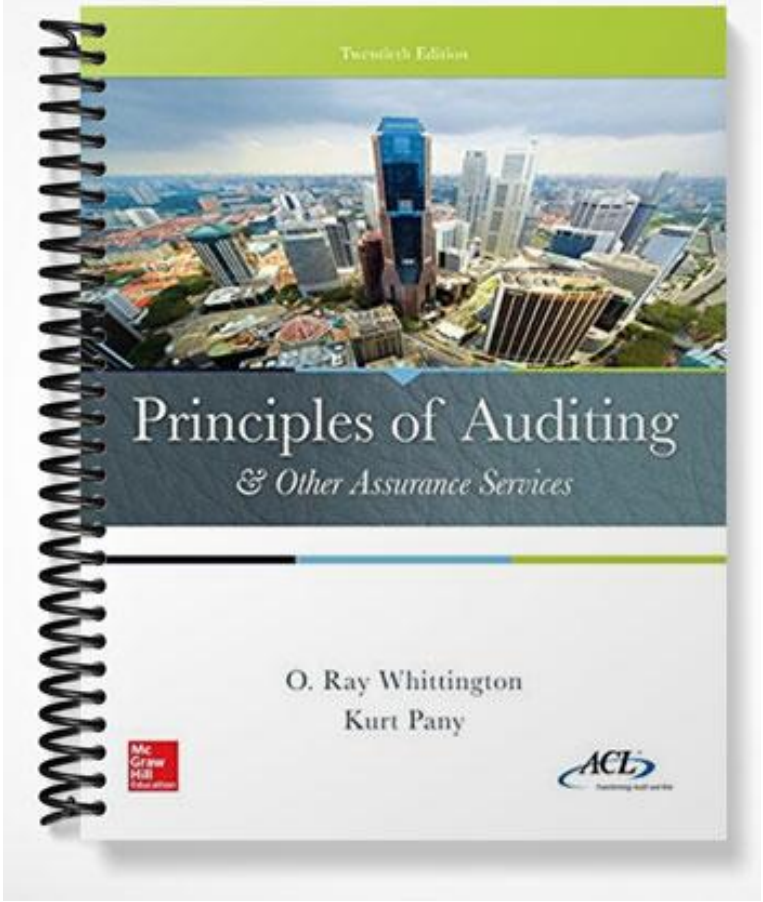
SOLUTIONS MANUAL



CHAPTER 2

Professional Standards

Review Questions

2-1 The Sarbanes-Oxley Act of 2002 created the PCAOB and gave this body authority to develop auditing standards for the audits of public companies. The AICPA has the authority, based on general acceptance (and adoption by state boards of accountancy and other regulatory bodies), to develop auditing standards for audits of nonpublic companies.

2-2 Generally accepted accounting principles are accounting principles which have substantial authoritative support, such as approval by the Governmental Accounting Standards Board or the Financial Accounting Standards Board. These standards provide the criteria (financial reporting framework) for financial reporting, including the nature and content of financial statements. Generally accepted auditing standards are those issued by the AICPA's Auditing Standards Board (ASB). GAAS are the standards for the auditor's work in fulfilling the overall objectives of a financial statement audit. GAAS address the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities.

2-3 A financial reporting framework is a set of criteria used to determine measurement, recognition, representation, and disclosure of all material items appearing in the financial statements; for example United States GAAP or IFRS. It is important to an audit because it is through consideration of that framework on which the auditor basis his or her opinion on the financial statements.

2-4 Generally accepted auditing standards are the *Statements on Auditing Standards* issued by the Auditing Standards Board.

2-5 In the context of the audit of financial statements, professional skepticism includes maintaining a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence. Throughout the audit the auditors should be alert for: (1) audit evidence that contradicts other audit evidence, (2) information that raises a question about the reliability of documents and responses to inquiries, (3) conditions indicating possible fraud, and (4) circumstances suggesting the need for additional audit procedures beyond those ordinarily required.

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2-6 The auditors' responsibilities concerning the detection of noncompliance with laws by clients depends on the relationship of the law or regulation to the financial statements. Certain laws and regulations, such as income tax laws, have a direct effect on the amounts and disclosures included in the financial statements. The auditors have a responsibility to design their audit to obtain reasonable assurance of detecting material violations of these laws and regulations.

Many other laws and regulations, such as occupational safety and health laws, do not have a direct effect on the amounts included in the financial statements. An audit carried out in accordance with generally accepted auditing standards is not designed to detect client noncompliance with these other laws.

Although an audit is not designed to provide reasonable assurance of detecting noncompliance with other laws, the CPAs should be aware of the possibility that they have occurred and investigate those identified. When they become aware of noncompliance with laws, the auditors should communicate the situation to the audit committee of the board of directors to remedy the situation and make appropriate modifications to the financial statements. If management fails to take appropriate action, the auditors should consider withdrawing from the engagement.

2-7 The first sentence of the quotation is correct. The completion of an audit of financial statements by a CPA following generally accepted auditing standards and satisfying the CPA provides the basis for expression of an unmodified opinion on the fairness of financial statements.

The second sentence of the quotation is in error. Auditors never express an opinion (either qualified or unmodified) on the fairness of financial statements without first performing an audit. The audit provides the basis for the expression of an opinion. Such factors as audits made in prior years, confidence in management, and a "quick review" of the current year's financial statements are not an acceptable substitute for appropriate audit procedures.

2-8 The management of Pike Company is primarily responsible for the fairness of the company's financial statements. The retention of certified public accountants to perform an audit and express an opinion on the statements does not relieve management of its obligation to give an honest and complete accounting of its conduct of corporate affairs.

2-9

Independent Auditor’s Report

To the Audit Committee of ABC Company

We have audited the accompanying consolidated balance sheets of ABC Company and its subsidiaries, as of December 31, 20X1 and 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended.

Management's Responsibility for the Financial Statements
Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United

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States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and its subsidiaries as of December 31, 20X1 and 20X0, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Williams & Co. LLP

Phoenix, Arizona
February 5, 20X2

2-10 Among the more common situations which prevent the issuance of an unmodified opinion upon completion of an audit are the following:

(1) Certain necessary auditing procedures were omitted at the request of the client, or for reasons beyond the control of the client or the auditors.
(2) The statements contained misstatements (or omissions) and the client refuses to change them.

2-11 In the opinion paragraph of the auditor's standard report the auditors make representations as to the following:

(1) The fairness of the financial statements, in all material respects.
(2) Application of generally accepted accounting principles.
(3) By implication consistent application of generally accepted accounting principles.
(4) By implication adequate disclosure.

2-12 The issuance of a standard audit report tells us that the audit was performed in accordance with generally accepted auditing standards and, accordingly, it was planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. The audit included performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. These procedures were determined based on the auditors' judgment, including their assessment of the risks of material misstatements of the financial statements. The auditors also evaluated the appropriateness of accounting policies used by the client, the reasonableness of significant accounting estimates, and the overall presentation of the financial statements.

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2-13 The auditors' report expresses an opinion on the client's financial statements, not on the accounting records. A major purpose of the audit is to give outsiders assurance that the financial statements are reliable. The client's accounting records are important to the public accounting firm only because they constitute evidence supporting the financial statements. The CPAs also gather evidence from outside the company and from internal sources other than the accounting records.

2-14 The public accounting firm must observe generally accepted auditing standards (or, if applicable, PCAOB Standards) in order to merit confidence in its opinion. The result of following these procedures is an audit report that includes a reasonable, but not absolute, assurance that the financial statements do not contain material misstatements due to errors or fraud. Reasonable assurance implies that there is a low level of risk remaining that the auditor expresses an opinion that the financial statements are properly stated when they are not. Reasonable and not absolute assurance is necessary due to (1) the nature of financial reporting (e.g., the necessary use of judgment), (2) the nature of audit procedures (e.g., they often do not provide absolutely conclusive evidence) and (3) the need to conduct an audit within a reasonable period of time at a reasonable cost. Accordingly, the auditor expresses an opinion on the financial statements, not a statement of fact.

2-15 Regardless of how careful and professional an audit of financial statements the public accounting firm has made, it cannot guarantee their correctness. The statements themselves include a variety of estimates; for example, the estimate of the allowance for uncollectible accounts and the choice of depreciation rates. Also, the auditors rely on a program of tests rather than on verifying every transaction. Some errors, therefore, may go undetected. The audit gives the auditors a firm basis for expressing an informed opinion on the financial statements, but no more than that.

2-16 A material amount is an amount that is sufficiently important to influence decisions made by reasonable users of financial statements. The amount may differ by account based on specific account characteristics. For example, a $100,000 shortage of cash may be extremely material to a small company, and a shortage of that amount might lead to bankruptcy. But, a $100,000 valuation overstatement of equipment may be of less significance if the company continues to produce its products and operate as in the past. Materiality is discussed further in Chapter 6.

2-17 If the guidance for a transaction or event is not specified within the authoritative GAAP (the FASB *Codification*), the auditor should first consider whether accounting principles for similar transactions or events exist within GAAP; if that is the case, those principles are followed to the extent considered appropriate. If not, nonauthoritative accounting guidance is consulted. Sources of nonauthoritative accounting guidance and literature include

- Practices that are widely recognized and prevalent either generally or in the industry.
- FASB Concepts Statements.
- AICPA Issues Papers
- International Financial Reporting Standards.
- Pronouncements of professional associations or regulatory agencies.
- Technical Information Service Inquiries and Replies included in AICPA
- Technical Practice Aids.
- Accounting textbooks, handbooks, and articles.

The appropriateness of the above nonauthoritative accounting guidance and literature depends on its relevance to particular circumstances, how specific it is, the general recognition of the issuer or author as a authority, and the extent of its use in practice.

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2-18 No. The attestation standards are meant to provide a general framework for the overall attestation function and do not supersede the generally accepted auditing standard which were developed for audits of annual historical financial statements. As a practical matter, the attestation standards are most directly relevant to attest engagements that are not covered by specific authoritative standards, such as attesting to attributes of computer software.

2-19 ***Quality control*** in a public accounting firm means policies and procedures which help assure that each audit meets at least a minimum standard of quality. Such control is vital because even one substandard audit could cause the firm to be defendant in a lawsuit that could threaten its continued existence.

Peer reviews refer to a study and appraisal by an independent evaluator ("peer reviewer") of a CPA firm's work. In a *system review*, the evaluator considers the CPA firm's system of quality control to perform accounting and auditing work. In an *engagement review*, the evaluator studies and evaluates a sample of a CPA firm's actual accounting work, including accounting reports issued and documentation prepared by the CPA firm as well as other procedures that the firm performed. Engagement reviews are only available for CPA firms that do not perform audits or other similar engagements.

Inspections are similar to peer reviews but are performed by the staff of the Public Company Accounting Oversight Board. However, in performing PCAOB inspections the staff focuses only on selected quality control issues and may consider aspects of practice management, such as the determination of partner compensation. In selecting audits and reviews for inspection, the PCAOB staff uses a risk assessment approach, which focuses on audits that have a high risk of lack of compliance.

2-20 (a) Engagement performance. The objective of quality control procedures in this area is to provide assurance that work performed is in accordance with professional standards and regulatory and legal requirements, with policies and procedures addressing: (1) engagement performance, (2) supervisions responsibilities and (3) review responsibilities.

(b) Human resources. The objective of quality control procedures in this area is to provide assurance that the firm has personnel with the capabilities, competence and commitment to ethical principles to: (1) perform its engagements in accordance with professional standards and regulatory and legal requirements and (2) enable the firm to issue reports that are appropriate in the circumstances.

(c) Monitoring. The objective of quality control procedures in this area is to determine that the policies and procedures established for each of the elements are suitably designed and effectively applied.

2-21 The AICPA's *Statement on Quality Control Standards* identify six "elements" (areas) in which the Institute feels that quality control procedures are appropriate, but it does not require any specific quality control procedures. The Statement recognizes that specific procedures will vary among firms, depending upon the size of the firm, the number of offices, and the nature of the firm's practice.

2-22 The duties of the Public Company Accounting Oversight Board include:

- Register public accounting firms that prepare audit reports for financial statement issuers.
- Establish or adopt auditing, quality control, ethics, independence and other standards relating to audit reports for issuers.
- Conduct inspections of registered public accounting firms.

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- Perform other duties or functions to promote high professional standards for audits, enforce compliance with the enabling act establishing the Board (i.e., the Sarbanes-Oxley Act of 2002 discussed in Chapter 1), set the budget, and manage operations.

2-23 A *system review* involves peer reviewers' study and appraisal of a CPA firm's system of quality control to perform accounting and auditing work. A systems review includes determining whether the CPA firm's system of quality control for its accounting and auditing practice (non-public clients) is designed and complied with to provide the CPA firm with reasonable assurance of performing and reporting in conformity with applicable standards, including the quality control standards. An *engagement review* is a type of peer review in which the peer reviewer selects a sample of a CPA firm's actual accounting work, including accounting reports issued and documentation prepared by the CPA firm. This form of peer review is only available for CPA firms that do not perform audits, but do perform accounting work, including reviews and compilations. The objective of an engagement review is to evaluate whether the CPA firm's reports are issued and procedures performed appropriately in accordance with applicable professional standards.

2-24 The international audit report differs from one based on PCAOB reporting standards in the following ways:

(1) The international report has an expanded description of management's responsibility for the financial statements and internal controls.

(2) The report also includes an expanded explanation of the audit process, which includes a description of the auditors' responsibility for internal control.

(3) The international report allows the accountants the following reporting options:

(a) Instead of indicating that the financial statements "present fairly, in all material respects," the accountants may substitute the phrase "give a true and fair view."
(b) The report may indicate that the financial statements comply with the country's relevant statutes or laws.
(c) The report may be signed using the personal name of the auditor, the firm, or both.

(4) The city in which the auditors maintain an office is required to be included in the international report.

Questions Requiring Analysis

2-25 The AICPA currently develops independence and ethical standards, quality control standards, and auditing and attestation standards that apply to its members. However, AICPA standards are applicable to the audits and auditors of nonpublic clients based on general acceptance by the courts, and adoption by state boards of accountancy and other regulatory bodies. The AICPA also has a voluntary peer review program, and enforces its standards on its members.

The PCAOB was given the legal authority to develop independence and ethical standards, quality control standards, and auditing and attestation standards that apply to public company auditors and integrated audits. The PCAOB also is charged with performing inspections of registered audit firms, and may sanction the firms for noncompliance with its standards and the provisions of Sarbanes-Oxley Act.

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The state boards of accountancy regulate CPA firms and CPAs in the various states and jurisdictions. They have the authority to establish their own standards, but have generally adopted the standards of other bodies such as the AICPA and the PCAOB. A state board enforces its standards in its state or jurisdiction and has the authority to revoke a CPA firm or individual CPA's right to practice in the state.

2-26 A firm of certified public accountants might find it difficult to maintain an attitude of independence during the audit of financial statements if the public accounting firm or a partner in the firm:

(1) Derived a major portion of the firm's income from one client;
(2) Had a personal financial interest in the company being audited;
(3) Made the fee contingent upon the obtaining of a bank loan by the client;
(4) Was financially indebted to the client;
(5) Was a member of the board of directors of the client company or otherwise participated in the management of the company.

2-27 If the certified public accountant is appointed controller of the corporation, he or she loses the independent status which is the most essential qualification of the certified public accountant. The interests of the officers of a corporation may at times be in conflict with the interests of creditors, bankers, or stockholders. These outside groups are best protected when independent CPAs examine the financial statements prepared by management of the corporation. The performance of an internal audit function under the direction of the new controller may be a highly desirable step, but it does not eliminate the need for an independent audit.

2-28 (a) To satisfy an auditor's responsibilities to detect Smith's errors and fraud, Reed should:

- Assess the risk that Smith's errors and fraud may cause its financial statements to contain a material misstatement.
- Design the audit to provide reasonable assurance of detecting errors and fraud that are material to the financial statements. In designing the audit, the auditors should respond to risks by altering their overall approach to the audit or modifying the nature timing and extent of audit procedures. They should also perform procedures to address the risk of management override of internal control.
- Exercise due care in planning, performing, and evaluating the results of audit procedures, and exercise the proper degree of professional skepticism to achieve reasonable assurance that material errors or fraud will be detected.

(b) Reed's responsibilities to detect Smith's noncompliance with laws that have a material and direct effect on Smith's financial statements are the same as that for errors and fraud.

Reed's responsibilities to detect noncompliance with laws that have an indirect effect on the financial statements are to be aware of the possibility that such noncompliance may have occurred. If specific information comes to Reed's attention that provides evidence concerning the possible existence of such noncompliance, Reed should apply audit procedures specifically directed to ascertaining whether noncompliance has occurred.

(c) Reed's responsibilities when noncompliance with laws has been identified is to discuss the situation with top management and to notify the audit committee of the board of directors so that proper action can be taken, including making any necessary disclosures or adjustments to the financial statements. If the client fails to take appropriate corrective action, Reed should withdraw from the engagement. In addition, legal counsel or other appropriate specialist will generally be contacted by the CPA.

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2-29 (a) The two forms of peer review are a system review and an engagement review.

(b) The PCAOB inspections focus on the public-company audit practice of the firm. The inspections are designed to determine the firm's compliance with the Sarbanes-Oxley Act, PCAOB and SEC requirements, and other professional standards.

(c) An inspection involves at least the following three components:

1. An inspection and review of selected public-company audit and review engagements.
2. An evaluation of the sufficiency of the quality control system of the firm, and the manner of the documentation and communication of the system.
3. Performance of such other testing of the audit, supervisory, and quality control procedures as are considered necessary.

PCAOB inspections differ from peer reviews in that the staff focuses only on selected quality control issues and may consider aspects of practice management, such as the determination of partner compensation. In selecting audits and reviews for inspection, the PCAOB staff uses a risk assessment approach, which focuses on audits that have a high risk of lack of compliance.

(d) The PCAOB staff selects audit engagements for inspection on a risk basis. They select audits with a higher risk of lack of noncompliance with professional standards. In addition, for the selected audits, the staff focuses on the higher-risks aspects of the engagement.

Objective Questions

2-30 Multiple Choice Questions

(a) (4) Because the license to practice as a CPA is granted by the state, the applicable state, through its state board of accountancy, has the right to revoke the right of an individual to practice as a CPA. Students are sometimes confused by the fact that while the CPA examination is administered nationally, it is the individual states that award CPA certificates.

(b) (2) The AICPA has authority to establish auditing standard for nonpublic companies. The Financial Accounting Standards board has authority for accounting standards of both public and nonpublic companies. The Public Company Accounting Oversight Board has authority to establish standards for audits and reviews of public companies, and quality controls for firms that audit public companies.

(c) (2) *FASB Concepts Statements* are considered nonauthoritative guidance. The other replies all represent authoritative guidance.

(d) (2) Financial statement audits provide reasonable, not absolute assurance.

(e) (2) The quality control standards were established to provide reasonable assurance that professional services confirm with professional standards. Answer (1) is incomplete since many standards in addition to reporting standards must be followed. Answer (3) is incorrect because a peer review monitors whether a firm's quality control standards are being met. Answer (4) is incorrect because continuing professional education is only one part of a system of quality control.

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(f) (3) The internal control of the client is not explicitly mentioned in the unqualified standard report although it is implicit in the reference to generally accepted auditing standards. Answers (1), (2), and (4) are all explicitly set forth in the unqualified standard form of audit report.

(g) (1) An independent mental attitude on the part of the auditor is required by the second general standard of the PCAOB. Answers (3) and (4) relate to the standards of field work. Answer (2) confuses generally accepted accounting principles with generally accepted auditing standards.

(h) (3) Such a quality control policy is designed to assure that personnel assigned to an engagement are independent to perform the work, an ethical requirement.

(i) (1) An audit provides reasonable assurance of detecting misstatements due to fraud, regardless of whether due to fraudulent financial reporting or misappropriation of assets.

(j) (1) An integrated audit report on the financial statements of a public company states that the audit was performed in accordance with Public Company Accounting Oversight Board standards, not AICPA standards.

(k) (3) The PCAOB staff performs inspections of audit firms that are registered with the PCAOB. In order to perform an audit of a public client an audit firm must be registered.

(l) (4) Neither the AICPA audit report nor the international audit report include an opinion on internal control. The other replies provide actual differences between the two reports.

2-31 Adapted AICPA Task-Based Simulation

Reviewer's Comments	Comment is correct (yes or no)	Explanation of incorrect comments (not required)
a. The report should not be addressed to management.	Yes	The report is ordinarily addressed to the audit committee, the board of directors, the shareholders or the company itself.
b. The report should indicate that we have "audited," rather than "examined" the financial statements (first paragraph after introduction).	Yes	
c. The report should not indicate anything concerning management's responsibility for internal control.	No	The report is correct as presented.
d. The report should state that the auditor's responsibility is to express "reasonable assurance," not an opinion (first paragraph under "auditor's responsibility).	No	While an audit does provide reasonable assurance, the report is correct as presented.
e. The audit is designed to assess risks of material misstatements due to errors or fraud; the term "illegal acts" is incorrect (second paragraph under auditor's	Yes	The word "errors" should replace "illegal acts" in the report (and the order of the terms should be reversed).

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responsibility).		
f. The report should not refer to an auditor as "evaluating the appropriateness of accounting policies," since those are the responsibility of management.	No	An audit report does refer to the appropriateness of accounting policies
g. The evidence should be sufficient and appropriate rather than "adequate" (third paragraph under auditor's responsibility).	Yes	Self explanatory.
h. The opinion should not include "in all material respects" since the auditor is providing an opinion on the accuracy of the financial statements (opinion paragraph).	No	Audits are performed to provide reasonable assurance of detecting material misstatements, and the report so indicates.
i. The opinion should be on "accounting principles generally accepted in the United States of America," not on auditing standards (opinion paragraph)."	Yes	The financial statements follow the appropriate accounting principles, while the audit follows generally accepted auditing standards.
j. The signature on the report should be that of the CPA firm, not that of the partner.	Yes	While the international report allows the partner to sign the report (in addition to the CPA firm name), the GAAS report does not.

2-32

Statement	Agree (A) or Disagree (D)	Comment
a. The report must begin with "CPA's Report" at the top.	D	The top must have a title that includes the term "independent."
b. The report is ordinarily addressed "to whom it may concern."	D	It is ordinarily addressed to the audit committee, the board of directors, or the company itself.
c. The report indicates that management is responsible for the preparation of the financial statements.	A	
d. The report indicates that the auditor's responsibility is to obtain particular assurance about whether the financial statements are free of material misstatements.	D	Reasonable assurance is obtained.
e. The report ordinarily concludes on whether the financial statements are in conformity with generally accepted auditing standards.	D	It concludes on whether the financial statements are in conformity with generally accepted accounting principles.
f. The report indicates that the audit procedures selected depend on the auditor's judgment.	A	
g. The report indicates that the audit evidence obtained is sufficient and appropriate to provide a basis for the audit opinion.	A	
h. The report indicates that the auditor considers and provides an opinion on internal control.	D	Internal control is considered, but no opinion is provide on it.

2-33

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Statement	Type of Audit Report
a. The auditors are unable to determine the overall fairness of the financial statements.	D
b. This is the report most clients prefer.	S
c. A limitation on the scope of the audit is significant, but not so as to overshadow an overall opinion.	Q
d. The financial statements are not fairly presented.	A
e. A material departure from GAAP exists, but not so material as to overshadow an overall opinion.	Q

2-34

Principles	Yes (Y) or No (N)	Comment
a. The purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material and immaterial respects, in accordance with the applicable financial reporting framework.	N	Not "immaterial"
b. The auditors are responsible for having appropriate competence and capabilities to perform the audit.	Y	
c. The auditor is unable to obtain absolute assurance that the financial statements are free from material misstatement.	Y	
d. The opinion states whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.	Y	
e. Inherent limitations of an audit include the need to conduct an audit to achieve a balance between the benefit to management and the benefit to the auditors.	N	The balance is a proper balance between benefit and cost.

2-35 Definitions

a. 3 Agreed-upon procedures report.
b. 7 Audit report.
c. 6 An unintentional misstatement.
d. 8 Generally accepted accounting principles.
e. 12 Misappropriation of assets.
f. 4 A review of a CPA firm conducted by PCAOB.
g. 10 Human resources and monitoring.
h. 2 A CPA firm that may conduct audits of public or nonpublic companies.

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Problems

2-36 SOLUTION: White Company (Estimated time: 20 minutes)

(a) No, Rezzo would not be justified in complying with White's request. Although Rezzo is a CPA, he has not audited the financial statements of White Company in accordance with generally accepted auditing standards. Preparation of financial statements cannot be construed as synonymous with auditing the statements. Furthermore, because of Rezzo's deep involvement with White Company, it is questionable whether he could maintain an independence of mental attitude if he did audit the financial statements.

(b) If Rezzo were justified in issuing a standard audit report on the financial statements of White Company, he should not do so until he has completed an audit of the financial statements. The auditor does not express an opinion on financial statements without first performing an audit.

(c) No, it would not be reasonable for the public accounting firm employing Rezzo to assign him to the audit of the White Company financial statements. Having himself prepared the financial statements; Rezzo would be in the position of attempting to independently evaluate the products of his own work. Independence of mental attitude in the appraisal of one's own work is extremely doubtful.

2-37 SOLUTION: Gray Manufacturing Corporation (Estimated time: 25 minutes)

The following memorandum summarizes the response of Bart James, CPA, to the request of a client for extension of the attest function to the problem of pollution control.

Dear John:

As much as I support your strenuous efforts to minimize air and water pollution from the manufacturing operations of your company, there are specific reasons which make it impossible for me as a CPA to attest to the extent of your accomplishments in this area along the lines you have suggested. When we perform the attest function with respect to your financial statements each year, we are expressing our professional opinion that your financial statements are prepared in conformity with certain standards, which we call "generally accepted accounting principles." In order for us to attest to the effectiveness of your pollution control program, recognized standards would have to be established in this field. No such standards presently exist for a factory to the best of my knowledge. Of course the federal government has set standards for exhaust emissions on automobile engines and we could, by retaining independent consulting engineers, obtain a basis for attesting to the compliance of a given automobile engine to those standards.

We are quite willing to extend the attest function in various directions if we can find a basis for objective comparison of a given operation with a clearly defined standard. Perhaps your engineering department can develop some specific quantitative data on the industrial waste from your operations. We might then be able to perform the necessary examination of such data to enable us to attest to the validity of your representations as to your operations. Of course, this would not be the same thing as providing your relative position in the industry. After reviewing this possibility with your engineering staff, if you would like to discuss the matter further with us, we will be glad to meet with you.

Sincerely,

Bart James

In-Class Team Case

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2-38 SOLUTION: Hide It (Estimated time: 25 minutes)

(a) No, this is not an error since errors are unintentional.

(b) This situation does appear to involve misstatements due to misappropriation of assets. It is a misstatement due to fraudulent financial reporting because of the omission of the information from the financial statements. If the $100,000 withdrawals have been abstracted for personal use, the situation also involves a misstatement arising from misappropriation of assets.

(c) Certain laws have a direct effect on the financial statement amounts and are considered on every audit. An example is income tax law that affects the amount of income tax expense in the financial statements of most clients. This situation involves what appears to be non-compliance with a law that has a "direct effect" since, at a minimum; taxes have not been paid on the income involved.

(d) The auditors will need to consider whether withdrawal is necessary, perhaps after consultation with their attorney. The case suggests that the unrecorded deposits occurred prior to current management involvement with the company. Note, however, that interest was earned during the period this management has been with the company, and withdrawals have been made during this same period. The auditors would wish to consider when current management became aware of the account and the nature of the withdrawals when considering whether to resign from the engagement.

Research and Discussion Case

2-39 SOLUTION: Enormo Corporation (Estimated time: 45 minutes)

(a) When the auditors discover illegal acts by a public client, they should consider three major factors. First, the auditors should consider the effect of the acts on the client's financial statements, including the possibility of fines and loss of business. To comply with generally accepted accounting principles, the financial statements must reflect the material effects of illegal acts.

Second, the illegal acts may affect the auditors' assessment of the integrity of management. In deciding whether to continue to serve the client, the auditors should consider the nature of the illegal acts and management's response to the acts after they are uncovered.

Third, the auditors should consider whether the occurrence of the illegal act indicates that there is a material weakness in the company’s internal control over financial reporting.

(b) The following courses of action are available to the auditors:

(1) The auditors could issue an unqualified opinion and take no further steps regarding the illegal activities. This course of action could be argued on the basis that the effect of the acts on the financial statements is not material. If the auditors take this course of action, they should also consider whether the illegal act and related actions by management and the board indicate a material weakness exists that would affect their report on internal control over financial reporting.

(2) The auditors could issue a qualified opinion because the financial statements depart from generally accepted accounting principles, in that they fail to disclose the illegal acts. This course of action could be argued on the basis that any illegal activities by the client are material, especially when management fails to take any steps to prevent

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the acts. If the auditors take this course of action, they should also consider whether the illegal act and related actions by management and the board indicate a material weakness exists that would affect their report on internal control over financial reporting.

(3) The auditors could withdraw from the engagement, because the client's failure to take actions to prevent such activities indicates that Enormo's management lacks sufficient integrity.

(c) We believe that the auditors should consider withdrawing from the engagement. Enormo's top management seems far too complacent regarding these activities. Their refusal to take any action to prevent the acts in the future provides a signal to lower level management that top management approves of illegal acts. The auditors clearly should question the integrity of management in this situation.

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