AUD 1
Unit Outline

Module 1—Professional Standards

Professional Standards

- The auditor is responsible for performing an audit in accordance with generally accepted auditing standards (GAAS). Compliance with GAAS is mandatory for all audit engagements.
- Different standards have to be followed depending on the type of engagement that is being performed. These standards are referred to explicitly in the appropriate reports.
    - GAAS, including:
        - The Statements on Auditing Standards (SASs) issued by the AICPA's Auditing Standards Board (ASB), which are used in audits of nonissuers. SASs are also used in audits of issuers, to the extent adopted by the Public Company Accounting Oversight Board (PCAOB).
        - PCAOB standards used in the audits of issuers, including SASs adopted by the PCAOB and auditing standards (AS) issued by the PCAOB.
    - Generally Accepted Government Auditing Standards (GAGAS)
    - Statements on Standards for Attestation Engagements (SSAE)
    - Statements on Standards for Accounting and Review Services (SSARS)

Auditing Guidance: The GAAS Hierarchy

- There are three levels of auditing guidance.
    - For the first level, auditors are required to comply with SASs published by the ASB for audits of nonissuers and PCAOB Auditing Standards for audits of issuers.
    - The second level is interpretive publications, which are recommendations for how SASs should be applied to certain situations.
    - The third level is other auditing publications, which have no authoritative status but may be helpful for the auditor.

Module 2—Audit Engagements

Audit Process Overview

- The chronological steps in the audit process are as follows: accept engagement; assess risk and plan response; perform procedures and obtain evidence; form conclusions; and reporting.

The Independent Audit Function: The Basics

- The purpose of an audit is to provide financial statement users with an opinion on whether the entity's financial statements are presented fairly in all material respects in accordance with the applicable financial reporting framework. In essence, the auditor's report provides credibility to the entity's financial statements.
- Client management's responsibilities for an audit include: the preparation of the financial statements in accordance with GAAP; the design, implementation, and maintenance of internal control relevant to financial statement preparation and presentation; and providing the auditor with access to all necessary information needed to perform an audit.

- The auditor is responsible for expressing an opinion on the financial statements based on the results of the audit. The auditor is also responsible for maintaining professional skepticism, complying with relevant ethical requirements, exercising professional judgment, obtaining sufficient appropriate audit evidence, and complying with GAAS.
- The external auditor is unable to obtain absolute assurance that the entity's financial statements are free from material misstatement because of the following inherent limitations: the level of subjectivity contained in financial reporting, the practical (cost versus benefit) and legal limitations in obtaining audit evidence during an audit engagement, and the need for timely financial reporting to financial statement users.

Determine the Nature and Scope of the Engagement

- When auditing nonissuers, the auditor must determine whether an audit is the most appropriate engagement or whether a review, compilation, or preparation would be more appropriate.
- When auditing issuers, the auditor must perform an integrated audit of the client's financial statements and internal controls over financial reporting.

Overall Objectives of Audit Engagements

- When conducting a financial statement audit, the overall objectives of the auditor are to:
  - Obtain reasonable assurance that the financial statements as a whole are free from material misstatement due to error or fraud, enabling the auditor to express an opinion on whether the financial statements are presented fairly in accordance with the applicable financial reporting framework.
  - Report on the financial statements and communicate the auditor's findings.

Module 3—Forming an Audit Opinion

Forming an Opinion on the Financial Statements

- The auditor should form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable framework.
- In order to form that opinion, the auditor should consider the following:
  - Whether sufficient appropriate audit evidence was obtained (as required by GAAS)
  - Whether uncorrected misstatements are material individually or in the aggregate
  - Whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework (e.g., GAAP)

Types of Opinions

- An unmodified (unqualified) opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with the applicable financial reporting framework. Note that *unmodified* is the term used for nonissuers and *unqualified* is the term used for issuers.
- The auditor's report should be modified when the auditor concludes that the financial statements as a whole are materially misstated (financial statement issue), or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement (audit issue).

Module 4—Unmodified (Unqualified) Opinion

Unmodified Audit Opinion (Nonissuers)

- An unmodified (nonissuer) or unqualified (issuer) opinion should be expressed on an audit report when the auditor concludes that the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.
- The main sections (some marked as optional or when relevant) in the standard nonissuer report are:
  - Auditor's Opinion—States the auditor's opinion regarding fair presentation of the financial statements in accordance with the applicable financial reporting framework. Additional information in this section includes the entity, financial statement titles, the dates or periods covered, and the identification of the applicable financial reporting framework.
  - Basis for Opinion—States that the audit was conducted in accordance with GAAS and that the auditor is required to be independent. This section also references the section of the auditor's report that describes auditor responsibilities and states whether the auditor believes that sufficient appropriate evidence has been obtained to provide a basis for the opinion.
  - Substantial Doubt About the Entity's Ability to Continue as a Going Concern (as necessary)—Draws attention to the note in the financial statements that discloses the conditions or events identified and states that the auditor's opinion is not modified with respect to this matter.
  - Key Audit Matters (when engaged)—States the definition of a key audit matter and describes each key audit matter identified.
  - Management's Responsibility Section—States that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework. Also, states that management's responsibility includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
  - Auditor's Responsibility Section—Include a statement on each of the following:
    - the responsibility of the auditor is to obtain reasonable assurance about whether the financial statements are free from material misstatement and to issue an auditor's report that includes the auditor's opinion;
    - reasonable assurance is a high level of assurance but is not absolute;
    - the risk of not detecting a material misstatement due to fraud is higher than one resulting from error;
    - misstatements are material if there is substantial likelihood they would influence the judgment made by a reasonable user;
    - the details or description of what is involved in performing an audit, including judgment, risk assessment, internal controls, evaluation of accounting policies, overall presentation, and going concern; and
    - the auditor is required to communicate certain matters, including the planned scope and timing of the audit, significant findings, and certain internal control-related matters, to those charged with governance.
  - Other Information (as necessary)—Identifies the other information included with the financial statements and clarifies the responsibilities of both management and the auditor with respect to such information. This section should include a statement that the auditor's opinion does not cover the other information.

  - Other Reporting Responsibilities (as necessary)—This paragraph is included only if the auditor addresses other reporting responsibilities in addition to GAAS.

- The auditor's report date indicates the date that sufficient appropriate audit evidence was obtained to support the auditor's opinion.

Unqualified Audit Opinion (Issuers)

- The three sections in the standard issuer report are:
  - Opinion section—States that an audit was performed and indicates the individual financial statements that were audited. States the auditor's opinion regarding fair presentation of the financial statements in conformity with the applicable financial reporting framework.
  - Basis for Opinion Section—The first paragraph of this section includes a statement on each of the following:
    - — the financial statements are the responsibility of management;
    - — the auditor's responsibility is to express an opinion; and
    - — the auditor is registered with the PCAOB and is required to be independent.

    The second paragraph of this section includes a statement on each of the following:
    - — the audit was conducted in accordance with the standards of the PCAOB;
    - — the audit was planned and performed to obtain reasonable assurance that the financial statements are free from material misstatement, whether due to error or fraud;
    - — the details or description of what is involved in performing an audit; and
    - — the auditor believes that the audit provides a reasonable basis for the opinion.
  - Critical Audit Matters Section—The auditor's report must include the section titled "Critical Audit Matters" and should include discussion of any critical audit matters (CAMs) arising from the current period's audit of the financial statements, or state that the auditor determined that there were no CAMs.

Required Auditor Reporting of Certain Audit Participants

- The auditor of an issuer must also file Form AP with the PCAOB for each audit report issued.

Module 5—Modified Opinions Due to Financial Statement Issues

Financial Statement Issues: Qualified or Adverse Opinion

- The auditor uses professional judgment to determine whether to issue a qualified opinion or an adverse opinion when audit evidence indicates that there is a material misstatement of the financial statements.
- Qualified Due to a Material GAAP Departure—The "except for" may be the result of inappropriate or misapplied accounting policies, inappropriate financial statement presentation, inadequate disclosure, or an unreasonable accounting estimate.

  A qualified opinion should be expressed when the auditor concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements.
- Adverse Opinion—The financial statements are not presented fairly (materially misstated) because management failed to follow GAAP. This opinion may be the result of inappropriate or misapplied accounting policies, inappropriate financial statement presentation, inadequate disclosure, or an unreasonable accounting estimate.

  An adverse opinion should be expressed when the auditor concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Nonissuer Reports

- When the auditor expresses a qualified or adverse opinion due to material misstatement of the financial statements, both the Auditor's Opinion and Basis for Opinion sections are modified to state the modified opinion and to describe the matter giving rise to modification. Additionally, the auditor *should not* include a "Key Audit Matters" section in the auditor's report when issuing an adverse opinion on the financial statements.

Issuer Reports

- When the auditor expresses a qualified or adverse opinion due to material misstatement of the financial statements, the auditor's report will include an additional paragraph immediately following the opinion paragraph and the opinion paragraph will be modified. The auditor is not required to report critical audit matters in the auditor's report when the auditor expresses an adverse opinion.

Module 6—Modified Opinions Due to Audit Issues

Audit Issues: Qualified Opinion or Disclaimer

- The auditor uses professional judgment to determine whether to issue a qualified opinion or a disclaimer of opinion when the auditors are unable to obtain sufficient appropriate audit evidence.
- Qualified Report Due to a Material GAAS Issue—"Except for" may be used if the auditor is unable to obtain sufficient appropriate audit evidence to support management's assertions about the nature of a matter involving an uncertainty, or the auditor is unable to fully complete an audit due to a scope limitation.

  A qualified opinion should be expressed when the auditor concludes that the possible effects of any undetected misstatements could be material but not pervasive.
- Disclaimer of Opinion—No opinion is expressed on the financial statements as a result of a material GAAS problem. This opinion may be the result of a significant uncertainty, a scope limitation, a lack of independence, or an auditor association with unaudited financial statements.

  A disclaimer of opinion should be expressed when the auditor is unable to obtain sufficient appropriate audit evidence to base an opinion on, and the auditor concludes that the possible effects of any undetected misstatements could be both material and pervasive.

Nonissuer Reports

- When the auditor expresses a qualified opinion or disclaimer of opinion, both the Auditor's Opinion and Basis for Opinion sections are modified to state the modified opinion or that no opinion is expressed and to describe the matter giving rise to modification or the reason for the inability to obtain sufficient appropriate audit evidence. Additionally, the auditor *should not* include a Key Audit Matters section in the auditor's report when issuing a disclaimer of opinion on the financial statements.

Issuer Reports

- When the auditor expresses a qualified opinion or disclaimer of opinion, a paragraph immediately following the opinion paragraph is added and the opinion paragraph is modified. In addition, a qualified opinion and a disclaimer of opinion will include modified language in the Basis for Opinion section. The auditor is not required to report critical audit matters in the auditor's report when the auditor expresses a disclaimer of opinion.

Module 7—Emphasis-of-Matter, Other-Matter, and Explanatory Paragraphs

Emphasis-of-Matter Paragraphs (Nonissuers)

- An emphasis-of-matter paragraph is included in the auditor's report of a nonissuer when required by GAAS or at the auditor's discretion. An emphasis-of-matter paragraph is used when referring to a matter that is appropriately presented or disclosed in the financial statements and is of such importance that it is fundamental to the users' understanding of the financial statements. The inclusion of an emphasis-of-matter paragraph in the auditor's report does not affect the auditor's opinion.
- Know the circumstances when an emphasis-of-matter paragraph is required.

Other-Matter Paragraphs (Nonissuers)

- An other-matter paragraph is included in the auditor's report of a nonissuer when required by GAAS or at the auditor's discretion. Other-matter paragraphs refer to matters other than those presented or disclosed in the financial statements that are relevant to the users' understanding of the audit, the auditor's responsibilities, or the auditor's report.

Explanatory Paragraph (Issuers)

- An explanatory paragraph is included in the auditor's report when required by PCAOB auditing standards or at the auditor's discretion. The inclusion of an explanatory paragraph in the auditor's report does not affect the auditor's opinion. The explanatory paragraph generally should include an appropriate title and should describe the matter being emphasized and the location of relevant disclosures about the matter in the financial statements.
- The explanatory paragraph will generally follow the opinion paragraph when added to an unqualified report.

Other Audit Considerations

- If there is no mention of consistency issues in the auditor's report, it implies that the entity's financial statements are comparable between reporting periods. The auditor should determine whether a change in accounting principle or an adjustment to correct a material misstatement in previously issued financial statements has affected the comparability of the entity's current financial statements. If the auditor is satisfied that certain criteria are met regarding the above, the auditor should include an emphasis-of-matter paragraph in the auditor's report.
- The auditor may be required by GAAS or may decide that it is necessary to include language in the auditor's report (or other written communication) that restricts the use of the auditor's written communication. In the auditor's report, such language is included in an other-matter (explanatory) paragraph.

Summary

- The candidate should be familiar with the different circumstances that require an emphasis-of-matter, other-matter, or explanatory paragraph.

Module 8—Reporting With Different Opinions and Other Auditors

Reporting on Comparative Financial Statements

- Reports on comparative financial statements pertain to two (or more) years, with the auditor's report clearly indicating the periods covered and the related audit opinions expressed.
- If, during the current audit, the auditor becomes aware of evidence that affects the prior year's financial statements and the opinion that was expressed, the auditor should update the prior opinion in the current year's audit report. The reasons for the updated opinion should be disclosed in the emphasis-of-matter or other-matter (explanatory) paragraph.

- The successor auditor may present the prior period financial statements audited by a predecessor auditor.
  - The predecessor auditor may reissue a report on financial statements if the report is still deemed appropriate.
  - If the predecessor auditor deems that its report is inappropriate, the predecessor auditor may revise and dual date its report.
- If the successor auditor does not present the predecessor's audit report, the successor auditor should express an opinion of the current period financial statements only. An other-matters (explanatory) paragraph should be included indicating that the financial statements from the prior period were audited by a predecessor auditor and the type of opinion expressed by the predecessor auditor; the nature of any emphasis-of-matter, other-matter, or explanatory paragraphs; and the report date.
- Under a scenario in which the current period financial statements are audited and presented in comparative form with prior financial statements that were compiled or reviewed, the auditor should include an other-matter (explanatory) paragraph in the current audit report indicating the distinction. A statement in the other-matter (explanatory) paragraph should also be included to indicate that these services are less in scope than an audit and, as such, do not provide a basis for expressing an opinion on the financial statements.

  The other-matter (explanatory) paragraph should also be used if the prior period's comparative statements were not audited, reviewed, or compiled. It should further indicate that the auditor assumes no responsibility for them.

Reporting on Audits of Group Financial Statements (Nonissuers)

- For audits of group financial statements for a nonissuer, the auditor should use his or her understanding of each component auditor to determine whether to make reference to the individual component auditor in the auditor's report.

  If the group engagement partner decides to assume responsibility for the work of a component auditor, then no reference to the component auditor should be made in the auditor's report.

Reporting with Referred-to Auditors (Issuers)

- The engagement partner is responsible for making the determination as to whether the participation of their audit firm is sufficient to carry out the responsibilities of the lead auditor.
- The lead auditor is responsible for supervising the other auditors used in the performance of the auditor and determining whether responsibility will be divided with the other auditors (referred-to auditors) or if the lead auditor will maintain full responsibility for the audit.
- In making the determination regarding the lead auditor, the engagement partner should consider qualitative and quantitative factors regarding locations, the risks of material misstatement associated with the locations, and the extent of firm supervision provided by the engagement partner's firm.
- When dividing responsibility with another auditor, the lead auditor is responsible for communicating with the referred-to auditor regarding necessary procedures to ensure necessary disclosures are included in the lead auditor's report.

Module 9—Subsequent Events

Recognition of Subsequent Events

- Subsequent events represent events or transactions that occur after the balance sheet date, but before the financial statements are issued. The subsequent event may require an adjustment to the financial statements or simply a footnote disclosure of the event.
- U.S. GAAP categorizes two types of subsequent events. A recognized subsequent event is a condition that existed on or before the balance sheet date that usually requires an adjustment to the financial statements. A nonrecognized subsequent event may involve a significant business event (e.g., sale of bonds) which occurred after the balance sheet date. Nonrecognized subsequent events usually do not require an adjustment to the financial statements, but instead are disclosed in the footnotes.

Management's Responsibility for Subsequent Events

- Public companies and other entities that intend to widely distribute financial statements must evaluate subsequent events through the date the financial statements are issued. All other entities must evaluate subsequent events through the date that the financial statements are available to be issued.

Auditor's Responsibility for Subsequent Events

- The auditor is responsible for gathering evidence related to subsequent events up to the date of the auditor's report.

Auditor's Responsibility After the Original Date of the Auditor's Report

- If the auditor becomes aware of information related to subsequent events after the original date of the auditor's report but before the report release date, the auditor should consider whether it is necessary to adjust the financial statements or the related disclosures, and may dual date the auditor's report to extend responsibility only for the particular subsequent event.

Module 10—Other Information and Supplementary Information

Other Information

- Often, audited financial statements are included in other documents, such as annual reports to shareholders. The auditor should read the other information to ensure that the credibility of the audited financial statements is not compromised by material inconsistencies between the other information and the audited financial statements.

Reporting on Other or Supplementary Information

- There should be a basic understanding of the auditor's responsibilities for each of the following other information (reporting) items.
  - The auditor must report on other information in documents that are accompanied by the audited financial statements, including how the auditor must handle situations when the other information is materially inconsistent with the financial statements or there is a material misstatement of fact.
  - The auditor of an issuer is not required to reference the other information in the auditor's report on the financial statements. If the auditor does choose to reference the other information, he or she may do so but should disclaim an opinion on the other information in an explanatory paragraph.
  - The auditor of a nonissuer is required to reference the other information in the auditor's report on the financial statements in a separate section with the heading "Other Information" or another appropriate heading. This section should include a statement that the auditor's opinion does not cover the other information.

- An auditor may be engaged to report on supplemental information in relation to the financial statements taken as a whole. When reporting on supplemental information, there are additional audit procedures that must be performed, which generally use the same materiality level used in a financial statement audit. The auditor's report on supplemental information may be presented in a separate section (nonissuer) or explanatory paragraph (issuer) in the audit report, or in a separate report.

Required Supplementary Information

- An entity may be required by a given standard setter to prepare specific information that is supplemental to the primary financial statements. In the absence of any separate requirement particular to the engagement, the auditor's opinion on the financial statements does not cover the required supplemental information. However, the audit report for nonissuers should include a separate section with the heading "Required Supplementary Information" to explain the circumstances and to disclaim an opinion on the supplemental information. PCAOB standards generally do not require the auditor to add an explanatory paragraph to the audit report for issuers.

Module 11—Special Purpose Frameworks

Special Purpose Frameworks

- A special purpose framework represents a financial reporting framework other than GAAP, which may include one of the following bases of accounting: cash basis, tax basis, regulatory basis, contractual basis, or any other basis of accounting that uses a definite set of logical and reasonable criteria that is applied to all material items appearing in the financial statements.

Auditor's Report on Special Purpose Financial Statements

- The candidate should be familiar with the reporting requirements for the individual special purpose frameworks as well as the major elements that are included in the special purpose framework reports.