Chapter 2

Multiple Choice

2-1.	B
2-2.	C
2-3.	A
2-4.	C
2-5.	C
2-6.	D
2-7.	B
2-8.	C
2-9.	D
2-10.	A
2-11.	A
2-12.	C
2-13.	B
2-14.	A
2-15.	C
2-16.	A
2-17.	C
2-18.	A
2-19.	B
2-20.	C

Discussion Questions

2-21. [LO 3,4] What is the value of auditors going through a formal process of linking management assertions to audit procedures to collect evidence? How does this process improve the audit?
The linkage is as follows: Management makes assertions regarding the financial statements. Specific risks exist that may threaten the appropriateness of those assertions. The auditor addresses the possibility that those risks have actually caused the assertions to be invalid by using various audit procedures, and those audit procedures result in the auditor collecting evidence. This formal linking clarifies the purpose of each audit step conducted and increases the likelihood that the auditor collects sufficient, appropriate evidence to determine whether management's assertions are valid.

2-22. [LO 1] Why does the auditor have to issue two opinions, one on internal control and one on the financial statements?
SEC registrants are required to file audited financial statements and management reports on internal control over financial reporting because SOX requires that both are examined through a single audit engagement (known as an integrated audit).

2-23. [LO 1, 3] Why does the auditor begin planning the financial statement audit phase before completing the tests of operating effectiveness of ICFR? Why not after the internal control audit is completed?
Planning continues throughout the audit as new information causes the audit team to revisit and revise the audit plan. If the ICFR is not well designed then there is more risk that the financial statements will be based on inaccurate information or will inappropriately represent the company's activities and financial position. Whether internal control is effectively designed impacts planning for the rest of the audit and is therefore examined before completing the test of operating effectiveness of ICFR.

2-24. [LO 4] Explain why auditors need to consider both existence and occurrence, and completeness when auditing an account balance? In terms of the transactions posted, how much "audit comfort" does investigating these two assertions provide?
Attaining a state of "audit comfort" involves being provided with evidence that sufficient audit risks have been alleviated. Regarding an account balance, if transactions really occurred in the accounting period in which they are shown (existence or occurrence) and all transactions are recorded (completeness), then the recorded amount must be accurate.

2-25. [LO 4] Is it possible that an auditor can make a professional judgment error and still be behaving with due professional care? Explain.
Yes. If an auditor is following the appropriate auditing guidance and is exercising professional judgment he is behaving with due professional care. At the same time the auditor must have an unbiased frame of mind and exercise professional skepticism. The fact that the auditor has to use professional judgment means that he or she must make decisions. Humans are fallible, even when they are careful. Just because an auditor makes a judgment error does not mean he or she was negligent.

2-26. [LO 4] Statistics indicates concern for both alpha and beta errors. In audit terms this might be described as being concerned about the risk of concluding that the financial statements are misrepresented when they are actually fair, AND the risk of saying that the financial statements are fair when they are not. However, audit risk is defined as the risk of issuing an unqualified audit report when the financial statements are misstated or ICFR is not effective. Why doesn't audit risk include the opposite error as well?
Audit risk for the integrated audit is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated or on ICFR that is not effective. In other words, the auditor may conclude and report that financial statements are fairly presented when they are not. The auditor may also conclude and report that ICFR is effective when it is not. This audit risk of an incorrect opinion exists because the evidence collected permits reasonable, but not absolute, confidence in the conclusion. The opposite error of issuing a qualified report when financial statements are correctly stated is not included in the definition of audit risk under the professional literature. The reason for this is probably because auditors are always very sure of their unfavorable findings - their clients wouldn't tolerate these types of errors.

2-27. [LO 5]   Why would the auditor want to inform management of problems with internal control as early as possible, so that remediation can be performed as early as possible?
Early remediation of internal control problems is important because if the design of important controls is determined to be deficient, the auditor must communicate this information to management as early as possible. Early identification increases the likelihood that management can resolve the problems by correcting the controls. Ideally, identification of design flaws occurs early enough during the year for management to correct any design problems before testing of ICFR operating effectiveness begins. The process through which management corrects internal control problems is often called remediation.

2-28. [LO 5]   Why are analytical procedures a required step in audit planning?
Analytical procedures can give the auditor a "big picture" view of a company. In a first year audit, analytical procedures during planning show the auditor areas that are most important to a client company, and those that may be of high risk because they are different from what is expected. In subsequent year audits, analytical procedures during planning can show the auditor what has changed from the prior year or from expected trends. This information helps the auditor identify risk areas and areas that will require more audit effort. Based on this information the auditor can plan the audit to direct audit resources to collect sufficient, appropriate evidence.

2-29. [LO 4]   The following terms are important in an integrated audit. Explain what they mean in the context of an audit and how/why they are related.

Materiality: This is the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Reasonable assurance: If an auditor lives up to all the audit guidance and standards during the performance of the audit, he or she is behaving with due professional care. As such, due professional care is linked to an expectation that the auditor has gained *reasonable assurance* about the financial statement management assertions. Reasonable assurance refers to a high, but not absolute, level of assurance that the auditor obtains regarding management assertions.

Detection risk: This is the risk that audit steps will miss (fail to detect) a misstatement that has occurred (inherent risk) and has slipped by the internal controls (control risk). In documenting the audit plan, the auditor identifies needed audit procedures based on information or assumptions about inherent and control risks. The evidence-gathering procedures are designed to limit the probability that a material misstatement that exists will remain undetected by the audit.

Audit risk: This is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statement that are materially misstated or on ICFR that is not effective.

Problems

2-30. [LO 7] List the 10 GAAS from the PCAOB standards and the 10 AICPA standards in 2 columns.

(a) Identify differences in each of the standards.
(b) Highlight any differences that you think indicates a difference in meaning.
(c) Add a 3^{rd} column and list the field work and reporting concepts from AS 5 that are the parallel for an ICFR audit to the standards for financial statement audits. Identify any significant differences in the words or meaning.

PCAOB	**AICPA**	**AS 5**
	GENERAL STANDARDS:	
1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.	**The auditor must have adequate technical training and proficiency to perform the audit.**	**Under AS 5, the General Standards are applicable to an audit of internal control over financial reporting.**
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.	**The auditor must maintain independence in mental attitude in all matters relating to the audit.**	
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.	**The auditor must exercise due professional care in the performance of the audit and the preparation of the report.**	
	STANDARDS OF FIELD WORK	
1. The work is to be adequately planned and assistants, if any, are to be properly supervised.	**1. The auditor must adequately plan the work and must properly supervise any assistants.**	**Planning the audit.**
2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.	**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**	**Role of risk assessment, Scaling the audit, Addressing the risk of fraud, Using the work of others, Materiality, Using a top-down approach, Identifying entity-level**

	whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.	**controls, Identifying significant accounts and disclosures and their relevant assertions, Understanding likely sources of misstatement, Selecting controls to test.**
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.	**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.**	**Testing controls, Evaluating identified deficiencies, Wrapping-up,**
STANDARDS OF REPORTING		
1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).	**1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).**	**Reporting on Internal Control**
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.	**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.**	
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.	**3. When the auditor determines that informative disclosures are not reasonably adequate , the auditor must so statein the auditor's report.**	
4. The report shall contain either an expression of opinion regarding the	**4. The auditor must either express an opinion regarding the financial**	

financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.	**statements, taken as a whole, or state than an opinion cannot be expressed. . 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.**	

2-31. [LO 6] You are the auditor for a non-public company, "A Golden Rule Carpentry". The company has a 12/31 fiscal year end. During your audit, you did not identify any material misstatements in the financial statements.

Required:

(a) Draft the appropriate audit report for the financial statement audit of "A Golden Rule Carpentry".

Independent Auditor's Report

We have audited the accompanying balance sheets of A Golden Rule Carpentry as of December 31, 20x1 and 20x0, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of A Golden Rule Carpentry's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of A Golden Rule Carpentry as of December 31, 20x1 and 20x0, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Hooks and Walker, CPAs
March 13, 20x2

(b) What assurances are provided in the audit report when the auditor states that the financial statements "present fairly… in conformity with accounting principles generally accepted in the United States of America"?

The assurances are that the financial statements reflect the company's financial position and economic events for the date and period report and that they conform with GAAP in all material respects. In other words the financial statements are not materially misstated, either from error or fraud.

(c) How is materiality referred to in the audit report and how does it relate to your response to (b)?

The main reference to materiality is stating that the financial statements are fair in all material respects. The auditor also relies on the concept of materiality when stating that the audit provides reasonable assurance. The auditor is not absolutely sure about the fairness of the financial statements. However, the auditor can be reasonably sure that there is nothing wrong with the financial statements that surpasses a materiality threshold.

(d) How do you think the auditor should respond upon finding a misstatement that he or she believes is material, if the client disagrees? In other words, client management believes the misstatement is not material?

The auditor should re-investigate the item(s) thought to be misstated to be sure the audit evidence is correct. The auditor discusses the finding with the client. If, after discussion, the auditor still believes the financial statements are materially misstated and the client company will not change them, the auditor must not issue an audit report that unqualified.

2-32. [LO 4] For each of the following accounts, list the 5 management assertions from most to least important for that account. State the reason justifying your order. Cash is completed as an example.

Note that these might be ordered in different ways, based on professional judgment. For this reason, the justification of the answer is important.

(a) Cash (in home currency)
   a. Existence
   b. Rights
   c. Presentation and disclosure
   d. Completeness
   e. Valuation

If cash does not exist, then none of the other assertions matter. However, even if cash is found to exist, it has to be owned by the company claiming it. Various disclosures can be required for cash, for example, if it is committed as a compensating balance. Completeness is not a big audit risk because it is unlikely that management would not report cash or that any amount omitted is material. Cash is reported at face value so valuation is not an issue for cash unless it is in a foreign currency.

(b) Long term debt
  a. Completeness
  b. Valuation
  c. Presentation and disclosure
  d. Rights and obligations
  e. Existence

  The biggest audit risks are that all debt is shown, that it is properly valued according to GAAP and that it is classified and disclosed properly in the financial statements. Leaving out debt or not showing it at the proper amount – or properly classified as long or short term -- would be of greatest concern to financial statement users. Because debt requires a lot of specific disclosure, the auditor is then concerned that the notes are proper. The auditor is far less concerned that the company would include debt that is not actually the company's obligation or that it would include debt that does not exist. These would reduce the net value of the balance sheet, so although they are misstatements, they would undervalue rather than overvalue.

(c) Officer salary expense paid through stock options
  a. Completeness
  b. Valuation
  c. Rights and obligations
  d. Presentation and disclosure
  e. Existence

  The order of the audit concerns is similar to those of debt. The auditor wants to be sure that all the officer compensation is recorded, but to do that, since it is paid through stock options it will likely have to be valued. The valuation can be complex, using stock valuation models. Any obligations that the company has as a result of these stock compensation transactions is also important. These obligations dilute earnings per share so the auditor is concerned that the obligations are properly posted. Presentation and disclosure is important because the disclosure is extensive. Also, those who follow a company's stock pay a lot of attention to EPS, so the auditor wants to be sure it is shown properly. (Note that for the presentation and disclosure to be proper, the completeness, valuation and obligation assertions must be proper.) The auditor is least concerned about existence, because if the company records compensation expense and a stock option effect that does not exist, it understates net income and net assets.

(d) Sales revenue

a. Occurrence
b. Valuation
d. Presentation and disclosure
d. Completeness
e. Rights

The greatest audit risk for revenue is that it really occurred and that it is recorded at the proper value. For straightforward sales, occurrence and valuation are easy to verify, with the primary risk being that a sale is fraudulent. For more complex sales transactions, such as those recognized over time, bill and hold, etc. determining when the sale occurred and how much to recognize can be more difficult and the auditor needs to determine that recognizing the revenue is justified. Presentation and disclosure are also straightforward unless the nature of the sales transaction is complex. Completeness is a lower audit concern because the misstatement would understate income – however, it is still a concern because if it is misstated it can affect more than one year. The rights assertion is a greater concern related to the receivables that can result from a sales transaction, rather than the sales themselves.

(e) Accounts receivable

a. Existence
b. Valuation
c. Rights
d. Presentation and disclosure
e. Completeness

The three top audit concerns all go together. Do the accounts receivable really exist? Has collectability been properly estimated so that the net value shown is materially fair? Does the company have (or still have) rights to the receivables? Examples of the issues that the auditor addresses: Can the sales be returned for a full refund, and if so, have (1) the returns been properly estimated and (2) sales and receivables properly reduced for the estimated returns? How has the allowance for doubtful accounts been estimated? Is the approach valid and has it been carried out properly? Does the company still own the receivables? Presentation and disclosure is straightforward but certain items must be disclosed. Again, completeness is last on the list of assertion concerns because if all the accounts receivable are not shown the misstatement is conservative and understates net book value.

(f) Property, plant and equipment

a. Existence
b. Valuation
c. Rights
d. Presentation and disclosure
e. Completeness

Property, plant and equipment is generally a low risk area. The auditor is concerned that items that should have been expensed have not been capitalized (existence), that the net value is proper – after depreciation is calculated. The rights assertion is addressed along with existence – if the company has possession of something and states that it owns it, did it pay for it? Presentation and disclosure is fairly straightforward, but the schedules required in the notes can be lengthy for some companies. Since PP&E is an asset, completeness is not a significant risk.

2-33. [LO 1,6] Identify each of the following items as being associated with

(a) an AICPA financial statement audit
(b) a PCAOB integrated audit
(c) both sets of audit standards

__(b)___ AS 5
__(c)___ "must" means a mandatory responsibility
__(b)___ operating effectiveness of ICFR must be tested
__(a)___ significant risks must be identified even if ICFR is not tested
__(c)___ 10 generally accepted auditing standards
__(b)___competent evidence
__(c)___ appropriate evidence
__(c)___ sufficient evidence

2-34. [LO 4] Match the following terms and descriptions.

(1) _____ management assertion
(2) _____appropriate
(3) _____design and operating
(4) _____negligence
(5) _____material
(6) _____entity level
(7) _____professional skepticism

A. Making a judgment error does not necessarily indicate this as long as the auditor uses due professional care
B. Presentation and disclosure
C. Having an objective viewpoint and a questioning mind
D. Would make a difference in the judgment of a decision maker
E. ICFR effectiveness
F. Competent
G. ICFR across the entire organization

Answers: (1) B; (2) F; (3) E; (4) A; (5) D; (6) G; (7) C

2-35. [LO 4] Order the following pieces of evidence based on their reliability from most to least reliable:

(a) A memo prepared internally and sent from the audit client CFO to the audit client CEO.
(b) An oral communication with the same information as in (a) spoken to the auditor by the accounts receivable clerk.
(c) A confirmation about debt owed to the audit client provided in writing directly to the auditor from the outside third party.
(d) A copy of an invoice prepared inside the company, sent to a customer and then returned by the customer with a check as a remittance advice.

Correct order:

(c) A confirmation about debt owed to the audit client provided in writing directly to the auditor from the outside third party. MOST RELIABLE
(d) A copy of an invoice prepared inside the company, sent to a customer and then returned by the customer with a check as a remittance advice
(a) A memo prepared internally and sent from the audit client CFO to the audit client CEO.
(b) An oral communication with the same information as in (a) spoken to the auditor by the accounts receivable clerk. LEAST RELIABLE

2-35**. (continued)** Without reordering the pieces of evidence state whether the following would increase or decrease reliability, and why.

a. The memo was sent to both the CEO, audit committee chair, and the company's principle outside bank.	**(a) Increase. Because the evidence went to multiple parties, include the bank which is independent of the company the auditor has evidence that the communication has not been changed, or drafted specifically to mislead the auditor.**
b. The oral communication was received from the CFO rather than the accounts receivable clerk.	**(b) Increase. Information that is important to the auditor, coming from the CFO would, in most cases be more reliable. For certain information, such as a response on how the accounts receivable clerk does his or her job, the accounts receivable clerk would be a more credible source of the information than the CFO.**
c. The confirmation process was handled by the client rather than the auditor, and the response was forwarded to the auditor after it was received at the client's place of business.	**(c) Decrease. Because the client handled the process and the response went to the client before it went to the auditor, the information is less reliable.**
d. The client company has poor internal control and the outside customer revised the invoice and paid a different amount from what was originally billed.	**(d) Decrease. The auditor needs to further investigate the evidence to determine whether the correct amount was the amount the client billed, or the amount the customer paid. Any information generated in an environment of poor internal control has less value.**

2-36. [LO 5] Given the following stages of an audit, identify in which stage the following audit activities occur.

Audit Stages		Audit Activities Answer:
(1)	Preliminary engagement activities	**b,c**
(2)	Planning and risk assessment	**g**
(3)	ICFR controls testing	**e,f**
(4)	Substantive procedures	**a**
(5)	Completion, wrap up and reporting	**d**

Audit Activities

(a) Vouching whether the amount at which a transaction is recorded agrees to the underlying document.
(b) Identifying who should work on the audit engagement.
(c) Determining whether the audit firm is independent of an audit client
(d) Communicating with the client's outside attorney
(e) Checking to see whether the cashier's office reconciles the bank account properly once a month
(f) Coming to a final decision on whether the ICFR is effective
(g) Determining the complexity of the different kinds of transactions that are handled at each of a company's places of doing businesses

2-37. [LO 7] Traber Electronics is a small privately owned retailer of electronic equipment and household appliances. Traber Electronics is required to provide audited financial statements as part of a due diligence investigation in consideration of a potential acquisition of Traber by a public company. In the interest of time, Traber appointed the audit firm of Makins & Howell, CPAs, without a formal proposal process. Makins & Howell immediately accepted the audit engagement in early October and agreed to the November 1st deadline for the auditor's report.

Katie Kammins, CPA, was recently promoted to in-charge auditor for Makins & Howell and was assigned to the Traber audit along with Joel Misten, the firm's university intern. Prior to her assignment to the Traber audit, all of Katie's audit experience was in the healthcare industry. Because most of Katie's healthcare clients had June 30th year-ends, Katie was available in October to work on the Traber engagement.

Katie and Joel got right to work. Katie informed Joel that there was no time to test controls, so she instructed him as to the proper procedures for proving the mathematical accuracy of the accounting journals and ledgers and tying the totals to the financial statements. There were no footnotes or other supplemental disclosures accompanying the financial statements and there were no prior year financial statements to be used as a basis of comparison, which helped expedite the audit process.

While Joel was busy with the mathematical tie-ins, Katie analyzed the company's sales and inventories, as these were the most significant revenue and asset accounts. For sales, Katie reviewed the monthly sales reports and learned that there were several large contracts that had been accounted for on the percentage of completion method. Although she wasn't sure about the propriety of the profits recognized, Katie held a series of discussion with Traber's controller, who assured Katie that the profits had been recorded in accordance with generally accepted accounting principles.

For inventories, Katie observed the items in the retail store, noting the reasonableness of their descriptions and saleable condition. She did not examine the inventory at the company's warehouse, as it represented less than half of the value of the asset account.

One week before the deadline, Makins & Howell provided their standard audit report, which included an unqualified opinion on Traber's financial statements.

Required:

Refer to each of the ten generally accepted auditing standards and indicate how the actions of Makins & Howell and/or its associates resulted in violations of these standards.

<u>General Standards</u>

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor. VIOLATION: Katie did not have experience in the industry and Joel did not have complete technical training as an auditor.

2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors. VIOLATION: Katie relied upon the representation of the company's controller without conducting an independent investigation of the large sales contracts, thus compromising her independence.

3. Due professional care is to be exercised in the performance of the audit and the preparation of the report. VIOLATION: There are multiple indications of deficiencies in the exercise of due care, including the lack of professional skepticism in the conduct of the audit as well as all of the problems with field work and reporting as noted below.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised. VIOLATION: The auditors went right to work without properly planning the audit. Although Katie instructed Joel as to his responsibilities, there is no indication that she supervised his work or that the firm's managers or partners reviewed the work of either Katie or Joel.

2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed. VIOLATION: Internal controls were not considered in this audit engagement.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit. VIOLATION: There is no indication of any confirmations or other competent evidence being obtained to prove the accuracy of management's representations or the company's accounting records.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP). VIOLATION: Although a standard report makes this assurance, there is no indication that the auditors have a reasonable basis for making this statement in their report, especially with regard to the recording of sales contracts on the percentage of completion basis and the verification of inventories.

2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period. VIOLATION: There were no procedures performed to verify the consistent application of accounting principles, as prior year financial statements were not provided to the auditors.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report. VIOLATION: Informative disclosures were omitted from the financial statements.

4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking. VIOLATION: Although a standard audit report includes an unqualified opinion, the facts of this case clearly indicate that there was not a reasonable basis for the expression of such an opinion.

2-38. [LO 5] Arin Pate, CPA, is scheduled to work on the integrated audits of two client companies in the coming month: Jacoh Industries and Morton Baxx, Ltd. Arin was assigned to both of these audit engagements in the prior year. As she works on the preliminary audit planning phase, Arin notes the following facts and features pertaining to each of these client companies:

a) Jacoh Industries is a manufacturer of medical imaging equipment. Although Jacoh's equipment is distributed worldwide, it operates at a single location. The equipment is promoted through sales teams and sales are accepted through an online ordering system. There is a significant investment in inventories, and internal control in this area is strong. In fact, Arin's firm has never had any significant audit differences or disagreements with the client. Within the past year, however, a new competitor has entered the market and Jacoh is experiencing a decline in sales volume. Although the company's income statement still shows a slight profit, cash flow challenges are now prevalent. Jacoh, however, has not suffered as much as several other competitors who are reporting losses for the first time.

b) Morton Baxx publishes a monthly fashion magazine. Subscription revenues and many of the advertising revenues are deferred. Most subscriptions are sold on an annual basis, but advertising contracts range from one month to one year. Publishing costs are typically recorded in the period that they are incurred. Morton Baxx's internal controls have been effective in the past.

Required:

In order to minimize audit risks on each of these audit engagements, what audit areas should Arin emphasize?

For Jacoh, since internal control is strong and there has been no change in the company's operations, there is likely a low risk of unintentional errors. However, given the decline in financial results and the problems in the competitive arena, there is a greater risk that management may attempt to conceal losses. Arin should emphasize the existence and valuation assertions for sales and inventories to detect possible overstatement of these accounts.

For Morton Baxx, since internal control is strong and there has been no change in the company's operations, there is likely a low risk of unintentional errors. However, given the complex nature of the deferrals related to revenue recognition, Arin should emphasize the valuation and allocation assertion. Supporting evidence for subscription revenues and advertising contracts should be carefully examined to make sure that the matching concepts being applied properly. This should be consistent with the prior year approach.

2-39. [LO 3, 5] The beginning of an auditing class is often frustrating for students because they feel there are so many things that they do not thoroughly understand. One of the challenges is that so many parts of an audit are either concurrent or iterative.

Required:

Reference the overview diagram of an integrated audit in Exhibit 2-1 and identify the aspects that are difficult to place in a strict chronological sequence.

(a) List the audit activities that may be iterative.
An iterative process is a process whereby a progressively "better" decision (or desired result) can be achieved by repeating rounds or cycles of analysis with the objective of bringing the desired result of decision closer to discovery of the correct decision or answer with each repetition. Although most of the audit planning occurs at the beginning of the audit, adjustments to the audit plan are necessary throughout the audit process. Risk assessment is a process that is carried out continuously throughout the entire audit. Audit planning and risk assessment would probably be considered the most iterative processes in an audit.

(b) Match and list the parts that are conducted concurrently.
With respect to the activities included on Exhibit 2-1 the following activities would be conducted during the same time frame:

Activity 1	**Activity 2**
Tests of ICFR operating effectiveness	**Substantive procedures on accounts**

Activity Assignments

2-40. Find the most current 10K (SEC annual report) and 10Q (SEC quarterly report) for Starbucks, either through the company's Web site or the SEC Web site. Find the auditor's report for the annual financial statements and the auditor's review report for the quarterly financial statements (if there is one). Match the language to the PCAOB sample report.
Results will vary depending on the period selected and the "PCAOB sample report" chosen. The 10K report for the period ended 9/27/2009 found on the company's web site was compared with the sample report on pages 5 and 6 of the text in chapter 1 (Mimimi Corporation). The report in the text is much longer and more detailed than the report found in the form 10K for Starbucks.

2-40. Go to the PCAOB Web site (*www.pcaobus.org*). What do the Auditing Standards issued by the PCAOB as of the current date cover? Are there any standards that are currently proposed but not yet final?
Student responses will vary depending on when this activity is undertaken. The standards as shown on the web site as of the date this solution was written include AS Numbers 1 and 3-7. Interim standards include AU Numbers, 110, 150 and 161 and about forty five others. The "current activities" section of the PCAOB's web site reveal an open comment

period for "Proposed Auditing Standards on Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards" and a closed comment period for "Re-proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards".

2-42. Go to the Web site of one of the Big Four public accounting firms (Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers). How do these firms market themselves on their Web sites? What type of service and industry expertise are highlighted? What do the Web sites present about the work environment and values of the firm? Is there discussion of a firm Code of conduct or values?.
Student responses will vary depending on which firm is selected.

2-43. Go to the web site of an international company and review its financial statements, including it auditor's report.
(a) What auditing standards are applied by the company's auditors?
(b) Which Big-four audit firm is primarily associated with the company's audits?
(c) How does the company's auditor's report compare with the one presented in this chapter?
Answers will vary depending on the international company selected.

2-44. Go to the Web site for international auditing standards: www.ifac.org/iasb/. Look for any standards and rules on that Web site that parallel those of the AICPA and PCAOB. Describe what you see as similarities and differences.
The materials found under the tab for the International Auditing and Assurance Standards Board (IAASB), "pronouncements" and "standards" include the 36 "International Standards on Auditing" (ISAs). These parallel those of the AICPA and the PCAOB. Descriptions of the similarities and differences will vary from student to student.