**a. What is an audit? Why is it important?**

* An audit is an Systematic examination and verification of the financial statements of a firm to be sure that the transaction records are a fair and accurate representation of the transactions they claim to represent, other relevant documents, and physical inspection of inventory by qualified accountants called auditors which can be internal by employees of the organization, or external by an outside firm.
* **Why is it important?**

Auditing helps organizations achieve goals and objectives by measuring overall performance and productivity, as detected in transactions and business records. An audit protects an organization from financial misstatements, presenting a reliable health picture of the organization to the markets. Fraud protection is a benefit of audits achieved through internal controls that prevent and detect accounting irregularities. Strengthening the financial integrity of an organization through an audit reduces risk and the cost of capital.

 **b. What role does auditing play in society?**

- Although the role of auditors have their own limitation such as the time budget and experience of the auditors, they have a clear role in society. auditors are reducing the agency problem. The auditors are playing role as watchdogs to help the shareholder monitor the credibility of the information presented by the management and verification of finance statement is showing true and fair view to the shareholder. In enhance credibility is the perception of the external stakeholders that the external auditors express an opinion in impartial and reduce conflicts of interest. Also, the role of external auditors as independence profession parties to verification the company financial statement. The auditors without independence, the auditors may affect its audit judgment. For example. The auditor's essence independence can underlie the success and credibility of the accounting profession to serve the public” After the Enron and Andersen cases' showing that auditors are failed to independence for provided the audit service to serve the public. This is because of the auditor have close personal relationship with the Enron Chief Accounting Officer" (Thibodeau. J, Freier.D). The Andersen audit partner are provide the non-audit service to their audit client this will conflict interest especially when the revenue of non-audit service is greater than the audit fee, this will lead auditor influence their opinion on audit report"

**c. What is an audit committee and why is it important?**

* Audit committee is provide oversight of the financial reporting process, the audit process, the system of internal controls and compliance with laws and regulations. The audit committee can expect to review significant accounting and reporting issues and recent professional and regulatory pronouncements to understand the potential impact on financial statements. An understanding of how management develops internal interim financial information is necessary to assess whether reports are complete and accurate. The committee reviews the results of the audit with management and external auditors, including matters required to be communicated to the committee under generally accepted auditing standards. Audit committees will consider internal controls and review their effectiveness. Reports on, and management responses to, observations and significant findings should be obtained and reviewed by the committee. Controls over financial reporting, information technology security and operational matters fall under the purview of the committee
* Audit committees is important to enhance audit quality. Effective audit committees and auditors build confidence in the integrity of financial reporting.
* **why is it important?** The audit committee is important to create the right environment for quality auditing. It is the audit committee's responsibility to create an environment that accommodates an open discussion in a culture of integrity, respect and transparency between management and auditors. Audit committees are responsible for overseeing the work of the auditors. Among other things, they need to understand the audit strategy, be satisfied that it addresses the major audit risks, and make sure the auditors exercise appropriate professional skepticism. They also need to ensure that the auditor has an appropriately independent mindset from management and is truly objective. Ultimately, this will enable the audit committee to draw conclusions about the effectiveness of the audit

**d. What are Working Papers and why are they important?**

* papers and documents, which consist of details about accounts, which are under audit. They are the written, private materials, which an auditor prepares for each audit. They describe the accounting information, which he obtained from his client, the method of examination used, his conclusions and the financial statements. “Working papers provide [basic evidence of audit](http://accountlearning.com/audit-evidence-meaning-definition-importance/) conducted in accordance with standard audit practices. They help the auditor in writing the report. The quality of audit work performed by the auditor can be judged by the character and contents of working papers prepared and maintained by the auditor.”
* Working papers are important to assist in the planning and performance of the audit, necessary for audit quality control purposes, provide assurance that the work delegated by the audit partner has been properly completed, provide evidence that an effective audit has been carried out, increase the economy, efficiency, and effectiveness of the audit, contain sufficiently detailed and up-to-date facts which justify the reasonableness of the auditor’s conclusions, retain a record of matters of continuing significance to future, enable the auditor to point out to the client the weakness of the internal control system in operation and inefficiency of the accountancy He may, therefore, be in a position to advise his client as to how to avoid such pitfalls. The working papers enable the auditor to prepare the report to be issued without much waste of time.

**2. GAAS –.**

**Generally Accepted Auditing Standards (GAAS) are 10 general guidelines to aid auditors in fulfilling their professional responsibilities. Briefly list and describe the 10 GAAS.**

**GA**AS classification:

* General standards:
1. Adequate technical training and proficiency to perform the audit.

The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor. if the auditor did not get enough training he may filed with his job or has mistakes

1. Independence

In all matters relating to the assignment, independence does not have the mental attitude that is maintained by the accounts auditors or auditor. An auditor must to understand responsibility about his performance of his duty to the fullest regardless to any external effectiveness.

1. Due professional care

Professional due diligence is to be exercised in performing the audit and the preparation of the report. In other words The auditor must exercise due professional care in the performance of The audit and the preparation of the report.

* Standards of Field Work

 4. Adequately plan.

The auditor must adequately plan the work and must properly supervise any assistants.

 5. Internal control.

The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

 6. Evidential matter.

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.

* Standards of Reporting

 7. Generally accepted accounting principles

The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles

 8. principles have not been consistently observe

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.

 9. Disclosures

 When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.

 10. Xpression an opinion regarding the financial statements, taken as a whole:

 The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor 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.

**3. DEFINITIONS.**

**Define the following terms and give an example of each.**

**a. Fraud.**

* [Accounting](http://www.investopedia.com/terms/a/accounting.asp) fraud is intentional manipulation of [financial statements](http://www.investopedia.com/terms/f/financial-statements.asp) to create a facade of a company's [financial health](http://www.investopedia.com/terms/f/financial-health.asp). It involves an employee, account or the organization itself and is misleading to investors and [shareholders](http://www.investopedia.com/terms/s/shareholder.asp). A company can falsify its financial statements by overstating its [revenue](http://www.investopedia.com/terms/r/revenue.asp) or assets, not recording expenses and under-recording liabilities.
* For example, “a company commits accounting fraud if it overstates its revenue. Suppose company ABC is actually operating at a loss and is not generating any revenues. On its financial statements, the company's profits would be inflated and its [net worth](http://www.investopedia.com/terms/n/networth.asp) would be overstated. If the company overstated its revenues, it would [drive its share price](http://www.investopedia.com/ask/answers/061615/how-companys-share-price-determined.asp) up and falsely depict the its true financial health”

**b. Materiality.**

* Materiality is the threshold above which missing or incorrect information in financial statements is considered to have an impact on the decision making of users. Materiality is sometimes construed in terms of net impact on reported profits, or the percentage or dollar change in a specific line item in the financial statements. The materiality concept concerns omissions, errors, and misleading statements in accounting reports.
* A classic example of the materiality concept or the materiality principle is “the immediate expensing of a $10 wastebasket that has a useful life of 10 years. The [*matching* principle](http://www.accountingcoach.com/blog/what-is-the-matching-principle) directs you to record the wastebasket as an asset and then depreciate its cost over its useful life of 10 years. The *materiality* principle allows you to [expense](http://www.accountingcoach.com/blog/what-is-an-expense) the entire $10 in the year it is acquired instead of recording [depreciation expense](http://www.accountingcoach.com/blog/what-is-depreciation-expense) of $1 per year for 10 years. The reason is that no investor, [creditor](http://www.accountingcoach.com/blog/what-is-a-creditor), or other interested party would be misled by not depreciating the wastebasket over a 10-year period”

**c. Integrity.**

* integrity is an important fundamental element of the accounting profession. Integrity requires accountants to be honest, candid and forthright with a client and the user of the financial information. Accountants should restrict themselves from personal gain or advantage using confidential information. While errors or differences in opinion regarding the applicability of accounting laws do exist, professional accountants should avoid the intentional opportunity to deceive and manipulate financial information.
* For example individuals who handle general accounting functions and then audit this information are essentially reviewing their own work. This situation may allow an accountant to hide a company’s negative financial information.. Accountants must remain free from conflicts of interest and other questionable business relationships when conducting accounting services

**4. AUDIT OPINIONS –.**

**a. List and describe 4 similarities and 4 differences between the Standard Unqualified Audit Report of a Nonpublic Company and a Standard Unqualified Audit Opinion for Public Companies.**

* Similarities:
1. Both reports are judgment on the a company's financial records and statements to give an opinion if the statements are fairly and appropriately presented, and in accordance with the standards.
2. Both reports have 7 main parts must be on the report regardless to the content include; title, address, introductory paragraph, scope paragraph, opinion paragraph, name of auditor and the date of report.
3. Both report address the report to the shareholder of the entity.
4. Both reports has has almost same content in the introductory paragraph, which is shows the statements that the have been audited by the auditor. Also, similar content in the scope paragraph, which describe more details about auditing. In addition, both reports similar in the opinion paragraph, which shows the auditor opinion about the health of the financial statements and the accounting critical.
* Differences:
1. Standard Unqualified Audit Report of a public Company did not include management’s responsibility paragraph which shows the management’s responsibility for the preparation of the financial statements accordance with the accounting standards while Standard Unqualified Audit Report of a Nonpublic Company has it
2. Standard Unqualified Audit Report of a Nonpublic Company did not include auditor’s responsibility paragraph which shows the auditor’s express an opinion on the financial statements while Standard Unqualified Audit Report of a Nonpublic Company has it
3. standard Unqualified Audit Report of a nonpublic Company did not include explanatory paragraph referring to the audit of internal control which describe more details while Standard Unqualified Audit Report of a public Company has it
4. For some engagements in Standard Unqualified Audit Report of a Nonpublic Company, financial statements might be audited in accordance with multiple auditing standards. However, the Standard Unqualified Audit Report of a public Company, financial statements might be audited in accordance with GAAP standards.

**b. Special unqualified audit reports may be issued. List and describe 3 circumstances under which a special report may be issued.**

1. Lack of Consistency in Accounting Principles. If there has been a change in accounting principles or in the method of their application, the auditor should add an explanatory paragraph to the report (following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts, or items thereof) that discusses the change and its effect thereon if the accounting change is considered relevant to the presentation.
2. Going Concern Uncertainties. If the auditor has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statement, the auditor should add an explanatory paragraph after the opinion paragraph of the report only if the auditor's substantial doubt is relevant to the presentation.
3. Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof). If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph preceding the opinion paragraph of the report.

**c. Besides an unqualified report, list the 3 other types of reports that may be issued by an auditor. Describe the circumstances under which each report may be issued.**

## Qualified Opinion

* Is a statement issued after an audit is done by a professional auditor that suggests the information provided was limited in scope and/or the company being audited has not maintained GAAP accounting principles. A qualified opinion, however, will include an additional paragraph that highlights the reason why the audit report is not unqualified.
* This opinion issued in situations when a company’s financial records have not been maintained in accordance with GAAP but no misrepresentations are identified, an auditor will issue a qualified opinion.

. 2. Adverse Opinion

* refers to the conclusion by an [auditor](http://www.investinganswers.com/node/5205) that a company's [financial statements](http://www.investinganswers.com/node/2293) inaccurately characterize the company's financial standing.
* This opinion issued in situations when a firm’s financial records do not conform to GAAP. In addition, the financial records provided by the business have been grossly misrepresented. Although this may occur by error, it is often an indication of fraud.

## Disclaimer of Opinion

* is basically a statement provided by the auditor that doesn’t lay down any sort of opinion with regard to the financial position and condition of the company. Disclaimer of opinion is provided by certified public accountant wherein he clarifies that an audit related opinion/statement cannot be provided owing to limitations of the examinations conducted.
* This opinion issued in situations when an auditor is unable to complete the audit report due to absence of financial records or insufficient cooperation from management

**5. SOX -**

**The Sarbanes-Oxley Act of 2002 made significant reforms for public companies and their auditors.**

**a. Describe the events that led up to the passage of the Act.**

1. large number of misstatements of financial statements, many of which resulted from fraudulent financial reporting.

The Sarbanes-Oxley Act was enacted in response to a series of high-profile financial scandals that occurred in the early 2000s at companies including Enron, WorldCom and Tyco that rattled investor confidence. The act, drafted by U.S. Congressmen Paul Sarbanes and Michael Oxley, was aimed at improving corporate governance and accountability. Now, all public companies must comply with SOX

1. The conviction of destroying evidence charges to the Big 5 accounting firm of Arthur Andersen

The Sarbanes-Oxley Act affects the IT departments charged with storing a corporation's electronic records. The act defines which records should be stored and for how long. SOX states that all business records, including electronic records and electronic messages, must be saved for "not less than five years." The consequences for noncompliance are fines, imprisonment or both

**b. Describe 5 of the major reforms made by the Act.**

1. SOX led to greater internal control of financial reporting, and increased expertise and independence among more-focused boards, committees and directors. “Sarbanes-Oxley Act is Section 404, which requires public companies to perform extensive [internal control](http://www.investopedia.com/terms/i/internalcontrols.asp) tests and include an internal control report with their annual audits”
2. Public companies are required to disclose any material off-balance sheet arrangements, such as [operating leases](http://www.investopedia.com/terms/o/operatinglease.asp) and special purposes entities. The company is also required to disclose any [pro forma](http://www.investopedia.com/terms/p/proforma.asp) statements and how they would look under the [generally accepted accounting principles (GAAP).](http://www.investopedia.com/terms/g/gaap.asp)
3. strengthening of audit committees at public companies. The audit committee receives wide [leverage](http://www.investopedia.com/terms/l/leverage.asp) in overseeing the company's top management accounting decisions. The audit committee members must be independent of the top management and gain new responsibilities such as approving numerous audit and non-audit services.
4. changes management's responsibility for financial reporting significantly. The act requires that top managers personally certify the accuracy of [financial reports](http://www.investopedia.com/university/financialstatements/). “If a top manager knowingly or willfully makes a false certification, he can face 10 to 20 years in prison”. If the company is forced to make a required [accounting restatement](http://www.investopedia.com/terms/r/restatement.asp) due to management's misconduct, top managers can be forced to give up their bonuses or profits made from selling the company's stock.
5. imposes harsher punishment for obstructing justice and [securities fraud](http://www.investopedia.com/terms/s/securities-fraud.asp), mail fraud and [wire fraud](http://www.investopedia.com/terms/w/wirefraud.asp). “The maximum sentence term for securities fraud increased to 25 years, and the maximum prison time for obstruction of justice increased to 20 years. The act increased the maximum penalties for mail and wire fraud from five to 20 years of prison time”

**6. MATERIALITY.**

**a. Materially is an important concept in auditing. Define the term materiality.**

Materially in general explain the misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements

**b. Give an example of a situation that can be considered material. Explain why you consider it to be material.**

“Maldives Plc’s total sales for the financial year 2012 amounts to $100 million and its total assets are $50 million. The company’s external auditors have found out that $3 million worth of sales shouldn’t be recognized in financial year 2012 because the risks and rewards inherent in the sales have not been transferred”

This example considers materiality due to size, this amount of $3 million is material in the context of total assets of $50 million. The company should adjust its financial statements

**c. How does materiality affect the audit of financial statements and reporting decisions?**

The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. The perceived needs of users are recognized in the discussion of materiality in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts. In an audit of financial statements, the auditor's judgment as to matters that are material to users of financial statements is based on consideration of the needs of users as a group; the auditor does not consider the possible effect of misstatements on specific individual users, whose needs may vary widely. “The determination of materiality, therefore, takes into account how users with such characteristics could reasonably be expected to be influenced in making economic decisions.”

**7. ASSERTIONS REGARDING FINANCIAL STATEMENTS**

**a. What are assertions?**

Audit Assertions are the implicit or explicit claims and representations made by the management responsible for the preparation of financial statements regarding the appropriateness of the various elements of financial statements and disclosures. “Financial statement assertions are management’s explanation about the recognition, measurement, presentation and disclosure of information in the financial statements.”

**b. Who makes these assertions?**

Management make the implicit or explicit assertions that the preparer of financial statements (management) is making to its users.

**c. What is the auditor’s responsibility regarding the financial statements?**

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. The auditor responsibility to the financial statements is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles. These standards require the auditor to state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles and to identify those circumstances in which such principles have not been consistently observed in the preparation of the financial statements of the current period in relation to those of the preceding period.

**d. List and describe 7 assertions regarding the financial statements.**

## Existence

The assertion of existence is the assertion that the assets, liabilities and [shareholders' equity](http://www.investopedia.com/terms/s/shareholdersequity.asp) balances appearing on a company's financial statements actually exist as stated at the end of the accounting period that the financial statement covers

“For example, any statement of inventory included in the financial statement carries the implicit assertion that such inventory exists, as stated, at the end of the accounting period. The assertion of existence applies to all assets or liabilities included in a financial statement”

2. Completeness

Checking completeness of a financial statement is to analyze whether all the transactions that are already given in the financial statement are correctly included. In order to abide by the completeness assertion, the auditors prove with the help of sufficient evidence that all the recorded transactions deserve to be included. This is further supported with an external document so as to provide evidence regarding the occurrence of the transaction.

3. Rights and Obligations:

This financial statement assertion is used to check whether the assets that are included in the financial statement are the rights and the liabilities are the obligations of the company. In order to ensure this, sometimes special purpose entities are created.

4. Management Assertions:

In Management Assertions auditors decompose the broad assertions into a detailed set of statements referred to as management assertions. It has a major role in financial statement assertions and audit assertions.

5. Accuracy and Valuation

The assertion of accuracy and valuation is the statement that all figures presented in a financial statement are accurate and based on proper valuation of assets, liabilities and equity balances.

6. Presentation and Disclosure

The final financial statement assertion is that of presentation and disclosure. This is the assertion that all appropriate information and disclosures regarding the company's financial statement are included in the statement, and that all the information presented in the statement is presented in a fair and clear manner that facilitates ease of understanding the information contained in the statement.

7. Occurrence

Being sure the the transactions and events recorded actually occur and pertain to the entity.

**8. ETHICS & PROFESSIONAL RESPONSIBILITIES –.**

**What is Ethics? List and describe 3 Theories of Ethical Behavior.**

* Ethics are concerned with fundamental principles of right and wrong and what people ought to do.

“Refers to a system or code of conduct based on moral duties and obligations that indicate how an individual should interact with others in society”

* Theories of Ethical Behavior.

1. Utilitarian Ethical Theory

“Utilitarian theory was first formulated in the eighteenth century by Jeremy Bentham and later refined by John Stuart Mill. Utilitarian look beyond self-interest to consider impartially the interests of all persons affected by an action. The theory emphasizes consequences of an action on the stakeholders. The stakeholders are those parties affected by the outcome of an action. Utilitarian recognize that trade-offs exist in decision-making. Utilitarian theory is concerned with making decisions that maximize net benefits and minimize overall harms for all stakeholders. It is similar to cost-benefit analysis decision-making. The ultimate rule to follow is the “Greatest Good for the Greatest Number.”

2. Virtue-Based Ethical Theory

Judgment is exercised not through a set of rules, but as a result of possessing those dispositions or virtues that enable choices to be made about what is good and holding in check desires for something other than what will help to achieve this goal. Thus, virtue-based ethics emphasizes certain qualities that define appropriate behavior and the right action to take. Unlike the other standard ethical theories discussed, virtue theory does not establish a set of criteria to evaluate potential decisions. “Rather, it emphasizes the internal characteristics of an individual with whom we would want to enter into a relationship of trust. The ultimate goal is for “the decision maker to do the right thing in the right

place as the right time in the right way.”

3. Rights-Based Ethical Theory

 Modern rights theory is associated with the eighteenth-century philosopher Immanuel Kant. Rights theory assumes that individuals have certain entitlements that should be respected such as freedom of speech, the right of privacy, and due process. Kant’s theory establishes an individual’s duty as a moral agent toward others who possess certain rights. It is based on a moral principle that he calls the categorical imperative. “One version of the categorical imperative emphasizes the universality of moral actions. The principle is stated as follows: “I ought never to act except in such a way that I can also will that my maxim (reason for acting) should become a universal law.” The ultimate guiding principle is, “I should only act in a way in which I would be happy if everyone in that situation would act the same.”

**b. Why is it important for an Auditor to behave ethically?**

It is important because the value of the ethical audit is that it enables the company to see itself through a variety of lenses: it captures the company's ethical profile. Companies recognize the importance of their financial profile for their investors, of their service profile for their customers, and of their profile as an employer for their current and potential employees. An ethical profile brings together all of the factors which affect a company's reputation, by examining the way in which it does business. By taking a picture of the value system at a given point in time, it can clarify the actual values to which the company operates, provide a baseline by which to measure future improvement learn how to meet any societal expectations which are not currently being met, give stakeholders the opportunity to clarify their expectations of the company's behavior. identify specific problem areas within the company. learn about the issues which motivate employees, identify general areas of vulnerability, particularly related to lack of openness. “In relation to the specific factors of the ethical environment, studies on codes of ethics have dominated the ethical accounting and auditing literature. Codes of ethics are important since they implicitly set limits for unethical behavior and are intended to offer guidance in ambiguous situations”

**c. Summarize the auditor’s professional responsibilities.**

* Auditing Standards

**In private company,** GAAS defines some general auditing standards for private company. GAAS mandates that auditors have adequate training and proficiency to do the audit. This means auditors should maintain professional certifications, like the certified public accountant designation and any specialty designations for their field. It's crucial that auditors maintain consistency in how they conduct the audit. GAAS mandates that auditors obtain sufficient and appropriate audit evidence. Auditors must conduct a risk assessment to judge what is a sufficient amount of evidence. The appropriateness of evidence can be up for debate, but it generally means the evidence should come from a reliable source and be relevant to the audit. The AICPA makes it clear that all audit reports should contain specific statements and disclosures. Auditors must identify the accounting framework they are using for the audit and offer an opinion on whether or not the financial statements were prepared according to the framework. Most U.S. companies follow the U.S. generally accepted accounting principles, but an audit could be conducted on a business based on the tax code or cash accounting.

**In public company, the** standards are similar to the private company with some exception “PCAOB auditing standards currently consist of two types of equally authoritative auditing standards: (i) standards originally issued by the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA") and adopted by the Board on an interim, transitional basis in April 2003 and (ii) standards issued by the Board”

* Standards of professional conduct

**In private company,** it established by the code professional conduct (AICPA) which is is a necessary component to any profession to maintain standards for the individuals within that profession to adhere. It brings about accountability, responsibility and trust to the individuals that the profession serves. Also, three standards include : independence decision with audit committee , certain independence implication of audits of mutual funds and related entities, and employments with audit clients issued by ISB . ISB also issued three interpretations include : impact on auditor independence of assisting clients in the implementation of FAS, the applicability of ISB standards, and an amendment of ISB interpretations.

**In public company, “**CPA must follow the auditing standards PCAOB. the code of professional conduct and also the more stringent Independence requirements established by the SEC, ISB and PCAOB”

**d. What is independence? An auditor may be independent of mind but not of**

**appearance. Explain the difference between the two. Why are both important?**

* An independent auditor is a [certified public accountant](http://www.investopedia.com/terms/c/cpa.asp) (CPA) or chartered accountant (CA) who examines the financial records and business transactions of a company with which he is not affiliated. An independent [auditor](http://www.investopedia.com/terms/a/auditor.asp) is typically used to avoid [conflicts of interest](http://www.investopedia.com/terms/c/conflict-of-interest.asp) and to ensure the integrity of performing an [audit](http://www.investopedia.com/terms/a/audit.asp).
* **difference between the two :**
1. **independent of mind**

More specifically, real independence concerns the [state of mind](https://en.wikipedia.org/wiki/Mental_health) an auditor is in, and how the auditor acts in/deals with a specific situation. An auditor who is independent 'in fact' has the ability to make independent decisions even if there is a perceived lack of independence present,or if the auditor is placed in a compromising position by company directors..

1. **independent of appearance**

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm’s, or a member of the assurance team’s, integrity, objectivity or professional scepticism had been compromised.

* **The Important for both types** of independence is to keep the The auditor independent from the client company, so that the audit opinion will not be influenced by any relationship between them. The auditors are expected to give an unbiased and honest professional opinion on the financial statements to the shareholders.

**e. The auditor’s independence rules also apply to covered members. Who are covered members? List and describe 4 covered members.**

1. An individual who was formerly employed by a client or associated with a client as an officer, director, promoter, underwriter, voting trustee, or trustee for a pension or profit-sharing trust of the client would impair his or her firm’s independence if the individual participated on the attest engagement team.
2. An individual in a position to influence the attest engagement is one who evaluates the performance or recommends the compensation of the [attest engagement](https://definedterm.com/a/definition/45694) [partner](https://definedterm.com/a/definition/45715); directly supervises or manages the [attest engagement](https://definedterm.com/a/definition/45694) [partner](https://definedterm.com/a/definition/45715), including all successively senior levels above that individual through the [firm](https://definedterm.com/a/definition/45702)’s chief executive; consults with the [attest engagement team](https://definedterm.com/a/definition/45695) regarding technical or industry-related issues specific to the [attest engagement](https://definedterm.com/a/definition/45694); or participates in or overseas, at all successively senior levels, quality control activities, including internal monitoring, with respect to the specific [attest engagement](https://definedterm.com/a/definition/45694).
3. A partner or manager who provides nonattest services to the attest client beginning once he or she provides ten hours of nonattest services to the client within any fiscal year and ending on the later of the date. First, the firm signs the report on the financial statements for the fiscal year during which those services were provided. Second, he or she no longer expects to provide ten or more hours of nonattest services to the attest client on a recurring basis.
4. “An entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles [GAAP] for consolidation purposes) by any of the individuals or entities described in (a) through (e) or by two or more such individuals or entities if they act together.”

**9. AUDITORS LIABILITY – .**

**a. Explain the difference between common law and statutory law.**

* Common law, also known as case law, allows judges to render decisions based on the rulings of earlier cases. Common law is guided by the regulations set forth in federal or state statutes, but it does not rely exclusively on those written laws.
* Statutory law refers to the written law established by the legislative branch of the government. Statutes may be enacted by both federal and state governments and must adhere to the rules set in the Constitution. Proposed statutes are reviewed by the legislature prior to being enacted into law.

**b. Under common law, describe the auditor’s liability;**

1. Liability to client

The auditor can be held liable to the client for :

* breach of contract

If the the auditors are not performing within the agreement set forth in the contract this will be considered a breach of contract. Also, if the client fail to complete his obligations . “ generally occurs when one of the parties avoids or neglects their legal obligations under the agreement. When hearing cases involving common law contracts, courts also consider where the breach was a result of a legal excuse or defense. Under the common law breach of contract remedies, a party filing a lawsuit could ask a court to award specific performance remedies, compensatory damages, or remedies for unjust enrichment. In other situations, a party may seek liquidated damages.

“

* Negligence

Is a failure to exercise the appropriate and or ethical ruled care expected to be exercised amongst specified circumstances. The area of [tort](https://en.wikipedia.org/wiki/Tort) law known as *negligence* involves harm caused by failing to act as a form of *carelessness* possibly with extenuating circumstances. The Elements of negligence claims are: duty of care; which is The legal liability of a defendant to a plaintiff is based on the defendant's failure to fulfil a responsibility, breach of duty; which is improvement if that the defendant owed a duty to the plaintiff/claimant, the matter of whether or not that duty was breached must be settled, factual causation; it must be shown that the particular acts or omissions were the cause of the loss or damage sustained, and harm; plaintiff may not recover unless he can prove that the defendant's breach caused a pecuniary injury. This should not be mistaken with the requirements that a plaintiff prove harm to recover.

* Fraud

 “an auditor can be held liable to clients for fraud when he or she acted with knowledge and intent to deceive. However, action alleging fraud on the part of the auditors result from lawsuits by Third parties”

1. Liability to third parties

The auditor can be held liable to the third parties for:

* Ordinary Negligence

s the failure to act as a reasonably prudent person. It is the failure to exercise such care as the great mass of mankind ordinarily exercises under the same or similar circumstances. Ordinary negligence is the want of exercise of ordinary care

Four Legal Standards for Third Parties

1. Private

“. The traditional view held that auditors had no liability under common law to third parties who did not have a privity relationship with the auditor. Privity here means that the obligations that exist under a contract are between the original parties to the contract, and failure to perform with due care results in a breach of that duty only to those parties. Many courts have reexamined the privity notion and substituted the concept of public responsibility”

1. Near privity

“ third parties whose relationship with the CPA approaches privity”

1. Foreseen third parties

“third parties whose reliance should before seen, even if the specific person is unknown to the auditor”

1. Reasonable foreseeable third parties

“ third parties whose reliance should be reasonably foreseeable, even if the specific person is unknown to the auditor”

* Fraud and Gross Negligence

This is a fraud committed by people outside an employee employer relationship. They can be committed against individuals, businesses, companies, the government or any other entity. Third party frauds are not as common as occupational frauds, but on average each fraud is for a larger amount. Some third party frauds are not meant to remain hidden forever. Some only remain hidden long enough for the fraudster to make their get-away. The fraudster may not care if the fraud is eventually discovered as they do not have a continuing relationship with the victim and they cannot be found. Third Party Must Prove “A false representation by the CPA,knowledge or belief by the CPA that the representation was false,the CPA intended to induce the 3rd party to rely on the false representation, the third party relied on the false representation and the third party suffered damages”

**c. List and describe the categories of parties that may be involved? What must be proven by the parties; what are the auditor’s possible defenses?**

1.Privity: The traditional view held that auditors had no liability under common law to third parties who did not have a privity relationship with the auditor

2. Near privity: “ third parties whose relationship with the CPA approaches privity”

3. Foreseen third parties: “third parties whose reliance should before seen, even if the specific person is unknown to the auditor”

4. Reasonably foreseeable third parties: “ third parties whose reliance should be reasonably foreseeable, even if the specific person is unknown to the auditor”

 Must be proven for these categorize: the auditor had a duty to the plaintiff to exercise due care, the auditor breached that duty and was negligent in following professional standards. the auditor’s breach of due care was the direct cause of the third party’s loss and the third party suffered and actual loss.

Auditor’s defense these categorize: no duty was owed , the client was negligent (contributory negligence, comparative negligence, or management fraud), the audit was performed in accordance with GAAS, the client suffered no loss, tny loss was caused by other events, the claim is invalid because the statute of limitations has expired.

**Other categorize**

1. Negligence

Is a failure to exercise the appropriate and or ethical ruled care expected to be exercised amongst specified circumstances. The area of [tort](https://en.wikipedia.org/wiki/Tort) law known as *negligence* involves harm caused by failing to act as a form of *carelessness* possibly with extenuating circumstances. The Elements of negligence claims are: duty of care; which is The legal liability of a defendant to a plaintiff is based on the defendant's failure to fulfil a responsibility, breach of duty.

Must be proven: “a duty was owed to the client, failure to act in accordance with that duty, a causal connection between the auditor’s negligence and the client’s damage and actual loss or damage to the client”.

Auditor’s defense against Clint negligence claims include; “no duty was owed to the client the client was negligent, the auditor’s work was performed in accordance with professional standards, the client suffered no loss.5, lack of causal connection between auditor negligence and the client loss and the claim is invalid because the statute of limitations has expired”

1. Ordinary Negligence

The failure to act as a reasonably prudent person. It is the failure to exercise such care as the great mass of mankind ordinarily exercises under the same or similar circumstances. Ordinary negligence is the want of exercise of ordinary care

* Must be proven : the auditor had a duty to the plaintiff to exercise due care, the auditor breached that duty by failing to act with due professional care. there was a direct causal connection between the auditor’s negligence and the third party’s injury, the third party suffered an actual loss as a result.
* Auditor’s defense: “no duty was owed to the third party (level of duty required depends on the case law followed by the courts), the third party was negligent, the auditor’s work was performed in accordance with professional standards, the third party suffered no loss, lack of causal connection between auditor negligence and the client loss, and the claim is invalid because the statute of limitations has expired”

3. Fraud and Gross Negligence

This is a fraud committed by people outside an employee employer relationship. They can be committed against individuals, businesses, companies, the government or any other entity. Third party frauds are not as common as occupational frauds, but on average each fraud is for a larger amount. Some third party frauds are not meant to remain hidden forever. Some only remain hidden long enough for the fraudster to make their get-away. The fraudster may not care if the fraud is eventually discovered as they do not have a continuing relationship with the victim and they cannot be found.

* Must be proven “A false representation by the CPA, knowledge or belief by the CPA that the representation was false, the CPA intended to induce the 3rd party to rely on the false representation, the third party relied on the false representation and the third party suffered damages”
* Auditor’s defense: “"If the auditor has been only negligent he or she can claim that his or her negligence did not rise to the level of gross negligence or fraud. The auditor can also raise the statute of limitations as defenses. Finally, the auditor can claim that the plaintiff's lack of due diligence led unjustifiably to reliance on a false representation"

**d. List and describe the SEC Act of 1933 and 1934. Who are the parties that the auditor may be liable to under these Acts? What must be proven by them against auditors? What are the auditor’s possible defenses?**

* **SEC Act of 1933**

The first significant case brought under the Securities Act of 1933. The auditors were unable to establish their due diligence, especially with respect to the S-1 review for subsequent events up to the effective date of the registration statement. Under the Securities Act of 1933, third Party must Prove “ The third party suffered losses by investing in the registered security and the audited financial statements contained a material omission or misstatement”

* **SEC Act of 1934**

Ernst and Ernst v. Hochfelder Established that the auditors could not be held liable under Rule 10b-5 of the Act for ordinary negligence. The U.S. Supreme Court concluded that the auditor's’ knowledge of the fraud must be proved before damages can be recovered under this provision of the Securities Exchange Act of 1934. Third party should improve “ a material, factual misrepresentation or omission, reliance on the financial statements, damages suffered as a result of reliance on the financial statements, scienter (gross negligence or recklessness may be enough)”

* **Who are the parties that the auditor may be liable to under these Acts? What must be proven by them against auditors? What are the auditor’s possible defenses?**
1. Section 11 under securities Act of 1933 which “ imposes a liability on issuers and others, including auditors, for losses suffered by third parties when false or misleading information is included in a registration statement”
* Must be proven : “ the third party suffered losses by investing in the registered security and the audited financial statements contained a material omission or misstatement”
* Auditor’s defense: due diligence which is the auditor should made investigation for purpose of the facts supporting or contradicting the information included in the registration statement”
1. Section 18 under securities Act of 1934 which “ imposes liability on any person who makes a material false or misleading statement in documents filed with the SEC. Section 10(b) and Rule 10b-5 are the greatest source of liability for auditors under this act”
* Must be proven : a material, factual misrepresentation or omission, reliance on the financial statements, damages suffered as a result of reliance on the financial statements and scienter.
* Auditor’s defense: The auditor performs the audit with enough due diligence. In addition, prove that the plaintiff loses did not caused by reliance on financial statement and The statute of limitations has expired.

**e. List and describe 5 steps that an auditor should take in order to prevent litigation.**

1. Service-Specific Documentation. Complete separate engagement letters for each service offered any given client, from audit, review, and compilation to tax, consulting, and other services. For example, while bookkeeping is less complex than other assignments and may be one of two or three services you provide to a client, it is important to be clear about the scope of bookkeeping services, especially when bank reconciliation is involved.
2. Set the Scope. Define limitations of services from day one and enforce them; clients often try to expand the scope after a problem is discovered.
3. Set the Tone. An engagement letter is a must. Failure to create this document can lead to broad interpretation of scope of services actually performed and lead to misunderstandings and unrealistic expectations.
4. Coordinate. Make sure invoices match the scope of the engagement; embellishment could result in fraud risks.
5. Set Realistic Standards. Don't overpromise. It's important that proposals align with the promise to deliver specific services, experience in accomplishing the services as well as the accountants' availability and resources.

**10. AUDIT ACCEPTANCE & PLANNING (4 points).**

**You are an experienced CPA and have been assigned to be the in-charge auditor to audit the financial statements of Montclair Company, a publicly held company for the first time. If you accept the engagement, you will supervise 3 assistants on the engagement and will be required to communicate with the predecessor auditor.**

**a. List the steps that you would take before accepting a new client.**

1. Evaluate prospective client integrity personally

Ask for and follow up with references, including attorneys, bankers, other business consultants, and major vendors or customers. Verify that relationships were not terminated due to disagreements regarding business operations or outstanding invoices.

1. Perform engagements with professional competence.

Before agreeing to propose on or accept an engagement, consider whether the requested service can be competently provided in accordance with applicable professional standards

1. Consider risks related to the particular engagement
2. Formalize the process

contact with the firms to develop a new client acceptance checklist to document the decision-making process. The checklist should identify what the firm deems important and provide a written record of representations made by prospective clients and why the firm accepted them

**b. List and describe the steps that you should take immediately after accepting a new audit client.**

1. request a permission of the new client before contacting with predecessor auditor

It is important to request a permission of the new client before contacting with predecessor auditor due to the fact as auditor it hard to disclose confidential any information about a client without firm’s consent.

2. Make some inquiries of predecessor auditor

These inquiries include; information that might bear on the Integrity of management, disagreements with management about accounting policies auditing procedures or other similarly significant matters. Communications to those charged with the government regarding fraud and noncompliance with laws or regulations by the entity. Communications to those charged with the government regarding regarding deficiencies and material weakness in internal control and the predecessor auditor's understanding about the reasons for the change of the auditors”

3. Make engagement letter

It is necessary to save both parties rights and avoid any mistakes and misstatements in future.

**c. List and describe the items that should be included in the engagement letter. Describe the benefits derived from the engagement letter.**

* **Items that should be included in the engagement letter:**
1. Name of the entity

Engagement will start with the entity’s name

2. The objectives of the engagement

Shows the purpose of the engagement and use this letter as improve between parties

3. Management’s responsibilities

The management of company is responsible for the financial statements from all sides.

4. The auditor’s responsibilities:

Ensure the validity and relevance of financial information in the financial statements and make sure they are free of any errors and manipulation. Give an opinion about the financial statements

5. The limitations of the engagement.

This shows what should be and what should not be during the engagement. In other words, give the terms of engagement

* **The benefit of the engagement letter** is to formalize the arrangements reached between the auditor and the entity. This also help to reduce the risk that any party may misinterpret what is expected or required of other party

**d. List and describe the steps involved in a financial statement audit.**

1. Engagement Acceptance

"The American Institute of CPAs recommends that an auditor evaluate the risks associated with each engagement. “Therefore, a CPA inquiries about any special circumstances, the integrity of management and pending lawsuits before performing an audit.

1. Planning

Auditing standards require that an auditor prepare adequate planning for an engagement. The amount of audit planning needed is in direct relation to the size and complexity of the organization. Audit planning involves obtaining an understanding of the organization's business and industry, performing trend and ratio analysis. The auditor utilizes the results of the planning process to determine the timing and extent of audit testing.

1. Audit Tests

During the fieldwork process, or the time the auditor spends at the organization offices, the auditor performs tests of financial data. "For instance, a CPA selects a random sample of forty disbursements to ensure checks are payable to the correct vendor and are written for the correct amount". In addition, an auditor reviews the invoice associated with the disbursement to ensure the expense is classified correctly and that the vendor actually exists.

1. Account Analysis

During the account analysis process, the auditor ensures that financial statement account balances are supported by underlying documentation and analysis. A CPA evaluates the results of tests, reviewers responses to inquires and records audit-adjusting journal entries.

1. Reporting

CPAs issue an opinion on audited financial statements as to whether the financial statements are presented in accordance with accounting principles generally accepted in the U.S. The opinion is issued on the Independent Auditor’s report.

1. Summation

An auditor is required to retain proper documentation regarding the audit and obtain signatures from management regarding management's responsibility for the information reported in the financial statements. The information is retained by the CPA should lawsuits occur regarding reported amounts and for future account analysis.

**11. PROPOSED NEW U.S. AUDITING STANDARD**

**In response from the outcry from the public, several countries have enacted a new Auditing Standard. The U.S. has also proposed a new standard.**

**a. What are the major components of the new U.S. Standard?**

The new repurposes in 2016 retain the existing “pass/fail” opinion and asked for basic elements of the auditor’s report with additional information in the auditor’s report about the audit and the auditor. "The auditor would be required to communicate audit report CAM arising from the audit of the current period’s financial statements. CAM are any matters arising from the audit of the financial statements communicated, or required to be communicated, to the audit committee and that: relate to accounts or disclosures that are material to the financial statements, and Involved especially challenging, subjective, or complex auditor judgment In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor would take into account specific factors such as the auditor’s assessment of the risks of material misstatement, including significant risks."

The changes on the auditor’s report are it recognize the CAM, describe the principal considerations that guide him to decide the matter is a CAM, describe how it was addressed in the audit and refer to the relevant financial statement accounts and disclosures.

So, The major component are “Limiting the source of potential CAM to matters communicated, or required to be communicated, to the audit committee, Adding a materiality component to the definition of CAM as it relates to accounts or disclosures, Narrowing the definition to only those matters that involved especially challenging, subjective, or complex auditor judgment, Narrowing the related documentation requirement to be consistent with the definition of a CAM, and Expanding the communication requirement so the auditor describes how the CAM was addressed in the audit” Also, it is important that the “A statement containing the year the auditor began serving consecutively as the company’s auditor (“auditor tenure”), The opinion to be the first section of the auditor’s report and required section titles to guide the reader, Enhancements to existing language in the auditor’s report, including related to the auditor’s responsibilities for fraud, A statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB”

**b.Do you think that the proposed Standard will be implemented? Explain why or why not.**

Yes, I think it is important to be implemented. The new changes may appear in auditors reporting on define facts and circumstances specially to the audit of a company. These facts and circumstances may apply to all audits conducted under PCAOB standards, so the communication of CAM would not be required for audits of brokers and dealers reporting under the SEC Act of 1934 Rule 17a-5, "investment companies other than business development companies, and employee stock purchase, savings, and similar

plans"

**c. If the new Auditing Standard was implemented, what impact will it have on the following parties:**

**i. The Financial Statement Users.**

**The financial statement users will get more information and a full detail about**

the statements and they will avoid any misunderstanding which make them take an investing decision fairly in their relationship with the company.

**ii. The Auditors.**

The auditors will give more information which make them prove a clear and fair opinion of the financial statements’ users and give a full information to their clients. So, the auditor may attract investors, obtain loans, and improve public appearance by their auditor's report.

**iii. The Company's Management.**

These changes my enhancements to existing language in the auditor’s report including the auditor responsibility and management responsibility. Management responsibility would be clearer for the users and decision maker about the company’s financial statements

**iv. The Standard setters and regulators.**

These changes may make the standard setters to follow up the new standard in order to make any enhancements required to keep this standard helpful for all company’s parties.