

Chapter 2—Financial Statement Audits and Auditors' Responsibilities

Reliability means that accounting information is:

- 1. free from error and bias—financial statements tell it like it is**
- 2. verifiable—refers to the degree of consensus among measures**
- 3. representatively faithful—the measurement itself should correspond to the phenomenon it is trying to measure (e.g., baseball speed—radar gun)**

In a 1985 administrative proceeding involving the Carnation Company, the SEC stressed the critical nature of reliability:

To the extent that investors cannot rely upon the accuracy and completeness of issuer statements, they will be less likely to invest, thereby reducing the liquidity of the securities markets.

Reliability is also called audit quality.

Conflicts of interest are explained by agency theory. Managers are the agents of shareholders or the principals of corporations. Managers often make decisions that are not aligned with shareholders' interests. Shareholders have a need to hire independent auditors to monitor management or attest to the financial statement representations of management.

SASs

All members of the AICPA must comply with SASs.

The POAB has indicated that it will take over issuing auditing standards for publicly traded firms from the AICPA in the near future.

- 1. adequate technical training and proficiency—requires the auditor to have formal education, adequate practical experience, and CPE**
- 2. independence in mental attitude—free from client influence**
- 3. due professional care—requires the auditor to act in good faith and not be negligent**

Standards of field work

- 1. adequate planning and supervision—deals with ascertaining that the engagement is sufficiently planned to ensure an adequate audit and proper supervision of assistants**

obtaining sufficient competent evidential matter—an auditor must use his or her judgment in deciding the sufficiency and competence of evidence needed

Standards of Reporting

**adequacy of informative disclosure—
related to the adequacy of footnotes
in the auditor's report**

**expression of an opinion—requires
the auditor to express an opinion on the
financial statements taken as a whole or
state that an opinion cannot be
expressed**

“Deep pockets” theory or insurance hypothesis—the auditor is seen to serve as an insurer of the accuracy of financial statements and indemnifier of losses sustained as a result of alleged financial statement misrepresentations

The auditor’s opinion on fairness applies to the financial statements taken as a whole not to individual accounts

2. Other types of opinions

1. Financial statements contain a material departure from GAAP

--using accounting principles that are not GAAP (e.g., direct writeoff method for A/R)

--failing to make required disclosures

In this instance, the auditor issues a qualified or adverse opinion (the latter is used only for departures that have an extremely material effect on the financial statements)

2. the auditor is unable to obtain sufficient competent evidence to verify one or more assertions of management (these circumstances are known as scope limitations)

--in this instance, the auditor issues a qualified opinion or disclaimer of opinion

--when one of these nonstandard reports is issued the reason for the opinion should be explained in one or more explanatory paragraphs