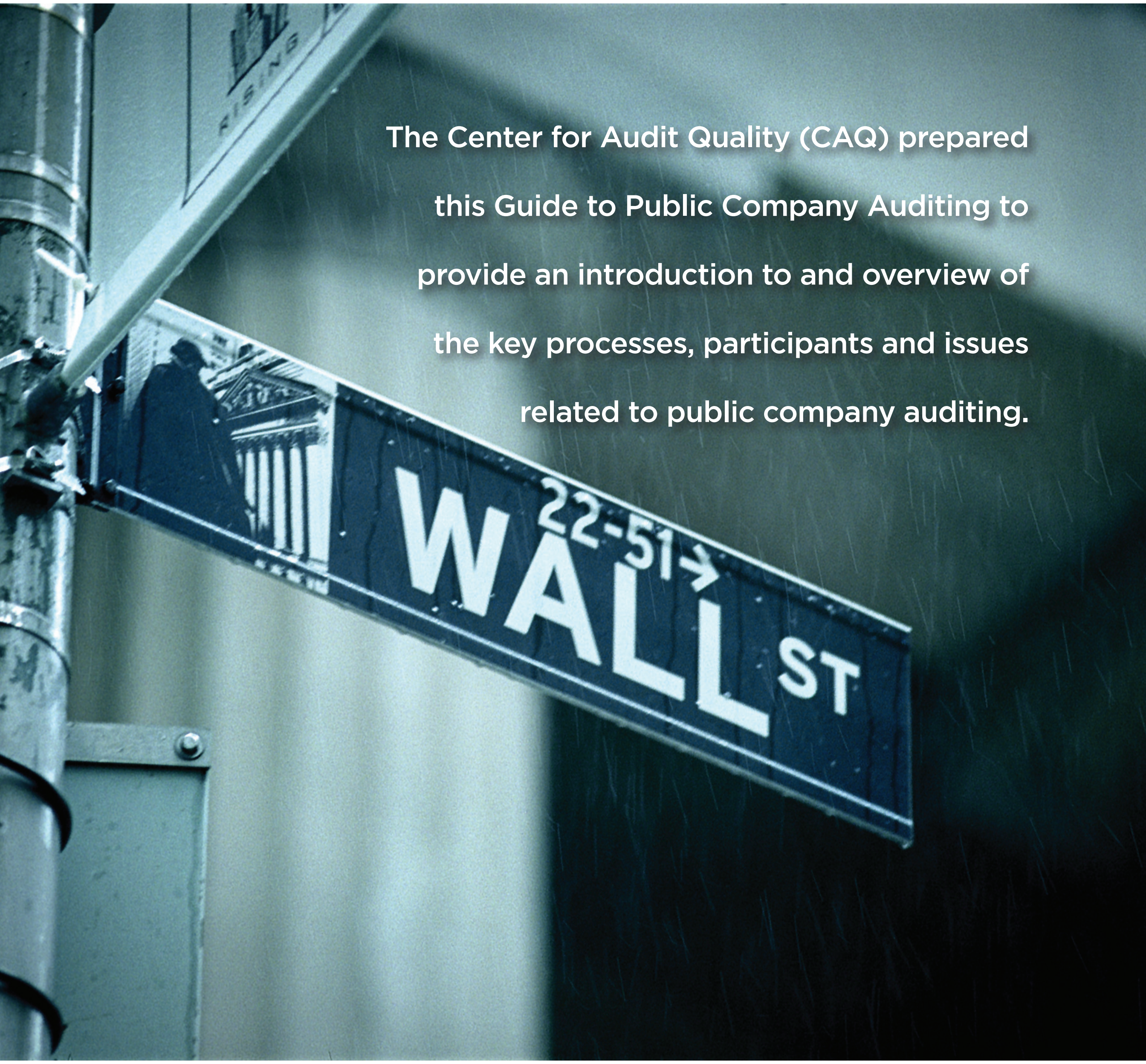
Guide to Public Company Auditing

CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

Affiliated with the American Institute of CPAs



The Center for Audit Quality (CAQ) prepared this Guide to Public Company Auditing to provide an introduction to and overview of the key processes, participants and issues related to public company auditing.

What is a Public Company?

A public company is a company that has issued securities such as stocks and bonds that can be bought and sold by the public on a stock exchange or an over-the-counter market. Public companies are required by federal law to regularly file a number of public financial reports to inform investors and policymakers about business performance. These reports, filed in accordance with rules established by the U.S. Securities and Exchange Commission (SEC), are an important tool for both individual and institutional investors and are essential to effective capital markets.

What is Public Company Auditing?

By law, public companies' annual financial statements are audited each year by independent auditors — accountants who examine the data for conformity with U.S. Generally Accepted Accounting Principles (GAAP). The auditors conduct a systematic examination of a company's accounting books, transaction records and other relevant documents to consider whether the financial statements are fairly presented and free from material misstatements. The auditor prepares a written report containing an opinion on the financial statements. That opinion is filed with the SEC and is available to investors and other interested parties.

The independent audit's overriding goal is to provide investors, capital market participants and policymakers with "reasonable assurance," beyond management's own assertions, that the financial statements can be relied upon for investment decisions and other purposes.

In addition to auditing financial statements, auditors often also assess the effectiveness of a company's internal controls over financial reporting. Internal controls are procedures designed by the company's management to address the risk of material errors and misstatements in financial statements. Auditor attestation that the controls are effective can boost investor confidence.

Investors' interests also are served when an auditor identifies control weaknesses and management addresses the shortcomings.

Auditors conduct a systematic examination to consider whether the financial statements are fairly presented and free from material misstatements.

Management, the Audit Committee and the Auditors

A company's management prepares the company's financial statements to inform investors and the public about the company's financial position and the results of its operations. Those statements and other related disclosures are examined by an independent auditing firm that is hired by the company's audit committee — board members who are responsible for overseeing a company's financial reporting and disclosure. The audit committee oversees the work of the auditor and monitors any disagreements between management and the auditor regarding financial reporting.

Auditors provide a written report that contains an opinion about whether the company's financial statements are fairly stated and comply with GAAP.

Who Are the Auditors?

Public company audit teams consist of accountants and other professionals under the leadership of senior Certified Public Accountants (CPA) employed by an accounting firm. The team is directed by an experienced CPA often designated as the "lead engagement partner." CPAs are accountants who, in addition to their college degree, have passed the Uniform Certified Public Accountant Examination™ and a special examination on ethics, and have relevant work experience. They also take at least 40 hours of appropriate continuing professional education each year.

Members of the audit team are selected based on their individual skills to match the specific requirements of each particular audit. The audit of a smaller business may be conducted by a relatively small team of accountants assembled by one of the hundreds of audit firms registered with the Public Company Accounting Oversight Board (PCAOB). The audit of a complex, global business, on the other hand, may require hundreds of professionals and would likely be conducted by one of the larger audit firms with international capabilities.

An audit team may include one or more members with in-depth knowledge of the client's business or industry. Other members of the team may specialize in valuations of the type of assets held by the client, or have experience with accounting for income taxes. Teams assigned to audit larger companies may include non-accounting professionals such as computer and systems experts, actuarial consultants and insurance specialists.

The audit team is directed by the lead engagement partner. Members are selected based on their individual skills.

What Does the Auditor Look For?

Independent audits are a core component of the U.S. financial system and help give investors, and the capital markets, the confidence to invest in public companies. Although clearly not a guarantee of the performance of such investments (which is affected by many factors), the close scrutiny provided by audits reduces "information risk" — the possibility that investment decisions will be based on inaccurate data. Without independent audits, investors would have to rely on management's word that its financial statements are accurate. Many investors likely would be less willing to risk their assets on data that has not withstood independent scrutiny.

The auditor follows professional standards in examining the books against established criteria, typically GAAP, to determine whether the financial statements provided by management reflect the business's operations and transactions during the time covered by those statements.

Without independent audits, investors would have to rely on management's word that its financial statements are accurate.

The examination of the financial statements includes sales, cash receipts, inventory levels and valuation, outstanding bills, liabilities, payroll and other operating expenses. Auditors will typically visit company offices, production facilities and other locations to learn about the business and verify the existence of physical assets or operations reported in the financial statements.

Auditors also may compare the company's experience with industry trends and patterns as they analyze whether the data makes sense. Individual metrics such as margins, inventory levels, uncollected revenues, late payments or debt levels that are out of line with similar companies may be an indicator that something is amiss and that further procedures are required. In designing the audit, the auditor will consider whether certain areas might require special scrutiny because of a company's business model. For example, examining inventory and inventory controls may be particularly important when auditing a manufacturer or a retailer. Similarly, examination of loan documentation is important when auditing a financial institution.

In examining internal controls over financial reporting, auditors will seek to ensure that the company has established effective procedures to reduce the chances of errors or fraud.

Internal controls can be as simple as requiring a second signature on checks over a certain amount or as complex as how and which employees are given access to sensitive information, including company data and computer programs.

The Audit Process

The audit process begins even before the auditor accepts an engagement with a prospective client. Prior to accepting an engagement, the audit firm will make a preliminary review to assess the potential risks, the nature and complexity of the prospective client's business, and whether the audit firm has the resources and expertise to perform the audit.

After accepting the engagement, the audit team meets with management of the company and the audit committee and begins to construct an audit plan based on an understanding of the company's business, its risks, and its controls to mitigate such risks, with a focus on the likelihood of any material misstatements in the company's financial statements. The auditors might review the public record, or gather information from outside analysts to learn about the industry and the company. The auditors determine the company's significant accounts and the type of transactions the company is involved in to determine what audit procedures to perform and how to assign audit resources. The planning process includes identifying the necessary audit evidence and the most effective procedures for collecting it.

The amount of time required to complete an audit depends in large part on the complexity of the task. The audit process ends with the completion of various quality control procedures prior to the audit firm's issuance of its report, including review procedures performed by another executive of the audit firm.

Finding Fraud

The preparation of an audit plan helps auditors identify areas of potential vulnerability for misconduct that require added attention, and/or areas where the risk of a financial misstatement might be greater than in other areas. For example, employees who work on commission may be tempted to accelerate the recording of sales to boost their earnings. The auditor might focus extra attention on sales and revenue recognition and examine a relatively larger number of transactions or test transactions around the end of the period for appropriate cut-off procedures by the company.

Because the audit's goal is "reasonable assurance," a properly planned and performed audit may not detect a material misstatement resulting from error or fraud.

Because the audit's goal under professional standards is "reasonable assurance" — not absolute assurance — that the financial statements being audited are free of material misstatements, a properly planned and performed audit may not detect a material misstatement resulting from error or fraud. Audits typically involve testing a sampling of data and exercising judgment about audit evidence — what to collect, how much is necessary, the extent and nature of testing, and the best way to gather it. Because auditors do not examine every transaction and event, there is no guarantee that all material misstatements, whether caused by error or fraud, will be detected.

The Audit Report

Once the audit is completed, the auditor issues an opinion via the audit report on the financial statements that falls into one of the following four categories:

- **"Unqualified" or Clean Audit Opinion:**
  In this context, "unqualified" means that in the auditor's professional opinion, the financial statements passed muster without any qualifications or exceptions. This is the most common audit outcome.

  An unqualified opinion means that the auditor has obtained reasonable assurance that the financial statements are free of material misstatement, and fairly present in all material respects the company's financial position as of the end of the most recent fiscal year and the results of operations and cash flows for the year, in conformity with GAAP. The words "reasonable assurance" and "material" are important because they indicate that the auditor does not scope the audit procedures to provide absolute assurance or to detect all misstatements, but rather performs selective procedures to identify those misstatements of significance that might affect decision-making by an investor or other user who relies on the audit opinion.

- **Unqualified Opinion With an Explanatory Paragraph:**
  This type of report is issued when the auditor believes the financial statements are fairly presented in all material respects in conformity with GAAP, but additional information should be disclosed. For example, an auditor might note a change in an accounting principle from a previous year, or that there is substantial doubt about the company's ability to continue as a going concern.

- **"Qualified" Opinion:**
  In a qualified opinion, the auditor reports that the financial statements are fairly presented in all material respects in conformity with GAAP, but with one or more specific exceptions, which the auditor describes. For example, the auditor might have identified a deviation from GAAP that has a material effect on the financial statements. In other instances, an auditor may not be able to obtain evidence to audit one or more areas of the financial statements. However, financial statements with such an opinion from the independent auditors are not acceptable to the SEC for purposes of satisfying a company's reporting requirements, and the SEC would require the company to take corrective measures.

- **Adverse or Disclaimer Opinion:**
  An adverse opinion is a failing grade that is issued when an auditor believes the financial statements taken as a whole are materially misstated or do not conform to GAAP. An adverse opinion typically signals significant problems that will make it difficult for a company to attract investors or access capital.

  In a disclaimer of opinion, the auditor declines to express an opinion because he or she was unable to access enough information to form an opinion, or because the scope of the audit was restricted by the company. This, too, would typically signal significant problems.

  Financial statements with either an adverse opinion or a disclaimer of opinion are not acceptable to the SEC for purposes of satisfying a company's reporting requirements, and the SEC would require the company to take corrective measures.

A new requirement, currently in effect for large public companies, is being phased in for smaller companies — the Opinion on Internal Control Over Financial Reporting. Depending on their size and other characteristics, some public companies are also required to file an opinion from their auditor stating whether the company maintained, in all material respects, effective internal control over financial reporting. The requirement will be in effect for all public companies by December 15, 2009.

Auditor Independence

Auditors' independence from company management is essential for a successful audit because it enables them to approach the audit with the necessary professional skepticism. To help protect their independence, external auditors report to a company's audit committee, who oversee the auditors' work and monitor any disagreements between management and the auditor regarding financial reporting.

In the past, auditors often were hired by and reported to company management with varying levels of audit committee involvement. Many observers believed that relationship made it more difficult to maintain independence. After several high-profile corporate frauds, the Sarbanes-Oxley Act of 2002 (SOX) strengthened corporate governance and auditor independence.

How Can Investors Access a Public Company's Financial Statements?

Every public company's annual financial statement, as well as other corporate information, is available to the public via the SEC's EDGAR Database at www.sec.gov/edgar/searchedgar/webusers.htm. A company's annual 10-K form is most useful, as it outlines the company's performance for the previous year. It is highly recommended that investors read a company's footnotes in addition to its financial statement to gain a full picture of the overall financial health of a company.

Detailed information on how to research public companies through the SEC's EDGAR Database can be found on the SEC's Web site at www.sec.gov/investor/pubs/edgarguide.htm.

The Sarbanes-Oxley Act

Named for its co-sponsors, Sen. Paul Sarbanes (D-Maryland) and Rep. Michael G. Oxley (R-Ohio), SOX was signed into law on July 30, 2002. Also known as the Public Company Accounting Reform and Investor Protection Act, SOX aimed to reinforce investor confidence and protect investors by improving the accuracy and reliability of corporate disclosure. SOX introduced highly significant changes to the financial reporting process and corporate governance by establishing new or enhanced standards for all U.S. public company boards, management and public accounting firms. The Act assigned new authority and responsibility to corporate audit committees, required public companies to make public assertions regarding their internal control over financial reporting and auditors to audit and publicly attest to those assertions, and also established the Public Company Accounting Oversight Board (PCAOB) for expanded regulatory oversight of the audits of public companies.

The Public Company Accounting Oversight Board

The PCAOB was established by SOX to oversee the audits of public companies in order to protect investors and enhance public confidence in the independent audit process. The PCAOB, which began operation in 2003, is charged with overseeing, regulating, inspecting and disciplining accounting firms in their roles as auditors of public companies. Any accounting firm that prepares or issues an audit report with respect to a public company, or that plays a substantial role in the preparation or furnishing of such a report, must register with the PCAOB and follow specific rules and guidelines it sets forth (see www.pcaobus.org for detailed information).

What is the Center for Audit Quality?

The CAQ is an autonomous member-based public policy organization serving investors, public company auditors and the capital markets. Its governing board is comprised of leaders from public company auditing firms and the American Institute of Certified Public Accountants (AICPA), as well as public board members who bring an outside perspective to the Center's agenda and activities. The CAQ is affiliated with the AICPA.

The CAQ's mission is to bolster public confidence in the audit process and to aid investors and the markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust.

The founding of the CAQ in January 2007 marked the first time public company auditors, as a group, have actively engaged with a variety of stakeholders — investors, issuers, regulators and educators — to foster a more robust dialogue among market participants. The mission of the CAQ is to bolster public confidence in the audit process and to aid investors and the markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust.

Public company auditors provide an essential perspective to the dialogue surrounding issues facing investors and the capital markets. By listening to those with the most at stake in quality audits and credible financial reporting, the CAQ is working to make public company audits even more reliable and relevant for investors, to facilitate productive discussion and develop viable solutions regarding marketplace challenges, and to modernize financial reporting to benefit all market participants.

CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

Affiliated with the American Institute of CPAs

Sources

Arens, A.A., Elder, R.J., & Beasley, M.S. (2006). Auditing and Assurance Services: An Integrated Approach (11th Edition). Pearson Prentice Hall.

Securities and Exchange Commission. (2002). *All about auditors: What investors need to know.* www.sec.gov/investor/pubs/aboutauditors.htm.

Securities and Exchange Commission. (2007). *SEC's Beginners Guide to Financial Statements.* www.sec.gov/investor/pubs/begfinstmtguide.htm.

InvestorWords.com: The biggest, best investing glossary on the Web. http://www.investorwords.com/3932/public_company.html.

Loth, R. (n/a). *What You Need to Know About Financial Statements.* http://investopedia.com/articles/basics/06/financialreporting.asp.

Investopedia Staff. (n/a). *Footnotes, Start Reading the Fine Print.* http://investopedia.com/articles/02/050102.asp.

CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets
Affiliated with the American Institute of CPAs

601 13th Street NW
Suite 800N
Washington, DC 20005
202.609.8120

www.TheCAQ.org