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Accounting

Principles of Auditing and Other Assurance Services
17th Edition

Whittington–Pany

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Preface

The 17th edition of *Principles of Auditing & Other Assurance Services* provides a carefully balanced presentation of auditing theory and practice. Written in a clear and understandable manner, it is particularly appropriate for students who have had limited or no audit experience. The approach is to integrate auditing material with that of previous accounting financial, managerial, and systems courses.

The text's first nine chapters emphasize the philosophy and environment of the auditing profession, with special attention paid to the nature and economic purpose of auditing, auditing standards, professional conduct, legal liability, audit evidence, audit planning, consideration of internal control, and audit sampling. Chapters 10 through 16 (the "procedural chapters") deal with internal control and obtaining evidence about the various financial statement accounts, emphasizing a risk-based approach to selecting appropriate auditing procedures. Chapter 17 presents the auditors' responsibilities under financial statement audits, integrated audits. Chapter 18 provides detailed guidance on integrated audits of public companies preformed in accordance with the Sarbanes-Oxley Act of 2002 and SEC requirements. Chapters 19 and 20 present the auditors' reporting responsibilities and other attestation and accounting services, such as reviews and compilations of financial statements and reports on prospective financial statements. Chapter 21 presents coverage of internal compliance and operational auditing.

The text is well suited for an introductory one-semester or one-quarter auditing course. Alternatively, it is appropriate for a two-course auditing sequence that covers the material in greater detail. For example, an introductory course might emphasize Chapters 1 through 10, 16, and 17. A second course may include coverage of the other procedural chapters (Chapters 11 through 15); integrated audits (18); other attestation and accounting services; and internal, operational, and compliance auditing (Chapters 19, 20, and 21). The instructor might also wish to consider covering portions of Chapter 9 on sampling in the second course, with or without ACL software. Overall, the text and supporting materials provide:

1. **A balanced presentation.** The text provides a carefully balanced presentation of auditing and assurance theory and practice. The concepts are written in a clear, concise, and understandable manner. Real company examples are integrated throughout the text to bring this material to life. Finally, Keystone Computers & Networks, Inc., the text's illustrative audit case, is integrated into selected chapters, providing students with hands-on audit experience.
2. **Organization around balance sheet accounts emphasized in previous accounting courses.** Organizing the text around balance sheet accounts is a particularly straightforward and user-friendly way to address the profession's recent risk assessment standards (*SASs 104–111*) for financial statement audits. These standards require an in-depth understanding of the audited company and its environment, a more rigorous assessment of the risks of where and how the financial statements could be materially misstated, and an improved linkage between the auditors' assessed risks and the particulars of audit procedures performed in response to those risks. Chapters 5 through 7 of the text describe the risk assessment approach in detail. Chapters 10 through 16 are aligned with the risk assessment approach presented in the new standards. Accordingly, the suggested audit approach and procedures of the professional standards flow smoothly from the approach suggested in earlier chapters of the text. In short, our organization of the book facilitates student learning of the risk assessment process in a very straightforward manner.
3. **CPA examination support.** This text includes both multiple choice questions and simulations aimed at helping students to pass the CPA exam.
4. **Strong student and instructor support.** The Online Learning Center provides instructors and students with a wealth of material to help keep students up-to-date. The Center also contains quizzes and other resources to help students in this course. The address of the Center (and the text Web site) is www.mhhe.com/whittington17e.

We are confident that the 17th edition of *Principles of Auditing & Other Assurance Services* will provide students with a clear perspective of today's auditing environment.

O. Ray Whittington
Kurt Pany

Notes

Chapter 1

The Role of the Public Accountant in the American Economy

Learning objectives

After studying this chapter, you should be able to:

- **LO1** Describe the nature of assurance services.
- **LO2** Identify assurance services that involve attestation.
- **LO3** Describe the nature of financial statement audits.
- **LO4** Explain why audits are demanded by society.
- **LO5** Describe how the credibility of the accounting profession was affected by the large number of companies reporting accounting irregularities in the beginning of this century.
- **LO6** Contrast the various types of audits and types of auditors.
- **LO7** Explain the regulatory process for auditors of public companies and auditors of nonpublic companies.
- **LO8** Describe how public accounting firms are typically organized and the responsibilities of auditors at the various levels in the organization.

Learning Objective 1

Describe the nature of assurance services.

Dependable information is essential to the very existence of our society. The investor making a decision to buy or sell securities, the banker deciding whether to approve a loan, the government in obtaining revenue based on income tax returns—all are relying upon information provided by others. In many of these situations, the goals of the providers of information run directly counter to those of the users of the information. Implicit in this line of reasoning is recognition of the social need for independent public accountants—individuals of professional competence and integrity who can tell us whether the information that we use constitutes a fair picture of what is really going on.

Our primary purpose in this chapter is to make clear the nature of independent audits and the accounting profession. We begin with a discussion of the broader concept of assurance services. Next, we describe those assurance services that involve attestation, of which audits of financial statements are an important type. Another purpose of this chapter is to summarize the influence exerted on the public accounting profession by the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), the Federal Accounting Standards Advisory Board (FASAB), the Public Company Accounting Oversight Board (PCAOB), and the Securities and Exchange Commission (SEC). We will also explore various types of audits and note the impact of The Institute of Internal Auditors (IIA) and the Government Accountability Office (GAO). Finally, we will examine other types of professional services and the nature and organization of public accounting firms.

What Are Assurance Services?

The name **assurance services** is used to describe the broad range of information enhancement services that are provided by certified public accountants (CPAs). In general, assurance services consist of two types: those that increase the reliability of information and those that involve putting information in a form or context that facilitates decision making. In this chapter we will focus on the first type—audit and assurance services that involve reliability enhancement.

The Attest Function

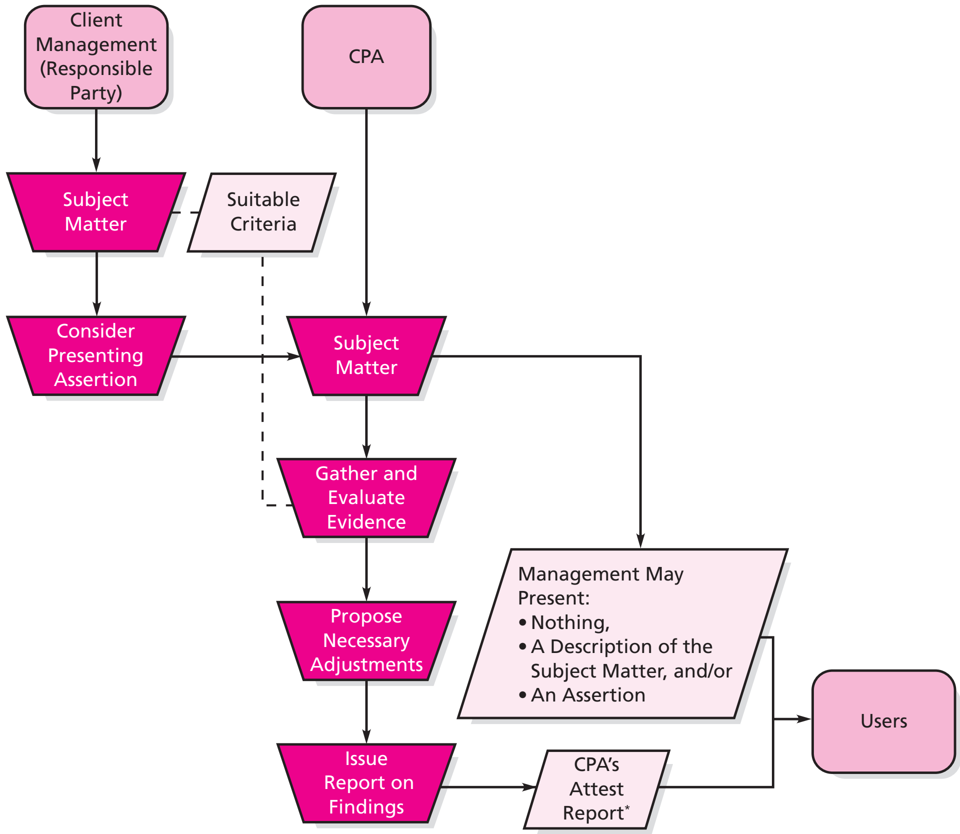
Learning Objective 2

Identify assurance services that involve attestation.

A major subset of assurance services is called *attestation services*. To attest to information means to provide assurance as to its reliability. More formally, an **attest engagement** is one in which:

> a practitioner is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter or an assertion about subject matter that is the responsibility of another party (e.g., management).

FIGURE 1.1
The Attest Function

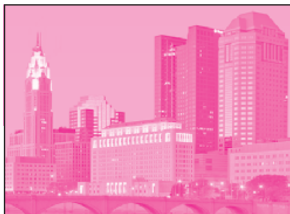


*If the criteria are not generally available to the users, they should be presented in the CPA's report or management's presentation.

CPAs attest to many types of subject matter (or assertions about subject matter), including financial forecasts, internal control, compliance with laws and regulations, and advertising claims.

Figure 1.1 describes the attest function, which begins with the subject matter that is the responsibility of another party, usually management. As an example, consider the situation in which the CPAs attest to a company's internal control over financial reporting. The subject matter of this engagement is internal control over financial reporting—internal control is the responsibility of management. The CPAs may be engaged to report directly on the internal control and express an opinion on whether a company's internal control over financial reporting follows certain *standards* (benchmarks). Alternatively, they may report on an assertion made by management that the company's internal control follows certain standards. In this second case the audit report would include an opinion on whether management's **assertion** is accurate. Managements of public companies are now required to include in their annual reports an assertion about the effectiveness of internal control over financial reporting and to engage their auditors to attest to the effectiveness of internal control. This form of reporting is described in detail in Chapters 7 and 18.

What standards must the subject matter follow? The standards are those established or developed by groups composed of experts and are referred to as **suitable criteria**. In an internal control engagement, the standards may be those that have been established by a committee of experts on internal control. In a financial statement audit, the standards may be **generally accepted accounting principles (GAAP)**; the CPAs perform an audit



Illustrative Case
The Value of Attest Services

CPAs have attested that a supermarket chain in Phoenix has the lowest overall prices in that city. The CPAs selected a sample of approximately 1,000 items and compared the prices to those of the various other major supermarkets. Representatives of the supermarket chain stated that the credibility added by the CPAs has helped to convince consumers that the chain's prices are indeed the lowest.

to gather sufficient evidence to issue their audit report which attests to the fairness of the financial statements (the subject matter).

The definition of an attest engagement refers to reports arising from three forms of engagements—examinations, reviews, and the performance of agreed-upon procedures. An **examination**, referred to as an *audit* when it involves historical financial statements, provides the highest form of assurance that CPAs can offer. In an examination, the CPAs select from all available evidence a combination that limits to a *low level* the risk of undetected misstatement and provides *reasonable assurance* that the subject matter (or assertion) is materially correct. A **review** is substantially lesser in scope of procedures than an examination and is designed to lend only a limited degree of assurance—a moderate risk of misstatement remains. If an examination or review does not meet the client's needs, the CPAs and specified user or users of the information may mutually decide on specific agreed-upon procedures that the CPAs will perform. An **agreed-upon procedures engagement** results in a report by the CPAs that describes those procedures and their findings. Figure 1.2 summarizes the three forms of attestation engagements.

Assurance and Nonassurance Services

It is important to understand the relationships among the range of services that are offered by CPAs, because different professional standards apply to each type of service. Figure 1.3 illustrates the universe of services that may be offered by CPAs and the relationships among these services. As shown, CPAs provide both assurance and nonassurance services but a few, specifically of the management consulting type, overlap. Certain management consulting services have assurance aspects. Later in this chapter, we will provide a brief description of the prevalent types of nonassurance services offered by CPA firms.

FIGURE 1.2 Forms of Attestation

Type of Engagement	Level of Assurance Provided	Risk of Material Misstatement	Nature of Assurance in Report	Procedures
Examination*	High ("reasonable")	Low	"In our opinion . . ."	Select from all available procedures any combination that can limit attestation risk to a low level
Review	Limited	Moderate	"Nothing came to our attention . . ."	Generally limited to inquiry and analytical procedures
Agreed-Upon Procedures	Summary of findings	Varies by specific engagement	Includes a summary of procedures followed and findings	Procedures agreed upon with the specified user or users

*Referred to as an *audit* when the subject matter is historical financial statements.

FIGURE 1.3
Relationships among Assurance Services, Attestation Services, and Nonassurance Services

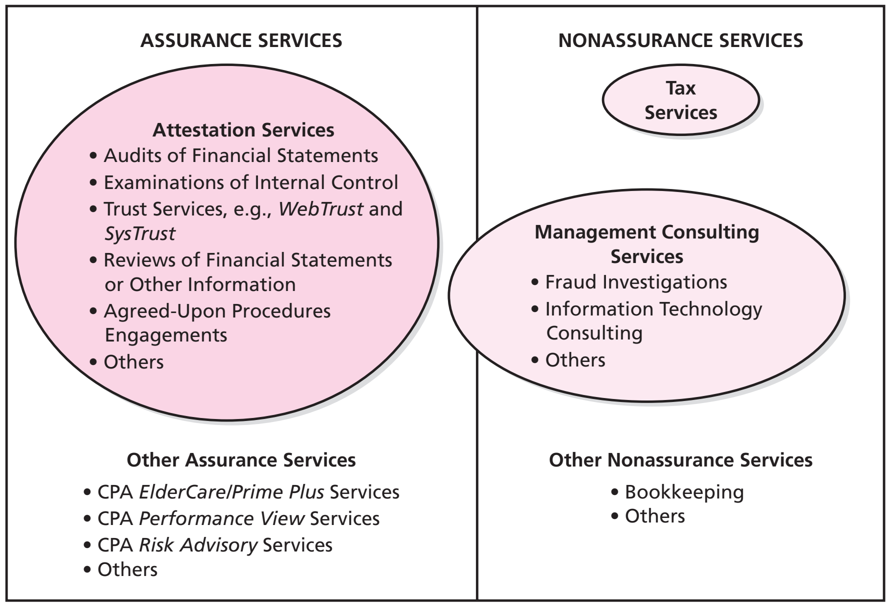


Figure 1.3 also illustrates that attestation services are only a portion of the assurance services that are offered by CPAs. A few examples of assurance services that do not involve attestation include:

- CPA *ElderCare/Prime Plus* services—providing assurance to individuals that their elderly family members' needs are being met by institutions and other professionals.
- CPA *Performance View* services—assisting in the development of performance measurement systems, or providing assurance about the effectiveness of the systems.
- CPA *Risk Advisory* services—assisting in the development of enterprise risk management systems, or providing assurance about the effectiveness of the systems.

Throughout the first 17 chapters of this textbook, we will focus primarily on the attest function as it relates to the audit of financial statements. Other types of attestation and assurance services are discussed in Chapters 18 through 21.

Financial Statement Audits

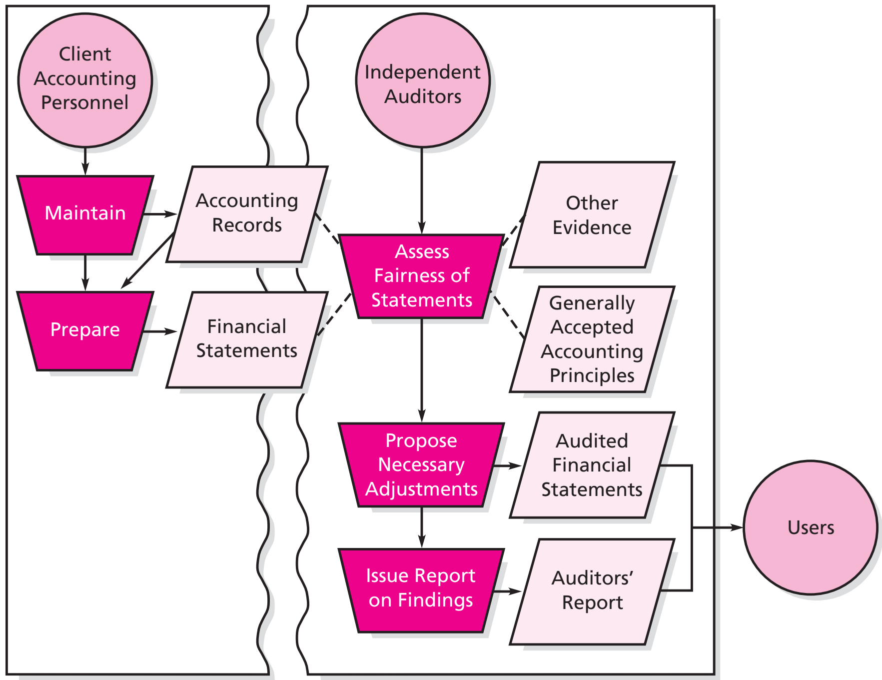
Learning Objective 3

Describe the nature of financial statement audits.

In a financial statement audit, the auditors undertake to gather evidence and provide a high level of assurance that the financial statements follow generally accepted accounting principles, or some other appropriate basis of accounting. An audit involves searching and verifying the accounting records and examining other evidence supporting the financial statements. By gathering information about the company and its environment, including internal control; inspecting documents; observing assets; making inquiries within and outside the company; and performing other auditing procedures, the auditors will gather the evidence necessary to issue an audit report. That audit report states that it is the auditors' opinion that the financial statements follow generally accepted accounting principles. The flowchart in Figure 1.4 illustrates an audit of financial statements.

The evidence gathered by the auditors focuses on whether the financial statements are presented in accordance with generally accepted accounting principles. More specifically, an audit addresses management's assertions that the assets listed in the balance sheet really exist, that the company has title (rights) to the assets, and that the valuations assigned to the assets have been established in conformity with generally accepted

FIGURE 1.4
Audit of Financial Statements



accounting principles. Evidence is gathered to show that the balance sheet contains *all the liabilities* of the company; otherwise the balance sheet might be grossly misleading because certain important liabilities have been accidentally or deliberately omitted. Similarly, the auditors gather evidence about the transactions recorded in the income statement. They demand evidence that the reported sales really occurred, that sales have been recorded at appropriate amounts, and that the recorded costs and expenses are applicable to the current period and all expenses have been recognized. Finally, the auditors consider whether the financial statement amounts are accurate, properly classified, and summarized and whether the notes are informative and complete. Only if sufficient evidence is gathered in support of all these significant assertions can the auditors provide an opinion on whether the financial statements are presented in accordance with generally accepted accounting principles.

The procedures included in an audit vary considerably from one engagement to the next. Many of the procedures appropriate to the audit of a small retail store would not be appropriate for the audit of a giant corporation such as General Motors. Auditors perform audits of all types of businesses, and of governmental and nonprofit organizations as well. Banks and breweries, factories and stores, colleges and churches, school districts and labor unions—all are regularly visited by auditors. The selection of the procedures best suited to each audit requires the exercise of professional skill and judgment.

What Creates the Demand for Audits?

Reliable accounting and financial reporting aid society in allocating resources in an efficient manner. A primary goal is to allocate limited capital resources to the production of those goods and services for which demand is great. Economic resources are attracted to the industries, the geographic areas, and the organizational entities that are shown by financial measurements to be capable of using the resources to the best advantage. Inadequate accounting and reporting, on the other hand, conceal waste and inefficiency, thereby preventing an efficient allocation of economic resources.

Learning Objective 4

Explain why audits are demanded by society.

The contribution of the independent auditor is to provide *credibility* to information. Credibility, in this usage, means that the information can be believed; that is, it can be relied upon by outsiders, such as stockholders, creditors, government regulators, customers, and other interested third parties. These third parties use the information to make various economic decisions, such as decisions about whether to invest in the organization.

Economic decisions are made under conditions of uncertainty; there is always a risk that the decision maker will select the wrong alternative and incur a significant loss. The credibility added to the information by auditors actually reduces the decision maker's risk. To be more precise, the auditors reduce information risk, which is the risk that the financial information used to make a decision is materially misstated.

Audited financial statements are the accepted means by which business corporations report their operating results and financial position. The word *audited,* when applied to financial statements, means that the balance sheet and the statements of income, retained earnings, and cash flows are accompanied by an audit report prepared by independent public accountants, expressing their professional opinion as to the fairness of the company's financial statements.

Financial statements prepared by management and transmitted to outsiders without first being audited by independent accountants leave a credibility gap. In reporting on its own administration of the business, management can hardly be expected to be entirely impartial and unbiased, any more than a football coach could be expected to serve as both coach and referee in the same game. Independent auditors have no material personal or financial interest in the business; their reports can be expected to be impartial and free from bias.

Unaudited financial statements may have been honestly, but carelessly, prepared. Liabilities may have been overlooked and omitted from the balance sheet. Assets may have been overstated as a result of arithmetical errors or due to a lack of knowledge of generally accepted accounting principles. Net income may have been exaggerated because expenses were capitalized or because sales transactions were recorded in advance of delivery dates.

Finally, there is the possibility that unaudited financial statements have been deliberately falsified in order to conceal theft and fraud or as a means of inducing the reader to invest in the business or to extend credit. Although deliberate falsification of financial statements is not common, it does occur and can cause devastating losses to persons who make decisions based upon such misleading statements.

For all these reasons (accidental errors, lack of knowledge of accounting principles, unintentional bias, and deliberate falsification), financial statements may depart from generally accepted accounting principles. Audits provide organizations with more credible financial statements to allow users to have more assurance that those statements do not materially depart from generally accepted accounting principles.

Illustrating the Demand for Auditing

A decision by a bank loan officer about whether to make a loan to a business can be used to illustrate the demand for auditing. Since the bank's objective in making the loan is to earn an appropriate rate of interest and to collect the principal of the loan at maturity, the loan officer is making two related decisions: (1) whether to make the loan at all, and (2) what rate of interest adequately compensates the bank for the level of risk assumed. The loan officer will make these decisions based on a careful study of the company's financial statements along with other information. The risk assumed by the bank related to this customer has two aspects:[1]

1. **Business risk**—the risk associated with a company's survival and profitability. This includes, for example, the risk that the company will not be able to make the interest payments and repay the principal of the loan because of economic conditions or poor

[1] For all loans, the banker also assumes *interest rate risk,* which varies depending on the terms of the loan. Interest rate risk reflects the risk due to potential changes in the "risk-free" interest rate.

management decisions. Business risk is assessed by considering factors such as the financial position of the company, the nature of its operations, the characteristics of the industry in which it operates, and the quality and integrity of its management.

2. **Information risk—**the risk that the information used to assess business risk is not accurate. Information risk includes the possibility that the financial statements might contain material departures from generally accepted accounting principles.

While auditing normally has only a limited effect on a company's business risk,[2] it can significantly affect the level of information risk. If the loan officer has assurance from the auditors that the company's financial statements are prepared in accordance with generally accepted accounting principles, he or she will have more confidence in his or her assessment of business risk. In addition, periodic audits performed after the loan has been made provide the loan officer with a way of monitoring management performance and compliance with the various loan provisions. By reducing information risk, the auditors reduce the overall risk to the bank; the loan officer is more likely to make the loan to the company and at a lower rate of interest. Therefore, management of the company has an incentive to provide audited financial statements to the loan officer to obtain the loan and to get the best possible interest rate.

A major portion of our economy is characterized by large corporate organizations that have gathered capital from millions of investors and that control economic resources spread throughout the country or even throughout the world. Top management in the corporate headquarters is often remote from the operations of company plants and branches and must rely on financial statements and other reports to control the corporation's resources. In brief, the decision makers in a large corporation cannot obtain much information on a firsthand basis. They must rely on information provided by lower-level management, and this fact creates a risk of receiving unreliable information. As in the case of the loan officer, auditing can reduce the risk of poor management decisions by reducing information risk and by monitoring the performance of management at every level within the organization.

The millions of individuals who have entrusted their savings to corporations by investing in securities rely upon annual and quarterly financial statements for investment decisions and for assurance that their invested funds are being used honestly and efficiently. Even greater numbers of people entrust their savings to banks, insurance companies, and pension funds, which in turn invest the money in corporate securities. Thus, directly or indirectly, almost everyone has a financial stake in corporate enterprises, and the public interest demands prompt, *reliable* financial reporting on the operations and the financial health of publicly owned corporations.

Various regulatory agencies also demand audit services. As an example, consider the income tax reporting system in our country. The information provided on tax returns is provided by taxpayers and may be biased because of the self-interest of the providers. The government attempts to compensate for this inherent weakness through verification by audits carried out by agents of the Internal Revenue Service.

Major Auditing Developments of the 20th Century

Although the objectives and concepts that guide present-day audits were almost unknown in the early years of the 20th century, audits of one type or another have been performed throughout the recorded history of commerce and government finance. The original meaning of the word *auditor* was "one who hears" and was appropriate to the era during which governmental accounting records were approved only after a public reading in which the accounts were read aloud. From medieval times on through the Industrial Revolution,

[2] Possible effects of an audit on business risk include modifications of management's operating decisions either due to knowledge that an audit will be performed or due to operating recommendations made by auditors. Accordingly, an audit *may* reduce business risk.

audits were performed to determine whether persons in positions of official responsibility in government and commerce were acting and reporting in an honest manner.

During the Industrial Revolution, as manufacturing concerns grew in size, their owners began to use the services of hired managers. With this separation of the ownership and management groups, the absentee owners turned increasingly to auditors to protect themselves against the danger of unintentional errors as well as fraud committed by managers and employees. Bankers were the primary outside users of financial reports (usually only balance sheets), and they were also concerned with whether the reports were distorted by errors or fraud. Before 1900, consistent with this primary objective to detect errors and fraud, audits often included a study of all, or almost all, recorded transactions.

In the first half of the 20th century, the direction of audit work tended to move away from fraud detection toward a new goal of determining whether financial statements gave a full and fair picture of financial position, operating results, and changes in financial position. This shift in emphasis was a response to the increasing number of shareholders and the corresponding increased size of corporate entities. In addition to the new shareholders, auditors became more responsible to governmental agencies, the stock exchanges representing these new investors, and other parties who might rely upon the financial information. No longer were bankers the only important outside users of audited financial data. The fairness of reported earnings became of prime importance.

As large-scale corporate entities developed rapidly in both Great Britain and the United States, auditors began to sample selected transactions, rather than study all transactions. Auditors and business managers gradually came to accept the proposition that careful examination of relatively few selected transactions would give a cost-effective, reliable indication of the accuracy of other similar transactions.

In addition to sampling, auditors became aware of the importance of effective internal control. A company's internal control consists of the policies and procedures established to provide reasonable assurance that the objectives of the company will be achieved, including the objective of preparing accurate financial statements. Auditors found that by studying the client's internal control they could identify areas of strength as well as of weakness. *The stronger the internal control, the less testing of financial statement account balances required by the auditors.* For any significant account or any phase of financial operations in which controls were weak, the auditors expanded the nature and extent of their tests of the account balance.

With the increased reliance upon sampling and internal control, professional standards began to emphasize limitations on auditors' ability to detect **fraud**. The profession recognized that audits designed to discover fraud would be too costly. Good internal control and surety bonds were recognized as better fraud protection techniques than audits.

Beginning in the 1960s, the detection of large-scale fraud assumed a larger role in the audit process. Professional standards, which used the term *irregularities* in place of fraud, described fraudulent financial reporting and misappropriation of assets. This shift in emphasis to taking a greater responsibility for the detection of fraud resulted from (1) a dramatic increase in congressional pressure to assume more responsibility for large-scale frauds, (2) a number of successful lawsuits claiming that fraudulent financial reporting (management fraud) had improperly gone undetected by the independent auditors, and (3) a belief by public accountants that audits should be expected to detect *material* fraud.

As a result of a number of instances of fraudulent financial reporting, the major accounting organizations[3] sponsored the *National Commission on Fraudulent Financial Reporting* (the Treadway Commission) to study the causes of fraudulent reporting and make recommendations to reduce its incidence. The commission's final report, which was issued in 1987, made a number of recommendations for auditors, public companies, regulators, and educators. Many of the recommendations for auditors were enacted by the

[3] The sponsoring organizations included the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute, The Institute of Internal Auditors, and the Institute of Management Accountants.

AICPA in a group of *Statements on Auditing Standards* known as the *expectation gap* standards. The commission's recommendations about internal control led to the development of an internal control framework, titled *Internal Control—Integrated Framework,* to be used to evaluate the internal control of an organization. The development of these internal control criteria increased the demand for attestation by auditors to the effectiveness of internal control. As an example, the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 was passed requiring management of large financial institutions to engage CPAs to attest to the effectiveness of assertions by management about the effectiveness of the institution's controls over financial reporting.

In the late 1980s and early 1990s, the billions of dollars in federal funds that were required to "bail out" the savings and loan industry caused a movement toward increased regulation of federally insured financial institutions. Congress and regulatory agencies believed that the key to preventing such problems was enacting effective laws and regulations and requiring reports by auditors on compliance with provisions of these laws and regulations. An important example of this type of legislation is the FDIC Improvement Act of 1991. In addition to requiring reporting on internal control, the law also requires management of large financial institutions to engage its CPAs to attest to management's assertion about the institution's compliance with laws and regulations related to the safety and soundness of the institution.

In 1996, in response to a continuing expectation gap between user demands and auditor performance, the AICPA issued guidance to auditors requiring an explicit assessment of the risk of material misstatement in financial statements due to fraud on all audits. This auditing standard was replaced in 2002 with an even more stringent standard that requires auditors to definitively design procedures to address the risk of fraudulent financial reporting.

A factor overlaying a number of changes has been fast-paced changes in information technology. From small computer accounting systems to large mainframe computers to networked enterprise-wide information systems to the use of the Internet to initiate and process transactions, auditing methods have had to adapt. While technology has not changed the basic objective of the financial statement audit, it has resulted in the need to develop innovative computer testing techniques and tools to assure audit effectiveness.

Many of the ideas mentioned in this brief historical sketch of the development of auditing will be analyzed in detail in later sections of this book. Our purpose at this point is merely to orient you with a quick overall look at some of the major auditing developments of the 20th century. These many developments, while significant, may be overshadowed by what has and will occur in the 21st century as the accounting profession faces significant challenges to its viability.

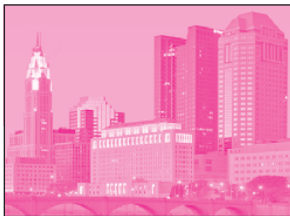
The Accounting Profession's Credibility Crisis

Learning Objective 5

Describe how the credibility of the accounting profession was affected by the large number of companies reporting accounting irregularities in the beginning of this century.

In 2000, at the request of the Securities and Exchange Commission, the accounting profession established the Panel on Audit Effectiveness. The panel was charged with the responsibility of reviewing and evaluating how independent audits of financial statements are performed and assessing whether recent trends in audit practices serve the public interest. Recommendations from the panel resulted in changes in auditing standards related to the detection of fraud, documentation of audit evidence and judgments, risk assessments, and the linkage of audit procedures to audit risks. However, even before these changes in audit requirements could be implemented, a series of events in the capital markets produced a chain reaction that caused unprecedented reforms in the accounting profession.

In December 2001 Enron Corporation filed for bankruptcy shortly after acknowledging that accounting irregularities had been used to significantly inflate earnings in the current and preceding years. Shortly thereafter, it was disclosed that WorldCom had used accounting fraud to significantly overstate its reported income. In addition to these two very visible cases, a record number of public companies restated prior-period financial statements, and almost weekly the Securities and Exchange Commission announced a new investigation



Illustrative Case

Massive Fraud at WorldCom

WorldCom reported over $11 billion in accounting irregularities, completely eliminating the company's previously reported profits for all of 2000 and 2001 and causing the company to declare bankruptcy.

At one time WorldCom had reported total assets in excess of $100 billion and a market value in excess of $150 billion, making it the largest bankruptcy in American history.

into another company's accounting practices. Investor uncertainty about the reliability of financial statements rocked an already weak financial market during the latter part of 2001 and the first half of 2002. It brought into question the effectiveness of financial statement audits and created a crisis of credibility for the accounting profession. More significantly, the highly publicized conviction of Andersen LLP, one of the then "Big 5" accounting firms, on charges of destruction of documents related to the Enron case brought into question the ethical principles of the public accounting profession.[4]

These events drew quick responses from a number of congressional committees, the SEC, and the U.S. Justice Department, as they began investigating corporate management and the accounting profession. By the summer of 2002, Congress had passed the **Sarbanes-Oxley Act of 2002**, which included a set of reforms that toughened penalties for corporate fraud, restricted the types of consulting CPAs may perform for public company audit clients, and created the Public Company Accounting Oversight Board (PCAOB) to oversee the accounting profession. The PCAOB, which has broad powers to develop and enforce standards for public accounting firms that audit companies that issue securities registered with the SEC, will be described in more detail later in this chapter.

Establishment of the PCAOB eliminated a significant portion of the accounting profession's system of self-regulation. It is clear that regulation of the profession, at least with respect to the audit of public (issuer) companies,[5] is no longer primarily in the hands of the accounting profession.

Types of Audits

Audits are often viewed as falling into three major categories: (1) financial audits, (2) compliance audits, and (3) operational audits. In addition, the Sarbanes-Oxley Act requires an integrated audit for public companies.

Financial Audits

Learning Objective 6

Contrast the various types of audits and types of auditors.

A **financial audit** is an audit of the financial accounting information of an entity. An **audit of financial statements** ordinarily covers the balance sheet and the related statements of income, retained earnings, and cash flows. The goal is to determine whether these statements have been prepared in conformity with generally accepted accounting principles. Financial statement audits are normally performed by firms of certified public accountants; however, internal auditors often perform financial audits of departments or business segments. Users of auditors' reports include management, investors, bankers, creditors, financial analysts, and government agencies.

[4] Ironically, the conviction of Andersen was overturned by the Supreme Court, but not before the firm had been dissolved.

[5] The AICPA and the PCAOB often use the terms *issuer* and *nonissuer* to refer to public and nonpublic companies, respectively. An issuer is a company that has securities registered with the SEC. We will use the terms public/issuer and nonpublic/nonissuer synonymously throughout this textbook.

Compliance Audits

The performance of a **compliance audit** is dependent upon the existence of verifiable data and of recognized criteria or standards, such as established laws and regulations, or an organization's policies and procedures. A familiar example is the audit of an income tax return by an auditor of the Internal Revenue Service (IRS). Such audits seek to determine whether a tax return is in compliance with tax laws and IRS regulations. The findings of the IRS auditors are transmitted to the taxpayer by means of the IRS auditor's report.

Another example of a compliance audit is the periodic bank examination by bank examiners employed by the Federal Deposit Insurance Corporation and the state banking departments. These audits measure compliance with banking laws and regulations and with traditional standards of sound banking practice.

Internal auditors perform audits of compliance with internal controls, other company policies and procedures, and applicable laws and regulations. Internal audit departments often are involved with documenting and testing internal control for management's reports required by the Sarbanes-Oxley Act.

Finally, many state and local governmental entities and nonprofit organizations that receive financial assistance from the federal government must arrange for compliance audits under the Single Audit Act or *OMB Circular A-133*. Such audits are designed to determine whether the financial assistance is spent in accordance with applicable laws and regulations. Compliance audits are described in greater detail in Chapter 21.

Operational Audits

An **operational audit** is a study of a specific unit of an organization for the purpose of measuring its performance. The operations of the receiving department of a manufacturing company, for example, may be evaluated in terms of its *effectiveness,* that is, its success in meeting its stated goals and responsibilities. Performance is also judged in terms of *efficiency,* that is, success in using to its best advantage the resources available to the department. Because the criteria for effectiveness and efficiency are not as clearly established as are generally accepted accounting principles and many laws and regulations, an operational audit tends to require more subjective judgment than do audits of financial statements or compliance audits. For example, quantifiable criteria often must be developed by the auditors to be used to measure the effectiveness or efficiency of the department. Operational auditing is also discussed in detail in Chapter 21.

Integrated Audits

The Sarbanes-Oxley Act requires that auditors of publicly traded companies in the United States perform an **integrated audit** that includes providing assurance on both the financial statements and the effectiveness of internal control over financial reporting. Specifically, the Sarbanes-Oxley Act and PCAOB *Standard No. 2*—which implements the integrated audit—require company management to assess and report on the company's internal control. The auditors, in addition to providing an opinion on the company's financial statements, report on both management's assessment and internal control effectiveness.

Types of Auditors

In addition to the audit of financial statements by certified public accountants, other professional groups carry on large-scale auditing programs. Among these other well-known types of auditors are internal auditors, auditors of the Government Accountability Office, and internal revenue agents.

Internal Auditors

Nearly every large corporation maintains an internal auditing staff. Internal auditors are also employed extensively by governmental and nonprofit organizations. A principal goal of the internal auditors is to investigate and appraise the effectiveness with which the various organizational units of the company are carrying out their assigned functions. Much attention is given by internal auditors to the study and appraisal of internal control.

A large part of the work of the internal auditors consists of operational audits; in addition, they may conduct numerous compliance audits. The number and kind of investigative projects vary from year to year. Unlike the CPAs, who are committed to verify each significant item in the annual financial statements, the internal auditors are not obligated to repeat their audits on an annual basis.

The internal auditing staff often reports to the audit committee of the board of directors and also to the president or another high-level executive. This strategic placement high in the organizational structure helps ensure that the internal auditors will have ready access to all units of the organization, and that their recommendations will be given prompt attention by department heads. It is imperative that the internal auditors be independent of the department heads and other line executives whose work they review. Thus, it would generally not be desirable for the internal auditing staff to be under the authority of the chief accountant. Regardless of their reporting level, however, the internal auditors are not independent in the same sense as the independent auditors. The internal auditors are employees of the organization in which they work, subject to the restraints inherent in the employer–employee relationship.

The Institute of Internal Auditors (IIA) is the international organization of internal auditors. It has developed various standards relating to internal auditing, and it administers the certified internal auditor (CIA) examination. Chapter 21 provides further discussion of the internal auditing profession and the CIA designation.

Government Accountability Office Auditors

Congress has long had its own auditing staff, headed by the comptroller general and known as the Government Accountability Office, or GAO.[6] The work of GAO auditors includes compliance, operational, and financial audits. These assignments include audits of government agencies to determine that spending programs follow the intent of Congress and operational audits to evaluate the effectiveness and efficiency of selected government programs. GAO auditors conduct examinations of corporations holding government contracts to verify that contract payments by the government have been proper. In addition, the financial statements of a number of federal agencies and the consolidated financial statements of the federal government are audited by the GAO.

The enormous size of many of the federal agencies has caused the GAO to stress the development of computer auditing techniques and statistical sampling plans. Its pioneering in these areas has led to the recognition of the GAO as a sophisticated professional auditing staff.

Internal Revenue Agents

The Internal Revenue Service is responsible for enforcement of the federal tax laws. Its agents conduct compliance audits of the income tax returns of individuals and corporations to determine that income has been computed and taxes paid as required by federal law. Although IRS audits include some simple individual tax returns that can be completed in an hour or so in an IRS office, they also include field audits of the nation's largest corporations and often involve highly complex tax issues.

The Public Accounting Profession

Learning Objective 7

Explain the regulatory process for auditors of public companies and auditors of nonpublic companies.

In recognition of the public trust afforded to public accountants, each state recognizes public accountancy as a profession and issues the certificate of **certified public accountant**. The CPA certificate is a symbol of technical competence. This official recognition by the state is comparable to that accorded to the legal, medical, and other professions.

The licensing of CPAs by the states reflects a belief that the public interest will be protected by an official identification of competent professional accountants who offer their

[6] The GAO changed its name from the General Accounting Office to the Government Accountability Office in 2004.

services to the public. Although CPAs provide various types of tax, consulting, and accounting services which are also provided by non-CPAs, the various states generally restrict the performance of audits of financial statements to CPAs. It is this performance of the attest function on financial statements that is most unique to CPAs.

American Institute of Certified Public Accountants

The **American Institute of Certified Public Accountants (AICPA)** is a voluntary national organization of more than 330,000 members. The following four major areas of the AICPA's work are of particular interest to students of auditing:

1. Establishing standards and rules to guide CPAs in their conduct of professional services.
2. Carrying on a program of research and publication.
3. Promoting continuing professional education.
4. Contributing to the profession's self-regulation.

Establishing Standards

The AICPA has assigned to its Auditing Standards Board (ASB) responsibility for issuing official pronouncements on auditing matters. A most important series of pronouncements on auditing by the Auditing Standards Board is entitled **Statements on Auditing Standards (SASs)**. The ASB currently has the authority to issue auditing standards only for audits of nonpublic companies. As indicated previously, the Public Company Accounting Oversight Board (PCAOB) issues standards for audits of public companies. The PCAOB has adopted the Auditing Standards Board's *Statements on Auditing Standards* that were in effect as of April 16, 2003 as interim standards for audits of publicly traded companies. The standards are "interim" in that they serve as a starting point as the PCAOB develops its own set of standards.

The AICPA also issues *Statements on Standards for Attestation Engagements* (SSAEs). These statements provide CPAs with guidance for attesting to information other than financial statements, such as financial forecasts. Chapter 2 also provides a description of the SSAEs.

The Accounting and Review Services Committee of the AICPA establishes standards for reporting on financial statements when the CPAs' role is to compile or review the financial statements rather than to perform an audit. The series of pronouncements by this committee is called *Statements on Standards for Accounting and Review Services* (SSARS). The SSARSs provide guidance for the many sensitive situations in which a public accounting firm is in some way associated with the financial statements of a nonpublic company and, therefore, needs to make clear the extent of the responsibility that the public accounting firm assumes for the fairness of the statements. SSARSs are discussed more fully in Chapter 19.

Research and Publication

In addition to the professional standards indicated above, the AICPA issues additional technical guidance. Many accounting students are familiar with the *Journal of Accountancy,* published monthly. Another AICPA monthly journal is *The Tax Advisor.* Publications bearing directly on auditing include:

- *Industry Audit and Accounting Guides.* These guides cover various industries, including, for example, *Audits of Casinos.*
- *Audit Risk Alerts.* These annual publications update auditors on practice issues and recently issued professional pronouncements that affect the audits of entities in various industries.
- *Auditing Practice Releases.* This series is intended to keep auditors informed of new developments and advances in auditing procedures.

A number of other AICPA publications bear directly on accounting issues, including:

- *Accounting Research Studies.* The results of studies of accounting methods are described in these publications.

- *Statements of Position* of the Accounting Standards Division. These statements express the AICPA's position on the appropriate method of accounting for particular events or transactions.
- *Accounting Trends & Techniques.* This is an annual study of current reporting practices of 600 large corporations.

Continuing Professional Education

Another important activity of the AICPA is the development of a continuing professional education program. Continuing education is a necessity for CPAs to remain knowledgeable about the unending stream of changes in accounting principles, tax law, auditing, computers, and consulting services. Continuing education programs are offered by the AICPA, state societies, and other professional organizations. State laws require CPAs to participate in continuing education programs as a condition for license renewal.

Professional Regulation

Historically, most of the regulation of accounting firms has been performed by the accounting profession itself through the AICPA. While the SEC has provided oversight and some regulation, prior to 2002 Congress had enacted limited legislation to regulate the profession. This situation changed significantly in 2002 with the passage of the Sarbanes-Oxley Act. As indicated previously, this legislation created the PCAOB, which now regulates all accounting firms that audit public (issuer) companies. The AICPA now provides very limited regulation for auditors of public companies but continues to regulate the accounting firms that do not audit public companies.

Regulation of Individual CPAs The membership of the AICPA has adopted ethical rules for CPAs in the form of its goal-oriented *Code of Professional Conduct.* This ethical code sets forth positively stated principles on which CPAs can make decisions about appropriate conduct. The AICPA *Code of Professional Conduct* is described completely in Chapter 3.

Self-regulation also is apparent in the requirements for regular membership in the AICPA, which include the following:

1. Members in public practice must practice with a firm enrolled in an approved practice (peer) review program.
2. New members must have 150 semester hours of college education, including a bachelor's degree from an accredited college or university.
3. Members must obtain continuing education: 120 hours every three years for members in public practice and 90 hours every three years for other members.

Regulation of Public Accounting Firms The AICPA also has a division in which the members are public accounting firms, rather than individual CPAs. The *Division for Public Accounting Firms* was created for the purpose of improving the quality of practice in public accounting firms of all sizes. The division has two sections: (1) the *Center for Public Company Audit Firms* and (2) the *Private Companies Practice Section* (PCPS).

The *Center for Public Company Audit Firms* is a voluntary membership organization of firms that audit or are interested in auditing public companies. The Center's purpose is to promote improvement in the quality of audits of public companies through the communication of information about SEC and PCAOB developments and the development of technical and educational information for members. The Center for Public Company Audit Firms also has a peer review program for the nonpublic company accounting and auditing practices of its members. The audits of public companies performed by these firms are subject to inspection by the PCAOB staff.

The *PCPS* attempts to improve the quality of accounting firms that audit nonpublic companies. A major requirement for membership in the section is periodic peer (practice) review. A *peer review* involves a critical review of one public accounting firm's practices by another public accounting firm. Such an external review clearly offers a more objective evaluation of the quality of performance than could be made by self-review. The purpose of this concept is to encourage rigorous adherence to the AICPA's quality control standards. Quality control standards and the peer review process are discussed in detail in Chapter 2.

The AICPA—In Perspective

Throughout its existence, the AICPA has contributed enormously to the evolution of generally accepted accounting principles as well as to the development of professional standards. The many technical divisions and committees of the institute (such as the Auditing Standards Board) provide a means of focusing the collective experience and ability of the profession on current problems. However, with the passage of the Sarbanes-Oxley Act, the AICPA's influence and responsibility have been significantly diminished.

The CPA Examination

The **CPA examination** is a uniform national examination prepared and graded by the American Institute of Certified Public Accountants. The exam is computerized and given on demand at computer centers throughout most of the year.

Although the preparation and grading of the examination are in the hands of the AICPA, the issuance of CPA certificates is a function of each state or territory. Passing the CPA examination does not, in itself, entitle the candidate to a CPA certificate; states have experience and education requirements that must be met before the CPA certificate is awarded.

The CPA examination is essentially an academic one; in most states, candidates are not required to have any work experience to sit for the examination. In the opinion of the authors, the ideal time to take the examination is immediately after the completion of a comprehensive program of accounting courses in a college or university. The format of the CPA examination includes the following four parts:

1. Auditing & Attestation.
2. Financial Accounting & Reporting (business enterprises, not-for-profit organizations, and governmental entities).
3. Regulation (professional responsibilities, business law, and taxation).
4. Business Environment & Concepts.

The exam consists of multiple choice questions and simulations, which are designed to replicate "real world" practice cases. The compilation of the questions and problems included in this textbook involved a review of CPA questions used in prior years and the selection of representative questions and problems. Use of this material is with the consent of the AICPA. Many other problems and questions (not from CPA examinations) are also included with each chapter.

State Boards of Accountancy

Permits to practice as a CPA are granted by the state boards of accountancy in the various states. These boards also regulate the profession and may suspend or revoke an accountant's certificate. While all state boards require successful completion of the CPA examination, the requirements for education and experience vary. A few states require only a baccalaureate degree, while most require 150 semester hours of education or a master's degree to sit for the CPA examination. The experience required generally ranges from none to two years. The AICPA currently is attempting to get states to adopt the revised Uniform Accounting Act to facilitate CPA practice across state lines. The state boards are organized through the National Association of State Boards of Accounting (NASBA).

Financial Accounting Standards Board

Auditors must determine whether financial statements are prepared in conformity with generally accepted accounting principles. The AICPA has designated the Financial Accounting Standards Board as the body with power to set forth these principles for entities other than federal, state, and local governments. Thus, *FASB Statements,* exposure drafts, public hearings, and research projects are all of major concern to the public accounting profession.

The structure, history, and pronouncements of the FASB (and its predecessor, the Accounting Principles Board) are appropriately covered in introductory, intermediate, and advanced accounting courses.

Governmental Accounting Standards Board

The Governmental Accounting Standards Board (GASB) was formed in 1984 to establish and improve standards of financial accounting for state and local government entities. The operational structure of the GASB is similar to that of the FASB. Auditors of state and local government entities, such as cities and school districts, look to the GASB pronouncements for the appropriate accounting principles.

Federal Accounting Standards Advisory Board

In 1990, the federal Office of Management and Budget, the U.S. Treasury, and the General Accounting Office (since renamed the Government Accountability Office) established the Federal Accounting Standards Advisory Board (FASAB) to develop accounting standards for the U.S. government. This body issues standards that are used to audit a number of major federal agencies and the U.S. government as a whole as required by the Government Management Reform Act of 1994.

The Public Company Accounting Oversight Board

As indicated previously, the **Public Company Accounting Oversight Board (PCAOB)** was created in 2002 to oversee and discipline CPAs and public accounting firms that audit public (issuer) companies. This five-member board, under the authority of the SEC, has the responsibility to establish or adopt "auditing, attestation, quality control, ethics, and independence standards relating to the preparation of audit reports" for SEC registrants (almost all publicly traded companies in the United States). In addition, the PCAOB has the responsibility to:

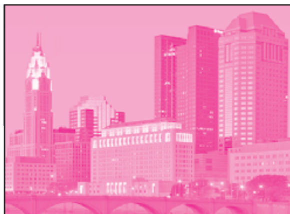
- Register public accounting firms that audit public companies.
- Perform inspections of the practices of registered firms.
- Conduct investigations and disciplinary proceedings of registered firms.
- Sanction registered firms.

As indicated previously, the inspection program of the PCAOB covers only the public company audit practice of CPA firms. The results of the inspections are posted on the PCAOB's Web site at www.pcaobus.org.

Securities and Exchange Commission

The **Securities and Exchange Commission (SEC)** is an agency of the U.S. government. It administers the Securities Act of 1933, the Securities Exchange Act of 1934, and other legislation concerning securities and financial matters. In addition, the SEC has oversight responsibility for the PCAOB. The primary function of the SEC is to protect investors and the public by requiring full disclosure of financial information by companies offering securities for sale to the public. A second objective is to prevent misrepresentation, deceit, or other fraud in the sale of securities.

The term *registration statement* is an important one in any discussion of the impact of the SEC on accounting practice. To *register* securities means to qualify them for sale to the public by filing with the SEC financial statements and other data in a form acceptable to the commission. A registration statement contains *audited financial statements,* including balance sheets for a two-year period and income statements and statements of cash flows for a three-year period.



Illustrative Case

Exiting the Consulting Business

Most of the large CPA firms sold or spun off their consulting practices. As examples, IBM bought the consulting practice of Pricewaterhouse-Coopers LLP, KPMG LLP spun off its consulting practice and took it public, and Ernst & Young LLP sold its consulting practice to Cap Gemini. The firms now provide a limited set of consulting services.

The legislation creating the SEC made the commission responsible for determining whether the financial statements presented to it reflect proper application of accounting principles. To aid the commission in discharging this responsibility, the securities acts provide for an examination and report by a public accounting firm registered with the Public Company Accounting Oversight Board. From its beginning, the SEC has been a major user of audited financial statements and has exercised great influence upon the development of accounting principles, the strengthening of auditing standards, and the concept of auditor independence.

Protection of investors, of course, requires that the public have available the information contained in a registration statement concerning a proposed issue of securities. The issuing company is therefore required to deliver to prospective buyers of securities a *prospectus,* or selling circular, from the registration statement. The registration of securities does not insure investors against loss; the SEC does not pass on the merit of securities. There is, in fact, only one purpose of registration: to provide disclosure of the important facts so that the investor has available all pertinent information on which to base an intelligent decision as to whether to buy a given security. If the SEC believes that a given registration statement does not meet its standards of disclosure, it may require amendment of the statement or may issue a stop order preventing sale of the securities.

To improve the quality of the financial statements filed with it and the professional standards of the independent accountants who report on these statements, the SEC has adopted a basic accounting regulation known as *Regulation S-X* and entitled *Form and Content of Financial Statements.* Between 1937 and 1982, the SEC issued 307 *Accounting Series Releases* (ASRs) addressing various accounting and auditing issues. In 1982 the series was replaced by two series—*Financial Reporting Releases* and *Accounting and Auditing Enforcement Releases. Financial Reporting Releases* present the SEC's current views on financial reporting and auditing issues. *Accounting and Auditing Enforcement Releases* summarize enforcement activities against auditors when the SEC has found deficiencies in the auditors' work. In addition, the standards of the PCAOB must be adopted through the SEC's regulation process.

Other Types of Professional Services

In addition to auditing and other assurance services, public accounting firms offer other types of services to their clients, including tax services, consulting services, accounting and review services, fraud investigation services, and personal financial planning. Public accounting firms tend to specialize in particular types of services depending on their size and the expertise of their personnel.

Tax Services

Tax services that are performed by public accounting firms fall into two broad categories: compliance work and tax planning. Compliance work involves preparing the federal, state, and local tax returns of corporations, partnerships, individuals, and estates and trusts. Tax planning, on the other hand, involves consulting with clients on how to structure their business affairs to legally minimize the amount and postpone the payment of their taxes.

Consulting Services

Public accounting firms offer a variety of services that are designed to improve the effectiveness and efficiency of their clients' operations. Initially, these services developed as a natural extension of the audit and primarily involved consulting on accounting and internal control systems. In recent years, public accounting firms have expanded by offering a host of services that tend to be more operational in nature. Examples are developing strategic planning models and management information systems and performing executive search services.

Performance of consulting services for audit clients has been a significant issue with respect to the independence of auditors, so much so that a number of restrictions have been placed on the types and extent of consulting services that may be performed by the auditors of public companies. This issue will be discussed in more detail in Chapter 3.

Accounting and Review Services

Audits are expensive. For a small business, the cost of an audit will run into the thousands of dollars; for large corporations, the cost may exceed a million dollars. The most common reason for a small business to incur the cost of an audit is the influence exerted by a bank that insists upon audited financial statements as a condition for granting a bank loan. If a small business is not in need of a significant amount of bank credit, the cost of an audit may exceed its benefits.

An alternative is to retain a public accounting firm to perform other services for nonpublic (nonissuer) companies, such as the compilation or review of financial statements. To compile financial statements means to prepare them; this service is often rendered when the client does not have accounting personnel capable of preparing statements. The public accounting firm issues a compilation report on the financial statements that provides *no assurance* that the statements are presented fairly in accordance with generally accepted accounting principles.

A review of financial statements by a public accounting firm is an attestation service that is substantially less in scope than an audit. It is designed to provide *limited assurance* on the credibility of the statements. A review stresses inquiries by the CPA and the comparison of amounts in the statements to comparable financial and nonfinancial data. These comparisons, which are referred to as analytical procedures, are useful in bringing to light possible misstatements of financial statement amounts. Compilations and reviews are discussed in Chapter 19.

Litigation Support Services

The level of litigation in the United States has created a fast-growing area of practice. CPAs are often used in business litigation cases as expert witnesses to calculate damages or explain complex business and accounting concepts to judges and juries. As a result, many public accounting firms have developed departments that specialize in litigation support services.

Fraud Investigation Services

Fraud investigation services generally involve engaging professionals to investigate suspected or known fraud. These types of services are also referred to as *forensic accounting services,* but forensic accounting is somewhat broader and includes litigation support services. Because of increased identified incidences of defalcation and theft, fraud investigation has become a significant part of the work performed by many internal audit departments. These types of services are also a practice specialty for many public accounting firms. To demonstrate expertise in the area of fraud investigation, the designation "Certified Fraud Examiner" has been developed by the Association of Certified Fraud Examiners.

Personal Financial Planning

Public accounting firms also may advise individuals on their personal financial affairs. For example, a public accounting firm may review a client's investment portfolio and evaluate whether the nature of the investments meets the client's financial objectives. The public accounting firm might also advise the client on the nature and amount of insurance coverage that is appropriate. The AICPA offers the designation "Personal Financial Specialist" to CPAs who satisfy certain experience requirements and pass a one-day examination on personal financial planning topics, such as income tax planning, risk management planning, investment planning, retirement planning, and estate planning.

Organization of the Public Accounting Profession

Learning Objective 8

Describe how public accounting firms are typically organized and the responsibilities of auditors at the various levels in the organization.

Many public accounting firms are organized as either sole practitioners or partnerships. A CPA may also practice as a member of a professional corporation or, in many states, as a *limited liability partnership* (LLP) or a *limited liability company* (LLC).

Professional corporations differ from traditional corporations in a number of respects. For example, all shareholders and directors of a professional corporation must be engaged in the practice of public accounting. In addition, shareholders and directors of the professional corporation may be held personally liable for the corporation's actions, although they may choose to carry liability insurance to cover damages caused by negligent actions. *Limited liability partnerships (companies)* are similar to professional corporations, but they provide for the protection of the personal assets of any shareholders or partners not directly involved in providing services on engagements resulting in litigation.

In comparison with a sole proprietorship, partnerships and professional corporations with multiple owners have several advantages. When two or more CPAs join forces, the opportunity for specialization is increased, and the scope of services offered to clients may be expanded. Also, qualified members of the staff may be rewarded by admission to the partnership or issuance of stock. Providing an opportunity to become part owner of the business is an important factor in the public accounting firm's ability to attract and retain competent personnel.

Public accounting firms range in size from one person to over 100,000 on the professional staff. In terms of size, public accounting firms are often grouped into the following four categories: local firms, regional firms, national firms, and Big 4 firms.

Local Firms

Local firms typically have one or two offices, include only one CPA or a few CPAs as partners, and serve clients in a single city or area. These firms often emphasize income tax, consulting, and accounting services. Auditing is usually only a small part of the practice and tends to involve small business concerns that find a need for audited financial statements to support applications for bank loans.

Regional Firms

Many local firms have become regional firms by opening additional offices in neighboring cities or states and increasing the number of professional staff. Merger with other local firms is often a route to regional status. This growth is often accompanied by an increase in the amount of auditing as compared to other services.

National Firms

Public accounting firms with offices in most major cities in the United States are called national firms. These firms may operate internationally as well, either with their own offices or through affiliations with firms in other countries.

Big 4 Firms

Often in the news are the large international public accounting firms. Until 1989, there were eight of these firms. However, mergers and the dissolution of (Arthur) Andersen LLP have reduced them to the Big 4. Since only a very large public accounting firm has sufficient staff and resources to audit a giant corporation, these firms audit nearly all of the largest American corporations. Although these firms offer a wide range of professional services, auditing represents a large, if not the largest, share of their work. Annual revenue of an international firm is in the billions of dollars. In alphabetical order, the four firms are Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and Pricewaterhouse-Coopers LLP.

Alternative Practice Structure Firms

Beginning in the late 1990s a number of publicly traded companies—including American Express, CBIZ, Inc., and H&R Block—began purchasing public accounting firms. These companies are often referred to as "consolidators" because they purchase public accounting firms in various cities and consolidate them into the overall corporation. In essence the approach is to purchase the nonattest portion of the practice, hire public accounting firm partners and other personnel as employees of the publicly traded company, and perform those services. The attest and auditing partners retain that status in the public accounting firm, but ordinarily they are also employees of the publicly traded company. The public accounting firm then provides attestation services, using partners and other staff members leased from the public company. This trend is having a profound effect on the public accounting profession, as we will indicate in several places throughout the text. For example, ethical complications are discussed in Chapter 3.

Industry Specialization

Public accounting firms have long recognized the value of industry specialization. When they possess a detailed knowledge and understanding of a client's industry, the auditors can be more effective at collecting and evaluating audit evidence. Also, they are in a better position to make valuable suggestions that will improve the client's operations and to provide the client consulting services.

A number of national and Big 4 public accounting firms have organized their firms along industry lines. Each industry group is made up of personnel involved in providing audit, tax, and consulting services for a specialized industry. The firms believe that such an organizational structure leads to the performance of higher-quality, integrated services to firms in specialized industries.

Responsibilities of the Professional Staff

Human resources—the competence, judgment, and integrity of personnel—represent the greatest asset of any public accounting firm. The professional staff of a typical public accounting firm includes partners, managers, senior accountants, and staff assistants.

Partners

The lead partner on an engagement is responsible for assuring that the audit is performed in accordance with applicable professional standards. Accordingly, this individual is ultimately responsible for adequate planning, supervision, and execution of the audit. Partners are also responsible for maintaining primary contacts with clients. These contacts include discussing with clients the objectives and scope of the audit work, resolving controversies that may arise as to how items are to be presented in the financial statements, and attending the client's stockholders' meetings to answer any questions regarding the financial statements or the auditors' report. Other responsibilities of the partner include recruiting new staff members, general supervision of the professional staff, reviewing audit working papers, and signing the audit reports.

Specialization by each partner in a different area of the firm's practice is often advantageous. One partner, for example, may have expertise in tax matters and head the firm's tax department; another may specialize in SEC registrations; and a third may devote full time to design and installation of computer information systems.

The partnership level in a public accounting firm is comparable to that of top management in an industrial organization. Executives at this level are concerned with the long-run well-being of the organization and of the community it serves. They should and do contribute important amounts of time to civic, professional, and educational activities in the community. Participation in the state society of certified public accountants and in the AICPA is, of course, important if the partners are to do their share in building the profession. Contribution of their specialized skills and professional judgment to leadership of civic organizations is equally important to developing the economic and social environment in which business and professional accomplishment is possible.

An important aspect of partners' active participation in various business and civic organizations is the prestige and recognition that may come to their firms. Many clients select a particular public accounting firm because they have come to know and respect one of the firm's partners. Thus, partners who are widely known and highly regarded within the community may be a significant factor in attracting business to the firm.

Managers

In large public accounting firms, managers or supervisors perform many of the duties that would be discharged by partners in smaller firms. A manager may be responsible for supervising two or more concurrent audit engagements. This supervisory work includes reviewing the audit working papers and discussing with the audit staff and with the client any accounting or auditing problems that may arise during the engagement. The manager is responsible for determining the audit procedures applicable to specific audits and for maintaining uniform standards of fieldwork. Often, managers have the administrative duties of compiling and collecting the firm's billings to clients.

Familiarity with tax laws, as well as a broad and current knowledge of accounting theory and practice, is an essential qualification for a successful manager. Like the partner, the audit manager may specialize in specific industries or other areas of the firm's practice.

Senior Auditors

The responsibility assumed by the senior "in-charge" auditor varies based on the size of the engagement. On a smaller engagement, the senior auditor may assume responsibility for planning and conducting the audit and drafting the audit report, subject to review and approval by the manager and partner. On larger engagements a senior auditor may assume responsibility for supervising some aspect of the audit, such as the audit of accounts receivable. In conducting the audit, the senior will delegate most audit tasks to assistants based on an appraisal of each assistant's ability to perform particular phases of the work. A well-qualified university graduate with a formal education in accounting may progress from staff assistant to senior auditor within two or three years, or even less.

One of the major responsibilities of the senior is on-the-job staff training. In assigning work to staff assistants, the senior should make clear the end objectives of the particular audit operation. By assigning assistants a wide variety of audit tasks and by providing constructive criticism of the assistants' work, the senior should try to make each audit a significant learning experience for the staff assistants.

Reviewing working papers shortly after they are completed is another duty of the senior in charge of an audit. This enables the senior to control the progress of the work and to ascertain that each phase of the engagement is adequately covered. At the conclusion of the fieldwork, the senior will make a final review, including tracing items from individual working papers to the financial statements.

The senior will also maintain a continuous record of the hours devoted by all members of the staff to the various phases of the audit. In addition to maintaining uniform professional standards of fieldwork, the senior is responsible for preventing the accumulation of excessive staff hours on inconsequential matters and for completing the entire engagement within the budgeted time, if possible.

Staff Assistants

The first position of a college graduate entering the public accounting profession is that of staff assistant. Staff assistants usually encounter a variety of assignments that fully utilize their capacity for analysis and growth. Of course some routine work must be done in every audit engagement, but college graduates with thorough training in accounting need have little fear of being assigned for long to extensive routine procedures when they enter the field of public accounting. Most firms are anxious to increase the assigned responsibility to younger staff members as rapidly as they are able to assume it. Ordinarily, the demand for accounting services is so high as to create a situation in which every incentive exists for the rapid development of promising assistants.

The audit staff members of all public accounting firms attend training programs that are either developed "in house" or sponsored by professional organizations. One of the most attractive features of the public accounting profession is the richness and variety of experience acquired even by the beginning staff member. Because of the high quality of the experience gained by certified public accountants as they move from one audit engagement to another, many business concerns select individuals from the public accounting field to fill such executive positions as controller or treasurer.

Professional Development for Public Accounting Firm Personnel

A major challenge in public accounting is keeping abreast of current developments within the profession. New business practices; new pronouncements by the Auditing Standards Board, the PCAOB, the SEC, the FASB, and the GASB; and changes in the tax laws are only a few of the factors that require members of the profession continually to update their technical knowledge.

A public accounting firm must make certain that the professional staff remains continuously up-to-date on technical issues. To assist in this updating process, most large public accounting firms maintain a separate professional development section.

Professional development sections offer a wide range of seminars and educational programs to personnel of the firm. The curriculum of each program is especially designed to suit the needs and responsibilities of participants. Partners may attend programs focusing on the firm's policies on audit quality control or current developments in a specialized industry; on the other hand, programs designed for staff assistants may cover audit procedures or use of the firm's audit software. In addition to offering educational programs, the professional development section usually publishes a monthly newsletter or journal for distribution to personnel of the public accounting firm and other interested persons.

Many public accounting firms that are too small to maintain their own professional development departments have banded together into associations of public accounting firms. These associations organize educational programs, distribute information on technical issues, and engage in other professional activities that are designed to meet the needs of their members. Since the costs of the association's professional activities are shared by all members, the firms are provided with many of the benefits of having their own professional development department at a fraction of the cost.

Seasonal Fluctuations in Public Accounting Work

One of the traditional disadvantages of the public accounting profession has been the concentration of work during the "busy season" from December through April, followed by a period of slack demand during the summer months. This seasonal trend is caused by the fact that many companies keep their records on a calendar-year basis and require auditing services immediately after the December 31 closing of the accounts. Another important factor is the spring deadline for filing of federal income tax returns.

Auditors often work a considerable number of hours of overtime during the busy season. Some public accounting firms pay their staff for overtime hours. Other firms allow their staff to accumulate the overtime in an "overtime bank" and to "withdraw" these hours in the form of additional vacation time during the less busy times of the year.

Relationships with Clients

The wide-ranging scope of public accountants' activities today demands that CPAs be interested in and well informed on economic trends, political developments, and other topics that play a significant part in business and social contacts. Although an in-depth knowledge of accounting is the most important qualification of the CPA, an ability to meet people easily and to gain their confidence and goodwill may be no less important in achieving success in the profession of public accounting. The ability to work effectively with clients will be enhanced by a sincere interest in their problems and by a relaxed and cordial manner.

The question of the auditor's independence inevitably arises in considering the advisability of social activities with clients. The partner in today's public accounting firm may play golf or tennis with the executives of client companies and other business associates. These relationships actually may make it easier to resolve differences of opinions that arise during an audit, if the client has learned to know and respect the partner. This mutual understanding need not prevent the CPA from standing firm on matters of accounting principle. Alternatively, such relationships have the potential for impairing auditor independence. Auditor response to differences of opinions when such relationships exist is perhaps the "moment of truth" for the practitioners of a profession.

The CPA must always remember that the concept of independence embodies an *appearance* of independence. This appearance of independence may be impaired if an auditor becomes excessively involved in social activities with clients. For example, if a CPA frequently attends lavish parties held by a client or dates an officer or employee of a client corporation, the question might be raised as to whether the CPA will appear independent to outsiders. This dilemma is but one illustration of the continual need for judgment and perspective on the part of the auditor.

Chapter Summary

This chapter explored the nature of assurance services, the attest function, independent audits, and the auditing profession. To summarize:

1. CPAs provide a wide array of information enhancement services referred to as assurance services. Currently, the primary type of assurance service provided by CPAs involves attestation. When performing attestation services, CPAs enhance the reliability of information by issuing an examination, review, or agreed-upon procedures report on subject matter or an assertion that is the responsibility of another party. In the case of financial statement audits, the report most frequently includes an opinion about whether management's financial statements conform to generally accepted accounting principles.
2. Since audits involve examinations of financial information by independent experts, they increase the credibility of the information contained in the statements. Decision makers both within and outside the organization can use audited financial information with confidence that it is not likely to be materially misstated. Audits reduce information risk and, therefore, they reduce the overall risk of making various types of economic decisions.
3. The nature and emphasis of auditing has changed over the years. Auditing began with the objective of detecting fraud by examination of all, or most, business transactions. Today the objective of an audit is to attest to the fairness of the financial statements. Because of the large size of business organizations, audits necessarily involve the use of sampling techniques based on the auditors' consideration of the organization's controls. CPAs also are being asked to assume more responsibility for attesting to compliance with laws and regulations and the effectiveness of controls.
4. Due to a number of very visible instances of fraudulent financial reporting, Congress passed the Sarbanes-Oxley Act of 2002. This act significantly changed the nature of audits of public (issuer) companies, as well as the regulation of auditors that perform such audits. The act created the Public Company Accounting Oversight Board (PCAOB) to regulate audits and auditors of public companies.
5. The auditing profession is much broader than auditors involved in public accounting; it also includes internal auditors and various governmental auditors, such as auditors of the Government Accountability Office and the Internal Revenue Service.

6. Various professional and regulatory organizations have a significant influence on the auditing profession, including the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the Federal Accounting Standards Advisory Board, the Public Company Accounting Oversight Board, the Securities and Exchange Commission, and The Institute of Internal Auditors.
7. In addition to performing attestation engagements, public accounting firms offer tax services, consulting services, and accounting and review services. Public accounting firms range in size from sole practitioners to the large international firms referred to as the Big 4 firms. The professional staff of a typical medium-to-large public accounting firm includes partners, managers, senior accountants, and staff assistants.

Key Terms Introduced or Emphasized in Chapter 1

Agreed-upon procedures engagement (3) An attest engagement in which the CPAs agree to perform procedures for a specified party and issue a report that is restricted to use by that party.

American Institute of Certified Public Accountants (AICPA) (13) The national professional organization of CPAs engaged in promoting high professional standards to ensure that CPAs serve the public interest.

Assertion (2) A representation or declaration made by the responsible party, typically management of the entity.

Assurance services (1) Professional services that enhance the quality of information, or its context, for decision makers. Many assurance services involve some form of attestation.

Attest engagement (1) An engagement in which the CPAs issue an examination, a review, or an agreed-upon procedures report on subject matter or an assertion about subject matter that is the responsibility of another party (e.g., management).

Audit of financial statements (10) An examination designed to provide an opinion, the CPA's highest level of assurance that the financial statements follow generally accepted accounting principles, or another acceptable basis of accounting.

Business risk (of the client) (6) The risk assumed by investors or creditors that is associated with the company's survival and profitability.

Certified public accountant (12) A person licensed by the state to practice public accounting as a profession, based on having passed the Uniform CPA Examination and having met certain educational and experience requirements.

Compliance audit (11) An audit to measure the compliance of the organization with some established criteria (e.g., laws and regulations, or internal control policies and procedures).

CPA examination (15) A uniform examination administered by the American Institute of Certified Public Accountants for state boards of accountancy to enable them to issue CPA licenses. The examination covers the topics of accounting and reporting, auditing, business environment, regulation, and professional responsibilities.

Examination (3) An attest engagement designed to provide the highest level of assurance that CPAs provide on an assertion. An examination of financial statements is referred to as an *audit*.

Financial audit (10) An audit of the financial accounting information of an organization or segment of the organization. This may involve a complete set of financial statements or a portion of a statement.

Fraud (8) Intentional misstatement of financial statements by management (fraudulent financial reporting), or theft of assets by employees (employee fraud). Fraud also is referred to as *irregularities*.

Generally accepted accounting principles (GAAP) (2) Concepts or standards established by such authoritative bodies as the FASB and the GASB and accepted by the accounting profession as essential to proper financial reporting.

Information risk (7) The risk that the information used by investors, creditors, and others to assess business risk is not accurate.

Integrated audit (11) As required by the Sarbanes-Oxley Act and the Public Company Accounting Oversight Board, an audit that includes providing assurance on both the financial statements and internal control over financial reporting. Integrated audits are required of publicly traded companies in the United States.

Operational audit (11) An analysis of a department or other unit of a business or governmental organization to measure the effectiveness and efficiency of operations.

Public Company Accounting Oversight Board (PCAOB) (16) The five-member board established in 2002 to oversee the audit of public (issuer) companies that are subject to the securities laws. The board has authority to establish or adopt, or both, rules for auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports.

Review (3) An engagement designed to express limited assurance relating to subject matter or an assertion. As discussed in further detail in Chapter 19, the procedures performed are generally limited to inquiries and analytical procedures.

Sarbanes-Oxley Act of 2002 (10) A set of reforms that toughened penalties for corporate fraud, restricted the kinds of consulting CPAs can perform for audit clients, and created the Public Company Accounting Oversight Board to oversee CPAs and public accounting firms.

Securities and Exchange Commission (SEC) (16) A government agency authorized to regulate companies seeking approval to issue securities for sale to the public.

Statements on Auditing Standards (SASs) (13) A series of statements issued by the Auditing Standards Board of the AICPA. These statements are considered to be interpretations of generally accepted auditing standards.

Suitable criteria (2) The standards or benchmarks used to measure and present the subject matter and against which the CPA evaluates the subject matter. Suitable criteria are criteria that are established or developed by groups composed of experts that follow due process procedures, including exposure of the proposed criteria for public comment. Suitable criteria must have each of the following attributes: objectivity, measurability, completeness, and relevance.

Review Questions

1–1. In late 2001 through 2002, the accounting profession faced a "crisis of credibility." Describe the events that led up to this crisis.

1–2. Define assurance services. What are the two distinct types?

1–3. What is the most common type of attest engagement? What is most frequently being "asserted" by management on this type of engagement?

1–4. What is the principal use and significance of an audit report to a large corporation with securities listed on a stock exchange? To a small family-owned enterprise?

1–5. Describe several business situations that would create a need for a report by an independent public accountant concerning the fairness of a company's financial statements.

1–6. Explain the following statement: One contribution of the independent auditor is to lend *credibility* to financial statements.

1–7. The overall risk of the investment in a business includes both business risk and information risk. Contrast these two types of risk. Which one is most directly affected by the auditors?

1–8. Contrast the objectives of auditing at the beginning of this century with the objectives of auditing today.

1–9. What does an operational audit attempt to measure? Does an operational audit involve more or fewer subjective judgments than a compliance audit or an audit of financial statements? Explain. To whom is the report usually directed after completion of an operational audit?

1–10. Distinguish between a compliance audit and an operational audit.

1–11. Is an *independent status* possible or desirable for internal auditors as compared with the independence of a public accounting firm? Explain.

1–12. Spacecraft, Inc., is a large corporation that is audited regularly by a public accounting firm but also maintains an internal auditing staff. Explain briefly how the relationship of the public accounting firm to Spacecraft differs from the relationship of the internal auditing staff to Spacecraft.

1–13. Describe briefly the function of the GAO.

1–14. List two of the important contributions to auditing literature by the AICPA.

1–15. What is meant by a *peer review* in public accounting?

1–16. How does the role of the SEC differ from that of the AICPA?

1–17. Apart from auditing, what other professional services are offered by public accounting firms?

1–18. What are the advantages of organizing a public accounting firm as a partnership rather than a sole proprietorship?

1–19. How does a professional corporation differ from a traditional corporation?

1–20. Public accounting firms are sometimes grouped into categories of local firms, regional firms, national firms, and international firms. Explain briefly the characteristics of each. Include in your answer the types of services stressed in each group.

1–21. Describe the various levels or positions of accounting personnel in a large public accounting firm.

1–22. List three of the more important responsibilities of a partner in a public accounting firm.

Questions Requiring Analysis

LO 5, 7 1–23. As a result of a number of events that caused Congress to doubt the ability of the accounting profession to regulate itself, a number of reforms were made to the accounting profession's system of self-regulation.

Required:

a. Provide a brief overview of the legislation that altered the self-regulation process of the accounting profession.

b. Explain the regulation process for accounting firms that audit public companies.

c. Explain the regulation process for accounting firms that do not audit public companies.

LO 4 1–24. A corporation is contemplating issuing debenture bonds to a group of investors.

Required:

a. Explain how independent audits of the corporation's financial statements facilitate this transaction.

b. Describe the likely effects on the transaction if the corporation decides not to obtain independent audits of its financial statements.

LO 5, 7 1–25. The Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board. Explain the major responsibilities of this board.

LO 4 1–26. The self-interest of the provider of financial information (whether an individual or a business entity) often runs directly counter to the interests of the user of the information.

Required:

a. Give an example of such opposing interests.

b. What may be done to compensate for the possible bias existing because of the self-interest of the individual or business entity providing the financial information?

LO 3 1–27. The role of the auditor in the American economy has changed over the years in response to changes in our economic and political institutions. Consequently, the nature of an audit today is quite different from that of an audit performed in the year 1900. Classify the following phrases into two groups: (1) phrases more applicable to an audit performed in 1900 and (2) phrases more applicable to an audit performed today.

a. Complete review of all transactions.

b. Assessment of internal control.

c. Auditors' attention concentrated on balance sheet.

d. Emphasis upon use of sampling techniques.

e. Determination of fairness of financial statements.

f. Audit procedures to prevent or detect fraud on the part of all employees and managers.

g. Registration statement.

h. Fairness of reported earnings per share.

i. Influence of stock exchanges and the investing public upon use of independent auditors.

j. Concern about fraudulent financial reporting.

k. Generally accepted auditing standards.

l. Bankers and short-term creditors as principal users of audit reports.

m. Pressure for more disclosure.

n. Auditing for compliance with laws and regulations.

Multiple Choice Questions

1–28. Select the best answer for each of the following items and give reasons for your choice.

LO 1, 2

a. Which of the following best describes the relationship between assurance services and attest services?
(1) While attest services involve financial data, assurance services involve nonfinancial data.
(2) While attest services require objectivity, assurance services do not require objectivity.
(3) Attest services are a subset of assurance services.
(4) Attest and assurance services are different terms referring to the same types of services.

LO 3

b. Which of the following has primary responsibility for the fairness of the representations made in financial statements?
(1) Client's management.
(2) Independent auditor.
(3) Audit committee.
(4) AICPA.

LO 3

c. The most important benefit of having an annual audit by a public accounting firm is to:
(1) Provide assurance to investors and other outsiders that the financial statements are reliable.
(2) Enable officers and directors to avoid personal responsibility for any misstatements in the financial statements.
(3) Meet the requirements of government agencies.
(4) Provide assurance that illegal acts, if any exist, will be brought to light.

LO 7

d. The Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB). Which of the following is *not* one of the responsibilities of that board?
(1) Establish independence standards for auditors of public companies.
(2) Review financial reports filed with the SEC.
(3) Establish auditing standards for audits of public companies.
(4) Sanction registered audit firms.

LO 7

e. Which of these organizations has the responsibility to perform inspections of auditors of public companies?
(1) American Institute of Certified Public Accountants.
(2) Securities and Exchange Commission.
(3) Financial Accounting Standards Board.
(4) Public Company Accounting Oversight Board.

LO 6

f. Governmental auditing, in addition to including audits of financial statements, often includes audits of efficiency, effectiveness, and:
(1) Adequacy.
(2) Evaluation.
(3) Accuracy.
(4) Compliance.

LO 6

g. In general, internal auditors' independence will be greatest when they report directly to the:
(1) Financial vice president.
(2) Corporate controller.
(3) Audit committee of the board of directors.
(4) Chief executive officer.

LO 5

h. Which of the following did *not* precipitate the passage of the Sarbanes-Oxley Act of 2002 to regulate public accounting firms:
(1) Disclosures related to accounting irregularities at Enron and WorldCom.
(2) Restatements of financial statements by a number of public companies.
(3) Conviction of the accounting firm of Arthur Andersen LLP.
(4) Ethical scandals at the AICPA.

LO 6 *i.* Which of the following organizations establishes accounting standards for U.S. government agencies?
(1) The Financial Accounting Standards Board.
(2) The Governmental Accounting Standards Board.
(3) The Federal Accounting Standards Advisory Board.
(4) The Public Company Accounting Oversight Board.

LO 6 *j.* Which of the following is correct about forensic audits?
(1) All audit engagements are forensic in nature.
(2) Forensic audits are performed by law firms; they are not performed by CPA firms.
(3) Forensic audits are equivalent to compliance audits.
(4) Forensic audits are usually performed in situations in which fraud has been found or is suspected.

LO 3 *k.* What best describes the purpose of the auditors' consideration of internal control in a financial statement audit for a nonpublic company?
(1) To determine the nature, timing, and extent of audit testing.
(2) To make recommendations to the client regarding improvements in internal control.
(3) To train new auditors on accounting and control systems.
(4) To identify opportunities for fraud within the client's operations.

LO 6 *l.* Which of the following is an example of a compliance audit?
(1) An audit of financial statements.
(2) An audit of a company's policies and procedures for adhering to environmental laws and regulations.
(3) An audit of a company's internal control over financial reporting.
(4) An audit of the efficiency and effectiveness of a company's legal department.

(AICPA, adapted)

Problems

LO 3, 4 1–29. Feller, the sole owner of a small hardware business, has been told that the business should have its financial statements audited by an independent CPA. Feller, having some bookkeeping experience, has personally prepared the company's financial statements and does not understand why such statements should be audited by a CPA. Feller discussed the matter with Farber, a CPA, and asked Farber to explain why an audit is considered important.

Required:
a. Describe the objectives of an independent audit.
b. Identify five ways in which an independent audit may be beneficial to Feller.

LO 3, 6 1–30. For the purposes of this problem, assume the existence of five types of auditors: CPA, GAO, IRS, bank examiner, and internal auditor. Also assume that the work of these various auditors can be grouped into five classifications: audits of financial statements, compliance audits, operational audits, accounting services, and consulting services.

For each of the following topics, you are to state the type of auditor most probably involved. Also identify the topic with one of the above classes of work.

You should organize your answer in a three-column format as follows: Column 1, the number of the topic; Column 2, the type of auditor involved; and Column 3, the class of work.

1. Financial statements of a small business to be submitted to a bank in support of a loan application.
2. Financial statements of a large bank listed on the New York Stock Exchange to be distributed to stockholders.
3. Review of the management directive stating the goals and responsibilities of a corporation's mail-handling department.
4. Review of costs and accomplishments of a military research program carried on within the air force to determine whether the program was cost effective.
5. Examination on a surprise basis of Midtown State Bank. Emphasis placed on verification of cash, marketable securities, and loans receivable and on consistent observation of the banking code.
6. Analysis of the accounting system of a small business with the objective of making recommendations concerning installation of a computer-based system.

7. Determination of fairness of financial statements for public distribution by a corporation that has a professional level internal auditing staff.
8. Review of the activities of the receiving department of a large manufacturing company, with special attention to efficiency of materials inspection and promptness of reports issued.
9. Review of the tax return of the corporate president to determine whether charitable contributions are adequately substantiated.
10. Review of daily attendance during spring term at Blue Ridge Consolidated School District to ascertain whether payments received from the state were substantiated by pupil-day data and whether disbursements by the district were within authorized limits.
11. Review of transactions of a government agency to determine whether disbursements under the Payment-In-Kind program of the U.S. Department of Agriculture followed the intent of Congress.
12. Compilation of quarterly financial statements for a small business that does not have any accounting personnel capable of preparing financial statements.

LO 3 1–31. In a discussion between Peters and Ferrel, two auditing students, Peters made the following statement: "A CPA is a professional person who is licensed by the state for the purpose of providing an independent expert opinion on the fairness of financial statements. To maintain an attitude of mental independence and objectivity in all phases of audit work, it is advisable that the CPA not fraternize with client personnel. The CPA should be courteous but reserved and dignified at all times. Indulging in social contacts with clients outside business hours will make it more difficult to be firm and objective if the CPA finds evidence of fraud or of unsound accounting practices."

Ferrel replied as follows: "You are 50 years behind the times, Peters. An auditor and a client are both human beings. The auditor needs the cooperation of the client to do a good job; you're much more likely to get cooperation if you're relaxed and friendly rather than being cold and impersonal. Having a few beers or going to a football game with a client won't keep the CPA from being independent. It will make the working relationship a lot more comfortable, and will probably cause the client to recommend the CPA to other business people who need auditing services. In other words, the approach you're recommending should be called 'How to Avoid Friends and Alienate Clients.' I will admit, though, that with so many women entering public accounting and other women holding executive positions in business, a few complications may arise when auditor–client relations get pretty relaxed."

Evaluate the opposing views expressed by Peters and Ferrel.

LO 7 1–32. Listed below are 10 publications in the fields of auditing and accounting.

1. *Statements on Auditing Standards* (SASs).
2. *The Journal of Accountancy.*
3. *Regulation S-X, Form and Content of Financial Statements.*
4. *Statements on Standards for Accounting and Review Services* (SSARSs).
5. *Financial Reporting Releases* (FRRs).
6. *Accounting and Reporting Standards for Corporate Financial Statements.*
7. *Accounting and Reporting Standards for Governmental Entities.*
8. *Industry Audit and Accounting Guides.*
9. *Auditing Practice Releases.*
10. *The Tax Advisor.*

The list of organizations shown below includes the sponsors or publishers of the above 10 publications.

a. Accounting Principles Board (APB).
b. Securities and Exchange Commission (SEC).
c. American Institute of Certified Public Accountants (AICPA).
d. Financial Accounting Standards Board (FASB).
e. Internal Revenue Service (IRS).
f. Government Accountability Office (GAO).
g. Governmental Accounting Standards Board (GASB).

Required: Identify the sponsoring organization for each of the 10 publications. (Some of the organizations may not have a publication in this list.) Organize your answer in a two-column format. In the left-hand column, list the number and name of each publication in the order shown above. In the right-hand column, list the identifying letter and the abbreviation of the sponsoring organization. For example, on line 1, list (1) *Statements on Auditing Standards* in the left column and (*c*) AICPA in the right column.

LO 3, 7 1–33. Each auditing term (or organizational name) in Column 1 below bears a close relationship to a term in Column 2.

Column 1	Column 2
1. Quality control	*a.* Regulation of auditors of public companies
2. Operational audit	*b.* Attest function
3. Internal control	*c.* Material information
4. Government Accountability Office	*d.* Credibility
5. Disclosure	*e.* Peer review
6. Critical characteristic that must be maintained by the accounting profession	*f.* Registration statement
	g. Accounting service
7. Public Company Accounting Oversight Board	*h.* Measurement of effectiveness and efficiency of a unit of an organization
8. Securities and Exchange Commission	*i.* Basis for sampling and testing
9. Audited financial statements	*j.* Auditing staff reporting to Congress
10. Compilation of financial statements	

Required: Identify the most closely related terms in Columns 1 and 2. Organize your answer in a two-column format by copying the numbers and terms in Column 1 as given. Then, rearrange the sequence of terms in Column 2 so that each line of your schedule will contain two closely related terms.

In-Class Team Case

LO 6, 8 1–34. Will Williams, a college senior, has begun the interviewing process. He has discovered a great variety of organizations in search of "accounting majors." He finds that various public accounting firms, corporations, the GAO, and the IRS are all interviewing candidates at his school.

Will has come to you for advice. He has suggested that although he has had only one class session of auditing, he already realizes that it is going to be a great course; however, he also especially enjoyed his tax and accounting systems courses.

Required: Compare and contrast his possibilities with public accounting firms, corporations, the GAO, and the IRS if he wishes to emphasize the following areas of expertise:

a. Taxation.

b. Auditing.

c. Systems design.

For example, first compare and contrast his likely responsibilities with each of the above organizations if he chooses to emphasize taxation.

Research and Discussion Case

LO 3, 8 1–35. Smith & Co., a local Dallas public accounting firm, is incorporated as a professional corporation, with three shareholders, all CPAs. The shareholders have developed a combination of marketing, software, and professional expertise that has allowed them to perform the accounting service of compiling individuals' personal financial statements in an extremely efficient manner.

The three shareholders are interested in "going national" with their accounting service but lack the capital necessary to expand to other cities. They are currently considering the possibility of obtaining outside capital as a way to expand their business by offering their firm's services to individuals in other markets. They estimate that if they raised $4 million of capital they could open and staff 15 offices within the next 12 months.

In a recent meeting of the three shareholders, the possibility of raising the capital through incorporation as a traditional corporation and thereby selling stock to the public was discussed. The original three shareholders would retain 51 percent of the total stock, which would be traded over the counter. The only work performed through the new corporation would be the compilation of individuals' financial statements.

Subsequently, the shareholders were dismayed to learn that states do not generally allow CPAs to practice as a traditional corporation. Also, those states that do allow "limited liability companies" generally require that shareholders be involved in public accounting. Only by establishing a separate organization not held out as a public accounting firm will the current three shareholders be allowed to follow their expansion plan.

Required:

a. Summarize the arguments for allowing public accounting firms to sell ownership interests to individuals not in public accounting through incorporation as a traditional corporation.

b. Summarize the arguments in favor of restricting public accounting firm ownership to those involved in public accounting.

c. Express your personal opinion as to whether ownership of public accounting firms should be restricted to individuals involved in public accounting.

Suggested References

AICPA, *Professional Standards,* Volume 2, Commerce Clearing House, Section ET 505 (*Code of Professional Conduct,* Rule 505).

Appropriate chapters from other accounting and business textbooks that discuss the advantages of the corporate form of business.

Notes

Chapter 2

Professional Standards

Standards are established to measure the quality of performance of individuals and organizations. Standards relating to the accounting profession concern themselves with certified public accountant (CPA) professional qualities, the judgment exercised by CPAs in the performance of their professional engagements, and a CPA firm's quality control.

Our purpose in this chapter is to make clear the nature of auditing standards, attestation standards, and quality control standards. In our discussion of the auditing standards, we consider in detail the nature of the independent **auditors' report**—that brief but important document that emerges as the end product of an audit engagement.

Learning objectives

After studying this chapter, you should be able to:

- **LO1** Describe the authority of the two types of auditing standards—PCAOB standards and AICPA generally accepted auditing standards.
- **LO2** Identify the authoritative status of the Statements on Auditing Standards.
- **LO3** Discuss the auditors' responsibility for detecting errors, fraud, and illegal acts.
- **LO4** Explain the key elements of the auditors' standard report.
- **LO5** Discuss the other types of reports that are issued by auditors.
- **LO6** Describe the attestation standards.
- **LO7** Describe the quality control standards and their purposes.
- **LO8** Explain the status of international accounting and auditing standards.

Auditing Standards for Public and Nonpublic Companies

Learning Objective 1

Describe the authority of the two types of auditing standards—PCAOB standards and AICPA generally accepted auditing standards.

The regulatory environment for auditors and audit firms has become much more complex with the passage of the Sarbanes-Oxley Act. Previously, the AICPA's standards, based on their general acceptance, applied to audits of both public (issuer) and nonpublic (nonissuer) companies. The Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB) and charged that body with the responsibility for developing and enforcing professional standards for integrated audits of public companies. Remember that the integrated audit involves auditing both the company's financial statements and its internal control over financial reporting. The PCAOB also is charged with the responsibility of regulating the public company audit practices of registered CPA firms. To complicate matters further, the state boards of accountancy have the authority to regulate CPAs and CPA firms that practice within their state or jurisdiction. Figure 2.1 on page 35 summarizes the regulatory authority of the PCAOB, the AICPA, and the state boards of accountancy.

In the majority of this textbook we will focus on the generally accepted auditing standards established by the AICPA. Currently, the AICPA standards do not differ substantially from the standards for audits of public companies because the PCAOB adopted the AICPA standards in existence at April 16, 2003, as its interim standards. As we present the audit process, we will describe situations in which PCAOB standards depart from AICPA standards. In addition, Chapter 18 specifically focuses on the integrated audit required for a public company, which involves the audit of the company's financial statements and attestation to its internal control over financial reporting.

AICPA Generally Accepted Auditing Standards

What are the standards developed by the public accounting profession through the AICPA? The AICPA has set forth the basic framework in the following 10 **generally accepted auditing standards** (*emphasis added*).

General Standards

1. The auditor must have *adequate technical training and proficiency* to perform the audit.
2. The auditor must maintain an *independence in mental attitude* in all matters relating to the audit.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.

Standards of Fieldwork

1. The auditor must *adequately plan* the work and must *properly supervise* any assistants.
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, whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.
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.

Standards of Reporting

1. The auditor must state in the auditor's report whether the financial statements *are presented in accordance with generally accepted accounting principles* (GAAP).
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. When the auditor determines that *informative disclosures are not adequate,* the auditor must so *state in the auditor's report*.
4. 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 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.

The 10 standards set forth by the AICPA include such subjective terms of measurement as "*adequately plan,*" "*sufficient understanding of the entity and its environment,*" and "*sufficient appropriate evidence*." To decide under the circumstances of each audit engagement what is adequate, sufficient, and appropriate requires the exercise of *professional judgment*. Auditing cannot be reduced to rote; the exercise of judgment by the auditor is vital at numerous points in every engagement. However, the formulation and publication of carefully worded auditing standards are of immense aid in raising the quality of audit work, even though these standards require professional judgment in their application.

General Standards—Auditor Qualifications and Quality of Work

The general standards are personal in nature in that they deal with auditor training and proficiency, auditor independence, and the need for due professional care. These standards apply to all parts of the audit, including fieldwork and reporting.

Training and Proficiency

How does the independent auditor achieve the "adequate technical training and proficiency" required by the first general standard? This requirement is usually interpreted to mean college or university education in accounting and auditing, participation in continuing education programs, and substantial public accounting experience. A technical knowledge of the industry in which the client operates is also part of the personal qualifications of the auditor. It follows that a CPA firm must not accept an audit engagement

FIGURE 2.1 Regulation of the Profession

Regulatory Bodies	Authority of Regulatory Bodies: Integrated Audits for Public Companies	Authority of Regulatory Bodies: Audits for Nonpublic Companies
Public Company Accounting Oversight Board (PCAOB)	1. Establishes standards* for the audits of public companies: • Auditing • Attestation • Quality control • Independence • Ethical behavior 2. PCAOB standards have authority based on federal legislation. 3. Registers CPA firms to audit public companies and may revoke a firm's registration or bar an individual CPA from participating in public company audits. 4. Performs inspections of the public company audit practices of registered CPA firms.	No standard-setting or regulatory responsibilities regarding CPA services for nonpublic companies.
American Institute of Certified Public Accountants (AICPA)	No standard-setting or regulatory responsibilities regarding public company audits.**	1. Establishes standards for: • Auditing • Attestation • Accounting and review • Quality control • Independence • Ethical behavior 2. AICPA standards have authority based on their general acceptance by state boards of accountancy, other legislative organizations, and the courts. 3. Firms may subject themselves to AICPA regulation by voluntarily joining one or both of the AICPA sections: (1) the Private Companies Practice Section (PCPS), or (2) the Center for Public Company Audit Firms. Both sections have voluntary peer review programs. 4. The AICPA Center for Public Company Audit Firms' peer review program covers the nonpublic practices of firms whose public company practices are inspected by the PCAOB. 5. The individual membership requirements of the AICPA require members to practice in a firm that participates in a practice review program.
State Boards of Accountancy	1. License CPAs and CPA firms to practice public accountancy in their states or jurisdictions and can revoke the right to practice in those jurisdictions. 2. In their jurisdictions, state boards have regulatory responsibility for both public and nonpublic practice. 3. State boards adopt AICPA and PCAOB standards but may supplement them with their own requirements.	

* The PCAOB adopted AICPA professional standards issued through April 16, 2003, as its interim standards. In addition, the SEC has oversight responsibility for the PCAOB and all standards must be approved and issued by the SEC.

** Technically, the AICPA general ethics requirements also would apply to an AICPA member performing services for public companies.

without first determining whether members of its staff have the proficiency needed to function effectively in the particular industry.

Independence

An opinion by an independent public accountant as to the fairness of a company's financial statements is of questionable value unless the accountant is truly independent. Consequently, the second auditing standard, which requires that in all matters relating to the assignment, an **independence** in mental attitude is to be maintained by the auditor, perhaps embodies the most essential factor in the existence of a public accounting profession.

If auditors own shares of stock in a company that they audit, or if they serve as members of the board of directors, they might subconsciously be biased in the performance of auditing duties. An auditor should therefore avoid any relationship with a client that would cause an outsider who had knowledge of all the facts to doubt the CPA's independence. It is not enough that auditors *be* independent; they must conduct themselves in such a manner that informed members of the public will have no reason to doubt their independence. Independence is a key element of professional ethics and will be described in detail in Chapter 3.

Due Professional Care

The third general standard requires due professional care in the conduct of the audit and in the preparation of the audit report. This standard requires the auditors to plan and carry out every step of the audit engagement in an alert and diligent manner. Full compliance with this standard would rule out any negligent acts or material omissions by the auditors. Of course, auditors, as well as members of other professions, inevitably make occasional errors in judgment.

Standards of Fieldwork—Planning, Accumulating, and Evaluating Evidence

The three standards of fieldwork relate to planning the audit, obtaining an understanding of the client and its environment, and obtaining sufficient appropriate audit evidence. Audit planning involves developing an overall strategy relating to collecting and evaluating the evidence to be obtained. By obtaining an understanding of the entity and its environment, including its **internal control**, the auditors can make assessments of the likelihood of whether the financial statements will be free from material errors and fraud. These assessments enable the auditors to evaluate the risks of material misstatement of the financial statements. To address these risks, the auditors perform procedures to substantiate the amounts on the financial statements being audited. Examples of such evidence include written confirmations from outsiders and the firsthand observation of assets by the auditors. The gathering and evaluating of evidence lies at the very heart of the audit process and is a continuing theme throughout this textbook.

Adequate Planning and Supervision

Adequate planning is essential to a satisfactory audit. The auditors must obtain an understanding with the client as to the nature and scope of the audit. They will identify portions of the audit that can be performed prior to the end of the period under audit; the vast majority of the auditors' risk assessment procedures may be performed before the end of the period. The appropriate number of audit staff of various levels of skill and the time required by each member need to be determined in advance of fieldwork. These are but a few of the elements of planning the audit.

Most of the fieldwork of an audit is carried out by staff members with limited professional experience. The key to successful use of relatively new staff members is close supervision at every level. This concept extends from providing a specific written audit program to staff members all the way to review of the work by the partner in charge of the engagement.

Sufficient Understanding of the Entity and Its Environment, Including Its Internal Control[1]

The auditors' understanding of the client and its environment allows the auditors to determine what can go wrong to result in materially misstated financial statements. In areas where the risk of material misstatement is high, the auditors must plan and perform more extensive audit procedures. Such procedures may be tests of controls or procedures to substantiate financial statement amounts.

Internal control provides assurance that the client's records are reliable. When the auditors find effective internal control, the quantity of other evidence required to substantiate the financial statement amounts is much less than if controls are weak. Thus, the auditors' assessment of internal control has a substantial impact on the nature of the audit process.

Sufficient Appropriate Audit Evidence

The third standard of fieldwork requires that the auditors gather sufficient appropriate evidence to have a basis for expressing an opinion on the financial statements. The term *appropriate* refers to the quality of the evidence; some forms of audit evidence are stronger and more convincing than others. In Chapter 5, we explore at length the meaning of this standard.

Standards of Reporting

The four reporting standards establish some specific directives for preparation of the auditors' report. The report must specifically state whether the financial statements are in conformity with generally accepted accounting principles. That is, it must contain an opinion on the financial statements as a whole, or must disclaim an opinion. **Consistency** in the application of generally accepted accounting principles and adequate informative disclosure in the financial statements is to be assumed unless the audit report states otherwise. These basic reporting standards are considered more fully in the latter part of this chapter.

AICPA Statements on Auditing Standards (SASs)

Learning Objective 2

Identify the authoritative status of the Statements on Auditing Standards.

Statements on Auditing Standards (SASs) are serially numbered pronouncements issued by the AICPA's Auditing Standards Board (ASB). The first in the series, *SAS 1*, is a codification of 54 *Statements* previously issued over many years by the Committee on Auditing Procedure, a predecessor of the ASB. Since *SAS 1* was released in 1972, many additional statements on specific topics have been issued to provide more detailed guidance than is available from the 10 generally accepted auditing standards.

The SASs are codified within the framework of the 10 generally accepted auditing standards. They are the most authoritative references that auditors can utilize to resolve problems encountered during the audit of a nonpublic company. The term *auditing standards* is often used in practice to refer to the SASs, to the generally accepted auditing standards, or to both. The authoritative status of the SASs is derived from the AICPA *Code of Professional Conduct* (Rule 202). The code requires auditors to adhere to these pronouncements.

[1] *SAS No. 105*, "Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards," revised the 10 generally accepted auditing standards. The only substantial change made by the standard was in this second standard of fieldwork, which previously stated:

> A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of further audit procedures.

Since the PCAOB has not yet adopted an equivalent standard, the 10 generally accepted auditing standards differ for public company audits. However, complying with *SAS No. 105*, with its requirement for a more complete understanding of the client's business and environment, would comply with the 10 generally accepted auditing standards of the PCAOB.

FIGURE 2.2
Terminology in Auditing Standards

Responsibility Level	Meaning	Words Used to Indicate Responsibility
Unconditional Responsibility	Auditors must fulfill responsibilities.	*"Must"* *"Is required"* *"Shall"* (PCAOB only)
Presumptively Mandatory Responsibility	Auditors must comply with requirements unless auditors demonstrate and document that alternative actions were sufficient to achieve the objectives of the standards.	*"Should"*
Responsibility to Consider (responsibility only established in PCAOB documents)	Auditors should consider; whether the auditors comply with the requirements depends on the exercise of professional judgment in the circumstances.	*"Might"* *"Could"* *Other phrases indicating a responsibility to consider*

When describing auditor responsibility, the exact wording of the pronouncement is extremely important. *SAS 102* (AU 120), "Defining Professional Requirements in Statements on Auditing Standards," describes the meaning of various terms used in auditing standards. In some cases the standard establishes an unconditional requirement that auditors must follow in all circumstances, while in others it provides matters to be considered, but not necessarily performed. Figure 2.2 provides a summary of the most relevant wording. Thus, for example, if a pronouncement states that an auditor "must" perform a particular procedure, if it is possible to perform that procedure, it *must* be performed on an audit. If a pronouncement says a procedure "should" be performed, there *may* be circumstances in which alternate procedures may be performed instead. These terms are used in essentially an equivalent manner in auditing standards of the PCAOB, as illustrated in Figure 2.2.

The SASs, although more detailed and specific than the generally accepted auditing standards, often do not prescribe specific auditing procedures to be followed. For more detailed, but less authoritative, guidelines on specific audit problems, auditors can refer to *interpretive publications,* which include appendixes to the SASs, *AICPA Audit and Accounting Guides,* and AICPA auditing *Statements of Position*. The auditors should be aware of and consider the interpretive publications applicable to their audits. If the auditors fail to apply the auditing guidance in such publications, they should be prepared to explain how they complied with the related SAS.

Other auditing publications include such publications as AICPA *Auditing Practice Releases;* various technical studies published by the AICPA; auditing textbooks; and articles in professional journals, such as the *Journal of Accountancy* and *The CPA Journal*. Other auditing publications have no authoritative status but may be helpful to the auditors in understanding and applying the SASs.

The role and authority of various auditing publications are summarized in Figure 2.3. Keep in mind, however, that compliance with auditing standards does not represent an ideal level of audit performance, but rather a *minimum standard* for all engagements.

Throughout this textbook, we will be making references to individual AICPA SASs. Each SAS is identified under two numbering systems: the original SAS number and an AU number. The SAS numbering system organizes the SASs by date of issue, whereas the AU numbering system organizes them by topic. Thus, *Statement on Auditing Standards 39,* "Audit Sampling," is identified as *SAS 39* and AU 350.

FIGURE 2.3
The GAAS Hierarchy

Category	Status	Audit Guidance
1. Standards	Auditors should be prepared to justify departures from these standards.	• The 10 generally accepted auditing standards. • Statements on Auditing Standards (SASs). • Other standards that apply for PCAOB and government audits, etc.
2. Interpretive Publications	Recommendations on the application of the SASs. If not followed, the auditors should be prepared to explain how they complied with the SAS provisions addressed by the interpretive publication.	• Appendixes to SASs. • Interpretations of SASs. • Auditing guidance in *AICPA Audit and Accounting Guides*. • AICPA auditing *Statements of Position*.
3. Other Auditing Publications	No authoritative status, but may help the auditor understand and apply the standards.	• Auditing articles in *Journal of Accountancy* and other professional journals. • Auditing articles in the *AICPA CPA Letter*. • Continuing education programs and other instruction materials. • Textbooks. • Guidebooks. • Audit programs. • Checklists.

The Auditors' Responsibility for Detecting Misstatements

Learning Objective 3

Discuss the auditors' responsibility for detecting errors, fraud, and illegal acts.

The auditors have a responsibility to plan and perform the audit to obtain *reasonable assurance* about whether the financial statements are free of material misstatement.[2] Reasonable assurance is achieved when **audit risk**, the risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated, is at an appropriately low level. Financial statements may be misstated due to various causes, including errors, fraud, and certain illegal acts.

Errors and Fraud

Auditing standards define **errors** as unintentional misstatements or omissions of amounts or disclosures in the financial statements. Errors may involve mistakes in gathering or processing data, unreasonable accounting estimates arising from oversight or misinterpretation of facts, or mistakes in the application of generally accepted accounting principles.

Fraud, as the term is used in *SAS 99,* "Consideration of Fraud in a Financial Statement Audit," relates to intentional acts that cause a misstatement of the financial statements. Misstatements due to fraud may occur due to either (1) fraudulent financial reporting or (2) misappropriation of assets (also referred to as "defalcation").

[2] The professional standards on these responsibilities are presented in *SAS 107* (AU 312), "Audit Risk and Materiality in Conducting an Audit," and *SAS 99* (AU 316), "Consideration of Fraud in a Financial Statement Audit."

During the planning of an audit, the auditors are required to assess the risk of material misstatements—whether caused by error or fraud. Based on that assessment, they plan and perform their audit to provide reasonable assurance of detecting such misstatements. To provide reasonable assurance, the auditors must exercise due care in planning, performing, and evaluating the results of their audit procedures. This requires auditors to exercise *professional skepticism,* which involves having a questioning mind and a critical assessment of audit evidence throughout the audit process.

An audit provides reasonable, but not absolute, assurance of detecting material misstatement of the financial statements. Providing absolute assurance is not possible because available audit evidence is often less than convincing or conclusive, and due to the characteristics of fraud. For example, fraud often includes collusion among management, employees, or third parties, and is concealed by falsifying documents (including forgery). An audit rarely involves authentication of documents, nor are auditors ordinarily experts in authentication. In addition, management has the ability to override controls which otherwise may appear to be effective. Even if possible, audits providing absolute assurance of detecting material misstatement of financial statements would be exorbitant in price.

Illegal Acts by Clients

Laws and regulations vary in their relation to the client's financial statements. Certain laws have a direct effect on the financial statement amounts (i.e., they require an accounting entry) and are considered on every audit. An example is income tax law, which affects the amount of income tax expense in the financial statements of most clients. The auditors' responsibility for detecting violations of these laws is greater than their responsibility to detect **illegal acts** arising from laws that only indirectly affect the client's financial statements, such as violations of antitrust laws. Violations of these laws have an indirect effect in that, while they may ultimately result in fines or penalties, at the point the financial statements are being issued no liability exists. Disclosure is only required.

As explained in *SAS 54* (AU 317), an audit carried out in accordance with generally accepted auditing standards should be designed to provide reasonable assurance of detecting illegal acts having a material *direct effect* on the determination of financial statement amounts—the same responsibility the auditors have for material errors and fraud. An audit does *not* generally provide a basis for detecting violations of laws or regulations that have an *indirect effect* on financial statement amounts.

The media and the public sometimes tend to blame auditors when illegal acts by a client company are not brought to light during an audit. Yet the very nature of audits cannot be relied on to detect all types of illegal acts by the client, particularly those with an indirect effect on the financial statements. On the other hand, audit procedures such as reading minutes of the board of directors and inquiring of management and the client's attorney may result in the discovery of certain indirect illegal acts. Also, the auditors must be alert throughout their audit for information that raises a question regarding the possibility of illegal acts, such as transactions that are unauthorized or improperly recorded, investigations by governmental agencies, and excessive or unusual payments.

If the auditors conclude that an illegal act has or is likely to have occurred (regardless of whether it is believed to possibly have a direct effect on the financial statements), they should attempt to assess the impact of the actions on the financial statements. This usually requires consulting legal counsel or another specialist. The auditors should also discuss the situation with top management and notify the audit committee of the board of directors with respect to the illegal act, unless it is clearly inconsequential. The communication with the audit committee should describe the event, the circumstances of its occurrence, and the effect on the financial statements.

The auditors should consider whether the client has taken appropriate remedial action concerning the act. Such remedial action may include taking disciplinary actions, establishing controls to safeguard against recurrence, and, if necessary, reporting the effects of the illegal acts in the financial statements. Ordinarily, if the client does not take the remedial action the auditors believe necessary in the circumstances, the auditors should withdraw from the engagement.[3] This action on the part of the auditors makes clear that they will not be associated in any way with dishonorable or illegal activities.

The Auditors' Reports

Learning Objective 4

Explain the key elements of the auditors' standard report.

The end product of an audit of a business entity is a report expressing the auditors' opinion on the client's financial statements. The content of the auditors' report varies somewhat depending on whether it results from the audit of a nonpublic or public company. We will first present the standard audit report for a nonpublic company, followed by a discussion of how the report for a public company differs.

The auditors' *standard unqualified report* (as illustrated on the next page) consists of three paragraphs. The first paragraph clarifies the responsibilities of management and the auditors and is referred to as the *introductory paragraph.* The second paragraph, which describes the nature of the audit, is called the *scope paragraph;* and the final paragraph, the *opinion paragraph,* is a concise statement of the auditors' opinion based on the audit.

The auditors' report is addressed to the person or persons who retained the auditors. In the case of corporations, the selection of an auditing firm is usually made by the board of directors and ratified by the stockholders.

The Introductory Paragraph of the Auditors' Report

To gain a full understanding of the introductory paragraph of the auditors' report, we need to emphasize the following two points:

1. *The client company is responsible for the financial statements*. The management of a company has the responsibility of maintaining adequate accounting records and of preparing proper financial statements for the use of stockholders and creditors. Even though the financial statements are sometimes constructed and printed in the auditors' office, primary responsibility for the statements remains with management. The auditors' product is their report. It is a separate document from the client's financial statements, although the two are closely related and transmitted together to stockholders, creditors, and other financial statement users.

   Once we recognize that the financial statements are the statements of the company and not of the auditors, we realize that the auditors have no right to make changes in the financial statements. What action then should the auditors take if they do not agree with the presentation of a material item in the balance sheet or income statement?

[3] The Private Securities Reform Act of 1995 places additional requirements upon public companies registered with the Securities and Exchange Commission and their auditors when (1) the illegal act has a material effect on the financial statements, (2) senior management and the board of directors have not taken appropriate remedial actions, and (3) the failure to take remedial action is reasonably expected to warrant departure from a standard audit report (or to warrant resignation). In such circumstances the auditors "shall, as soon as practicable," communicate their conclusions directly to the board of directors. Within one day the company must notify the Securities and Exchange Commission of having received such a communication and must send a copy of that notification to the auditor. If the auditors do not receive such notice within the one-day period, they must furnish the report to the SEC within one business day after the failure of the company to give the required notice.

Auditors' Report for Audits of Nonpublic Companies

Independent Auditors' Report

To the Board of Directors and Stockholders, XYZ Company:

We have audited the accompanying balance sheet of XYZ Company as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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 audit provides 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 XYZ Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Los Angeles, California

Blue, Gray & Company
Certified Public Accountants
February 26, 20X2

Assume, for example, that the allowance for uncollectible accounts is not sufficient (in the auditors' view) to cover the probable collection losses in the accounts receivable.

The auditors will first discuss the problem with management and point out why they believe that the valuation allowance is inadequate. If management agrees to increase the allowance for uncollectible accounts, an adjusting entry will be made for that purpose, and the problem is solved. If management is not convinced by the auditors' arguments and declines to increase the allowance, the auditors will probably *qualify* their opinion by stating in the report that the financial statements reflect fairly the company's financial position and operating results, *except for the effects of not providing an adequate provision for uncollectible accounts*. Usually such issues are satisfactorily disposed of in discussions between the auditors and the client, and a qualification of the auditors' opinion is avoided. A full consideration of the use of qualifications in the auditors' report is presented in Chapter 17.

2. *The auditors render a report on the financial statements, not on the accounting records*. The primary purpose of an audit is to provide assurance to the users of the financial statements that these statements are reliable. Auditors do not express an opinion on the client's accounting records. The auditors' investigation of financial statement items includes reference to the client's accounting records, but it is not limited to these records. An audit includes observation of tangible assets, inspection of such documents as purchase orders and contracts, and the gathering of evidence from outsiders (such as banks, customers, and suppliers), as well as analysis of the client's accounting records.

A principal means of establishing the validity of a balance sheet and income statement is to compare the statement figures to the accounting records and to the original evidence of transactions. However, the auditors' use of the accounting records is only a means to an end—and merely a part of the audit. It is, therefore, appropriate for the auditors to state in their report that they have made an audit of the *financial statements* rather than to say that they have made an audit of the accounting records. In the illustration, the auditors' report covers the years for which financial statements are being presented by the company. Reporting on such comparative financial statements is discussed in detail in Chapter 17.

The Scope Paragraph of the Auditors' Report

The scope paragraph describes the nature of the CPAs' audit. It states that the audit was conducted in accordance with auditing standards generally accepted in the United States of America[4] and points out that, while an audit is meant to obtain *reasonable assurance* that the financial statements are free of material misstatement, the procedures are applied on a test basis. Thus, an audit cannot provide *absolute assurance* that the financial statements are free from material misstatement; the auditors do, however, believe that the procedures performed provide a reasonable basis for their opinion.

The Opinion Paragraph of the Auditors' Report

The opinion paragraph consists of only one sentence, which is restated here with certain significant phrases shown in italics:

> *In our opinion*, the financial statements referred to above *present fairly*, *in all material respects*, the financial position of XYZ Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with *accounting principles generally accepted in the United States of America*.

Each of the italicized phrases has a special significance. The first phrase, "in our opinion," makes clear that the auditors are expressing nothing more than an informed opinion; they are not guaranteeing or certifying that the statements are accurate, correct, or true. In an earlier period of public accounting, the wording of the audit report contained the phrase "we certify that," but this expression was discontinued on the grounds that it was misleading. To "certify" implies absolute assurance of accuracy, which an audit does not provide.

The auditors cannot guarantee the correctness of the financial statements because the statements include many estimates, not absolute facts. Furthermore, the auditors do not make a complete and detailed examination of all transactions. Their audit is limited to a program of tests that leaves the possibility of some misstatements going undetected. Because of limitations inherent in the accounting process and because of practical limitations of time and cost in performing an audit, the auditors' work culminates in the expression of an opinion and not in the issuance of a guarantee of accuracy.

The Financial Statements "Present Fairly, in All Material Respects . . ."

Since many of the items in financial statements cannot be measured exactly, the auditors cannot say that the statements present exactly or correctly the financial position or operating results. The meaning of "present fairly," as used in the context of the auditors' report, has been much discussed in court cases and in auditing literature. Some accountants believed that financial statements were fair if they conformed to GAAP; others insisted that fairness was a distinct concept, broader than mere compliance with GAAP. This discussion led to the issuance by the Auditing Standards Board of *SAS 69* (AU 411), "The Meaning of 'Present Fairly in Conformity with Generally Accepted Accounting Principles' in the Independent Auditor's Report." *SAS 69* states that fairly presented financial statements are:

1. Prepared in accordance with accounting principles that have *general acceptance* and are *appropriate* in the circumstances.
2. *Informative* of matters that may affect their use, understanding, and interpretation.

[4] Historically, *audit reports* referred simply to generally accepted auditing standards and generally accepted accounting principles. The globalization of business resulted in a modification of the standard report which identifies the source of the standards followed (e.g., International, United States [of America], or some other country). In this text we will use the new terminology in report illustrations, but, like the standards, will refer to generally accepted auditing standards (GAAS) and generally accepted accounting principles (GAAP) in other contexts.

3. Presented in a manner that is *classified and summarized in a reasonable manner,* neither too detailed nor too condensed.
4. Prepared to *reflect transactions and events* within a range of reasonable limits.

What Is "Material"?

Auditors cannot issue an unqualified opinion on financial statements that contain material deficiencies. The term *material* may be defined as "sufficiently important to influence decisions made by reasonable users of financial statements." Materiality is influenced by the size of the organization that is being audited. In the audit of a small client—such as a condominium property owners' association—$1,000 might be considered material. On the other hand, in the audit of a company such as IBM or Microsoft, an amount of $1 million might be considered immaterial.

In practice, one of the most significant elements of professional judgment is the ability to draw the line between material and immaterial departures from generally accepted accounting principles. The auditor who raises objections over immaterial items will soon lose the respect of both clients and associates. On the other hand, the auditor who fails to identify and disclose material deficiencies in financial statements may be liable for the losses of those who rely upon the audited statements. In short, applying the concept of materiality is one of the most complex problems faced by auditors.

Materiality depends upon both the *dollar amount* and the *nature of the item*. For example, a $500,000 error in the balance of the Cash account is ordinarily far more significant than a $500,000 error in the balance of Accumulated Depreciation. If a corporation sells assets to a member of top management and then buys the assets back at a higher price, this *related party transaction* warrants disclosure even though the dollar amounts are not large in relation to the financial statements as a whole. The reason for requiring disclosure of such a transaction is based more on the nature of the transaction than upon the dollar amount. Materiality is discussed further in Chapter 6.

Adequate Informative Disclosure

If financial statements are to present fairly, in all material respects, the financial position and operating results of a company, there must be **adequate disclosure** of all essential information. A financial statement may be misleading if it does not give a complete picture. For example, if an extraordinary item arising from an uninsured flood loss of plant and equipment were combined with operating income and not clearly identified, the reader might be misled as to the earning power of the company. Adequate disclosure means the information is accurate and complete and has been clearly conveyed to the financial statement user.

Generally Accepted Accounting Principles (GAAP)

The next key phrase to be considered is "accounting principles generally accepted in the United States of America." The wording of the audit report implies that these accounting principles represent a concept well known to CPAs and sophisticated users of financial statements. However, no official list of accounting principles exists, and a satisfactory concise definition has yet to be developed.

In evaluating whether a particular accounting principle used by a client is generally accepted, the auditors may refer to a variety of sources, from *Statements* and *Interpretations* of the FASB, the GASB, and the FASAB to articles in accounting journals. The auditors look to these references to determine whether there is *substantial authoritative support* for the principle. Figure 2.4 illustrates the relative authority of sources of generally accepted accounting principles from the category with highest authority to that with the least. As illustrated, the pronouncements of generally accepted accounting principles differ among state and local governments, federal government entities, and businesses and not-for-profit organizations.