CHAPTER 1
AUDITING: INTEGRAL TO THE ECONOMY
LEARNING OBJECTIVES

1. Define the objective of external auditing and describe its role in meeting society’s demands for reliable financial and internal control information
2. Identify parties involved in preparing and auditing financial statements and briefly describe their roles
3. List the types of audit service providers and the skills and knowledge needed by professionals entering the external auditing profession
4. Identify organizations that affect the external auditing profession and the nature of their effects
LEARNING OBJECTIVES

5. Define audit quality and identify drivers of audit quality as specified by the Financial Reporting Council’s Audit Quality Framework

6. Identify professional requirements that help to achieve audit quality and minimize auditor exposure to lawsuits
PROFESSIONAL JUDGMENT IN CONTEXT - IMPORTANCE OF CONDUCTING A QUALITY AUDIT AND COMPLYING WITH PROFESSIONAL STANDARDS

- Penalties were imposed on Bentleys Brisbane Partnership and Robert Forbes by PCAOB because it concluded that they failed to:
  - Exercise due professional care
  - Exercise professional skepticism
  - Obtain sufficient evidence necessary to issue an audit opinion on the financial statements of Alloy Steel’s 2006 fiscal year end financial statements
What is the objective of auditing, and what process should auditors follow to accomplish this objective? (LO 1)

Why do companies obtain audited financial statements? (LO 1)

Who are the users of audited financial statements? (LO 1)

What skills and knowledge are needed to be a competent audit professional? (LO 3)
PROFESSIONAL JUDGMENT IN CONTEXT - IMPORTANCE OF CONDUCTING A QUALITY AUDIT AND COMPLYING WITH PROFESSIONAL STANDARDS

• Why is it vital to perform an audit in a quality manner? (LO 5)
• Why are low quality audits, like those performed in this case, harmful? (LO 5)
DEFINE THE OBJECTIVE OF EXTERNAL AUDITING AND DESCRIBE ITS ROLE IN MEETING SOCIETY’S DEMANDS FOR RELIABLE FINANCIAL AND INTERNAL CONTROL INFORMATION
EXTERNAL AUDITING PROFESSION

Financial statement audit

• Systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users
Objectives of external auditing is to provide opinions on:

- Reliability of financial statements
- Internal control effectiveness

**Integrated audit**: Provided when an external auditor is engaged to perform an audit of the effectiveness of internal control over financial reporting that is integrated with an audit of financial statements
EXTERNAL AUDITING PROFESSION

• External audit is intended to enhance confidence that users can place on management-prepared financial statements

• **Unqualified audit report**: When the auditor issues this type of report, it implies that the auditor has no reservations about management’s financial statements or internal controls
EXTERNAL AUDITING PROFESSION

• When the auditor has reservations about the fair presentation of the financial statements
  • Audit report is modified to explain the nature of the reservations

• Adverse opinion is expressed when auditors believe that:
  • Financial statements taken as a whole are not presented fairly in conformity with GAAP and/or
  • Client’s internal controls not effective
EXTERNAL AUDITING: A SPECIAL FUNCTION

• Described by Chief Justice Warren Burger - Captures the essence of the external auditing profession
  • Most important party served by the auditors is the public
  • Auditing requires:
    • Technical competence
    • Freedom from bias
    • Concern for the integrity of the financial reporting process
  • Auditors - Guardians of the capital markets
EXTERNAL AUDITING: A SPECIAL FUNCTION

• Public expects auditors to:
  • Find fraud
  • Require that management use accounting principles that best portray the spirit of the concepts adopted by accounting standard setters
  • Be independent of management

• Auditing profession faces many pressures
  • Keeping fees down
  • Making careful decisions regarding independence
  • Conducting a quality audit
AUDITING IN PRACTICE - WHY IS OWNING STOCK IN AN AUDIT CLIENT UNACCEPTABLE?

• When auditors own stock in their audit clients
  • They are not independent of their clients because they are part owners
• Auditors may make judgments that favor the client company rather than external users of the financial statements
• External users may perceive an independence conflict
EXHIBIT 1.2 - USERS OF AUDITED FINANCIAL STATEMENTS AND DECISIONS THEY MAKE BASED ON THE REPORTS

<table>
<thead>
<tr>
<th>User</th>
<th>Types of Decisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management</td>
<td>Review performance, make operational decisions, report results to capital markets</td>
</tr>
<tr>
<td>Stockholders</td>
<td>Buy or sell stock</td>
</tr>
<tr>
<td>Bondholders</td>
<td>Buy or sell bonds</td>
</tr>
<tr>
<td>Financial Institutions</td>
<td>Evaluate loan decisions, considering interest rates, terms, and risk</td>
</tr>
<tr>
<td>Taxing Authorities</td>
<td>Determine taxable income and tax due</td>
</tr>
<tr>
<td>Regulatory Agencies</td>
<td>Develop regulations and monitor compliance</td>
</tr>
<tr>
<td>Labor Unions</td>
<td>Make collective bargaining decisions</td>
</tr>
<tr>
<td>Court System</td>
<td>Assess the financial position of a company in litigation</td>
</tr>
<tr>
<td>Vendors</td>
<td>Assess credit risk</td>
</tr>
<tr>
<td>Retired Employees</td>
<td>Protect employees from surprises concerning pensions and other post-retirement benefits</td>
</tr>
</tbody>
</table>
NEED FOR UNBIASED REPORTING AND INDEPENDENT ASSURANCE - FACTORS

Why is there a risk that information provided by management may not always be reliable?

• Potential bias
  • Management has incentives to bias financial information to convey a better impression of financial data than real circumstances might merit

• Remoteness
  • Organization and users of its financial information are distant from each other in terms of either geographic distance or the extent of information available to the both parties
NEED FOR UNBIASED REPORTING AND INDEPENDENT ASSURANCE - FACTORS

• Complexity
  • Difficulty in determining a proper presentation of complex transactions, information, and processing systems

• Consequences
  • With unreliable information, investors lose a significant source of information needed to make important decisions
OVERALL OBJECTIVES IN CONDUCTING AN AUDIT

• Obtaining assurance about financial statements being free from material misstatement
• Reporting on financial statements based on auditor’s findings
OVERALL OBJECTIVES IN CONDUCTING AN AUDIT

• In completing these objectives, the auditor:
  • Complies with relevant ethical requirements
  • Plans and performs an audit with professional skepticism
  • Exercises professional judgment
  • Obtains sufficient appropriate evidence on which to base the auditor’s opinion
  • Conducts audit in accordance with professional auditing standards
EXHIBIT 1.3 - THE AUDIT OPINION FORMULATION PROCESS

I. Making Client Acceptance and Continuance Decisions
   - Chapter 14

II. Performing Risk Assessment
    - Chapters 3, 7 and 9–13

III. Obtaining Evidence about Internal Control Operating Effectiveness
    - Chapters 8–13 and 16

IV. Obtaining Substantive Evidence about Accounts, Disclosures and Assertions
    - Chapters 8–13 and 16

V. Completing the Audit and Making Reporting Decisions
   - Chapters 14 and 15

The Auditing Profession, the Risk of Fraud and Mechanisms to Address Fraud: Regulation, Corporate Governance, and Audit Quality
- Chapters 1 and 2

Professional Liability and the Need for Quality Auditor Judgments and Ethical Decisions
- Chapter 4

The Audit Opinion Formulation Process and A Framework for Obtaining Audit Evidence
- Chapters 5 and 6
IDENTIFY PARTIES INVOLVED IN PREPARING AUDITED FINANCIAL STATEMENTS AND BRIEFLY DESCRIBE THEIR ROLES
EXHIBIT 1.4 - PARTIES INVOLVED IN PREPARING AND AUDITING FINANCIAL STATEMENTS

ORGANIZATION

Management
Maintains Internal Controls and Prepares Reports

Internal Audit Function
Provides Internal Assurance on Internal Controls and Reports

Audit Committee
Provides Oversight of the Reporting Process and Other Parties

Financial Statements and Related Disclosures Along With the Auditor’s Reports Disseminated to Users

External Auditor
Provides Independent Audit of Internal Controls and Financial Statements
LEARNING OBJECTIVE 3

LIST THE TYPES OF AUDIT SERVICE PROVIDERS AND THE SKILLS AND KNOWLEDGE NEEDED BY PROFESSIONALS ENTERING THE EXTERNAL AUDITING PROFESSION
PROVIDERS OF EXTERNAL AUDITING SERVICES

• External auditing profession includes:
  • Sole-practitioner firms
  • Local and regional firms
  • Large multinational professional services firms
PROVIDERS OF EXTERNAL AUDITING SERVICES

- Organizational hierarchy of audit firms

| Partners/Owners | • Responsible for overall conduct of each audit  
|                 | • Responsible for many audit engagements  
|                 |     being conducted simultaneously  
| Managers        | • Review audit work of seniors and staff  
|                 | • Responsible for fewer audit engagements  
|                 |     being conducted simultaneously  
| Seniors         | • Responsible for overseeing day-to-day  
|                 |     activities on a specific audit  
|                 | • Oversee performance of auditing procedures |
SKILLS AND KNOWLEDGE NEEDED FOR EXTERNAL AUDITING PROFESSION

- Technical knowledge and expertise
  - Auditors must:
    - Understand accounting and auditing authoritative literature
    - Develop industry and client-specific knowledge
    - Develop and apply computer skills
    - Evaluate internal controls
    - Assess and respond to fraud risk
SKILLS AND KNOWLEDGE NEEDED FOR EXTERNAL AUDITING PROFESSION

• Leadership, teamwork, and professional skills
  • Auditors:
    • Make presentations to management and audit committee members
    • Exercise logical reasoning
    • Communicate decisions to users
    • Manage and supervise by providing meaningful feedback
    • Act with integrity and ethics and Interact in a team environment
    • Collaborate and maintain a professional personal presence
**AUDITING IN PRACTICE - SHOULD I WORK FOR A LARGE OR A SMALL AUDIT FIRM?**

- **Difference between large and small audit firms**

<table>
<thead>
<tr>
<th></th>
<th><strong>Larger Audit Firms</strong></th>
<th><strong>Smaller Audit Firms</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Working in a team environment</td>
<td>multiple teams that typically disband after each audit engagement</td>
<td>teams that overlap across engagements</td>
</tr>
<tr>
<td>Work specialization</td>
<td>specialized by function, i.e., audit or tax, but usually not both</td>
<td>less specialized by function; an individual may work across functions and industries</td>
</tr>
<tr>
<td></td>
<td>may also be specialized by industry</td>
<td></td>
</tr>
<tr>
<td>Type of work</td>
<td>primarily external audit</td>
<td></td>
</tr>
<tr>
<td>Organizational culture</td>
<td>relatively formal</td>
<td>relatively less formal</td>
</tr>
<tr>
<td>Staff turnover</td>
<td>relatively higher</td>
<td>relatively lower</td>
</tr>
</tbody>
</table>
LEARNING OBJECTIVE 4

IDENTIFY ORGANIZATIONS THAT AFFECT THE EXTERNAL AUDITING PROFESSION AND THE NATURE OF THEIR EFFECTS
Due to various failures in auditing profession during early 2000s Congress passed the Sarbanes-Oxley Act of 2002.

- This legislation had an impact on audit firms through:
  - Increasing auditor independence
  - Enhancing the role and importance of audit committee
  - Requiring reporting on internal control over financial reporting
  - Providing new oversight of external auditing profession by Public Company Accounting Oversight Board
• Private sector, nonprofit organization
• Oversees auditors of public companies
• Goal of the PCAOB
  • To protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)

- Primary responsibilities related to auditors
  - Registration of audit firms that audit public companies
  - Periodic inspections of registered audit firms
  - Establishment of auditing and related standards for registered audit firms
  - Investigation and discipline of registered audit firms for violations of relevant laws or professional standards
SECURITIES AND EXCHANGE COMMISSION (SEC)

- Governmental body established by Congress in 1934
- Regulates the capital market system
- Has authority to establish GAAP for companies whose stock is publicly traded
- Responsible to prosecute public companies and their auditors for violating SEC laws
AUDITING IN PRACTICE - LOCATING ENFORCEMENT ACTIONS ON THE SEC WEB SITE

- SEC issues enforcement actions:
  - To penalize individuals and firms for wrongdoings in auditing professions
  - To have a deterrence effect
- Steps to see what enforcement releases have been made recently:
  - Go to www.sec.gov.
  - Go to the “Divisions and Offices” section and click “Enforcement”
AUDITING IN PRACTICE - LOCATING ENFORCEMENT ACTIONS ON THE SEC WEB SITE

• Click “Accounting and Auditing Enforcement Releases”
• Click the appropriate year
• Click the enforcement release that you wish to read
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- Primary governing organization of the public accounting profession
- Develops standards for audits of nonpublic companies
- Responsible for a peer review program
- Provides continuing education programs
- Prepares and administers the Uniform CPA Examination - through its Board of Examiners
CENTER FOR AUDIT QUALITY (CAQ)

- Organization affiliated with AICPA
- Dedicated to enhance investor confidence and trust in financial markets
- A thought leader in:
  - Fostering audit quality
  - Collaborating with auditors and financial statement users about emerging issues
  - Advocating for accounting and auditing standards that promote auditors’ effectiveness
INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD (IAASB)

- Part of the International Federation of Accountants (IFAC)
  - A global organization for the accounting profession
- Sets International Standards on Auditing (ISAs)
- Facilitates convergence of national and international auditing standards
COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION (COSO)

- Provider of thought leadership and guidance on:
  - Internal control
  - Enterprise risk management
  - Fraudulent deterrence
- Provides the internal control framework
  - Serves as benchmark for auditors
COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION (COSO)

- Sponsored by the following organizations:
  - Financial Executives International
  - The American Institute of Certified Public Accountants
  - The American Accounting Association
  - The Institute of Internal Auditors
  - The Association of Accountants and Financial Professionals in Business (IMA)
ACCOUNTING STANDARD SETTERS

• Generally accepted accounting principles (GAAP)
  • Has general acceptance and provides criteria by which to assess the fairness of a financial statement presentation
  • GAAP traditionally been set by FASB, with approval by the SEC in the United States
ACCOUNTING STANDARD SETTERS

• International accounting standards (IFRS - International Financial Reporting Standards)
  • Set by the IFRS Foundation of IASB
  • Their goal is to develop a single set of international financial reporting standards that is:
    • Understandable
    • Enforceable
    • Globally accepted
STATE BOARDS OF ACCOUNTANCY

• Certified Public Accountants (CPAs)
  • Licensed by state boards of accountancy which are charged with regulating the profession at the state level
  • Required by all state boards for passage of Uniform CPA Examination as one criterion for licensure
THE COURT SYSTEM

• Acts as a quality-control mechanism for the auditing profession
• Third parties may sue CPAs under federal securities laws, various state statutes, and common law for substandard audit work
LEARNING OBJECTIVE 5

DEFINE AUDIT QUALITY AND IDENTIFY DRIVERS OF AUDIT QUALITY AS SPECIFIED BY THE FINANCIAL REPORTING COUNCIL’S AUDIT QUALITY FRAMEWORK
AUDIT QUALITY

• Performing an audit in accordance with accepted auditing standards (GAAS)
  • Providing assurance that audited financial statements and disclosures are presented in accordance with GAAP
  • Providing assurance that those financial statements are not materially misstated whether due to errors or fraud
EXHIBIT 1.5 - DRIVERS OF AUDIT QUALITY

• Primary drivers of audit quality included in Audit Quality Framework developed by Financial Reporting Council (FRC)
DRIVERS OF AUDIT QUALITY

• Audit firm culture contributes to audit quality when leadership:
  • Creates work culture where audit quality is valued and rewarded
  • Emphasizes that ‘doing the right thing’ is appropriate from a public interest perspective
  • Ensures that employees have time and resources to address difficult issues
  • Ensures that monetary considerations do not adversely affect audit quality
DRIVERS OF AUDIT QUALITY

• Promotes benefits of audit partners seeking guidance on difficult issues
• Ensures that audit firm has quality systems in place
• Fosters evaluation and compensation practices
• Ensures that audit quality is monitored within audit firm with appropriate consequences in case of loopholes
Drivers of Audit Quality

• Skills and qualities required of engagement team
  • Understanding clients’ business and adhering to auditing and ethical standards
  • Exhibiting professional skepticism and addressing issues identified during audit
  • Ensuring that staff has appropriate experience and is properly supervised
  • Ensuring that lower level staff is provided with mentoring and on the job training opportunities
  • Attending to and learning during training
DRIVERS OF AUDIT QUALITY

• There is effectiveness of the audit process when:
  • Audit methodology is well structured and:
    • Encourages partners and managers to work diligently in planning the audit
    • Provides a framework and procedures to obtain sufficient appropriate audit evidence in an effective and efficient manner
    • Requires appropriate audit documentation
    • Provides for complying with auditing standards, but does not inhibit professional judgment
DRIVERS OF AUDIT QUALITY

• Ensuring that audit work is effectively reviewed
• Audit quality control procedures are effective, understood, and applied
• Quality technical support is available when auditors encounter unfamiliar situations
• Ethical standards are communicated and achieved
• Auditors’ evidence collection not constrained by financial pressures
DRIVERS OF AUDIT QUALITY

• Reliability and usefulness of audit reporting include:
  • Audit reports
  • Auditors appropriately concluding as to the truth and fairness of financial statements
DRIVERS OF AUDIT QUALITY

• Auditors communicating with audit committee about the following:
  • Audit scope
  • Threats to auditor objectivity
  • Important risks identified and judgments made in reaching audit opinion
  • Qualitative aspects of client’s accounting and possible ways of improving financial reporting
FACTORS OUTSIDE THE CONTROL OF AUDITORS

- Client corporate governance
- Regulatory environment
LEARNING OBJECTIVE 6

IDENTIFY PROFESSIONAL REQUIREMENTS THAT HELP TO ACHIEVE AUDIT QUALITY AND MINIMIZE AUDITOR EXPOSURE TO LAWSUITS
ACHIEVING AUDIT QUALITY AND MINIMIZING LAWSUITS

• Professional requirements that help to achieve audit quality
  • Maintaining auditor independence
  • Participating in review programs
  • Issuing engagement letters
  • Making appropriate client acceptance
  • Evaluating the audit firm’s limitations
  • Maintaining quality audit documentation
PCAOB INDEPENDENCE REQUIREMENTS

- Applicable to auditors of public companies
- Designed to address requirements in Sarbanes-Oxley Act of 2002
SEC INDEPENDENCE REQUIREMENTS

- Taking principles-based approach
- Applicable to auditors of public companies
- Principles dictate that auditor independence is impaired when:
  - Mutual or conflicting interest between accountant and audit client
  - Accountant auditing own work
  - Accountant acting as management or employee of audit client
  - Accountant being an advocate for audit client
AICPA INDEPENDENCE REQUIREMENTS

• Threats to independence
  • Self-review threat
  • Advocacy threat
  • Adverse interest threat
  • Familiarity threat
  • Undue influence threat
  • Financial self-interest threat
  • Management participation threat
Safeguards to avoid independence problems include:

- Safeguards created by profession or regulation
- Safeguards created by audit client
- Safeguards created by audit firm
REVIEW PROGRAMS

- External inspections/peer reviews
- Engagement quality reviews
- Interoffice reviews
ENGAGEMENT LETTER

• States scope of work to be done on audit
• There should be no doubt in the mind of client, external auditor, or court system - regarding expectations agreed to by external auditor and client
• Includes:
  • Audit fee
  • Timing description of external auditor’s work
  • Documentation that client is expected to provide to external auditor
CLIENT ACCEPTANCE/CONTINUANCE DECISIONS

• Guidelines established to screen out:
  • Clients in financial and/or organizational difficulty
  • Clients constituting a disproportionate percentage of firm’s total practice
  • Disreputable clients
  • Clients offering an unreasonably low fee for auditor’s services
AUDIT FIRM LIMITATIONS

• An external audit firm should not undertake engagement that it is not qualified to handle
  • Important for smaller and growing firms
AUDIT DOCUMENTATION

• Document everything done on audit
• Documentation should clearly show evidence of supervisory review
• Documentation should indicate:
  • What tests were performed
  • Who performed them
  • Any significant judgments made