Solutions for Chapter 1

Auditing: Integral to the Economy

Review Questions:

1-1. The special function performed by the public accounting profession is the attestation to the fairness of the financial statements of clients. The special function ensures the reliability and integrity of the financial reporting system. Judge Burger described the special function as "certifying the public reports that collectively depict a corporation's financial status," which involves "a public responsibility transcending any employment relationship with the client."

The auditing profession exists to serve the users of an organization's financial statements. These include lenders, investors, management, government, and (indirectly) all individuals who are ultimately affected by the integrity of the financial reporting process. Auditors need to remember that they are serving the public interest and not the interests of client management.

1-2. The audit opinion formulation process is a systematic approach by which the auditor evaluates the risk of being associated with a client, through the process of gathering and evaluating audit evidence, to determining the type of audit opinion that should be rendered. The stages and outcome of each stage are as follows:

- *Assessing Client Acceptance and Retention*: The outcome is determining whether or not a firm should serve a potential client. The decision will depend on the risk to the auditor of being associated with a particular client.
- *Understanding the Client*: The outcome is a business understanding of the client, its major processes, the risks inherent in its business, and the impact of current economic and competitive issues on the client and its financial statements.
- *Obtaining Evidence About Controls*: The outcome is an understanding of the client's internal control over financial reporting and whether the controls are sufficient to mitigate the risk of material misstatements in a company's financial statements.
- *Obtaining Substantive Evidence about Account Balances*: The outcome is the audit evidence that is gathered, evaluated, and synthesized to determine if the auditor has sufficient competent evidence to render an audit opinion.
- *Wrapping Up the Engagement:* A final review of evidence, as well as a review of the audit process by someone outside of the audit to determine whether all procedures have been performed and that audit risks have been evaluated. The final outcome is the decision on which audit opinion to render.

1-3. Some of the factors leading up to the change include: (a) the failure of one of the largest public accounting firms in the world (Arthur Andersen & Co.); (b) four of the largest bankruptcies in history—and each of the bankruptcies occurred in companies where financial statement misrepresentation had taken place; (c) billions of dollars in investment and retirement fund losses; (d) a sense that auditors were not independent of management and (e) a question as to whether the public accounting profession could sufficiently govern itself to ensure that it would always act in the public interest. In response to these failures, Congress passed the Sarbanes-Oxley Act of 2002. The public accounting profession has been impacted by this Act in a number of ways including:

- The U.S. audit standards for public company audits are now set by a regulatory agency – the PCAOB.
- The audit committee is to take the role of the client and has the responsibility to hire/fire the auditor.
- Auditor independence requirements have been strengthened.
- Audits of internal controls are now required for larger public companies.

While the environment has changed, the expectations of users have stayed essentially the same. They expect (a) auditors to detect and report on fraud, and (b) certify financial statements that are both in accordance with GAAP and are transparent regarding economic activities and conditions.

1-4. An audit service requires a report to a third-party user and thus requires independence on the part of the attestor. Audit services differ from general assurance services in that assurance services do not require a report to a third party. For example, a company may request assurance services concerning their internal controls. At their request, the company may be the only recipient of a report. Thus, the difference is related to whether or not the service is provided to third parties. Further, an audit service is generally recognized as one that pertains to an organization's financial statements and internal controls over financial reporting and the results of the audit service will be communicated to third-party users.

1-5. Auditors exercise professional judgment in virtually every aspect of the audit. That judgment requires the auditor to exercise professional skepticism within a framework of knowledge of the economics of a business and accounting knowledge. That judgment is utilized in the following types of areas (but is not limited to these examples):

- Evaluating the risk of being associated with a particular client,
- Evaluating the risk associated with a client's internal control process and the potential implications regarding potential misstatements in accounting records,
- Evaluating the economics of an organization's financial transactions or the economic value of an organization's assets or liabilities,
- Applying the proper accounting treatment to issues that arise during the conduct of the audit.

1-6. Assurance services are needed because there is a:

- Potential bias in providing information

- Remoteness between a user and the organization or trading partner
- Complexity exists in the transaction, information, or processing systems such that it is difficult to determine their proper presentation without a review by an independent expert
- Need to limit negative consequences that arise from relying on inaccurate information.

Interested parties need to have confidence that the information they are using to make choices is reliable. The public accounting profession has strict independence rules and has traditionally been in a position of high trust with the investing public, which gives them an important competitive advantage. The public accounting profession also must have expertise in a variety of different kinds of business processes to have the ability to deal with many types of transactions. Recent PCAOB requirements call for auditors to comment on the appropriateness of accounting principles, which should reduce the number of unpleasant financial “surprises” that users have encountered during the past decade.

1-7. The primary reference points (criteria) to determine fairness of presentation are:

- GAAP – generally accepted accounting principles determined by the FASB, the GAO, or the IASB (International Accounting Standards Board).
- COSO – *Internal Control, Integrated Framework* for reports on internal control over financial reporting.

It is important to have criteria against which to judge fairness so that everyone is communicating on the same page. Otherwise it becomes one individual’s opinion versus the opinion of someone else.

1-8. Complexity affects the demand for auditing services in that both users and management need the expertise of professionals who understand the underlying economic substance of transactions and financial instruments and, thus, who have the ability to determine the appropriate accounting best to "fairly" portray the economic substance of an organization's activities and financial condition.

The business environment in which the auditor must function is increasingly complex. The major forms of complexity relate to:

a. Computer systems, which are becoming increasingly interdependent across organizations.
b. Increased complexity of financial instruments and transactions entered into by organizations.
c. The economic environment in which we all must operate. The changing environment includes such items as the increased need to have a global outlook in

providing goods and services and the need to be attuned to societal regulations in such areas as environmental protection.

1-9. The ten standards have historically provided the foundation for the financial statement audit. These standards are stated as unconditional requirements. The proposed principles are not requirements but serve as the fundamental principles governing an audit. The structure of the principles addresses the purpose of an audit, personal responsibilities of the auditor, auditor actions in performing the audit, and reporting. The structure is similar to the ten standards. The headings General and Fieldwork have been changed to the principles of Responsibilities and Performance. The Reporting principles are written at a less detailed level than the current reporting standards.

1-10. All three of these parties are important users. Arguments can be made for each group as follows. Ultimately, however, the auditor needs to remember that the audit should have a public interest focus:

Shareholders: They are owners of the organization and thus they represent the group to which management is ultimately accountable (i.e., management serves only per the wishes of shareholders). Owners as a group depend on an independent audit to inform them of the stewardship and overall performance of management. Shareholders are also represented through the Board of Directors whom they elect to represent their best interests.

Creditors: They invest capital in the organization in the form of short-- or long--term loans. Creditors are concerned with the safety of their loans and look to audited reports to provide information on the status of the organization's financial position and its earning power to assess the relative safety of their loans or their decision to grant credit to an organization.

Management: They are interested in seeing that the financial statements show their performance, and if possible, to do so in a way that is most favorable to them. Many members of management now have bonus (salary) agreements tied to reported profits. Additionally, management may have stock options or stock investments that are significantly affected by the reported profits of the company. Auditors need to remember that management is NOT the client, even though they work closely with management and the client pays the auditor's fee.

Of the three groups, management is more often quite short-term oriented in its perspective (although certainly not all members of management fall into this group). Often, management may be interested in achieving short--term objectives and in applying accounting principles and judgments that are aggressive and seek to maximize reported income. Creditors, on the other hand, are more concerned with the safety of their loans and would prefer a conservative approach to accounting that might understate assets and revenue and thus provide a cushion for safety. Investors are generally more long-term oriented (although this is less true with the majority of stock ownership now residing in mutual funds) and are generally more interested in the quality of reported earnings and assets (i.e., they do not desire any over-- or under--statement; rather, they want the most accurate information on which to make decisions).

The auditors resolve potential conflicts by:

- Understanding the economic substance of transactions.
- Determining how the economic substance guides the accounting choices.
- Ensuring the accounting follows GAAP.

Unbiased reporting implies that the auditor always favors appropriate accounting over the desires of individual users.

1-11. The audit enhances the quality of financial statements because the user has the assurance that an *independent, qualified professional* has examined the financial statements and has rendered an opinion on their fairness. The independence and expertise of the auditor serves as a quality control function to overcome the potential bias of management in presenting the financial statements in a manner that most flatters an assessment of their performance. The audit is designed to add credibility to the financial statements.

An audit does not necessarily ensure a fair presentation of a company's financial statements although it does dramatically increase the likelihood that there are no material misstatements in the company's financial statements. The audit provides reasonable, not absolute, assurance about the accuracy of the financial statements. The caveats about fairness exist for two reasons:

a. Fairness is judged within a framework of GAAP. Some question whether GAAP result in the fairest possible presentations when there are significant changes in market values of investments or assets. For example, the SEC has encouraged financial institutions to move from using historical cost required by GAAP to market values for all investments in securities because it believes that market value presents a better picture of economic reality than does historical cost.
b. Although designed to detect fraud, it might be possible that a well-executed audit may still fail to detect fraud.

In addition, an audit does not provide unequivocal assurance that the control systems are free of material weaknesses, i.e., there is always “audit risk” even in a well-designed and well-executed audit.

1-12. Due professional care is the expectation that an audit will be conducted with the skill and care of a professional. The standard of due professional care plays a role in litigation against auditors. Plaintiffs will try to show that the auditor did not do what a reasonably prudent auditor would have done. To evaluate the standard, a third-party also decides whether someone with similar skills in a similar situation would have acted in the same way.

1-13. Current economic trends can affect the valuation of assets and liabilities, as well as estimates that will affect the valuation of those assets. For example, if interest rates are increasing, that changes the discount rate for estimating pension liabilities. Or, if an organization, such as Borders Bookstores, announces they are closing one-third of their stores, it means that the valuation of the stores on the books must be changed from historical cost less accumulated depreciation to current market value. There are similar issues that relate the realizability of accounts receivable, loans receivable, or inventory. The bottom line is that auditors must be aware of current economic trends and how they will affect their audit clients.

1-14. For the most part, the standards issued by the IAASB are quite similar to that of the two U.S. based audit standard setters. The IAASB Audit Standards are quite consistent with that of the PCAOB as well as that of the AICPA. Most of the concepts are the same, but are stated differently. All are principles-based supplemented by more detailed guidance. They are very similar in the following ways:

- Requirement of independence,
- Gathering and evaluation of sufficient evidence,
- Documentation of audit work,
- Audit designed to minimize audit risk,
- Due professional care
- Reasonable assurance,
- Nature of the audit report

The AICPA and the IAASB have announced a plan to work towards convergence of existing and future standards. The PCAOB has not yet announced a plan for convergence.

Areas in which the standards differ include:

- Opinions on accounting treatment and financial reporting framework.
- Reporting on internal control over financial reporting.
- Focus on independence vs. professional skepticism.

1-15. Assurance engagements are designed to provide ‘positive assurance’, i.e. the item being attested to is either properly presented, or is not properly presented. For example, one of the Big 4 firms provides assurance to the audience that the votes are properly maintained and counted for the Emmy Awards.

- A ‘limited assurance engagement’ does not contemplate a full audit or assurance engagement such that sufficient information (evidence) is gathered to warrant a positive statement about whether the item being assured is, or is not, properly presented. Rather, based on a more limited amount of work, the auditor either states that 'nothing came to his or her attention – based on the limited procedures – that indicates something is not fairly presented'. This is often referred to as 'negative assurance'. An even more limited assurance engagement is one in which the accountant expresses 'no assurance' whatsoever on the item being reported. An example of this would be a compilation engagement in which the auditor prepares the client's financial statements.

1-16. Independence means objectivity and freedom from bias. The auditor can favor neither the client nor the third party in evaluating the fairness of the financial statements. The auditor must be independent in fact and in appearance. Independence in fact means the auditor is unbiased and objective. An auditor could be independent in fact if he or she owned a few shares of common stock in an audit client, but might not appear independent to a third party. Independence in appearance means that a third party with knowledge of the auditor's relationship with the client would consider the auditor to be independent. If users don't perceive auditors to be independent then the value of the audit is lacking. .

1-17. Internal auditing exists as a separate audit function within an organization with a reporting responsibility to management, the board of directors, and the audit committee of the board of directors. The scope of internal audits is generally much broader than that of the external auditor. Internal auditing is viewed as an integral part of the organization's risk, governance, and control processes. The internal auditor often performs operational audits, compliance audits, and computer system audits in addition to financial--type audits. The internal auditing function must strive to achieve independence while working within the organization. This is usually accomplished by reporting to a high management level and the audit committee of the board of directors to ensure that no audit findings are suppressed.

Persons are licensed as CPA's by state regulatory agencies. Only CPAs are licensed to render an audit opinion. Internal auditors are not so licensed, but many internal auditors are either Certified Internal Auditors or CPAs and adhere to the professional standards, as do the external auditors. The internal audit function is also responsible to the organization for which it serves.

1-18. A public accounting firm that does not have any public clients is subject to the *auditing and ethical standards* as promulgated by the AICPA; and is not subject to the standards set by the PCAOB. An audit firm serving only non-public companies differs in the following ways:

- Can perform all types of attestation services, including compilations and reviews (negative assurance and no assurance),
- Can perform consulting activities for clients as long as they do not violate the AICPA rules. For example, it can perform tax services for managers of their clients,

- They are not required to perform audits of internal control over financial reporting,
- Their audits can focus more on direct tests of account balances.

1-19. The GAO is the audit arm of the U.S. Congress with a broad mission to evaluate the effectiveness, efficiency, and compliance of governmental agencies and other agencies that are direct recipients of governmental funds.

Although the GAO performs all the types of audits performed by internal auditors, it tends to perform more economy and efficiency audits because Congress is very concerned with the manner in which the government carries out the various pieces of legislation enacted by Congress. The scope of the GAO's audits is extremely broad. A major part of the GAO's work is devoted to developing measurable criteria to compare agency functions with legislative intent.

In setting standards for municipal audits, the GAO is responsible for issuing *Government Auditing Standards*. The standards apply to "audits of government organizations, programs, activities, and functions, and of government funds received by contractors, nonprofit organizations, and other nongovernmental organizations . . . The standards pertain to the auditor's professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports" (Foreword from the *Standards).*

1-20. The Securities and Exchange Commission (SEC) has the power to dictate accounting principles and to determine overall audit standards. This power to regulate the securities industry in the aftermath of the Great Depression was given by Congress to the SEC in 1933 and 1934. It dictates the form of filings that must be made with it and that are available as public documents for new issuances of debt or capital instruments. Companies that meet minimum criteria for diversity of ownership must also file annual and quarterly reports with the SEC. The SEC has traditionally worked with the accounting profession to keep the standard--setting process in the private sector. A representative of the SEC, for example, sits on the Emerging Issues Task Force of the FASB. In addition to power to set standards, the SEC has the power to suspend parties from practicing before it. Further, the SEC has the power to negate rules promulgated by the PCAOB, and is certainly involved in a political capacity in shaping that organization’s agenda.

1-21. The PCAOB:

a) Sets auditing standards for audits of public companies
b) Performs inspections of all firms that are registered with it.
c) All firms that audit public companies are required to register with the PCAOB and are inspected by the PCAOB.
d) Does not set accounting standards, this is delegated to the FASB and the SEC.

The AICPA:

a) Does not set auditing standards for the audits of public firms anymore. They do set standards for audits, reviews, and compilations of non-public companies.
b) Requires peer reviews of non-registered firms to assess the quality of their audit practices.
c) Does not set accounting standards for public companies.

1-22. COSO is the *Committee of Sponsoring Organizations of the Treadway Commission.* The five sponsoring organizations include:

- The American Accounting Association
- The American Institute of CPAs
- Financial Executives International
- Institute of Internal Auditors
- Institute of Management Accountants

Its major importance to the auditing profession stems from the almost universal adoption of its framework, *Internal Control, Integrated Framework* that serves as the criteria by which companies judge whether or not they have effective internal control. COSO has also been active in developing new guidance for smaller business, as well as guidance for the monitoring component of internal control.

1-23. For the most part, local CPA firms are subject to the same auditing and accounting standards as the large international CPA firms. The differences relate to whether the audit firms have (a) public clients, or (b) international clients. If a firm has public clients, then the firm is subject to the standards of the PCAOB for those public clients. If a firm has clients that are domiciled in other countries, then they should utilize international auditing standards. If the audit firm only has non-pubic clients, then they are subject to auditing standards promulgated by the AICPA.

1-24. The development of audit programs follow the standards in determining that sufficient evidence is gathered in order to evaluate the assertions being addressed in the audit engagement. That is, the steps in an audit program are basically a list procedures that an auditor, following professional standards, would be required to perform.

1-25. The court system acts as a check and balance on the profession to ensure that it does not ignore the needs of clients and third--party users and allow misleading financial reports to be issued or the performance of substandard audits.

The court system does not directly set accounting or auditing standards. However, the courts have been active in identifying situations in which they believe individual auditors have been deficient. The identification of these deficiencies in court cases has often led the profession to develop more detailed standards to guide practice. Examples of standards that have evolved directly from the outcome of lawsuits include the standards on subsequent events and related--party transactions.

1-26 An audit program details the audit objectives and the audit procedures to be completed to accomplish those objectives. The information that should be gathered includes:

- The client's business and the industry within which it operates
- Business risks the company faces and determining how those risks might affect the presentation of a company's financial results
- Potential fraud risks
- Management compensation plans and how those plans may motivate management actions that could affect the financial statements
- Appropriate level(s) of materiality
- The quality of the design of the client's internal controls over financial reporting
- Management's approach to assessing internal control over financial reporting and whether management has sufficient documentation of the design and operation of internal controls over financial reporting
- The client's accounting policies and procedures
- The financial statement items more likely to require adjustment, as well as those that are subjective in nature
- Factors that may require the extension or modification of audit tests, such as potential related-party transactions or the possibility of material misstatements
- Potential coordination of work with the client's internal audit function
- The type of reports to be issued, such as consolidated statements or single-company statements, special reports, internal control reports, or other reports to be filed with the SEC or other regulatory agencies

1-27 Within an auditing context**, materiality** is a concept that relates to the importance or significance of an item, such as a financial statement amount, transaction, or discrepancy. But materiality is not simply a function of specific dollar amounts in the organization's financial statements. The auditor should consider qualitative, as well as quantitative, dimensions of materiality as a basis for designing the audit process to address material misstatements.

Materiality guidelines usually involve applying percentages to some base, such as total assets, total revenue, or pretax income. For example, an auditor might choose to set overall materiality at 1% of total assets or revenue, whichever is higher. CPA firms may have more complicated guidance based on the nature of the industry or a composite of materiality decisions made by experts in the firm. Although many audit firms have developed guidelines for materiality decisions, it is important to note that any guideline is just a starting point that is adjusted for other relevant information, some of which may be qualitative. For example, if the client has a loan with a restrictive covenant that requires a current ratio of 2:1, any potential misstatement or adjustment amount that would bring that ratio under 2:1 would be judged to be qualitatively material..

1-28 Audit procedures that would address this assertion include:

- *Auditing Additions to PPE*—Take a *sample* of all additions to property plant and equipment and verify the cost through reference to vendor invoices to determine that cost is accurately recorded. If there is a high risk that the valuation may be misstated, the auditor may choose to take a larger sample.
- *Assessing the Potential Impairment of the Asset Additions* Review continued operation of the assets through inquiry of management to determine if the assets should be written down to an impaired value. Gather current economic information and independent evidence as to the current market price of the assets to corroborate management's statements.

Multiple Choice Questions:

1-29. c.
1-30. b.
1-31. c. (assurance services don't always require a third party)
1-32. d.
1-33. a.
1-34. d.
1-35. b.
1-36. c.
1-37. d.
1-38. a.
1-39. f.

Discussion and Research Questions:

1-40. a. Neutrality is enhanced when each party uses the same reference point to determine the fairness of an organization's financial statements. If the reference is perceived as being neutral, then the criterion helps the profession stay neutral. Generally accepted accounting principles have been designed as standards that are neutral for users and are applicable to general-purpose financial statements. GAAP are required for all client financial statements that must be filed with the SEC. Some small companies prepare financial statements on a tax or cash basis. In such instances, there must be disclosure that such statements are on a comprehensive basis of accounting other than GAAP.

One of the major objectives of the FASB *Concepts Statements* is neutrality. The auditing profession adheres to the accounting standards universally recognized by their general acceptance. Auditors present an independent, objective assessment of a company's financial transactions and thus serve as a buffer to prevent management from contriving transactions that will lead to a misleading presentation and thus favor one group over another. (It must be admitted, however, that the independent auditor is not always successful in achieving this latter objective. Usually a good class discussion can be built around the auditor's responsibility for ensuring a fair presentation and unbiased results.)

b. This question is intended to stimulate discussion on the part of students. It is difficult to specify the most important users because a particular category of users may have more interest in one particular set of financial statements. The users that students should identify would include:

Investors: Existing shareholders, potential shareholders, and the financial community as part of the investing public make up this group. Investors look to the financial statements and the accompanying audit report to communicate the state of the company's financial health and the performance of management.

An existing investor might prefer an accounting treatment that would enhance current reported profit such as extending the depreciable life of assets.

Lenders: This group includes bank loan officers, bondholders, and vendors who supply credit to the organization. Lenders are primarily interested in the safety of their loans and look to the audited financial statements to provide information on assets, profitability, and potential overextension of the company with too much debt outstanding. Lenders generally prefer that the company take a conservative approach to accounting. A lender would prefer that assets be depreciated over the shortest possible life thereby encouraging more conservative balance sheet presentation of assets.

Management and board of directors: Management is an important user because it receives an objective overview of the quality of its internal accounting system. Additionally, management needs objective, verifiable information on which to make decisions affecting other users. The audit provides an independent analysis of the financial reporting system and enhances the reliability of data affecting management decisions. Management is often motivated to use accounting principles that boost income because management bonuses are often tied with income.

Indirect users such as consumers: This group is not normally considered when textbooks refer to important users. However, recent failures in the savings and loan industry and related securities firms indicate that virtually no one remains untouched when the integrity of the financial reporting process declines.

Indirect users are concerned about the accuracy of economic presentation of financial results and current position. As noted earlier, the SEC, on behalf of these groups has urged more current value accounting because of the agency's belief that such a presentation better presents the true economic picture of the entity.

Governmental regulatory agencies: Governmental regulatory agencies at both the state and federal level exist to protect various constituencies. The free flow of reliable information is important to these agencies in identifying situations in which action should be taken to protect other groups. For example, a state insurance commission may review the financial reports o insurance companies reporting to them as a basis to determine whether regulatory action is required to protect the investments of various insurance policyholders. An agency's objectives dictate its views toward accounting principles. Insurance commissions, for example, dictate a conservative identification of admittable assets in filings with the state insurance commissions. Most other agencies have similar objectives that dictate the form in which financial statements are filed for regulatory purposes.

Labor and labor unions: Labor increasingly negotiates contracts with bonuses or other payments contingent on the level of reported profitability of an employer. Additionally, labor is interested in past profitability as a basis for negotiating current wage levels.

1-41.

a. The value of the audit to external users, e.g. investors and creditors is that the audit provides an informed and unbiased report on the public company's financial statements, and in some instances, its internal controls.

b. An audit of internal controls provides value to the public in three ways:

- it informs users of the accountability that management has assumed in fulfilling its stewardship function,
- it provides confidence in the company's processes to control its information and to provide reliable information on an interim basis, and
- it helps ensure investors that management has reliable information on which to makes its internal decisions.

c. An audit committee is important for the following reasons:

- it provides oversight of the audit function on behalf of shareholders and the board,
- it is charged with the sole authority to engage the external auditor and therefore the auditor is accountable to the audit committee rather than management,
- it helps ensure the independence and integrity of the audit process.

1-42.

a. The major objectives of an independent audit are to systematically acquire and evaluate audit evidence to determine the fairness of a company's financial statements (as judged by applicable criteria, such as GAAP) and to communicate that opinion to interested users.

An audit may specifically benefit the auditee (Quello) in the following ways:

1. An independent assessment of the fairness of presentation enhances the perceived reliability of the financial report and assists the company in obtaining loans or new capital because the investing and lending public will have confidence in the financial figures.

2. The auditor's expertise in related areas may help the client in
   (a) Tax planning.
   (b) Preparing tax returns.
   (c) Selecting and implementing accounting information systems.
   (d) Identifying sources of capital or loans.
   (e) Preparing financial forecasts or analyses that may assist the company in obtaining loans or new capital.
   (f) Determining the efficiency of existing accounting operations.
   (g) Observing areas in which efficiency and effectiveness of operations might be improved.

3. The auditor's testing and evaluations of controls may provide insights into areas in which improvements could be made.

4. The independent assessment and testing of transactions represent a management control device because individuals know that their work will be tested and evaluated.

5. The threat, as well as the performance, of an audit may act to deter potential fraud.

6. The auditor's expertise may lead to improved financial presentations because of the application of accounting principles or improved financial statement disclosure.

7. The auditor's knowledge may lead to improved reporting for regulatory purposes.

b. Some of the points that might be discussed by management in determining the nature of the CPA firm to engage to conduct the audit:

   1. The audit fees for conducting the audit.
   2. The reputation of the auditor in the community and potential impact of auditor reputation in securing loans or capital.
   3. The ability of the auditor to assist the firm in expanding the scope of its operations beyond the immediate geographic area.
   4. The industry-specific knowledge of the potential auditors.
   5. The individual personnel servicing the company, that is, the involvement of a partner versus other personnel on the engagement.

6. Perceived audit expertise in ancillary areas such as tax, financial projections and analysis, mergers and acquisitions, and systems.
7. The outcome of any recent peer review performed on the public accounting firm.
8. The satisfaction of other clients with the level of service obtained from the firm.
9. The need for national support staff for complex issues.
10. Plans by the company to issue stock.
11. The ability of the audit firm to use state-of-the art technology on the engagement and to introduce that technology to the client.

(Note: The above list is not inclusive. Students are generally quite good in identifying other factors that may or may not be important and thus provide for excellent classroom discussion.)

c. The company is not required to have an audit committee. However, an audit committee is recommended as a best practice. Further, as the company plans to grow, it will be important to establish all elements of effective internal control over financial reporting. Thus, an audit committee will be valuable to the company if it considers going public in the future.

d. Quello is not required to issue a report on the quality of its controls over financial reporting. Such a requirement exists only for larger public companies. However, the Company could engage the CPA firm to evaluate its internal controls as a basis for improvement and future success.

1-43.

a. Most users agree with this statement. Therefore the auditing profession has expanded its approaches to provide greater assurance that it will detect material fraud. However, many misstatements that are made in conjunction with an organization's financial statements are not intentional but are simply the result of errors. The audit function is designed to detect *material misstatements* -- whether they are due to errors or fraud. Thus, the audit function is actually broader than just looking for fraud. Ensuring that a financial statement contains no material misstatements ensures that the auditor addresses the likelihood that material errors and fraud may have occurred.

b. There is an independence problem, in some views, because the primary purpose of the audit is to furnish financial statements to a bank or to another investor in order to raise capital for the firm. Thus, the control of hiring and firing by the management is seen by some as an impairment of the auditor’s independence. However, there is really no one else to do the hiring in such cases.

c. Many people agree with this. The Red Cross, and other nonprofit organizations, owe accountability to their donors beyond that which is conveyed in financial statements. The Red Cross has been criticized for poor internal controls and poor and inefficient operations. Most donors have a vested interest in understanding that their contributions have been used properly.

d. As time has passed, most observers have come to the conclusion that the expectations are not too high. However, they do need some fine tuning in relationship to how much users want to pay for an audit.

e. Many practitioners believe this statement is true. However, there should be good class discussion on this issue as it is germane to raise the question as to whether "if it is good for non-public companies, why is it not good for public companies?" There are various answers to this question, and many of them are dependent on the external users of the company's financial reports.

f. Many believe this statement is true. However, audit firms sometimes think that the PCAOB is overly zealous in its inspection process. The PCAOB must prove itself in setting standards that encourage and warrant the public trust, and in providing oversight to the auditing profession in a manner that is both effective and fair.

g. GAAP represents rules and conventions that are acceptable at one point in time. Much of the diversity in accounting principles is necessary to reflect real economic differences between organizations and the types of transactions in which the organization is engaged. Beyond this argument, differences such as LIFO / FIFO accounting have evolved over the years. The profession attempts to mitigate the potential problems associated with the diversity by providing disclosure of the differences and by developing other procedures to make it difficult for firms to change accounting principles. Thus, the financial statements of a company should be comparable over a period of time.

h. This is true. Auditors need to provide clear guidance to the board, the audit committee, and to management as to whether they believe the financial statements best portray the economic events of the entity being audited.

i. Most practitioners do not feel this constitutes a problem. However, the PCAOB has provided guidance where auditors of public companies cannot provide such tax services for executive management of their clients.

1-44.

a. Areas in which audit judgment will be made, include, but are not limited to, the following:

- Evaluating the risk of being associated with a particular client,
- Evaluating the risk associated with a client's internal control process and the potential implications regarding potential misstatements in accounting records,
- Determining the appropriate audit procedures to perform in light of the identified risks,
- Assessing appropriate level(s) of materiality,

- Evaluating the economics of an organization's financial transactions or the economic value of an organization's assets or liabilities, and
- Applying the proper accounting treatment to issues that arise during the conduct of the audit.

A quick review demonstrates that professional judgment is not at all limited to accounting issues. A good auditor must understand the business, its transactions, its contracts, and the economics of it transactions and contracts.

b. There is disagreement on whether principles-based accounting will lead to more or less consistent judgments. Many believe that it will lead to less consistent accounting because the rules are not as well specified. However, the alternative view is that accounting judgments will become more consistent (especially on an international basis) because auditors will need to take more time to understand and portray the economics of transactions or the value of securities. The rationale for the accounting opinions must be well reasoned and documented. This should also improve consistency. That said, it will be a tremendous challenge for the public accounting firms to change the mindset to accounting judgments and it will require a period of extensive review by concurring partners.

c. It is very reasonable – especially from a user's perspective – to expect that judgments made by different auditors on different clients will be consistent. In other words, similar economic situations should lead to similar accounting judgments. An audit firm's structure enhances the review and consistency of judgment in the following ways:

1) Continuing professional education on accounting issues,
2) Firm guidelines and pronouncements on accounting issues,
3) Review of significant accounting judgments by audit managers,
4) Further review by engagement partners,
5) Further review by concurring or engagement quality partners (a subject matter partner that is not otherwise on the audit),
6) Internal inspections of the quality of audits by internal review teams.

1-45.

a. Understanding a business helps the auditor identify accounts that may be misstated. This is particularly true when the misstatements may not be related to the actual recording of transactions; but are due to changes in valuation that take place over time. The auditor should understand:

- competitive actions that could possibly make a product or service obsolete,
- competitive effects on pricing,
- changes in the economy or industry that could affect the collectability of receivables,
- use of products that may affect warranty claims,

- whether current technology utilized by the firm is up to date,
- changes made by competitors in their warranties.

This understanding can be applied to the listed accounts as follows:

Inventory: the auditor's knowledge of competitor actions, the company's product placement in the market, current trends in consumer purchasing, and so forth, will help the auditor determine if there is inventory that should be written down to a market value that is lower than cost.

Allowance for Uncollectible Accounts: Changes in the economy may indicate that certain parties are less likely to be able to pay. In 2007, there was a great fall-off in sub-prime loans leading to greater loan loss reserves for many financial institutions, and ultimately, the failure of some financial institutions.

Warranty Liability and warranty expenses: The market often dictates changes in warranty policies. For example, General Motors increased its standard warranty from 36,000 miles to 100,000 miles on some products. The increase in warranty coverage will likely be accompanied by an increase in warranty claims which should be accrued for by the company.

b. The auditor brings a perspective to a privately-held company that is often broader than that held by management. The auditor sees a number of different clients, different industries, and differing strategies. The perspectives developed by the auditor may provide insight to the client's management that they otherwise would not have. These insights may relate to efficiencies in operations, approaches to internal control, or financial reporting guidelines.

1-46.

a. Assurances and Evidence

Assurance Tested	**Evidence to be Gathered to Test Assurance**
All goods are shipped in a timely fashion.	Take a sample of orders and trace to shipping evidence, e.g. shipping documents, UPS documents, or other evidence of shipment. Take a sample of customer complaints or inquiries and determine if there is a pattern of customers complaining that goods are not received in a timely fashion.
Goods are as advertised.	Take a sample of advertisements and compare the qualities advertised with a sample of products.
Company stands behind goods that are damaged in transit.	Take a sample of complaints or credit adjustment requests submitted by customers. Determine whether or not the requests were handled consistently with advertised company policy.

Assurance Tested	Evidence to be Gathered to Test Assurance
Company fulfills promises made in its credit policies.	Take a sample of credit sales. Determine that sales are billed according to company policy. Determine that interest, if applicable, is billed according to company policy.
Credit card and billing information is kept safe and not sold to other electronic retailers.	Inquire of company policies designed to safeguard customer information. Inquire of management as to (a) any sales of customer information; and (b) policies and procedures in place to protect the privacy of customer information. Review customer complaints to determine if any relate to customer privacy issues. Determine that company data are protected. Attempt accesses to such data to determine if unauthorized users can access such data.

b. The assurances should be provided frequently enough to assure customers that the policies and procedures continue to be effective, perhaps every three or six months.

c. The assurances should be evident on the company's Web page. Various symbols are currently used, representing various assurance providers.

d. The CPA has objectivity and integrity along with the skills needed to provide such assurances.

e. Well-established companies with a long history of good business practices probably do not need such assurances.

f. Other potential providers include industry associations, Internet provider companies, Web browser companies such as AOL, companies that provide e-commerce Web services, etc. Alternatively, the companies may provide the assurances by promoting the quality of its processes, soliciting testimonials from customers, and promoting a reputation of quality of services.

1-47.

a. Internal auditing is defined as follows:

Internal auditing is an *independent* and *objective assurance and consulting activity* that is designed to add value to improve an organization's operations. It helps an organization accomplish its objectives by bringing a *systematic, disciplined approach* to *evaluate and improve the effectiveness of risk management, control, and governance processes*.

It is defined as both an assurance and a consulting activity. Assurance is designed to add value to an organization by providing management, the board of directors, and operating management with independent analysis regarding company operations as well as compliance with company policies and procedures. As companies enter into more trading partner agreements, internal auditors may be called upon to provide assurance on controls and operating procedures to the company's trading partners. Assurance services have been the historical base of internal auditing and will continue to play a major role in the future development of the profession as the demand for an increasing array of assurances continues to increase.

Consulting activities create an additional "value added" component to internal auditing. Internal auditors are unique in that they see the breadth of corporate activities and can provide insight into operations that few operational managers may have. Consulting implies that auditors are willing to share recommendations on how to improve operations. Additionally, auditors can serve on task forces to find ways to improve operations. However, the final decision on actions to take and implementation still rests with management.

b. The internal audit focus is on the risk management, control, and governance processes in an organization. The role regarding risk management and control is as follows:

i. Determine whether the company has a systematic process to identify, measure, control, or otherwise manage or take risks.
ii. Determine whether the company manages risks according to a company approved risk policy.
iii. Determine whether the company has sufficient controls in place to identify and manage risk.
iv. Determine if the controls are working properly.

Controls are integrally related to risk. Controls exist to assist the organization in identifying, mitigating, or preventing undue risks. The auditor's role is to determine that proper controls are implemented and are operating effectively in light of the organization's risks.

An internal auditor also uses risk to identify areas for audit review. The auditor should work with management to systematically identify risk and consult with management and the audit committee to identify the risk areas that should be reviewed by the audit function each year.

c. Internal auditing is a good career alternative to a career in public accounting. Some of the reasons for pursuing a career in internal auditing include:

1. Internal auditing is a broad discipline. An internal audit department will be composed of individuals with a wide variety of industry and company experience.
2. Internal auditing is one of the fastest growth areas of public accounting firms. Most of the large public accounting firms, as well as other firms, are developing strong practices in outsourcing the internal audit function.

3. An internal auditor has the opportunity to develop a keen understanding of all aspects of a business by rotating audits through various areas. The auditor's knowledge obtained in one operational audit can usually be transferred to other operational audits.

4. Internal auditing presents an excellent training ground for future management positions. The internal auditor performing operational auditing is developing a broad perspective of the organization that provides excellent background for promoting the auditor into management positions.

5. The internal auditing department is becoming increasingly professionalized with the Certified Internal Auditor (CIA) certificate becoming recognized on a global basis as a standard of competence and excellence in internal auditing.

d. Public accounting firms are moving to perform internal audit work on an outsourcing basis (sometimes referred to as “extended audit work”.) The public accounting firms argue that they can provide the same quality of work more efficiently, in many cases, because they can bring experienced personnel with a fresh view to the audit. They can also bring wide industry expertise and technology that often is not available within the internal audit department. Outsourced internal audit work appears to be a major growth field for the public accounting profession.

e. Answers will vary depending on updates to the IIA’s website. At print date of this solutions manual, a variety of certifications are available in addition to the traditional “certified internal auditor” designation, including: certification in control self-assessment, certification in financial services auditing, and certification in being a governmental auditing professional.

1-48.

a. The American Institute of CPAs (AICPA) is a body representing CPAs that has lessened in its power. No longer having the power to oversee the audits of public companies, it still has a number of senior committees that develop auditing standards, study and develop interpretations of preferred accounting for complex transactions, discipline members for violation of the profession's *Code of Professional Conduct*, monitor the quality of the practice of public accounting through two practice divisions, and work to establish reasonable boundaries on new areas of services to be performed by public accounting firms and CPAs.

b. The Institute of Internal Auditors (IIA) is a worldwide professional organization of internal auditors. Like the AICPA, the IIA works to enhance the professionalism of internal auditing and has issued standards for the practice of internal auditing and a code of ethics and has developed a certification program, the *Certified Internal Auditor* (CIA), to identify a standard of excellence for the professional practice of internal auditing. CIAs must adhere to the profession's standards and must meet continuing education requirements. However, unlike the CPA certificate, the CIA certificate is not a licensing requirement for individuals to practice.

c. The Governmental Accountability Office (GAO) is the audit function of the U.S. Congress. In addition to performing audits, it is responsible for developing standards for auditing governmental units. The standards promulgated by the GAO are applicable to the conduct of governmental audit work in the United States. Most governmental regulations, particularly grant programs, require audits to be conducted in accordance with governmental audit standards. CPA firms or internal auditors performing governmental audits in conjunction with grants or other governmental programs must adhere to the governmental auditing standards.

d. The Securities and Exchange Commission (SEC) is the primary governmental agency with the responsibility to regulate the securities market in the United States. One major part of its activity is to ensure a free and accurate flow of reliable financial information. Within the purview of these general powers, the SEC has the power to dictate accounting principles for companies that must report to it and has the ability to specify information that must be included in both annual reports and periodic reports that must be filed. The SEC also has the ability to censure firms practicing before it and in some instances, may also bar firms from practicing before it. The SEC also issues *Accounting Series Releases* in response to problems it has identified and specifies appropriate accounting to address them. The SEC has become more activist in the past two decades and has shown an increasing willingness to react to what it believes to be substandard reporting by specifying reporting improvements.

e. The Public Company Accounting Oversight Board (PCAOB) is a quasi-public board appointed by the SEC as part of the Sarbanes-Oxley Act of 2002 to provide oversight of the firms that audit public companies that are registered with the SEC. It has the authority to set auditing standards for the audits of public companies. In addition, all CPA firms that audit public companies are required to register with it, and the PCAOB performs quality reviews of each of these firms. The board has the power to prohibit a firm from performing audits on public companies, should such an extreme case arise.

f. The International Auditing and Assurance Standards Board (IAASB). The IAASB sets the standards for auditing public companies on a global basis. The standard setting reflects the many constituents of the board.

1-49.

a. A career starting within internal auditing would most likely differ from a career starting in public accounting in the following ways:

1. The internal auditor would audit a number of different functions within one organization rather than audit the same type of function within a larger number of organizations. If the organization is large and diverse, the internal auditor will likely have very wide experiences across both functional areas and industry types.

2. The internal auditor will most likely perform operational audits rather than, or in addition to, financial audits and will try to provide recommendations to improve the operations of the organization.
3. The internal auditor would develop expertise in risk management and controls, including controls designed to evaluate the efficiency of operations.
4. The internal auditor will pursue certification as a Certified Internal Auditor to exhibit professional competence in the area of internal auditing. Many individuals will also sit for the CPA exam to enhance their professional recognition and to obtain recognition that they may perform some financial audit work in connection with the annual audit of the company.

b. Internal auditing provides an excellent starting point for a career in management because the internal auditor is in a position to understand all aspects of an organization and how it comes together to accomplish its objectives. By performing operational audits, the internal auditor learns about the "best" kind of procedures to accomplish organizational objectives and then compares actual company performance with the "best" types of procedures. The auditor is always looking for constructive ways in which organizational objectives can be performed more efficiently or where cost savings can be realized. Finally, the new internal auditor can make a strong impression with existing management by demonstrating insight on the effectiveness of operations. To be successful, the internal auditor must learn how to deal with people who do not necessarily want to be reviewed and then convince them that the auditor's recommendations can help them accomplish their own task. Much of management involves working with people, and internal auditors find out about the importance this very early in their career. It is not a desk job!

1-50.

1. Auditing does not involve the creation of goods. However, it does serve a worthwhile purpose in our society because it enhances the flow of reliable financial information needed to conduct commerce in our economy. It also assists in the conduct of government by providing reliable information for tax purposes and regulatory purposes. Audits have been legally mandated to ensure objective information. However, research has indicated that audits would be required even if not mandated. The initial audits performed in conjunction with the settlement of the new world arose because of owners' need to have an independent assessment of the returns earned by their managers.

2. The accounting profession *did* provide early warning signals of the potential problems within many industries. However, it clearly failed in other areas. Some of the problems were related to the impreciseness of accounting principles (e.g. Enron) while others were more closely related to regulatory failures (e.g. Savings & Loan Industry). However, many of the failures were due to systematic problems in the

accounting profession that has been addressed, although not necessarily fixed, by Sarbanes-Oxley.

3. Finding fraud may be important. However, many misstatements that are made in conjunction with an organization's financial statements are not intentional but are simply the result of errors. The audit function is designed to detect *material misstatements* -- whether they are due to errors or fraud. Thus, the audit function is actually broader than the colleague had desired. Ensuring that a financial statement contains no material misstatements also ensures that the auditor addresses the likelihood that material fraud may also have occurred. As we will see later, SAS 99 has increased the auditor’s responsibility to search for fraud.

4. There is a potential problem with the auditors being hired by management. The Sarbanes-Oxley Act requires companies that are publicly traded to have an audit committee composed of independent directors (nonmembers of management) that have the responsibility for evaluating the performance of the auditors. The audit committee should exist to present the views and interests of outside owners of the organization and provide effective insulation against undue pressure by management on the audit function. The SEC is very cognizant of independence issues and periodically addresses actions or relationships that they believe may impair the auditor’s independence.

5. Most observers believe this statement is true. However, the PCAOB must prove itself in setting standards that engenders the public trust.

6. GAAP represents rules and conventions that are acceptable at one point in time. Much of the diversity in accounting principles is necessary to reflect real economic differences between organizations and the types of transactions in which the organization is engaged. Beyond this argument, differences such as LIFO / FIFO accounting have evolved over the years. The profession attempts to mitigate the potential problems associated with the diversity by providing disclosure of the differences and by developing other procedures to make it difficult for firms to change accounting principles. Thus, the financial statements of a company should be comparable over a period of time.

7. It seems that this individual really wants to have a career in auditing. External auditing has changed; in today's environment, the auditor must thoroughly understand a company's business in order to audit it. A key function of internal auditors is to add value through their recommendations.

8. The external audit is designed to present an opinion on the fairness of a company’s financial statement in accordance with GAAP. It is not directly designed to assess the performance of management, although the financial statements may provide some evidence on the performance of management.

9. Auditors operate in an environment in which they must have a sense of trust with management – at least to the extent that confidential or proprietary information is not made public. Thus, if all recommendations made to management were to be made public, management might simply ask that recommendations no longer be made. Further, it must be recognized that many of the recommendations made to improve operations are informal in nature and might not be based on thorough study of a particular area. Auditors may justifiably fear litigation from recommendations made public that were made only on informal observations.

10. Congress, in developing the Sarbanes-Oxley Act believes this statement is true. Maintaining adequate controls is a significant part of corporate governance. Congress believes the owner (shareholder) should receive reports on the quality of controls implemented by management. In the first three years of public reports on internal control, there has been a dramatic change in the quality of controls in many organizations. During the first year of Sarbanes-Oxley, approximately 16% of the companies received adverse reports on the quality of their internal controls. This percentage has gone down dramatically.

1-51.

a. There seems to be a misinterpretation on the part of many users that a "clean" audit opinion means that the company is in good health. This, unfortunately, is a miscommunication. A "clean" audit opinion means only that the financial statements are fairly presented, not that they represent a company that is in good financial health. The audit function provides data that are "fairly presented" in accordance with GAAP, but such information alone does not constitute all the information an informed user should know about a company.

b. The auditor is a guarantor *only* of following generally accepted auditing standards in determining whether the statements are fairly presented, in all material respects, in accordance with generally accepted accounting principles. Assessment of fair presentation is provided with reasonable assurance only within the context of GAAP.

c. This question and should encourage a widely ranging discussion by users. Topics that might be addressed include these:
    1. The potential deficiencies in GAAP.
    2. The ability to detect fraud when management has attempted to cover it up.
    3. The responsibilities of users to perform their own work and to not expect someone else to make decisions for them.
    4. The overall responsibility of management for the integrity of the financial statements.
    5. The value of reports on internal control.
    6. The difficulty of measuring the economics of complex transactions.

1-52.

a. The five members will vary depending on the time period. While the five members all have significant experience in business and often financial affairs, no more than two of the five members are CPAs. In fact, at some points board members may be "acting" as appointment of board members is in process.

b. This exercise is designed to exhibit the constantly evolving nature of accounting standards, as well as provide the student with the experience of understanding new accounting standards. Additionally, these exercises provide the student with more experience in navigating official websites.

1-53.

a. The purpose of this exercise is to exhibit the numerous cases brought by the SEC each day, as well as to provide the student with practice in understanding and analyzing the cases.

b. The purpose of this exercise is to exhibit the constantly evolving nature of professional accounting guidance that is provided by the SEC.

1-54.

This exercise is designed to exhibit the different goals of public company audit firms and those that audit non-public companies. Typically the smaller firms that audit non-public clients have a motto such as "Your most trusted business advisor" which designates them as more of a business partner serving management than a party meant to serve the public. In this role, the non-public audit firms usually perform a number of services other than just an audit, and profitability of their client is a major goal as much if not more so than to serve the public.

1-55.

	IAASB	**PCAOB**	**AICPA Auditing Standards Board**
Composition of Standards Setting Board	18 members, with 10 nominated by IFAC members (2 of which are U.S.), 3 public members, and 5 from major firms, including all of the Big 4 plus Grant Thornton. Has less substantial legal authority.	5 members, of which only 2 can be CPAs, and the CPAs do not necessarily have to have audit experience. All are appointed by the SEC since the PCAOB is a quasi-regulatory organization. Has more substantial legal authority.	19 members, including one academic, a representative from each of the Big 4 firms, and a wide representation from other audit firms. All CPAs. Members are appointed by the AICPA. Has less substantial legal authority.

The GAO does not have outside members or a special board. Rather, the GAO has a department within the GAO that deals with standard setting. However, they do subject all of their proposed standards to a period of public comment in which they seek feedback on the proposed standards.

1-56.

a. On the "pro" side, having the same standards makes audits more comparable for the public and the auditors. Nobody has to go through the trouble of reconciling differences in audits. On the "con" side, standards that seem appropriate for public clients may require more time and effort than necessary to gain comfort with a non-public company's financial statements. Auditors should be able to work in the most efficient way if they are going to be profitable.

b. Examples could include the following: (1) public companies might have audit standards that are more applicable to larger and more complex entities, (2) non-public companies might have audit standards that adjust for weaker internal controls (e.g., lack of segregation of duties), (3) public companies might have audit standards that are geared toward more remote and less-informed users (e.g., shareholders) rather than less remote and better-informed users (e.g., bankers).

c. The main authority and standards come from the GAO and their standards for the audit of governmental entities. The auditor would look to the GASB for guidance on the proper accounting standards.

d. The audit committee determines the nature of the audit to be performed, given obvious restrictions based on the nature of the organization, i.e., publicly traded, private, governmental entity etc. For private entities, the audit committee could specify whether the audit is conducted according to PCAOB standards, international auditing standards, or AICPA standards (although using AICPA standards would currently be most likely). The audit committee has some leeway unless specified by regulation. For governmental entities and for US domiciled public companies filing reports in US securities markets, there is no choice: governmental entities must follow GAO standards; public companies must follow PCAOB standards.

1-57.

GAAS	Holmes' Failure to Comply with GAAS
General Standards: Technical Training and proficiency as an auditor	The college students did not have the proper training and proficiency and were not properly supervised.
Independence	Holmes lacked independence because of the financial

GAAS	Holmes' Failure to Comply with GAAS
	interest in whether the bank loan is granted to Ray.
Due professional care	Holmes failed to follow the fieldwork and reporting standards as a reasonably prudent auditor would have done. He did not critically review the work done or the judgments of the assistants.
Field work standards: Planning and supervision	Holmes accepted the engagement without first considering the availability of qualified staff. He also failed to supervise the assistants and plan the work adequately.
Understanding internal control structure	Holmes and the assistants did not obtain an understanding of the business, industry, or its internal control system.
Sufficient, competent evidence	Holmes gathered no evidence to corroborate the information in the financial statements. The work performed was more an accounting service than an audit service.
Reporting standards: Adherence to GAAP	The report made no reference to GAAP. Because Holmes did not do a proper audit, no opinion should have been expressed as to the fairness of the financial statements in accordance with GAAP.
Identification of circumstances in which such principles have not bee consistently observed	Holmes was not in a position to determine whether the accounting principles had been consistently observed due to the lack of evidence.
Informative disclosures	There were no footnotes. At a minimum, the significant accounting policies should be described. Disclosures were obviously inadequate, but the audit report did not mention this.
Opinion	Even though an opinion was expressed, it is not based on the results of a proper audit. A disclaimer should have been issued because Holmes failed to conduct an audit in accordance with GAAS.

The students should be reminded that while the ten standards have historically provided guidance, they are being replaced by principles proposed by the AICPA. As of late 2010, the proposed date for the change is December 15, 2012.

1-58.

a. The standard of due professional care plays a role in litigation against auditors. Plaintiffs will try to show that the auditor did not do what a reasonably prudent auditor would have done. To evaluate the standard, a third-party also decides whether someone with similar skills in a similar situation would have acted in the same way.

b. Independence is vitally important to the auditing profession. Auditors exist to create confidence in the public that financial statements are free from material misstatement. When auditors are not independent, the public cannot necessarily trust that the statements are free from material misstatement, because they could have incentives to allow misstatements. Lack of independence was a primary concern prior to adoption of the Sarbanes-Oxley Act because the auditing profession was rapidly losing the public trust that had taken decades to build. Congress saw the need to begin rebuilding this public trust through legislation, since self-regulation (via the AICPA) proved inadequate.

c. The question becomes one of how to remain skeptical despite continued indications that there are no major problems at the client. There are three fundamental approaches that are often taken:

- Continuous training and especially reinforcement of the importance of professional skepticism,
- Supervisory review throughout every aspect of an audit,
- A personal commitment from each auditor.

d. According to the Reporting Standards, the auditor does not have the option of simply walking away from the audit. The auditor is required to render an opinion if the auditor has developed sufficient evidence to render an opinion. Management could choose to issue financial statements without the auditor's opinion, but then the auditor should notify the SEC (if applicable) and other parties that the auditor has reached an opinion, but management has chosen not to issue audited financial statements. If the auditor chooses to resign from the audit, then the auditor must disclose all the reasons for the resignation in a letter to the SEC.

1-59.

a. Students may find various definitions of materiality. One definition describes materiality as the

> "magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

Materiality is used in both accounting and auditing to help guide decisions about the magnitude of problems in the financial statements that must be fixed prior to issuance of an unqualified audit opinion; materiality is also used to guide decisions about areas that are considered key to the focus of the audit.

b. In the past when audit committees were not independent, materiality would not normally have been discussed with audit committees or management. Now, materiality should be discussed with the audit committee to determine what an appropriate level of materiality might be for that audit. The audit committee can help to determine stakeholders and their decision-making criteria.

Some argue that management should be unaware of materiality. If they know the amount, they might feel free to misstate up to that level in many different accounts, which could add up to a significant number (and fraud). Management would also have the ability to focus on only having good control of high dollar transactions, possibly compromising control over smaller transactions which can add up in a hurry. With this in mind, the SEC has put the audit profession on alert for offsetting material misstatements, swings in accounting estimates, or consistent immaterial adjustments. Note that we return to this issue in detail in Chapter 18.

That said, materiality is a guideline that is well understood in the profession. As long as the auditor indicates that there is both a quantitative and qualitative component of materiality then a general discussion with management and the audit committee does not do any harm. In some cases, management or the audit committee may want the auditor to look at some areas with a lower level of materiality.

c. Materiality guidelines usually involve applying percentages to some base, such as total assets, total revenue, or pretax income as a starting point. The base should be a "stable" account however, making total assets a better choice than pretax income.

In determining the amount to set for materiality, the auditor should consider the riskiness of the audit, qualitative factors such as the effect on trends and ratios, as well as the stakeholders who will be making decisions based on the financial statement presentation.

1-60.

a. Construction equipment is an asset. That is the amount that the equipment was purchased for originally. The accumulated depreciation account is a summation of all the depreciation taken on the construction equipment. $1,278,000 - $386,000 = $892,000 is the current carrying value of the equipment. Around 25% has been depreciated to date. By the end of the useful life of the equipment, the carrying value will be zero (fully depreciated). The leased equipment represents assets that are rented and not owned.

b. The equipment held by the company could be characterized as fairly new. Only about 25% of the equipment value has been depreciated to date.

c. If the number of leased equipment pieces is small, examine each lease agreement to ensure that the accounting for the item is correct given the appropriate accounting guidance.

d. Randomly select invoices for new pieces of equipment and check that the total amount paid for the equipment (likely based on an invoice) is reflected in the total amount. Review the invoice to make sure the equipment was bought and not leased.

e. The auditor should question the method and calculations for the current year depreciation entries and make an assessment if the method, the number of years of useful life, and the calculations are reasonable. The auditor should also determine whether there is an impairment in the value of the equipment.

f. First, the auditor can review past transactions and useful lives. If the company often recognized gains on trade-ins of assets, then the useful life was too short (the opposite if the company recognized losses). The auditor can also review management plans, industry usage, and industry practice for other insight on the useful life. Finally, the auditor can audit the internal controls on the system that calculates depreciation, and can utilize verbal inquiry for an explanation of useful life.

Cases:

1-61. a. The GAO would first review operational policies and guidelines by the EPA and then examine actual staffing to determine areas in which the EPA has concentrated its activities. The GAO will also develop information on accomplishments of the agency and compare performance in one area with another. Lack of accomplishments in cost recovery, as well as lack of personnel assigned to the cost recovery function, would indicate a low priority assigned by the agency.

b. Long-term, measurable goals are necessary to establish a benchmark against which progress can be evaluated. Without measurable goals, it is extremely difficult to determine whether a governmental agency is accomplishing the mission planned when legislation was enacted by the Congress. Much of the frustration of the GAO in performing its audits relates to the identification of such goals.

c. Yes, the GAO report described represents an audit that could be viewed as a combination of an operational audit and a compliance audit.

d. The GAO determines identifiable criteria against which to measure operations, interpret legislative intent, and determine the extent to which the agency is accomplishing legislative objectives. The GAO audit work focuses much more on operational audit and compliance audits whereas the public accounting profession focuses on a much narrower objective in auditing the fairness of a company's financial statements.

1-62.

a. The website notes the following:

> The PCAOB is a private sector, nonprofit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports.

With respect to its authority to discipline auditors, the website notes:

> The PCAOB has authority to investigate and discipline registered public accounting firms and persons associated with those firms for noncompliance with the Sarbanes-Oxley Act of 2002, the rules of the PCAOB and the Securities and Exchange Commission, and other laws, rules, and professional standards governing the audits of public companies. When violations are found, the PCAOB can impose appropriate sanctions.

b. The website indicates:

> The PCAOB enforcement staff conducts informal inquiries as well as formal investigations that arise from several sources including:

- PCAOB inspections of registered firms
- PCAOB research and analysis
- Other regulators
- Public disclosures of restatements and auditor changes
- News reports
- Confidential tips from the public

c. This answer will vary over time. The first disciplinary order was issued in May 2005, with more being added each year.

d. There are many instances that the students can point to, all of which relate to the respondents' audits of American Fiber Green Products, Inc. Some examples include: the audit was not properly planned, only a few auditing procedures were performed and significant account balances and transactions were not tested, and documentation was incomplete.

e. The PCAOB registration of the firm was revoked. Further, the individual auditor was barred from being associated with a registered public accounting firm – basically prohibiting the auditor from auditing public clients. Most students will agree that the sanctions seem appropriate, and some students may even argue for additional sanctions (e.g., fines).

ACADEMIC RESEARCH CASE (LO 1)

i. **What is the issue being addressed in the paper?**
The issue being addressed is the role that risk, internal controls, and risk management within a company has on external audit demand and therefore, audit fees. Much research has been done on factors that may have an effect on audit fees. Some research has indicated that audit fees are affected by the size of the company, inherent risks such as receivables and litigation risk attributable to the auditor. Other research has indicated that these results are not consistent. Specifically, this research focuses on four risk issues that may affect audit fees. The risks that confront the stakeholders of a company may affect audit demand as each stakeholder may face different risks. Risk associated with the amount of internal controls, as well as whether the controls in place are voluntary or mandatory, in a company may also affect the need for external auditing. The level of corporate governance in a company may also have an effect on the level of necessity for auditing services, thus affecting fees.

ii. **Why is this issue important to practicing auditors?**
Practicing auditors need to be aware that there are a multitude of risks and other factors within a company that dictate the demand of a company for the services of an external auditor, and this demand in turn will affect audit fees. The majority of the risk factors are company specific and therefore not within the control of the auditor or the audit firm.

iii. **What are the findings of the paper?**
The research indicated that there is a positive association between internal control/ risk management in an organization and audit fees as well as corporate governance and audit fees. In an organization with multiple stakeholders, the stakeholders are able to share control costs and therefore more apt to lead to an increased voluntary demand for levels of control. Audit fees are higher when a company has an audit committee, discloses a high level of financial risk management, and has a larger proportion of independent Board Members. Audit fees are lower when a company does not have an audit committee, has a smaller portion of independent board members, and discloses a relatively high level of compliance risk management, which is consistent with the theory that mandated internal controls lower audit fees.

iv. **What are the implications of these findings for audit quality (or audit practice) on the audit profession?**
Companies with greater corporate governance and voluntary controls have an increased need and desire for external audit assurance. This would also imply that these companies expect a higher quality audit, but they are more willing to pay for the higher quality audit. Companies with less corporate governance and only mandatory controls are more willing to sacrifice audit quality to reduce audit fees for the company.

v. **Describe the research methodology used as a basis for the conclusions.**
Data was gathered using companies in Belgium as Belgium has an environment where stakeholders other than shareholders have a significant effect on corporate behavior. The researchers contacted 102 individual companies and requested disclosure of total fees paid for statutory audits of 2001 accounts. Information about corporate governance was also

requested. Only 50 companies elected to provide all information necessary to complete the research. Risk and risk-management data for these companies was hand-collected from the 2001 annual reports. Estimation models were used to determine the effect of risk variables, governance variables, and the joint effect of these risks. Risk variables were given a score of 1 to 5 and included disclosures about management of financial risk, disclosures about management of compliance risk, disclosures about management of environmental risk, disclosures about management of technology risk, and disclosures about management of internal process risk as well as disclosure about management of change management risk. Dummy variables include a variable equal to 1 if the company has an internal auditor and 0 if not as well as a variable equal to 1 f the company has a formal model of risk management and 0 if not. The standard risk measures of net income and receivables average of total assets was also used in the research. Governance variables included if external auditors were part of the Big 5, if the company has an audit committee, number of non-execs on the board, percentage of board members that are non-execs, number of independent board members, percentage of board members that were independent, total number of board members, and if the CEO was chairperson on the board.

vi. Describe any limitations of the research that the student (and practice) should be aware of.

The student (and practice) should be aware that the research is somewhat limited due to a relatively small sampling of companies being used. Also, the risk and risk management data was retrieved from the 2001 annual reports. Therefore, there is the risk that the companies used for this research may have had incentives for disclosing or not disclosing information that affect management actions. Also, the Belgian economy and market is unique so it is not clear how these results would apply to a more market-driven economy like the United States.

Research is not an exact science. We look for the soundness of the research to uncover patterns of behavior that is demonstrated within the audit profession. Then we have to look for indications of how the audit practice should be influenced by the results.