



AUDITING AND THE PUBLIC ACCOUNTING PROFESSION— INTEGRITY OF FINANCIAL REPORTING

INTERNAL AUDITORS UNCOVER FINANCIAL FRAUD AT WORLDCOM

In June 2002, WorldCom announced that during the previous two years \$3.8 billion in costs had been capitalized rather than expensed. This announcement shook a sagging investor's confidence that was already weakened by the restatement of financial statements by companies like Enron, Waste Management, and Sunbeam and by allegations of dishonesty at the top of other U.S. companies. The size of WorldCom's financial fraud was so significant that this event propelled Congress to pass the Sarbanes-Oxley Act of 2002 to further regulate the financial reporting process.

With hindsight we now see WorldCom as a company that, during price wars that reduced profits in its long-distance markets, relied on aggressive accounting practices to bolster earnings. How do we now know this? The public learned about WorldCom's financial fraud through the hard work of several "auditing heroes" led by Cynthia Cooper (age 38), WorldCom's vice president for Internal Auditing. What did Cynthia Cooper and her staff of internal auditors do to uncover the financial fraud? The internal audit team:

- Followed up on an e-mail with a local newspaper article about a former employee in WorldCom's Texas office who had been fired after he raised questions about a minor accounting matter involving capital expenditures.
- Recognized that \$2 billion in capital expenditures had not been authorized as part of the capital budget process.
- Did not settle for glib answers from the director of financial planning who described the \$2 billion in capital expenditures as "prepaid capacity" but could not explain the nature of "prepaid capacity."
- Uncovered over \$500 million in capitalized computer costs that were not supported by vendor's invoices.
- Demonstrated their independence by continuing to investigate the capitalization of line costs (fees paid to lease portions of other companies' telephone networks) even when instructed by Scott Sullivan, the CFO, to delay this particular audit until the 3rd quarter.

The issue came to a head when Cynthia Cooper and her audit team brought evidence of the improper capitalization of expense to the chairman of WorldCom's audit committee. The audit committee instructed the internal auditors to work with WorldCom's new external auditor, KPMG. Within a week the internal and external auditors compiled evidence of the financial fraud for the audit committee and the external auditors concluded that the accounting treatment was not in accordance with generally accepted accounting

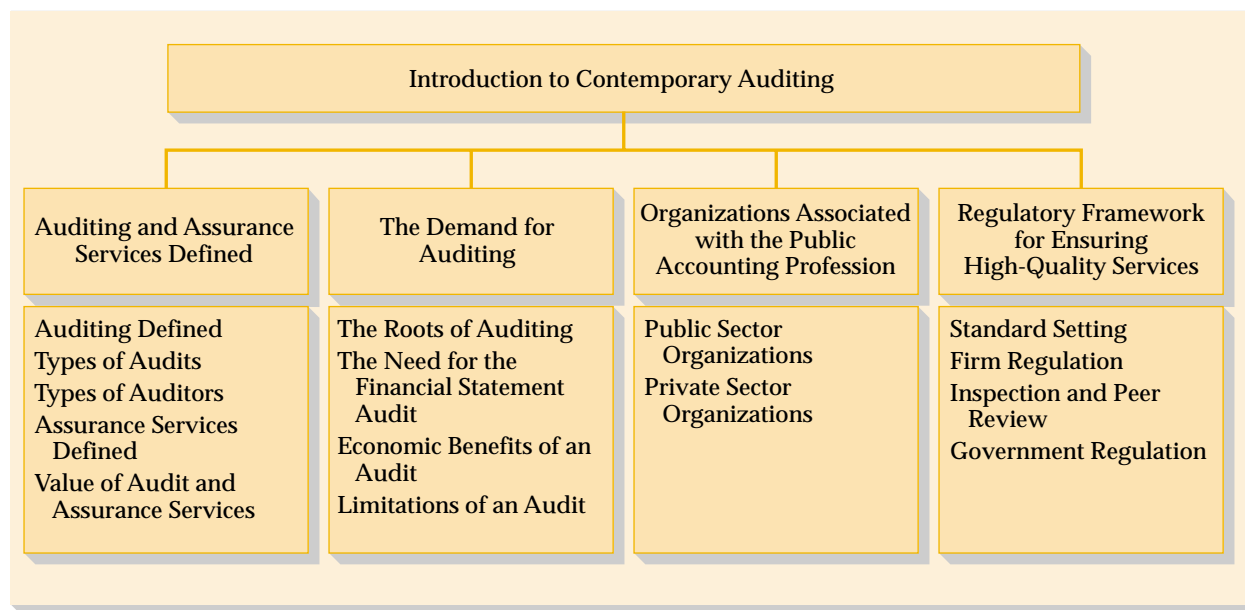
principles. Scott Sullivan, the CFO, was given the opportunity to make his case to the audit committee, but the committee members were not persuaded.

The next day the audit committee and the board of directors made public the \$3.8 billion restatement of earnings due to the fact that costs had been capitalized that should have been expensed. The audit committee and board of directors also fired the then CFO, Scott Sullivan, who was subsequently indicted by the U.S. Justice Department.

Source: Susan Pulliam and Deborah Solomon, "How Three Unlikely Sleuths Exposed Fraud at World-Com," *Wall Street Journal*, October 30, 2002, p.1.

[PREVIEW OF CHAPTER 1]

As fraudulent financial reporting and restatements of earnings have become more prevalent, auditing (external audits, internal audits, and governmental audits) has become more important. Financial statement audits provide an important level of assurance about the integrity of financial statement information used by decision makers. Chapter 1 provides an introduction to contemporary auditing and assurance services, describes the organizations associated with the public accounting profession, and ends with a discussion of the regulatory framework that ensures high-quality audit and assurance services. The following diagram provides an overview of the chapter organization and content.



Chapter 1 addresses the following aspects of the auditor's knowledge.

focus on auditor knowledge

After studying this chapter you should understand the following aspects of an auditor's knowledge base:

1. Know the common attributes of activities defined as auditing.
2. Know the differences between the different types of audits and auditors.
3. Know the common attributes of assurance services.

4. Know the variety of services and levels of assurance in the universe of assurance services.
5. Know the value of the audit and other assurance services.
6. Know a historical perspective of the demand for auditing.
7. Know the factors that influence the need for financial statement audits.
8. Know the economic benefits and inherent limitations associated with a financial statement audit.
9. Know the public sector and private sector organizations associated with auditing and assurance services.
10. Know the four components of the auditing profession's multilevel regulatory framework.
11. Know the elements of a system of quality control for a CPA firm's attest practice.

AUDITING AND ASSURANCE SERVICES DEFINED

Auditing plays a vital role in business, government, and our economy. Evidence of the importance of auditing is provided by the following:

- Investors and financial analysts value the work of auditors who audit the financial statements of over 15,000 public companies annually, including all companies whose securities are traded on the New York Stock Exchange and NASDAQ. Many investors and financial analysts rely on financial statement audits to provide assurance about the credibility of critical information that they use when making investment decisions.
- Bankers, bonding agencies, and other creditors rely on financial statement audits to ensure that they are using reliable information when extending credit to public and private companies.
- The Sarbanes-Oxley Act of 2002 requires auditors to provide assurance about the quality of internal control over financial reporting in addition to assurance about fair presentation in financial statements.
- The federal government values the work of auditors who audit state and local governments receiving \$500,000 or more per year in financial assistance from the federal government under the Single Audit Act.
- The board of directors and audit committees of many public companies value the work of internal auditors who evaluate information systems and report to the board about potential improvements in company operations.
- The federal government values the work of auditors working for the Internal Revenue Service who recommended an additional \$4.3 billion in taxes based on corporate audits conducted in 2003.¹

As a vocation, auditing offers the opportunity for challenging and rewarding careers in public accounting, industry, and government. Many auditors develop a client base with a concentration in one or more key industries. As a result of serving many clients in similar industries, few individuals understand the key competitiveness factors for a business better than the auditor.

¹ Reported by the Transactional Records Access Clearing House at Syracuse University, http://trac.syr.edu/tracirs/trends/current/taxpen_corp.html

Individuals choosing an auditing career in a public accounting firm have the opportunity to progress from a starting position of staff assistant to senior auditor, to manager, and then to partner. Becoming a partner ordinarily takes from 10 to 12 years. As auditors progress in their careers, they can expect to be faced with more challenging accounting and auditing issues. In the process of earning a partnership, CPAs develop a reputation for expertise in accounting, auditing, and giving unbiased professional views regarding financial reporting, internal control, business risk, and performance measurement. Auditing career paths in industry and government vary considerably. Some state and local government chief auditor positions are elective offices. Regardless of their career path, most auditors are recognized for their expertise in evaluating organizational performance.

AUDITING DEFINED

The term *auditing* is used to describe a broad range of activities in our society. The following broad definition of auditing identifies a number of common attributes of most modern auditing activities as depicted in Figure 1-1. The Report of the Committee on Basic Auditing Concepts of the American Accounting Association (*Accounting Review*, vol. 47) defines **auditing** as

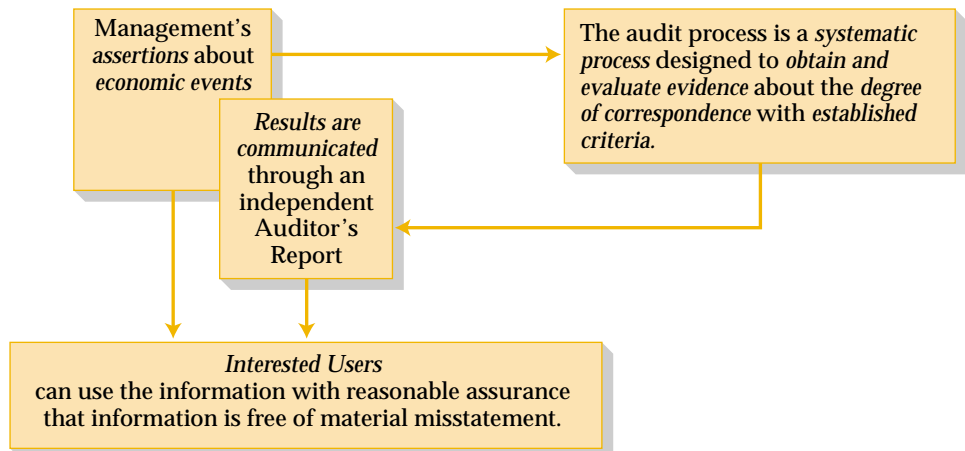
a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.

Several attributes of auditing contained in this definition merit special comment:

- A *systematic process* connotes a logical, structured, and organized series of steps or procedures.
- *Objectively obtaining and evaluating evidence* means examining the bases for the assertions and judiciously evaluating the results without bias or prejudice either for or against the individual (or entity) making the assertions.

Auditor Knowledge 1
 ■ Know the common attributes of activities defined as auditing.

Figure 1-1 ■ Overview of the Audit Process



- *Assertions about economic actions and events* are the representations made by the entity or individual. They comprise the subject matter of auditing. Assertions include information contained in financial statements, internal operating reports, and tax returns.
- *Degree of correspondence* refers to the closeness with which the assertions can be identified with established criteria. The expression of correspondence may be quantified, such as the amount of a shortage in a petty cash fund, or it may be qualitative, such as the fairness of financial statements.
- *Established criteria* are the standards against which the assertions or representations are judged. Criteria may be specific rules prescribed by a legislative body, budgets and other measures of performance set by management, or generally accepted accounting principles (GAAP) established by the Financial Accounting Standards Board (FASB) and other authoritative bodies.
- *Communicating the results* is achieved through a written report that indicates the degree of correspondence between the assertions and established criteria. The communication of results either enhances or weakens the credibility of the representations made by another party. The goal of the audit process is to add credibility to management’s representations so that interested users can use the information with reasonable assurance that it is free of material misstatement.
- *Interested users* are individuals who use (rely on) the auditor’s findings. In a business environment, they include stockholders, management, creditors, governmental agencies, and the public.

These attributes provide a sound description of the auditor’s work. Many of these attributes are common to all types of audits. Figure 1-2 compares some of the significant differences between various types of audits: financial statement audits, compliance audits, audit reports on internal control, and operational audits.

Figure 1-2 ■ Comparative Summary of Types of Audits

Type of Audit	Financial Statement Audit	Compliance Audit	Audit Report on Internal Control	Operational Audit
Assertion about economic actions and events	Presentation of financial position, results of operations, and cash flows	Claims or data pertaining to adherence to policies, laws, regulations, etc.	Adequacy of system of internal control over financial reporting	Operational or performance data
Established criteria	Generally accepted accounting principles	Management’s policy or laws and regulations	COSO criteria for evaluating internal controls	Objectives set by management
Communication of results	Opinion of independent CPA	Summary of findings or assurance regarding degree of compliance	Opinion of independent CPA	Summary of findings regarding efficiency and effectiveness observed
Interested users	Investors, creditors and others	Management, board of directors, and others	Investors, creditors and others	Management and board of directors

Auditor Knowledge 2

■ Know the differences between the different types of audits and auditors.

TYPES OF AUDITS

Three types of audits normally demonstrate the key characteristics included in the definition of auditing: financial statement audits, compliance audits, and operational audits. The audit report on internal control over financial reporting is a variation of a compliance audit. The nature of each type of audit is briefly described in the following pages.

Financial Statement Audit

A **financial statement audit** involves obtaining and evaluating evidence about an entity's presentation of its financial position, results of operations, and cash flows for the purpose of expressing an opinion on whether they are presented fairly in conformity with established criteria—usually generally accepted accounting principles (GAAP). In most states only CPAs can perform financial statement audits, and the company whose statements are being audited usually hires the external audit firm. The results of financial statement audits are distributed to a wide spectrum of users such as stockholders, creditors, regulatory agencies, and the general public through the auditor's report on financial statements. In addition, the external auditor also prepares a report to the audit committee of the board of directors about the company's accounting policies, internal controls, and other audit findings.

Financial statement audits for major corporations are indispensable to the functioning of our national securities markets. Many lenders and creditors also rely on financial statement audits to obtain assurance about the reliability of information used to support lending decisions. High-quality financial audits significantly reduce the risk that investors and creditors will use poor-quality information when making a variety of investment decisions. In addition, the audit logic developed for financial statement audits is the cornerstone on which auditors have developed compliance audits, operational audits, and a wide array of attest and assurance services. As a result, this text gives extensive consideration to the logic underlying the audit of financial statements.

Compliance Audit

A **compliance audit** involves obtaining and evaluating evidence to determine whether certain financial or operating activities of an entity conform to specified conditions, rules, or regulations. The established criteria in this type of audit may come from a variety of sources. The Sarbanes-Oxley Act of 2002 requires companies to have a dual-purpose audit that audits both the financial statements and management's assertion as to whether it has complied with criteria regarding an adequate system of internal control over financial reporting. Compliance audits may also be based on criteria established by creditors. For instance, a bond covenant may require the maintenance of a specified current ratio. Possibly the widest application of compliance audits relates to criteria based on government regulations. Corporations, for example, must comply with extensive income tax and other government regulations that are subject to audit. Defense contractors must comply with the terms and conditions of government contracts.

audit engagements on compliance with internal controls

A number of studies, beginning with the Trueblood Commission in the 1980s, have come to the conclusion that a sound system of internal control helps prevent fraud. Section 404 of the Sarbanes-Oxley Act of 2002 established a requirement that the management of a public company establish and maintain adequate internal controls over financial reporting and report annually on (1) management's responsibility for internal controls over financial reporting and (2) the effectiveness of such controls.

Each annual report filed with the SEC should include an internal control report:

- Stating that management is responsible for establishing and maintaining adequate internal controls and procedures over financial reporting.
- Containing management's assessment, as of the end of the most recent fiscal year, of the effectiveness of the company's internal controls and procedures over financial reporting.

In addition, the independent auditor must audit (provide reasonable assurance about) management's assertions regarding the system of internal control over financial reporting. Under Sarbanes-Oxley, an independent auditor will audit both the financial statement audits and management's assertions regarding compliance with criteria about the adequacy of internal control over financial reporting.

PCAOB

Public Companies
Accounting Oversight Board

Some reports of independent auditors come in the form of an audit report on the adequacy of internal control for general-purpose users. Other reports on compliance audits may be directed to the authority that established the criteria and may include either (1) a summary of findings or (2) an expression of assurance as to the degree of compliance with those criteria.

Operational Audit

An **operational audit** involves obtaining and evaluating evidence about the efficiency and effectiveness of an entity's operating activities in relation to specified objectives. This type of audit is sometimes referred to as a performance audit or a management audit. In a business enterprise, the scope of the audit may encompass all the activities of (1) a department, branch, or division, or (2) a function that may cross business unit lines such as marketing or data processing. In the federal government, an operational audit might extend to all the activities of (1) an agency, such as the Federal Emergency Management Agency (FEMA) or (2) a particular program, such as the distribution of food stamps. The criteria or objectives against which efficiency and effectiveness are measured may be specified, for example, by management or enabling legislation. In other cases, the operational auditor may assist in specifying the criteria to be used. Reports on such audits typically include not only an assessment of efficiency and effectiveness, but also recommendations for improvement. When performed by CPA firms, such audits are likely to involve individuals from the consulting department, or individuals with extensive industry expertise, such as the audit staff.

TYPES OF AUDITORS

Individuals who are engaged to audit economic actions and events for individuals and legal entities are generally classified into three groups: (1) independent auditors, (2) internal auditors, and (3) government auditors.

Independent Auditors

Independent auditors are usually CPAs who are either individual practitioners or members of public accounting firms who render professional auditing services to clients. In general, licensing involves passing the uniform CPA examination and obtaining practical experience in auditing. By virtue of their education, training, and experience, independent auditors are qualified to perform each type of audit described previously. The clients of independent auditors may include profit-making business enterprises, not-for-profit organizations, and governmental agencies.

Like members of the medical and legal professions, independent auditors work on a fee basis. There are similarities between the role of an independent auditor in a public accounting firm and an attorney who is a member of a law firm. However, there is also a major difference: The auditor is expected to be independent of the client in making an audit and in reporting the results, whereas the attorney is expected to be an advocate for the client in rendering legal services. Users rely on the auditor's independence and derive value from the fact that the auditor is unbiased with respect to the client under audit. More attention will be given to independence in later chapters.

Internal Auditors

Internal auditors are employees of the organizations they audit. This type of auditor is involved in an independent evaluation of evidence, called internal auditing, within an organization as a service to the organization. The objective of internal auditing is to assist the management of the organization in the effective discharge of its responsibilities.

The scope of the internal audit function extends to all phases of an organization's activities. Internal auditors are primarily involved with compliance and operational audits. However, as is explained later, the work of internal auditors may supplement the work of independent auditors in financial statement audits.

Many internal auditors hold the certified internal auditor (CIA) credential and some are also CPAs. The international association of internal auditors is the Institute of Internal Auditors (IIA), which prescribes certification criteria and administers the certified internal auditor examination. In addition, the IIA has established practice standards for internal auditing and a code of ethics.

Government Auditors

Government auditors are employed by various local, state, and federal governmental agencies. At the federal level, the three primary agencies are the General Accounting Office (GAO), the Internal Revenue Service (IRS), and the Defense Contract Audit Agency (DCAA).

In performing the audit function for Congress, GAO auditors engage in a wide range of audit activities, including financial statement audits, compliance audits,

and operational audits. The results of these audits are reported to the U.S. Congress and the public. GAO auditors are also involved in fact-finding and evaluating alternatives for Congress.

IRS auditors (or agents) audit the returns of taxpayers for compliance with applicable tax laws. Their findings are generally restricted to the agency and the taxpayer. The Defense Contract Audit Agency, as its name suggests, conducts audits of defense contractors and their operations, and reports to the Department of Defense. The national organization for government accountants is the Association of Government Accountants (AGA). Today most government auditors hold CPA and/or CIA certificates.

ASSURANCE SERVICES DEFINED

Assurance services is a broader term that includes audits and a variety of other assurances about various representations of management. The AICPA Special Committee on Assurance Services² developed the following definition.

Assurance services are independent professional services that improve the quality of information, or its context, for decision makers.

There are several important differences between the AAA definition of auditing and the AICPA definition of assurance service that relate to the qualities of the auditor, not just the audit process.

- The concept of *independence* is a key aspect of assurance services. Users rely on the CPA's independence and derive value from the fact that the CPA is unbiased and objective.
- The concept of *professional services* encompasses the application of professional judgment that is a unique attribute that the CPA brings to the engagement. CPAs bring their professional skepticism and objectivity to an engagement. Although advances in information technology can speed the accumulation or analysis of data, technology cannot replace the practitioner's professional judgment.
- The purpose of assurance services is to improve the *quality of information or its context*. Quality, as discussed by the Special Committee on Assurance Services, encompasses the concepts of decision usefulness. Assurance services improve the quality of information by improving its reliability or relevance. The Special Committee defines reliability and relevance as follows:³
 - Reliability includes representational faithfulness, neutrality, and consistency among periods.
 - Relevance includes understandability, comparability with other entities, usability, and completeness.
- The *decision maker* is featured prominently in the services definition. Assurance services are intended to provide a benefit to the decision maker. Decision makers may be clients or outside third parties.

² Additional information on assurance services can be found by visiting the Assurance Services web site, which can be accessed through the AICPA homepage at <http://www.aicpa.org>.

³ The definitions of reliability and relevance used by the Special Committee on Assurance Services differ somewhat from the description in Statement of Financial Accounting Concepts No. 2.

Auditor Knowledge 3

- Know the common attributes of assurance services.

what it means to be a professional

John Carey's book, *The Rise of the Accounting Profession: From Technician to Professional*, identified seven criteria that distinguish professions from other pursuits. Each of these is discussed here in the context of the requirements to be recognized as a Certified Public Accountant (CPA).

1. *A Body of Specialized Knowledge.* CPAs are recognized as experts in the areas of accounting, auditing, and taxation. This reputation is enhanced by the CPA's expertise in business and organizational success.
2. *A Formal Educational Process.* In most states students must complete 150 semester hours of education including a minimum study in accounting, business, and other subjects in order to qualify to sit for the CPA exam.
3. *Standards Governing Admission.* In order to become a CPA, candidates usually must complete education requirements including the study of accounting, pass the CPA exam, and complete an experience requirement (usually one year of experience).
4. *A Code of Ethics.* The American Institute of CPAs has adopted a code of professional ethics that governs the behavior of CPAs. This code of ethics has been important in establishing a reputation for the CPA profession as one where its members are recognized as acting with integrity and objectivity. In addition, many states have written similar codes into their state accountancy laws.
5. *A Recognized Status Indicated by a License or Special Designation.* Today 54 jurisdictions license CPAs, most of which give CPAs exclusive rights in the practice of accounting and auditing. In addition, CPAs do not have to register as enrolled agents when practicing taxation.
6. *A Public Interest in the Work that the Practitioner's Perform.* CPAs who practice as auditors perform an important role in providing assurance about the reliability of the financial information included in audited financial statements.
7. *A Recognition by Professionals of a Social Obligation.* The auditing profession has recognized the importance of their obligation to the public through self-regulation in the form of peer reviews to ensure high standards in the quality of work. The investing public depends on auditors to provide reasonable assurance that audited financial statements are free of material misstatement.

Auditor Knowledge 4

■ Know the variety of services and levels of assurance in the universe of assurance services.

The audit is only one type of an assurance service. The audit focuses primarily on the information contained in financial statements. Assurance services deal with a wide array of information used by decision makers, not just financial statement users.

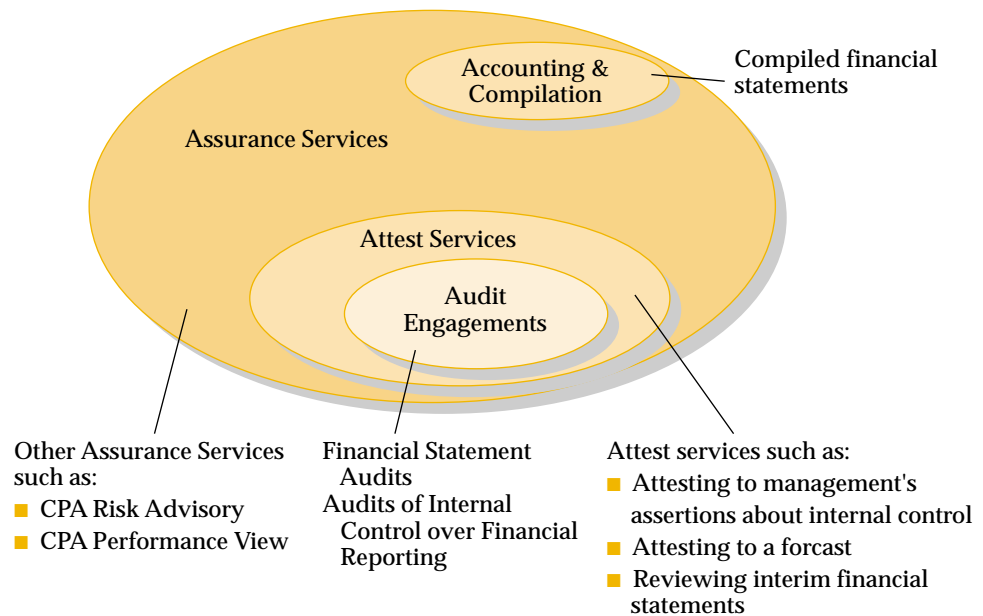
Example Assurance Services

Figure 1-3 depicts the universe of assurance services. The following discussion provides examples of assurance and attest services provided by CPAs, along with an explanation of the levels of assurance that are often associated with the various services.

Audit Engagements

The purpose of an **audit engagement** is to provide *reasonable assurance*, not a guarantee, that the financial information is free of material misstatement. This type of

Figure 1-3 ■ Universe of Assurance Services



audit involves obtaining and evaluating evidence about an entity's historical financial statements. Although the financial statements of public companies are prepared in accordance with GAAP, financial statements of private companies can be audited in accordance with a federal income tax basis of accounting or a cash basis of accounting. Auditors can also audit only an element of the financial statements such as royalties payable. In addition, auditors of public companies audit the effectiveness of internal controls over financial reporting.

Attest Services

An **attest service** is one in which the CPA firm issues a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. In recent years, growing recognition of the skills and experience of CPAs has resulted in a demand from clients, regulating agencies, and others for a variety of attest services.

The term **examination** is used to describe other services that culminate in the positive expression of an opinion as to whether or not another party's assertions conform to stated criteria. Examples include examinations of (1) prospective (rather than historical) financial statements and (2) an entity's compliance with specified laws or regulations. In an examination, as in an audit, the CPA also issues a "positive" expression of opinion on whether management's assertions are presented fairly in conformity with established criteria. Again the goal is to provide *reasonable assurance* that management's assertion is free of material misstatement.

Reviews of financial information also fall under the category of attest services because CPAs provide *negative assurance* about financial information. A **review engagement** consists primarily of inquiries of an entity's management

and comparative analyses of financial information. The scope of this service is significantly less than that of an audit or examination. The purpose is to give *negative assurance* as opposed to the positive expression of opinion given in an audit. Thus, instead of stating that financial statements are “presented fairly in conformity with GAAP,” a review report states that the reviewer is “not aware of any material modifications that should be made to the statements in order for them to be in conformity with GAAP.” This service is sometimes performed on the interim statements of public companies and the annual statements of nonpublic companies. CPAs may also review management’s representation about compliance with debt covenants.

The auditor can also complete an agreed-upon procedures engagement. An **agreed-upon procedures engagement** is one in which the auditor performs specific procedures to attest to management’s assertion (for example, the amount of royalties payable) for an outside third party (the entity receiving the royalties). The specific procedures to be performed are agreed upon by the party making the assertion, the party using the assertion, and the CPA. The level of assurance depends on the nature and extensiveness of the attest procedures agreed upon by all parties.

Accounting and Compilation Services

A CPA firm may be engaged by a client to perform a variety of **accounting services**, including doing manual or automated bookkeeping, journalizing, and posting adjusting entries. The CPA may also be engaged to perform a **compilation service** through which the CPA, who is an expert regarding GAAP, drafts and compiles financial statements for the client. When the CPA “compiles” a set of financial statements, the CPA provides *no assurance* about whether the financial statements present fairly in accordance with GAAP, for the CPA has not obtained evidence supporting the financial statements. Nevertheless, this is an important assurance service that improves the relevance of information for decision makers in nonpublic entities. Accounting services are a major activity for some sole practitioners and local CPA firms.

Other Assurance Services

Assurance services are generally focused on improving the relevance or reliability of information used by decision makers. Examples of other types of assurance services include:

- **CPA Risk Advisory services**—services in which the CPA can improve the quality of risk information for internal decision makers through independent assessments of the likelihood that an event or action will adversely affect an organization’s ability to achieve its business objectives and execute its strategies successfully.
- **CPA Performance View**—a service that focuses on providing assurance regarding an organization’s use of both financial and nonfinancial measures to evaluate the effectiveness and efficiency of its activities.

These services build upon the trust and reputation for integrity and objectivity earned by CPAs, but extend traditional services into totally new areas, as discussed in detail in Chapter 20.

Levels of Assurance

CPAs can provide several levels of assurance when performing assurance services. The common levels of assurance discussed above are as follows:

- **Reasonable assurance.** This is a very high level of assurance but not a guarantee. In audit and examination engagements the CPA needs to obtain sufficient, competent evidence to support a positive opinion that the assertion is presented fairly in all material respects.
- **Negative assurance or review-level assurance.** This is substantially less than an audit or examination. In a review engagement the CPA makes inquiries and performs analytical procedures so that the reviewer can state that he or she is “not aware of any material modifications that should be made to management’s assertion.”
- **Agreed-upon procedures.** In some cases the entity making an assertion and the entity using an assertion will agree on specific procedures to be performed by the CPA. The level of assurance that is obtained depends on the nature and extensiveness of the agreed-upon procedures performed by the CPA.
- **Compilation without assurance.** In some cases the CPA may compile information to provide decision makers with relevant information. In this case the CPA provides *no assurance* about the underlying reliability of the information.

VALUE OF AUDIT AND ASSURANCE SERVICES

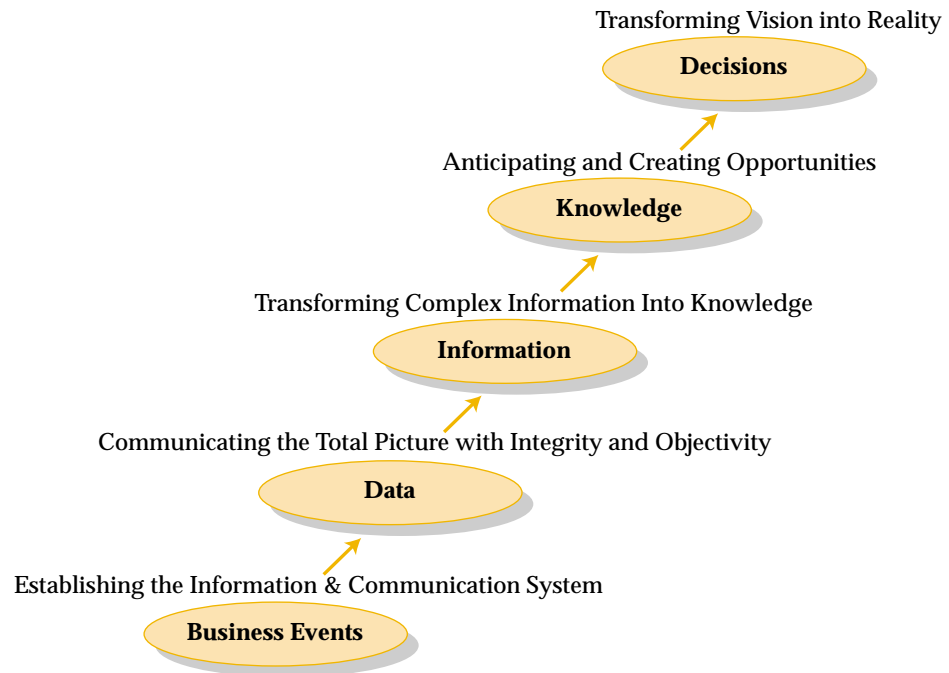
Figure 1-4 describes the accountant’s value chain. Accountants provide a wide array of services that assist decision makers. Understanding this value chain may help in understanding the value of audit and assurance services. The steps in the accountant’s value chain can be described as follows:

- **Capturing business events in the form of data.** This is the job of the accounting information and communication system. In addition, many internal controls function at this level to ensure that accounting data are accurate. In the initial step, for example, data may be input regarding inventory transactions.
- **Communicating the total picture with integrity and objectivity.** This is the process of developing financial statements and other information that might be reported to management, the board of directors, or outside creditors and investors. This second step might be exemplified by developing financial statements that report inventory and other transactions.
- **Transforming complex information into knowledge.** This is the process of provide a context for information and making it usable. An example of the third step might be determining that a company turns inventory four times a year. This information is not very useful, however, without the context of the company, its industry, and its competitors. A retail grocer or a brewer would expect to turn its inventory much more frequently than four times a year. However, this would be an unrealistically high inventory turn for a winery. Jewelry stores and pharmaceutical companies also have slower inventory turns. Significant value is added by establishing a knowledgeable setting for how information will be used.
- **Anticipating and creating opportunities.** If a company is turning its inventory four times a year, and that is slow for the industry, then the next question becomes one of determining how to increase inventory turns. This step might

Auditor Knowledge 5

- Know the value of the audit and other assurance services.

Figure 1-4 ■ The Accountant's Value Chain



involve identifying slow-moving inventory and determining a strategy for selling off that inventory.

- **Decision making.** Ultimately, management decide on a course of action to improve inventory management. Management must make the sales and streamline the inventory management process to improve inventory turns.

The role of the financial statement audit is to provide reasonable assurance that the information sets known as financial statements prepared in accordance with GAAP are presented fairly in all material respects. Financial statements that contain material misstatements often lead to poor decisions. For example, many investors in WorldCom made investment decisions based on information that did not accurately reflect the underlying profitability of the company. When the information was corrected, share price declined and investors lost billions of dollars. Imagine the value to investors of having information that was materially correct in the first place. This value is not limited to outside investors. Many directors rely on audited information to fulfill their role in evaluating the performance of management and guiding the company. Management needs reliable information for day-to-day decision making. Without information that is fairly presented, the decisions made by these members of management are significantly handicapped.

Reliable information is the foundation for many decisions. The purpose of an audit is to provide assurance that information used in decision making is reliable. Without audits, outsiders who use information provided by management may not have an adequate foundation on which to make important decisions. The

value of every step above *information* on the value chain is dependent upon the credibility of that information.

In addition, internal auditors provide a variety of services in this value chain. For example, they might test internal controls and perform other procedures to provide assurance about the underlying accuracy of information used by management. In addition, they might perform operational audits that use the information coming from the accounting system combined with knowledge of the business and industry to recommend operational improvements. The operational audit assists management in identifying opportunities for improving profitability or for reducing liquidity or solvency risks.

Other assurance services are also aimed at providing valuable information to decision makers. Even though the compilation service provides no assurance about the credibility of underlying information, it usually provides information for decision makers that they would not otherwise have. The review service adds some credibility to underlying information (negative assurance vs. reasonable assurance), but this level of credibility benefits decision makers at a reasonable cost. A service such as *CPA Performance View* is designed to provide decision makers with additional, relevant information that they otherwise might not have. A service such as *CPA Risk Advisory* assists the decision makers in understanding the risks associated with various business opportunities. Each of these services provides value to the decision maker by providing more relevant or more reliable information.

LEARNING CHECK

- 1-1 Explain the seven attributes that describe the nature of the auditor's work.
- 1-2 Distinguish among the three principal types of audits and describe the nature of the auditor's report for each.
- 1-3 Distinguish among the three principal types of auditors and indicate the types of audits each may perform.
- 1-4
 - a. Provide two examples of examination engagements and explain the level of assurance provided by the CPA.
 - b. Provide an example of a review engagement and explain the level of assurance provided by the CPA.
- 1-5 What assurance is provided by CPAs who perform accounting and compilation services for a client? Explain the benefits received by a client who requests accounting and compilation services.
- 1-6 Identify two other assurance services provided by CPAs and explain how they improve the relevance or reliability of information used by decision makers.
- 1-7
 - a. Explain the value of the audit in the context of the accountant's value chain.
 - b. Explain the value of the compilation service and the review service in the context of the accountant's value chain.
 - c. Explain the value of the *CPA Risk Advisory* service in the context of the accountant's value chain.

[KEY TERMS]

Accounting services, p. 14	Examination, p. 13
Agreed-upon procedures, p. 15	Financial statement audit, p. 8
Agreed-upon procedures engagement, p. 14	Government auditors, p. 10
Assurance services, p. 11	Independent auditors, p. 10
Attest service, p. 13	Internal auditors, p. 10
Audit engagement, p. 12	Negative assurance or review-level assurance, p. 15
Auditing, p. 6	Operational audit, p. 9
Compilation service, p. 14	Reasonable assurance, p. 15
Compilation without assurance, p. 15	Review engagement, p. 13
Compliance audit, p. 8	

[THE DEMAND FOR AUDITING]

Auditor Knowledge 6

■ Know a historical perspective of the demand for auditing.

THE ROOTS OF AUDITING

The beginning of the company audit can be linked to British legislation during the industrial revolution in the mid-1800s. Advances in transportation and industrial technology resulted in new economies of scale, larger companies, the advent of professional managers, and the growth of diverse absentee ownership of companies. The development of professional managers who were separate from investors and creditors created a demand for someone to add credibility to management's financial representations. Initially, company audits had to be performed by one or more stockholders, who were not company officers and who were designated by the other stockholders as their representatives. The auditing profession quickly emerged to meet marketplace needs, and legislation was soon revised to permit persons other than stockholders to perform the audits, giving rise to the formation of auditing firms. Some of these early British firms, such as Deloitte & Co., Peat, Marwick, & Mitchell, and Price Waterhouse & Co., can be traced to firms that today practice on an international scale.

The British influence migrated to the United States in the late 1800s as English and Scottish investors sent their own auditors to check on management's statements about the condition of American companies in which they had heavily invested. The focus of these early audits was on finding errors in the balance sheet accounts and stemming the growth of fraud associated with the increasing phenomenon of professional managers and absentee owners. During the early 1900s, the demand for audits expanded greatly owing to rapid growth in the public ownership of corporate securities.

Following the stock market crash of 1929, significant deficiencies were recognized in financial reporting, and the profession was challenged to provide stronger leadership in the further development of accounting and auditing. By then, the income statement had gained status, and attention had to be paid to measures of operating performance and concepts of income as well as financial condition. In order to enhance the credibility of information prepared for investors, the New York Stock Exchange, in 1932, adopted a requirement that all

listed corporations obtain an audit certificate from an independent CPA. Passage of the Securities Act of 1933 and the Securities Exchange Act of 1934 further added to the demand for audit services for publicly owned companies.

In response to these demands and growth in the size and complexity of businesses, by the 1940s three important changes in audit practice had evolved: (1) a shift from detailed verification of accounts to sampling or testing as the basis for rendering an opinion on the fairness of financial statements, (2) development of the practice of linking the testing to be done to the auditor's evaluation of a company's internal controls, and (3) deemphasis of the detection of fraud as an audit objective. The auditor's responsibility to find fraud is the subject of controversy to this day and is explained further both in the next chapter and in Chapter 9.

In the 1980s the auditing profession came under scrutiny by Congress following discovery of financial frauds at several public companies such as Equity Funding and National Student Marketing. At this time the public accounting profession took another step in ensuring high-quality audit services. Various states adopted requirements that CPAs engage in annual, continuing professional education in order to maintain their licenses. The public accounting profession also took a voluntary step by instituting a program of peer review. Under this program, a CPA firm would submit its accounting and auditing practice to a review by independent peers every three years.

During the 1980s the accounting profession slowly addressed the issue of its responsibility for finding financial fraud. The National Commission of Fraudulent Financial Reporting made recommendations for improvements in internal controls, and the Auditing Standards Board issued a series of 10 new auditing standards in 1988 to narrow a perceived "expectations gap" in order to bring auditor responsibilities more in line with investor's expectations. The profession also developed new attestation standards as CPAs were asked to render their independent professional judgment about assertions other than financial statement assertions. CPAs were routinely hired to provide review-level assurance to lenders about a company's compliance with debt covenants or to apply agreed-upon procedures to royalty agreements. As information technology advanced and companies subcontracted accounting work to outside organizations, CPAs were asked to attest to the internal controls of the outside service provider.

From 1990 to 2000 CPA firms became professional service firms, hiring a wide variety of business professionals that sold consulting services to their clients. By 2000 consulting revenues exceeded auditing revenues at all the national CPA firms, and in some cases consulting fees to an audit client exceeded the size of the audit fee. The SEC and the investing public began to question how CPAs could be independent on audit issues when the firms were so dependent on consulting revenues. The quality of audits was further questioned when a series of restatements of earnings from public companies such as Sunbeam, Waste Management, Xerox, Adelphia, Enron, and WorldCom brought about a crisis of confidence in the work of auditors. Even though these events were relatively rare out of the approximately 15,000 annual public company audits, the consequences for shareholders amounted to losses in the billions of dollars.

Over the years the demand for auditing has been influenced by professional managers who misled investors by materially misstating the financial performance in their company's financial statements. Investors expect auditors to intervene and find financial statement misstatements. During the 20th century auditors were self-regulated, and the profession set its own standards. The Auditing

Standards Board struggled to find a balance of setting standards to expect auditors to find most financial statement misstatements, but to not set the standard so high that auditors appeared to be self-serving. Corporate management protested standards that would cause significant increases in audit fees.

By 2002 the collapse of Enron and WorldCom led Congress to pass the Sarbanes-Oxley Act of 2002. This Act created the Public Companies Accounting Oversight Board (PCAOB) and gave it responsibility for setting auditing, ethics, independence, and quality control standards for audits of public companies. Congress believed that self-regulation of auditors had not worked and that the SEC was better positioned to protect the investor's interest. The Sarbanes-Oxley Act of 2002 also extended the auditor's work beyond the financial statement audit. A number of important commissions have recognized the importance of good internal controls in preventing financial statement misstatements. Section 404 of the Sarbanes-Oxley Act of 2002 also requires auditors to audit management's assertion about the adequacy of internal controls over financial reporting.

Auditor Knowledge 7

■ Know the factors that influence the need for financial statement audits.

NEED FOR FINANCIAL STATEMENT AUDITS

The FASB, in *Statement of Financial Accounting Concepts No. 2*, states that relevance and reliability are two primary qualities that make accounting information useful for decision makers. Users of financial statements look to the independent auditor's report for assurance about the reliability of information and its conformance to generally accepted accounting principles (a measure of relevance of financial information).

The need for independent audits of financial statements can further be attributed to four conditions as follows:

- **Conflict of Interest.** Many users of financial statements are concerned about an actual or potential conflict of interest between themselves and the management of the reporting entity. The apprehension extends to a fear that the financial statements prepared by management may be significantly biased in management's favor. A 1998 *Business Week* survey found that 67 percent of CFOs had been asked to misrepresent results and that 12 percent did so.⁴ In the same year *CFO Magazine* did a survey that found that 45 percent of CFOs had been asked to misrepresent financial results and that 38 percent of the group did so.⁵ Users seek assurance from outside independent auditors that financial statements are free of management bias to combat these pressures.
- **Consequence.** Published financial statements represent an important and, in some cases, the only source of information used in making significant lending, investment, and other decisions. Thus, users want the financial statement to contain as much relevant and reliable information as possible. This need is recognized by the extensive disclosure requirements imposed by the SEC on the companies under its jurisdiction. It is also recognized by the relevance of GAAP disclosures to many lenders. Financial statement users look to the independent

⁴ S. Shuster, "The Seventh Annual Business Week Forum of Chief Financial Officers," *Business Week*, July 13, 1998.

⁵ S. Barr, "Misreporting Results," *CFO: The Magazine for Senior Financial Executives*, December 1998, pp. 36-38.

auditor for assurance that the financial statements have been prepared in conformity with GAAP, including all the appropriate disclosures.

- **Complexity.** Both the subject matter of accounting and the process of preparing financial statements have become increasingly complex. Accounting for the impairment of fixed assets or goodwill, and accounting for leases, pensions, and income taxes are examples of this complexity. As the level of complexity increases, so does the risk of misinterpretations and of intentional or unintentional misstatements. Finding it impossible to evaluate the quality of the financial statements themselves, users rely on the independent auditors to assess the quality of the information contained in the statements.
- **Remoteness.** Distance, time, and cost make it impractical for users of financial statements to seek direct access to the underlying accounting records to perform their own verifications of the financial statement assertions. Rather than accept the quality of the financial data on faith, once again users rely on the independent auditor's report to meet their needs.

These four conditions collectively contribute to **information risk**, which is the risk that the financial statements may be incorrect, incomplete, or biased. Thus, it can be said that financial statement audits enhance the credibility of financial statement by reducing information risk. This information risk was exhibited in cases such as material misstatement of earnings at WorldCom.

Auditor Knowledge 8

- Know the economic benefits and inherent limitations associated with a financial statement audit.

ECONOMIC BENEFITS OF AN AUDIT

The annual audit fee for Microsoft, a Fortune 500 company, was disclosed as \$15.9 million for the year ended June 30, 2004. Clearly, economic benefits must accrue from audits to justify such costs. Among the economic benefits of financial statement audits are the following:

- **Access to Capital Markets.** As noted previously, public companies must satisfy statutory audit requirements under the federal securities acts in order to register securities and have them traded on securities markets. In addition, stock markets may impose their own requirements for listing securities. Without audits, companies would be denied access to these capital markets and many private companies would be denied access to loans.
- **Lower Cost of Capital.** Small companies often have financial statement audits to obtain bank loans on more favorable borrowing terms. Because of the reduced information risk associated with audited financial statements, creditors may offer loans with lower interest rates.
- **Deterrent to Inefficiency and Fraud.** Research has demonstrated that when employees know that an independent audit is to be made, they take care to make fewer errors in performing accounting functions and are less likely to misappropriate company assets. Thus, the data in company records will be more reliable, and losses from embezzlements and the like will be reduced. In addition, the fact that financial statement assertions are to be verified reduces the likelihood that management will engage in fraudulent financial reporting.
- **Control and Operational Improvements.** Based on observations made during a financial statement audit, the independent auditor often makes suggestions to improve internal control, to evaluate management's assessments of business

risks, to recommend improved performance measures, and to make recommendations to achieve greater operational efficiencies within the client's organization. These benefits are especially valuable to small and medium-sized companies.

A company's management, including its board of directors, and shareholders find that the significant benefits discussed above make the financial statement audit valuable.

LIMITATIONS OF AN AUDIT

A financial statement audit is subject to a number of inherent limitations. One constraint is that the auditor works within fairly restrictive economic limits. Following are two important economic limitations.

- **Reasonable Cost.** A limitation on the cost of an audit results in selective testing, or sampling, of the accounting records and supporting data. In addition, the auditor may choose to test internal controls and may obtain assurance from a well-functioning system of internal controls.
- **Reasonable Length of Time.** The auditor's report on many public companies is usually issued three to five weeks after the balance sheet date. This time constraint may affect the amount of evidence that can be obtained concerning events and transactions after the balance sheet date that may have an effect on the financial statements. Moreover, there is a relatively short time period available for resolving uncertainties existing at the statement date.

Another significant limitation is the established accounting framework for preparing financial statements. Following are two important limitations associated with the established accounting framework.

- **Alternative Accounting Principles.** Alternative accounting principles are permitted under GAAP. Financial statement users must be knowledgeable about a company's accounting choices and their effect on financial statements.
- **Accounting Estimates.** Estimates are an inherent part of the accounting process, and no one, including auditors, can foresee the outcome of uncertainties. Estimates range from the allowance for doubtful accounts and an inventory obsolescence reserve to impairment tests for fixed assets and goodwill. An audit cannot add exactness and certainty to financial statements when these factors do not exist.

Despite these limitations, a financial statement audit adds credibility to the financial statements.

LEARNING CHECK

- 1-8 Explain the historical development of the demand for financial statement audits.
- 1-9 Cite four factors that contribute to the need for a financial statement audit.
- 1-10 Explain four economic benefits of a financial statement audit.
- 1-11 Describe four the inherent limitations of a financial statement audit.

KEY TERMS

- Access to capital markets, p. 21
- Accounting estimates, p. 22
- Alternative accounting principles, p. 22
- Complexity, p. 21
- Conflict of interest, p. 20
- Consequence, p. 20
- Control and operational improvements, p. 21
- Deterrent to inefficiency and fraud, p. 21
- Information risk, p. 21
- Lower cost of capital, p. 21
- Reasonable cost, p. 22
- Reasonable length of time, p. 22
- Remoteness, p. 21

ORGANIZATIONS ASSOCIATED WITH THE PUBLIC ACCOUNTING PROFESSION

The modern profession of public accounting is influenced by a number of professional and regulatory organizations that either function within the profession itself or directly influence the profession through their standard-setting and regulatory activities. These organizations, representing both the private and public sectors, are identified in Figure 1-5.

Auditor Knowledge 9

■ Know the public sector and private sector organizations associated with auditing and assurance services.

PUBLIC SECTOR ORGANIZATIONS

Securities and Exchange Commission

The **Securities and Exchange Commission (SEC)** is a federal government agency that was created under the 1934 Securities Exchange Act to regulate the distribution of securities offered for public sale and subsequent trading of securities on stock exchanges and over-the-counter markets. Under the provisions of this Act, the SEC has the authority to establish GAAP for companies under its jurisdiction. Throughout its history, the SEC has, with few exceptions, delegated this authority to the private sector, and it currently recognizes the pronouncements of the FASB

Figure 1-5 ■ Organizations Associated with the Public Accounting Profession

Public Sector Organizations	Private Sector Organizations
Securities and Exchange Commission	Public Companies Accounting Oversight Board
State boards of accountancy	American Institute of Certified Public Accountants
U.S. General Accounting Office	State societies of certified public accountants
Internal Revenue Service	Practice units (CPA firms)
State and federal courts	Accounting standards setting bodies: FASB and GASB
U.S. Congress	

as constituting GAAP in the filing of financial statements with the agency. In some instances, however, the SEC's disclosure requirements exceed GAAP.

The SEC also exerts considerable influence over auditing and the public accounting profession. The Sarbanes-Oxley Act of 2002 established a private sector Public Companies Accounting Oversight Board (see p. 25) to oversee the audit of public companies that are subject to securities laws. The PCAOB's rulemaking process results in proposals that do not take effect until the SEC approves them. Over the years, the SEC has not been reluctant to use this authority. Further consideration is given in Chapter 4 to the independent auditor's responsibilities in filings with the SEC.

State Boards of Accountancy

There are 54 boards of accountancy (one in each state, one in the District of Columbia, and one in each U.S. territory). The primary functions of the **state boards of accountancy** are issuing licenses to practice as a CPA, renewing licenses, and suspending or revoking licenses to practice. State boards usually consist of five to seven CPAs and at least one public member, who are generally appointed by the governor. A full-time administrator and a small (five to ten) administrative staff are common. Each board administers its state accountancy laws, which set forth the conditions for licensing of CPAs, codes of professional ethics, and, in most cases, mandatory continuing professional education requirements. State boards are also becoming more active in positive enforcement programs aimed at maintaining high quality in audit practice.

U.S. General Accounting Office

The **General Accounting Office (GAO)** is the nonpartisan, federal audit agency of the U.S. Congress. Headed by the Comptroller General of the United States, the GAO has the authority to issue standards pertaining to the audit of governmental organizations, programs, activities, and functions. Its standards have been published in a booklet called *Government Auditing Standards*, also known as the "yellow book" after the color of its cover. These standards apply not only to government auditors, but to CPAs who perform audits of federal agencies and other entities that receive federal financial assistance, including state and local governments, institutions of higher education, and certain nonprofit organizations and contractors.

Internal Revenue Service

The Internal Revenue Service (IRS) is the division of the U.S. Treasury Department responsible for administration and enforcement of the federal tax laws. A publication that has a major influence on CPAs who perform tax services is the IRS's Circular 230, *Rules Governing the Practice of Attorneys and Agents Before the Internal Revenue Service*. CPAs who depart from these rules are subject to fines and other penalties that can be imposed by the IRS.

State and Federal Courts

Occasionally, CPA firms are sued for alleged substandard work in performing audits or other services. In reaching a judgment in a particular case, generally the courts have looked to the standards of performance established by the profession

itself. But occasionally, the courts have ruled that the profession's standards were not adequate for the protection of the public. Following trends of such court decisions, the profession has responded by raising existing practice standards. Examples include mandating the use of particular auditing procedures pertaining to accounts receivable, inventories, related-party transactions, and the discovery of subsequent events.

U.S. Congress

Following a number of widely publicized audit failures, congressional committees have undertaken several investigations of the accounting profession over the past two decades. The investigations have focused on such matters as the independence of CPA firms, their effectiveness in auditing publicly held companies, and their responsibilities for detecting and reporting fraud and illegal client acts (whistleblowing). The financial frauds at Enron and WorldCom prompted an inquiry into whether the profession's regulatory system is adequate to protect the public. In response, Congress passed the Sarbanes-Oxley Act of 2002 that created the PCAOB which sets independence, auditing, quality control, and ethics standards for auditors of public companies.

PRIVATE SECTOR ORGANIZATIONS

Public Companies Accounting Oversight Board

The **Public Companies Accounting Oversight Board (PCAOB)** describes itself as a private sector, nonprofit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. The PCAOB was given authority in five major areas:

1. Registering public accounting firms that audit the financial statements of public companies.
2. Setting quality control standards for peer review of auditors of public companies and conducting inspections of registered public accounting firms.
3. Setting auditing standards for audits of public companies.
4. Setting independence and ethics rules for auditors of public companies.
5. Performing other duties or functions to promote high professional standards for public company audits, and enforce compliance with the Sarbanes-Oxley Act of 2002.

The PCAOB has enforcement authority and can prohibit CPA, or accounting firms, from auditing public companies. The PCAOB's rulemaking process results in the adoption of rules that are then submitted to the SEC for approval. PCAOB rules do not take effect unless approved by the SEC.

American Institute of Certified Public Accountants

The public accounting profession's national professional organization is the **American Institute of Certified Public Accountants (AICPA)**. As stated in its annual report, the mission of the AICPA is to act on behalf of its members and provide necessary support to assure that CPAs serve the public interest in performing quality

professional services. Membership in the AICPA is voluntary. Currently, there are over 300,000 members of whom 45 percent are in public accounting, 40 percent in business and industry, and the remainder in education, government, or retired.

The AICPA provides a broad range of services to its members. In addition, the AICPA develops and distributes continuing professional education (CPE) materials and courses, provides technical accounting and auditing assistance through a technical information hotline and an extensive library of technical references, and publishes a variety of books, studies, and surveys, as well as three periodicals—the *Journal of Accountancy*, *The Tax Advisor*, and *The CPA Letter*.

Through its senior technical committees, members participate in establishing a variety of professional standards for CPAs who provide services to private companies. Three AICPA divisions or teams have a direct impact on auditing.

1. The AICPA Practice Monitoring Program is responsible for quality control standards and peer reviews of firms that provide assurance services to private companies.
2. The Auditing and Attest Standards Team sets auditing and attest standards for audit, accounting, and review services provided to private companies.
3. The Professional Ethics Division is responsible for setting and enforcing the AICPA Code of Professional Conduct.

State Societies of Certified Public Accountants

CPAs within each state have formed a state society (or association) of CPAs. As in the AICPA, membership in a state society is voluntary and many CPAs are members of both the AICPA and a state society. State societies function through small full-time staffs and committees composed of their members. Although state societies are autonomous, they usually cooperate with each other and the AICPA in areas of mutual interest, such as continuing professional education, quality control, and ethics.

Practice Units (CPA Firms)

A CPA may practice as a sole practitioner or as a member of a firm. A CPA firm may be organized as a proprietorship, limited liability partnership, professional corporation, or any other form of organization permitted by state law or regulation. There are approximately 45,000 practice units in the United States. These firms are often classified into four groups—the Big Four, second-tier, regional, and local firms.

The four largest firms in the United States are referred to as the Big Four. Together, their clients include over 95 percent of the Fortune 500 companies and thousands of smaller clients. The combined U.S. revenues of the Big Four exceeded \$20 billion in 2003, or about one-quarter of the total revenues of the U.S. profession. Each of these firms had worldwide affiliations with partnerships in many countries. With offices in the principal cities of the United States as well as major cities throughout the world, these are truly international firms. The competitive environment is changing as some of the largest accounting firms are not CPA firms. Names like H&R Block, Century Business Services, and

American Express are on the list. Selected additional data for these and several other practice units are presented in Figure 1-6. In 1999 each of the Big Four firms earned less than 50 percent of its revenues from accounting and auditing services. These firms have now sold off significant portions of their consulting practices, and the pendulum has swung back to a point where the majority of these firms earn over 60 percent of their revenues from accounting and auditing services.

As the figure shows, distinct gaps in the size of revenues separate the second-tier firms from both the Big Four and smaller firms. Although the international reach of these firms is significantly less than that of the Big Four, the domestic practice of each is national in scope. Thus, these firms provide competition for the Big Four in serving large, publicly held companies as well as other clients of all sizes.

Figure 1-6 also includes three examples of regional firms. The offices of these firms tend to be concentrated in a more limited geographical area such as the East, Midwest, or West. Although these firms serve some publicly owned companies, their clients tend to be smaller than those of the Big Four and second-tier firms.

Local firms may have one or several offices within a state. The local firm is by far the most common form of practice unit. Although some local firms serve public companies, their clients are primarily smaller businesses and individuals. Some of the smallest local firms decline to perform audit services because of the high cost of maintaining competence and the increased exposure to legal liability.

To remain competitive, many smaller and mid-sized firms join an association of CPA firms. There are more than two dozen associations in the United States with as few as 6 and as many as 60 practice unit members. Associations vary widely in the services provided to members, but most offer staff training programs, a directory of experts in member firms available for consultation with other member firms about their areas of expertise, assistance in recruiting personnel, and client referral services.

Accounting Standard-Setting Bodies

The Financial Accounting Standards Board (FASB) and Governmental Accounting Standards Board (GASB) are independent private sector standard-setting bodies whose primary functions are the development of generally accepted accounting principles for business and not-for-profit entities, and state and local governmental entities, respectively. The statements and interpretations issued by both boards have been officially recognized by the AICPA as constituting GAAP.

The FASB consists of seven full-time members who are assisted by a research staff and an advisory council. Before its Statements of Financial Accounting Standards (SFASs) are issued, a due process is followed including issuing exposure drafts for public comment and, in some cases, holding public hearings. The GASB follows a similar process in issuing its Statements of Governmental Accounting Standards (SGASs).

Figure 1-6 ■ Select Accounting Firm Data

Rank by Revenue	Firm	U.S. Revenue (\$Mil)	No. of			Revenues Sources (%)		
			U.S. Offices	Partners	Prof. Staff	Actg/ Audit	Tax	MCS/ Other
Big Four								
1	Deloitte & Touche	6,511.0	91	2,613	20,487	39%	25%	27%
2	Ernst & Young	5,260.0	86	2,000	14,400	62%	35%	3%
3	PricewaterhouseCoopers	4,850.0	125	2,000	21,000	62%	33%	5%
4	KPMG	3,793.0	94	1,622	11,529	67%	33%	0%
		20,414.0						
Second Tier								
5	H&R Block	3,694.7	10,000	n.a.	n.a.	0%	58%	42%
6	RSM McGladrey	595.9	91	498	2,701	39%	42%	19%
7	Grant Thornton	484.8	48	328	2,217	52%	33%	15%
8	Jackson Hewitt Tax Inc.	397.3	4,225	n.a.	129	0%	100%	0%
9	American Express Tax and Business Services	367.5	50	330	1,650	36%	32%	32%
10	Century Business Services Inc.	354.0	146	n.a.	1,475	40%	40%	20%
11	BDO Seidman	350.0	36	281	1,243	46%	37%	17%
Regional								
12	Crowe Group LLP	247.3	16	153	925	24%	19%	57%
13	BKD	215.7	27	194	952	42%	36%	22%
14	Moss Adams	181.0	23	185	825	36%	38%	26%
Local								
23	Eisner	71.9	3	65	234	53%	27%	20%
25	Berdon	64.0	2	39	245	38%	36%	26%

Source: Accounting Today Special Report: Top 100 Firms Study 2000, March 2004.

LEARNING CHECK

- 1-12 Identify six public sector organizations and five private sector organizations associated with the auditing profession.
- 1-13 Explain the authority of the SEC and state boards of accountancy with respect to auditors and the auditing profession.
- 1-14
 - a. Explain the authority given to the PCAOB.
 - b. Identify three important AICPA divisions or teams that have a direct impact on auditors.

- 1-15 a. In what form of business may a CPA firm be organized?
 b. In what four groups are CPA firms often classified?

KEY TERMS

American Institute of Certified
 Public Accountants (AICPA), p. 25
 General Accounting Office, p. 24
 Public Companies Accounting
 Oversight Board (PCAOB), p. 25

Securities and Exchange Commission
 (SEC), p. 23
 State boards of accountancy, p. 24

REGULATORY FRAMEWORK FOR ENSURING HIGH-QUALITY SERVICES

Auditor Knowledge 10

- Know the four components of the auditing profession's multilevel regulatory framework.

Every profession is concerned about the quality of its services, and the public accounting profession is no exception. Quality services are essential to ensure that the profession meets its responsibilities to the general public, clients, and regulators.

To help assure quality in the performance of audits and other professional services, the profession has developed a multilevel regulatory framework. This framework encompasses many activities of the private and public sector organizations associated with the profession that were described in previous sections of this chapter. For purposes of describing the multilevel framework, these activities may be organized into four components as follows:

- **Standard setting.** The private and public sectors establish standards for accounting, professional services, ethics, and quality control to govern the conduct of CPAs and CPA firms.
- **Firm regulation.** Each CPA firm adopts policies and procedures to assure that practicing accountants adhere to professional standards.
- **Inspection and peer review.** The PCAOB and the AICPA have implemented a comprehensive program of inspection of audits by PCAOB staff and peers in other accounting firms.
- **Government regulation.** Only qualified professionals are licensed to practice, and auditor conduct is monitored and regulated by the PCAOB, state boards of accountancy, and the courts.

Each component is discussed further in the following sections.

STANDARD SETTING

When performing auditing and assurance services CPAs must follow a variety of professional standards. Those standards are set differently for services performed for public companies and for private companies. Figure 1-7 outlines the various professional organizations that set relevant professional standards.

The focus of this discussion relates to the standards that influence the performance of high-quality audits. This book addresses **standard setting** that influences

Figure 1-7 ■ Standard-Setting Organizations in the United States

	Public Companies	Private Companies
Accounting: Generally accepted standards followed when preparing financial statements.	FASB/GASB/SEC	FASB/GASB
Auditing: Generally accepted standards for performing audits and reporting on financial statements.	PCAOB	AICPA
Quality Control: Standards for quality of practice that provide the basis for inspection and peer review.	PCAOB	AICPA
Ethics and Professional Conduct: Standards for ethical conduct.	PCAOB	AICPA
Other Attest and Assurance Services: Standards for performing other attest engagements or other assurance services.	AICPA	AICPA

the performance of high-quality audits and other assurance services—for example, professional standards associated with auditing standards, quality control standards, ethical standards, and standards for other attest and assurance services. In April 2003 the PCAOB adopted existing auditing and quality control standards that had previously been developed by the AICPA. The auditing standards that are common to the audits of both public and private companies are discussed throughout this book, along with discussion of additional standards that pertain to the audits of public companies. Quality control standards are examined below. When this book went to press, the quality control standards were the same for public and private companies. Standards for ethical conduct are discussed in Chapter 3. Once again, ethical standards that are common for auditors of public and private companies are discussed, along with how independence standards differ for auditors of public and private companies. Other attest and assurance services are discussed in Part 5 of this book.

Quality Control Standards

Statement on Quality Control Standards (SQCS) No. 1, System of Quality Control for a CPA Firm, mandates that a CPA firm shall have a system of quality control. SQCS No. 2 identifies five quality control elements that should be considered by a firm in adopting quality control policies and procedures to provide reasonable assurance of conforming with professional standards in performing auditing and accounting and review services. Their application to other services such as tax and consulting is voluntary. The five elements and their purposes are shown in Figure 1-8.

Quality control standards are important because they provide the basis for conducting peer reviews and inspections of the quality of work performed by CPA firms. The five elements of quality control can be summarized as follows:

Independence, Integrity, and Objectivity

Independence, integrity, and objectivity address whether a firm has no appearance of a vested interest in the client for whom it is performing attest services, and whether the firm performs professional services without subordi-

Auditor Knowledge 11

■ Know the elements of a system of quality control for a CPA firm's attest practice.

Figure 1-8 ■ Quality Control Elements (SQCS No. 2)

Element	Purpose
Independence, Integrity, and Objectivity	<p>A firm should establish policies and procedures to assure that personnel:</p> <ul style="list-style-type: none"> ■ Are independent of clients when performing attest services. ■ Perform all professional responsibilities with integrity and maintain objectivity while performing those responsibilities.
Personnel Management	<p>The firm's policies and procedures related to personnel management should provide it with reasonable assurance that:</p> <ul style="list-style-type: none"> ■ Personnel hired have the characteristics needed to perform competently. ■ Work is assigned to personnel who have the technical training and proficiency required for the assignment. ■ Personnel selected for advancement have the qualifications needed to perform the responsibilities they will be called on to assume. ■ Personnel participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill their assigned responsibilities and the requirements of the AICPA and regulatory agencies.
Acceptance and Continuance of Clients and Engagements	<p>In general, a firm should establish policies and procedures that minimize the likelihood of being associated with a client whose management lacks integrity. In addition, the firm must establish policies and procedures that:</p> <ul style="list-style-type: none"> ■ Provide reasonable assurance that it will accept only engagements it can complete with due professional competence. ■ Facilitate an understanding with the client about the nature, scope, and limitations of the services to be performed.
Engagement Performance	<p>A firm should establish policies and procedures for:</p> <ul style="list-style-type: none"> ■ Planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. ■ Assuring that personnel consult with other professionals and seek assistance from persons having appropriate expertise, judgment, and authority, when appropriate, and on a timely basis.
Monitoring	<p>Monitoring is an ongoing process of evaluating the firm's system of quality control. Inspection is a measure of the system of quality control at a point in time. A firm must establish policies and procedures that provide an ongoing consideration and evaluation of:</p> <ul style="list-style-type: none"> ■ Relevance and adequacy of its policies and procedures. ■ Appropriateness of its guidance materials and any practice aids. ■ Effectiveness of professional development activities. ■ Compliance with its policies and procedures.

nating judgment and in a way that is free of conflicts of interest. For example, an international firm may have professional staff report their investments on a regular basis so that they make sure that professionals are independent of the clients in cases where they might influence the outcome of an audit. In addition, the tone communicated from the highest levels of a CPA firm should encourage CPAs to act with integrity and objectivity. These concepts are discussed in more depth in Chapter 3.

Personnel Management

Personnel management addresses a variety of procedures within a CPA firm for hiring, promoting, and firing accounting professionals. An important aspect of performing an audit involves making sure that auditors have adequate training, experience, and supervision to perform assigned tasks. Audit firms need to have procedures in place so that they hire employees with sufficient technical competence, they give individuals the training to allow for their advancement, and they ensure that work assignments and promotions are consistent with an individual's technical training and proficiency. Many firms evaluate work performance after work is completed for each client as a basis for effective personnel management.

Acceptance and Continuance of Clients and Engagements

Auditors have several concerns about **acceptance and continuance of clients and engagements**. First, the audit process relies on management's cooperation, and the process can break down if the client lacks honesty and integrity. CPA firms want to take steps to minimize the likelihood of being associated with a client that lacks integrity. Second, auditors also need to ensure that they can reasonably expect to complete an engagement with professional competence. It is common for some smaller audit firms to decline the audit of public companies or to decline engagements of clients in industries where they do not have sufficient expertise.

Engagement Performance

Engagement performance is about the policies and practices that ensure an audit is carried out appropriately with due professional care. For example, many key audit decisions require significant professional judgment. Many firms will therefore have several professionals review the work of others to ensure that professionals concur on key issues and that the working papers document compliance with professional standards.

Monitoring

Monitoring is an ongoing process whereby a firm evaluates the effectiveness of the other four elements of quality control. Most firms perform internal inspections in which a team from other offices actually inspects audit working papers, evidence of compliance with independence policies, personnel management decisions, and client acceptance and continuance decisions. In this way the firm monitors compliance with its own policies.

As a firm considers how it will administer a system of quality control, it should consider three key issues. First, responsibility should be assigned within the firm to appropriate individuals for the design and maintenance of its quality control policies. Second, it should communicate its quality control policies and procedures to its personnel on a timely basis in a manner that provides reasonable assurance that they are understood and complied with. Finally, it should document compliance with its quality control policies and procedures. The form and content of the documentation is a matter of professional judgment and depends on such factors as firm size, number of offices, degree of authority allowed personnel and offices, the nature and complexity of the accounting and attest practice, firm organization, and cost-benefit considerations.

FIRM REGULATION

Firm regulation occurs within a CPA firm. A prime example is implementing a system of quality control as mandated by the quality control standards discussed in the preceding section. This means that the firm's day-to-day actions will comply with the policies and procedures pertaining to the quality control elements. For example, to assist staff in meeting professional standards, firms provide on-the-job training and require their professionals to participate in continuing professional education courses. Personnel who adhere to standards for professional services and show growth and progression in their skills often receive pay raises and promotions. Personnel whose work is identified as substandard may be terminated if rapid improvement is not forthcoming.

A CPA firm is motivated by numerous incentives to do good work, including pride, professionalism, and a desire to be competitive with other firms. Additional motivation results from the desire to avoid the expense and damage to the firm's reputation that accompanies litigation and other actions brought against it for alleged noncompliance with professional standards.

INSPECTION AND PEER REVIEW

Quality control standards provide the basis for firm regulation and the performance of high-quality audit and attest services. **Inspection and peer review** provide an external review of whether a firm is in fact meeting quality control standards. The following discussion outlines both the PCAOB's inspection program of accounting firms that audit public companies and the AICPA's practice monitoring (peer review) program of accounting firms that perform audit and attest services for private companies.

PCAOB Inspection Program

The Sarbanes-Oxley Act of 2002 instructs the PCAOB to conduct a continuing program of inspections to assess the degree of compliance of each accounting firm registered to audit public companies with the rules of the PCAOB, the SEC, and other professional standards in connection with its performance of audits, issuance of audit reports, and related matters. In conducting inspections, the Sarbanes-Oxley Act of 2002 states that the PCAOB should:

- Inspect and review selected audit and review engagements of the firm.
- Evaluate the sufficiency of the firm's quality control systems and the firm's documentation and communication of that system.
- Perform such other testing of the audit, supervisory, and quality control procedures of the firm as are necessary or appropriate in light of the purpose of the inspection and the responsibilities of the board.

The PCAOB conducts annual inspections of firms that regularly provide audit reports for over 100 public companies. The PCAOB inspects the quality control activities of firms that provide audit reports for 100 or fewer public companies every three years.

Finally, the Sarbanes-Oxley Act of 2002 states that a written report of the Board's findings for each inspection shall be transmitted to the SEC and to each appropriate state regulatory authority, accompanied by any letter of response

from the registered public accounting firm, and shall be made available in appropriate detail to the public.

AICPA Practice Monitoring (Peer Review) Program

Since the early 1980s the AICPA has sponsored a practice monitoring program through which a CPA firm would submit its accounting and auditing practice to a review by independent peers every three years. Participation is required for all members of the AICPA, and many state boards of accountancy require that auditors of private companies undergo a form of peer review equivalent to the AICPA program. Recall that auditors of public companies are inspected by the PCAOB.

The purpose of a peer review is to determine whether:

- The reviewed firm's system of quality control for its accounting and auditing practice has been designed in accordance with quality control standards established by the AICPA.
- The reviewed firm's quality control policies and procedures were being complied with to provide the firm with reasonable assurance of conforming with professional standards.
- The reviewed firm has demonstrated the knowledge, skills, and abilities necessary to perform accounting, auditing, and attestation engagements in accordance with professional standards, in all material respects.

At the end of the peer review, the independent peer review team will issue a report on the firm's compliance with quality control standards and, if applicable, a letter of comment with recommendations for improvement. The firm may then file the report with the state board of accountancy, and clients can ask to see the results of a firm's peer review.

GOVERNMENT REGULATION

Government regulates the auditing profession primarily through the activities of state boards of accountancy (which have the authority to issue and revoke CPA licenses), the SEC, and state and federal courts as discussed in previous sections.

Recently, the U.S. Congress enacted the Sarbanes-Oxley Act of 2002 with regulatory legislation to be administered by the SEC and the PCAOB. The SEC plays an important role in linking private sector and public sector regulation; it does so through its authority over the PCAOB, a private sector organization. It is the SEC that puts significant teeth in the standard-setting, inspection, and enforcement authority of the PCAOB.

State boards of accountancy regularly ask firms to submit their peer review letters as part of obtaining a license for the firm to perform audit and attest services. Although peer reviews are performed as part of the self-regulation of the CPAs performing services for private companies, it is the state board of accountancy that has the authority to grant or revoke a CPA's, or CPA firm's, license to practice.

LEARNING CHECK

- 1-16 a. What is the purpose of the profession's multilevel regulatory framework?
b. Describe the four components of the multilevel regulatory framework.
- 1-17 State the five elements of a system of quality control for a CPA firm.

- 1-18 a. Describe the key elements of the PCAOB inspection program.
- b. Describe the purpose of the AICPA practice monitoring (peer review) program.

[KEY TERMS

Acceptance and continuance of clients and engagements, p. 32 Engagement performance, p. 32 Firm regulation, p. 29, 33 Government regulation, p. 29, 34 Independence, integrity, and objectivity, p. 30	Inspection and peer review, p. 29, 33 Monitoring, p. 32 Personnel management, p. 32 Standard setting, p.29
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[FOCUS ON AUDITOR KNOWLEDGE]

This chapter introduces some basic knowledge about auditing and assurance services, presents the organizations associated with the public accounting profession, and provides an overview of the regulatory framework associated with ensuring high-quality audit and attest services. Figure 1-9 summarizes the key components of auditor knowledge discussed in this chapter and provides page references to where these decisions are discussed in more detail.

Figure 1-9 ■ Summary of Auditor Knowledge Discussed in Chapter 1

Auditor Knowledge	Summary	Chapter References
K1. Know the common attributes of activities defined as auditing.	The Report of the Committee on Basic Auditing Concepts of the American Accounting Association defines auditing as “a <i>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.</i> ” The common attributes auditing activities are identified in the preceding italics.	pp. 6–7
K2. Know the differences between the different types of audits and auditors.	This chapter distinguishes between financial statement audits, compliance audits, and operational audits. Figure 1-2 provides a useful summary of the difference between these types of audits. The chapter also discusses the differences between independent auditors, internal auditors, and government auditors.	pp. 8–11
K3. Know the common attributes of assurance services.	The AICPA Special Committee on Assurance Services defines assurance services as “ <i>independent professional services that improve the quality of information, or its context, for decision makers.</i> ” The common attributes of assurance services are identified in the preceding italics.	pp. 11–12

(table continues)

Figure 1-9 ■ (Continued)

Auditor Knowledge	Summary	Chapter References
K4. Know the variety of services and levels of assurance in the universe of assurance services.	Figure 1-3 describes the universe of assurance services, which includes audit engagements, attest engagements, accounting and compilation engagements, and other assurance engagements. CPAs can provide a variety of levels of assurance when performing these engagements including reasonable assurance, negative assurance, assurance that varies with the nature of agreed-upon procedures, and engagements with no assurance.	pp. 12–15
K5. Know the value of the audit and other assurance services.	Decision makers need credible and reliable information to support their decisions. The purpose of the audit is to provide reasonable assurance that information used by investors, creditors, and others is, in fact, reliable. Figure 1-4 demonstrates that the information captured about business events is the foundation for many business decisions. If this foundation is weak, every step that builds on that foundation is also weak. The value of the audit can be seen in the losses suffered by investors in WorldCom who made investment decisions based on unreliable information about the company's profitability and liquidity and solvency risks.	pp. 15–17
K6. Know a historical perspective of the demand for auditing.	The chapter provides a historical prospective that looks back on the last 120 years and the events that have influenced the demand for auditing. In general, the demand for auditing has been significantly influenced by professional managers who misled investors by materially misstating their company's financial performance in financial statements prepared for owners and other investors. Auditors add credibility to management's assertions by reducing information risk for financial statement users.	pp. 18–20
K7. Know the factors that influence the need for financial statement audits.	The need for financial statement audits has been influenced by an inherent <i>conflict of interest</i> between management and owners, by the <i>consequence</i> and importance of financial statement information to investors, by the <i>complexity</i> inherent in the preparation of financial statements, and by the <i>remoteness</i> of investors from management of the firms they invest in.	pp. 20–21
K8. Know the economic benefits and inherent limitations associated with a financial statement audit.	The economic benefits of an audit to a company and its owners include (1) access to capital markets, (2) lower cost of capital, (3) the audit as a deterrent to inefficiency and fraud, and (4) control and operational improvements that are often suggested by auditors. The inherent limitations of an audit include the fact that audits must be performed (1) at a reasonable cost and (2) in a reasonable length of time. There are also two important inherent limitations associated with our established accounting framework: (1) alternative accounting principles are often accepted and (2) the accounting process involves making significant accounting estimates.	pp. 21–22

(table continues)

Figure 1-9 ■ (Continued)

Auditor Knowledge	Summary	Chapter References
K9. Know the public sector and private sector organizations associated with auditing and assurance services.	Figure 1-5 summarizes a number of public sector and private sector organizations that are associated with the public accounting profession. The chapter explains their role in accounting and auditing.	pp. 23–28
K10. Know the four components of the auditing profession's multilevel regulatory framework.	The four components of the auditing profession's multilevel regulatory framework are (1) standard setting (see Figure 1-7), (2) firm regulation, (3) inspection and peer review, and (4) government regulation.	pp. 29–30
K11. Know the elements of a system of quality control for a CPA firm's attest practice.	The five elements of quality control are (1) independence, integrity, and objectivity, (2) personnel management, (3) acceptance and continuance of clients and engagements, (4) engagement performance, and (5) monitoring. Each of these elements is explained further in Figure 1-8. The system of quality control provides the standards by which the profession evaluates an audit firm's quality of practice when performing peer reviews.	pp. 30–34

objective questions

Objective questions are available for the students at www.wiley.com/college/boynton

comprehensive questions

- 1-19 **(Types of audits and auditors)** J. Cowan, an engineer, is the president of Arco Engineering. At a meeting of the board of directors, Cowan was asked to explain why audits of the company are made by (1) internal auditors, (2) independent auditors, and (3) government auditors. One board member suggested that the company's total audit expense might be lower if all auditing was done by internal auditors. J. Cowan was unable to distinguish between the three types of auditors or to satisfactorily respond to the board member's suggestion.

Required

- a. Explain the different kinds of audits made by each type of auditor.
 - b. Identify the sources of practice standards applicable to each type of auditor.
 - c. Comment on the board member's suggestion to have all auditing done by internal auditors.
- 1-20 **(Types of audits and auditors)** After performing an audit, the auditor determines that
1. The financial statements of a corporation are presented fairly.
 2. A company's receiving department is inefficient.

3. A company's tax return does not conform with IRS regulations.
4. A government supply depot is not meeting planned program objectives.
5. The financial statements of a physician are properly prepared on a cash basis.
6. A foreman is not carrying out his assigned responsibilities.
7. The IRS is in violation of an established government employment practice.
8. A company is meeting the terms of a government contract.
9. A municipality's financial statements correctly show actual cash receipts and disbursements.
10. The postal service in midtown is inefficient.
11. A company is meeting the terms of a bond contract.
12. A department is not meeting the company's prescribed policies concerning overtime work.

Required

- a. Indicate the type of audit that is involved: (1) financial, (2) compliance, or (3) operational.
- b. Identify the type of auditor that is involved: (1) independent, (2) internal, (3) government—GAO, or (4) government—IRS.
- c. Identify the primary recipient(s) of the audit report: stockholders, management, Congress, and so on. Use the following format for your answers:

TYPE OF AUDIT	TYPE OF AUDITOR(S)	PRIMARY RECIPIENT(S)

- 1-21 **(Accountant value chain and the value of the audit)** You have just completed an audit for a small business client. In the process of performing the audit you found that the client turns its receivables, on average, every 58 days (this is after the client increased its provision for doubtful accounts based on your audit). You also discover that the median collection period for the industry is 45 days and the upper quartile is 59 days. Answer the following questions using this information.

Required

- a. Explain each step of the account's value chain in the context of this information and knowledge.
 - b. Explain the value of the audit in the context of whether the financial statements are compiled versus being audited.
- 1-22 **(Benefits and limitations of an audit)** A fellow business student questions the benefits of an audit as follows. "Why should a company hire auditors? As far as I can tell auditors of public companies charge millions of dollars in audit fees, and it is not clear to me that management receives any benefit for this expenditure. It is just money down the drain. It is also not clear to me that auditors accomplish anything. We have seen a number of material

restatements of financial statements. Why should a company pay for audits that are ineffective? I think auditors are just a drain on society.”

Required

- a. Explain the economic benefits provided by a financial statement audit.
- b. Explain the inherent limitations that might prevent auditors from finding every potential material misstatement in financial statements.

1-23 **(Organizations associated with the public accounting profession)** Several private and public sector organizations are associated with the profession. Listed below are activities pertaining to these organizations.

1. License individuals to practice as CPAs.
2. Promulgate GAAP.
3. Issue Statements on Auditing Standards.
4. Regulate the distribution and trading of securities offered for public sale.
5. Establish its own code of professional ethics.
6. Issue Statements of Financial Accounting Standards.
7. Impose mandatory continuing education as a requirement for renewal of license to practice as a CPA.
8. Issue disclosure requirements for companies under its jurisdiction that may exceed GAAP.
9. Issue auditing interpretations.
10. Cooperate with the AICPA in areas of mutual interest such as continuing professional education and ethics enforcement.
11. Take punitive action against an independent auditor.
12. Establish accounting principles for state and local governmental entities.
13. Establish GAAS.
14. Suspend or revoke a CPA's license to practice.
15. Establish quality control standards.
16. Operate as proprietorships, partnerships, or professional corporations.
17. Issue government auditing standards.
18. Administer federal tax laws.

Required

Indicate the organization or organizations associated with each activity.

1-24 **(Regulatory framework)** The accounting profession's commitment to achieving high quality in rendering professional services is demonstrated by the breadth and effectiveness of its multilevel regulatory framework.

Required

- a. One component of this framework is standard setting which occurs primarily in the private sector. Identify four types of standards included in this component and the private sector bodies that establish them.
- b. Identify and briefly describe the other three components of the regulatory framework.

1-25 **(Quality control elements)** The AICPA has established five elements of quality control. Listed below are specific policies and procedures adopted by the CPA firm of Baily, Brown & Co.:

1. Periodic evaluations are made of personnel.
2. Ongoing supervision is given to less experienced personnel.
3. An experienced CPA is designated as a public utility industry expert.
4. Rules on independence are communicated to the professional staff.
5. The scope and content of the firm's inspection program are defined.
6. All new employees must be college graduates.
7. Copies of Statements on Auditing Standards are provided for all professional staff.
8. A partner assigns personnel to engagements.
9. All new clients must be solvent at the time the engagement is accepted.

Required

- a. Identify the quality control element that applies to each of the foregoing items.
- b. For each element of quality control identified in (a) state the purpose of the element.
- c. Indicate another policy or procedure that applies to the element. Use the following format for your answers:

POLICY/ PROCEDURE NUMBER	(A) QUALITY CONTROL ELEMENT	(B) PURPOSE OF POLICY/PROCEDURE	(C) ADDITIONAL PROCEDURE

1-26 **(Regulating audit quality)** The Public Companies Accounting Oversight Board and the AICPA's Practice Monitoring (Peer Review) Program play important roles in the profession's regulation of the quality of audit and assurance services.

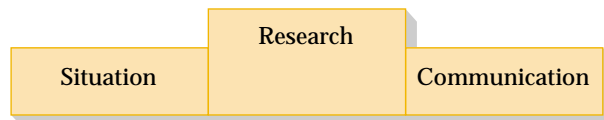
Required

- a. The activities of these two organizations are directed toward CPA firms. How, if at all, do these divisions have a direct impact on individual members?
- b. Why do we have two organizations involved in peer review? Discuss the similarities in the objectives of the peer reviews and practice monitoring programs of the PCAOB and the AICPA.
- c. Identify the similarities in the peer review objectives of the two organizations and the common responsibilities and functions of the peer review teams used by each.
- d. What are the primary activities of the AICPA Practice Monitoring (Peer Review) Program?

professional simulation



Tom Meyers has a successful tax practice as a sole practitioner. Tom is a sole owner and he has 3 professional staff to assist him in tax research and tax return preparation. He has a number of clients that have small, and growing businesses. He has compiled financial statements for these businesses with no assurance. As a result, he has had minimal requirements for peer review. Now he has several clients who have grown to the point where they need audited financial statements for lenders. In order to better serve these clients, Tom is considering taking in Kenny Vaughn, an audit manager with a national CPA firm, as a partner to manage a new audit and assurance practice.



Tom and Kenny want to better understand what will be required in terms of how the combined practice will need to follow quality control standards. In particular, they are concerned about professional requirements for monitoring compliance with quality control standards. Research the professional standards and identify the quality control standards that:

1. Explain the monitoring procedures that should be performed by the firm.
2. Explain the factors that should be considered by small firms with a limited number of management individuals.

Do this by indicating in the box below the appropriate QC section paragraphs that responds to these questions.

1. QC Section _____
2. QC Section _____



Draft a report with your recommendations for specific monitoring procedures that should be performed by Meyers and Vaughn. Remember: Your response will be graded for both technical relevance and writing skills. For writing skills you should demonstrate an ability to develop your ideas, organize them, and express them clearly.

To: Tom Meyers and Kenny Vaughn

Re: Monitoring Procedures

From: CPA Candidate