

Chapter 1

Auditing: Integral to the Economy

Learning Objectives:

By studying this chapter, students should be able to:

1. Define the objective of auditing and describe the role of auditing in meeting society's demands for unbiased financial and internal control information.
2. List the types of audit services providers and the knowledge needed by professionals entering the public accounting profession.
3. Identify organizations that affect the public accounting profession and the nature of their effects.
4. Identify the various auditing standards that affect the public accounting profession and compare these auditing standards on relevant dimensions.
5. Describe the audit opinion formation process and list key steps in that process.
6. Identify and describe non-audit assurance and attestation services provided by external auditors and discuss the relevant professional standards.
7. Describe the unique roles of internal auditors and governmental auditors.

Teaching Suggestions

The public and management of organizations rely on various services provided by public accounting firms, internal audit departments, and others in the “assurance” business. This chapter explores the growing importance of assurance in our society, describes how auditing fits within the assurance framework, and discusses the requirements to become an auditor. Attention is given to the various types of assurance, the services CPAs provide, and the professional and regulatory organizations that impact them.

Most accounting students do not fully comprehend what assurance or auditing entails nor will they have read Chapter 1 before the first class period. Accordingly, much of the first class period should be devoted to broadly defining assurance. Transparency 1-4 should serve as a good basis of discussion. Examples of assurance outside the accounting context--such as the suitability of computer software developed to simulate flight or textbooks written for introductory calculus classes can be used to illustrate the concept. From this broad perspective, students can be led into areas more familiar to accountants: financial auditing, operational auditing, and compliance auditing as performed by CPAs, internal auditors, and governmental auditors. Throughout the discussion, stress the need of the free enterprise system for a free flow of reliable information. Spend a few minutes summarizing the major changes that have come about in the wake of the Sarbanes-Oxley Legislation of 2002 and explain the need for restored confidence in the accounting profession.

Once students are familiar with attestation in a broad sense, narrow the discussion to independent financial auditing which is the subject matter for most of this course. Students often find that an overview of the audit process helps to put the various topics covered in the text into perspective. Transparency 1-6 diagrams the audit process and may be referred to frequently as the course progresses. Conclude by discussing the standard audit report and how the report serves as a communication mechanism with the user of external financial statements; briefly explain reviews and compilations and how these differ from an audit.

Suggested Homework Problems

Learning Objectives	Review Questions	Multiple-Choice Questions	Discussion and Research Questions	Cases
LO 1	1-1-1, 1-5, 1-6, 1-7, 1-8, 1-10, 1-11, 1-12, 1-16	1-29, 1-30, 1-36	1-40, 1-41, 1-42, 1-43, 1-44, 1-50, 1-51,	1-61, 1-62
LO 2	1-18, 1-23		1-44,	
LO 3	1-3, 1-13, 1-20, 1-21, 1-22, 1-25	1-32, 1-33, 1-35	1-41, 1-43, 1-44, 1-48, 1-50, 1-52, 1-55, 1-56	1-62
LO 4	1-9, 1-14	1-32, 1-37, 1-38	1-43, 1-48, 1-50, 1-55, 1-56, 1-57, 1-58	1-62
LO 5	1-2, 1-24, 1-26, 1-27, 1-28	1-39	1-44, 1-45, 1-59, 1-60	1-62
LO 6	1-4,	1-31	1-46, 1-54	
LO 7	1-17, 1-19,	1-34	1-48, 1-49	1-61
LO 8				

Chapter Outline

I. Introduction

The external audit profession develops opinions on financial statements based on sampling and audit analysis. This chapter defines the broad nature of audit and assurance services, discusses the demand for such services, identifies the providers of such services, and focuses on the audit of an organization's financial statements and its internal controls over financial reporting.

II. The Auditing Profession

- A. The capital markets depend on accurate, reliable, and objective (neutral) data that portray the economic nature of an entity's business.
- B. Accounting transactions are becoming increasingly complicated as companies engage in more elaborate structures as well as in transactions that are difficult to measure.
- C. The economy is becoming global and accounting is moving towards global harmonization.
- D. As a profession, we are in a period of change in which auditors and accountants are called upon to make professional judgments.
- E. Audit firms need professionals who make consistent judgments across a wide variety of companies, countries, and types of transactions.

II. LO 1: Objective and Role of Auditing

- A. A financial statement audit has been defined as a:
 - 1. 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.
 - 2. Auditing is a unique function that is licensed by the government to promote the effective functioning of the capital markets. But that unique license comes with a price—accountability and responsibility to the public.

B. Challenges of the Profession

- 1. Detect material fraud and assure that users of financial statements are free from fraud.
- 2. Complex accounting transactions and organizational structures.
- 3. Computer systems are complex.
- 4. Many companies are global.

5. Time pressure to get audit done.
6. Need to generate sufficient audit fees.

C. Need for Unbiased Reporting and Independent Assurance

1. Potential bias in providing information.
2. Remoteness between a user and the organization or trading partner.
3. Complexity of the transactions, information, or processing systems.
4. Investors need to manage their risk and thereby minimize financial surprises.
5. Consequences to investors, and others, of relying on inaccurate information can be quite significant.

D. Users of Audited Financial Statements

1. Management.
2. Stockholders.
3. Financial Institutions.
4. Taxing Authorities.
5. Investors.
6. Regulatory Agencies.
7. Labor and Labor Unions.
8. Bondholders.
9. Court System.
10. Vendors.
11. Retired Employees.

E. Providers of Public Accounting Services

1. The public accounting profession includes:
 - (i) Sole-practitioner firms,
 - (ii) local and regional firms, and
 - (iii) large multinational professional services firms such as the Big 4.
2. The organizational structure of accounting firms varies dramatically.

F. Typical Organizational Hierarchy of CPA Firms

1. Partners (or owners) form the top of the pyramid and are responsible for the overall conduct of each audit.
2. Managers, who review the audit work performed by staff personnel (the base of the pyramid).
3. Seniors are responsible for overseeing the day-to-day activities on a specific.
4. Staff personnel typically spend two to four years at a staff level, after which they assume increasing supervisory responsibilities.

G. Knowledge and Expertise Needed

1. Accounting and Auditing.
2. Knowledge of the Client's Industry, Business, and Risks.
3. Computer Skills and Accounting Systems.
4. Internal Control Expertise.
5. Fraud - auditors need to be aware of the incentives for employees (including upper-level management) to commit fraud, the opportunities that weak internal controls may create that will allow a fraud to be perpetrated or concealed, and the rationalizations that employees may use to justify their actions and to continue or escalate the fraud over time.

H. Organizations Affecting the Public Accounting Profession

1. Congress:
2. Sarbanes-Oxley Act of 2002.
3. Auditor Independence and the Role of the Audit Committee.
4. Required Reporting on Internal Control over Financial Reporting.
5. Oversight of the Accounting Profession.
6. Public Company Accounting Oversight Board (PCAOB).
7. The Securities and Exchange Commission (SEC).
8. American Institute of Certified Public Accountants (AICPA).
9. International Auditing and Assurance Standards Board (IAASB).
10. Committee of Sponsoring Organizations (COSO).
11. Accounting Standard Setters:
12. Generally accepted accounting principles (GAAP) set by Financial Accounting Standards Board (FASB), with approval by the Securities and Exchange Commission (SEC).
13. International Financial Reporting Standards (IFRS) set by the International Accounting Standards Board (IASB).
14. State Boards of Accountancy.
15. The Court System.

I. Audit Standard Setting in the Public Accounting Profession

1. Auditors in the United States follow auditing guidance issued by the AICPA, PCAOB, and IAASB.
2. Auditing standards set by these various authorities have a common objective—to provide assurance to the public that audits are conducted in a professional manner.

J. Overall Audit Guidance Issued by the AICPA and the IAASB

1. The guidance, which is almost identical, recognizes that the objective of an audit is to obtain reasonable assurance about whether the financial statements are free from material misstatement and to report on the financial statements based on the auditor's findings.
2. In completing these objectives, the auditor:
 - (i) Complies with relevant ethical requirements.
 - (ii) Plans and performs an audit with professional skepticism.
 - (iii) Exercises professional judgment.
 - (iv) Obtains sufficient appropriate evidence on which to base the auditor's opinion.
 - (v) Conducts the audit in accordance with professional auditing standards.
3. This overall guidance is supplemented with specific auditing standards (SASs issued by the AICPA and ISAs issued by the IAASB)

K. Auditing Standards Issued by the AICPA

1. Ten standards that fall within three categories:
2. General standards—applicable to the auditor and audit firm
3. Fieldwork standards—applicable to the conduct of the audit
4. Reporting standards—applicable to communicating the auditor's opinion
5. The ten standards were developed by the ASB of the AICPA and have been adopted by the PCAOB.
6. The AICPA is working on converging its standards with those of the IAASB. As part of that convergence, the ten standards will be replaced by principles.

L. General Standards

1. The audit be performed by individuals having adequate technical training and proficiency as an auditor.
2. Auditors be independent in their mental attitude in conducting the audit (independence in fact) and be perceived by users as independent of the client (independence in appearance).
3. The audit be conducted with due professional care which is a standard of care that would be expected of a reasonably prudent auditor.

M. Fieldwork Standards

1. An audit be properly planned and supervised.
2. Auditors develop an understanding of the client's controls as an important prerequisite to developing specific audit tests.
3. Auditors obtain sufficient appropriate audit evidence by performing audit procedures to provide a reasonable basis for the audit opinion being provided.

N. Reporting Standards

1. The auditor to state explicitly whether the financial statements are fairly presented.
2. The auditor, to identify, in the auditor's report, those circumstances in which accounting principles have not been consistently observed in the current period in comparison to the preceding period.
3. The auditor to review disclosures for adequacy.
4. The auditor to express an opinion on the financial statements as a whole or state that an opinion cannot be expressed.

O. Principles Governing an Audit Conducted in Accordance GAAS

1. In place of the ten standards, the AICPA has now developed fundamental principles in four categories.
2. Purpose of an Audit and Premise Upon Which an Audit Is Conducted.
3. Responsibilities.
4. Performance.
5. Reporting.

P. Purpose of an Audit and Premise Upon Which an Audit Is Conducted

1. The purpose of an audit is to enhance the degree of confidence that users can place in the financial statement. This purpose is achieved when an auditor expresses an opinion on the financial statements.
2. An audit is based on the premise that management has responsibility to prepare the financial statements, maintain internal control over financial reporting, and provide the auditor with relevant information and access to personnel.

Q. Responsibilities

1. Auditors are responsible for having the appropriate competence and capabilities to perform the audit, should comply with ethical requirements, and maintain professional skepticism throughout the audit.

R. Performance

1. The auditor needs to obtain reasonable assurance as to whether the financial statements are free from material misstatement.
2. Obtaining reasonable assurance requires the auditor to plan and supervise the work, determine materiality levels, identify risks of material misstatement, and design and implement appropriate audit responses to the assessed risks.
3. An audit has inherent limitations such that the auditor is not able to obtain absolute assurance about whether the financial statements are free from misstatement.

S. Reporting

1. The auditor expresses an opinion as to whether the financial statements are free of material misstatement or states that an opinion cannot be expressed.

T. Auditing Standards Issued by the IAASB

1. As of 2010, the IAASB auditing standards comprise thirty-six International Standards on Auditing (ISAs).
2. Over 100 countries have national auditing standards that are based on the ISA.
3. It is expected that the standards of the AICPA and IAASB will converge.

U. Auditing Standards Issued by the PCAOB

1. The PCAOB, which came into existence in 2002, issues auditing standards that apply to auditors of U.S. public companies.
2. As of 2010, the PCAOB has issued fifteen Auditing Standards (ASs).
3. Further, the PCAOB adopted the AICPA standards that were in place on April 16, 2003 (referred to as interim standards).
4. Public company auditors must follow these standards of the AICPA unless they have been superseded by a PCAOB standard.

V. The Audit Opinion Formulation Process

1. Phases I and II: Making Client Decisions and Gaining an Understanding of the Client.
2. Phases III and IV: Obtaining Evidence.
3. Management Assertions.
4. Audit Procedures to Test Assertions.
5. Phase V: Wrapping Up the Audit and Making Reporting Decisions.

W. Other Assurance and Attestation Services**1. Assurance vs. Attestation vs. Audit****(i) Assurance Services**

1. The broadest service.
2. The AICPA's Special Committee on Assurance Services defines assurance services as "independent professional services that improve the quality of information, or its context, for decision makers."
3. The items on which assurance is provided can range from financial statements to computer system integrity to quality of products and services being sold to compliance with regulatory requirements.
4. The assurance can be on information or processes.
5. Examples of assurance services that have been performed by auditing firms include:
6. The adequacy of the process for capturing and reporting medical data.
7. The adequacy and reasonableness of the economic plans to build a new convention center in a major U.S. city.
8. All types of assurance services involve three critical components:
 - a. Information or a process on which the assurance service is provided.
 - b. A user or a group of users who derive value from the assurance services provided.
 - c. An assurance service provider.
9. Providers of Assurance Services
 - a. Many regional and local CPA firms provide a variety of assurance services to both audit and nonaudit clients.
 - b. The large public accounting firms may provide consulting services—but they are not allowed to provide such services for their publicly traded audit clients.
 - c. Smaller accounting firms that do not have public clients follow standards developed by the AICPA regarding services that they may perform for an audit client.
 - d. Many smaller public accounting firms provide information systems consulting, financial planning, tax planning, and

internal audit services to both audit clients and nonaudit clients.

10. Levels of Assurance Provided

- a. The IAASB has taken a two-pronged approach to the level of assurance provided that ultimately parallels the approach developed in the United States.
- b. The IAASB identifies two levels of assurance that can be provided:
- c. Reasonable assurance
- d. Limited assurance
- e. Reasonable assurance engagements are “engagements in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.”
- f. A “limited assurance” engagement is one in which the objective is to provide less assurance by doing less work that may be appropriately understood by all involved parties.
- g. In the United States, a limited assurance engagement related to financial statements is referred to as a review.

(ii) Attestation Services

1. Attestation services are a subset of assurance services and always involve a report that goes to external users.
 2. For example, the auditor might provide a report to third parties about the quality of a company’s internal controls over compliance with regulation.
 3. The narrowest attestation service is the audit of a company’s financial statements.
 4. An audit is a subset of the other services that an auditor can provide.
2. Sometimes the terms assurance, attestation, and audit are used interchangeably. However, they differ on two fundamental dimensions:
- (i) Existence of an outside third party that relies on the auditor’s opinion

(ii) Nature of services provided

X. Other Auditing Professions

1. The Internal Audit Profession.

- (i) Internal auditing is defined as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.
 - (ii) Internal auditors may provide both assurance and consulting services.
 - (iii) Specific assurance services that internal auditors perform for an organization include:
 - 1. Effectiveness of a company's process for identifying and managing risk.
 - 2. Quality of an organization's governance processes.
 - 3. Effectiveness and efficiency of an organization's control processes.
 - 4. Effectiveness and efficiency of operations, with suggestions for operational improvements.
 - 5. Compliance of company operations with company policies and/or regulatory policies.
 - (iv) The Institute of Internal Auditors (IIA) is a voluntary organization dedicated to enhancing the professionalism and status of the internal auditing profession.
 - 1. With more than 170,000 members located in over 100 countries, the IIA is responsible for issuing standards for the profession.
 - 2. The IIA administers the Certified Internal Auditor (CIA) program and has established a peer review process to help ensure that the practice of internal auditing around the globe is consistent with the professional standards.
- ### **2. The Governmental Auditing Profession.**
- (i) Governmental auditors are employed by various federal, state, and local agencies and perform all the types of audits that internal auditors perform.

- (ii) The U.S. Government Accountability Office places an emphasis on performance audits. These audits determine:
1. Whether the entity is acquiring, protecting, and using its resources economically and efficiently.
 2. The causes of inefficiencies or uneconomical practices; (3) whether the entity has complied with laws and regulations.
 3. The extent to which the desired results or benefits established by the legislature or other authorizing body are being achieved.
 4. The effectiveness of organizations, programs, activities, or functions.

TRANSPARENCY 1-1

Auditing Defined

Auditing is defined 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.

TRANSPARENCY 1-2

Exhibit 1.2 Report of Independent Registered Public Accounting Firm

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of NSG Company:

We have audited the accompanying balance sheets of NSG Company (the Company) as of December 31, 2012 and 2011, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), NSG's internal control over financial reporting as of December 31, 2012, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 14, 2013 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Rittenberg, Johnstone, & Gramling CPAs

Madison, Wisconsin

March 14, 2013

TRANSPARENCY 1-3

Exhibit 1.3 Users of Audited Financial Statements

User	Primary Use of Report
Management	Review performance, make decisions, report results to capital markets
Stockholders	Assess performance, vote on organizational matters including the board of directors, make decision to buy or sell stock, or purchase more stock as part of a stock offering
Financial Institutions	Loan decisions—interest rates, terms, and risk
Taxing Authorities	Determine taxable income and tax due
Investors	Buy or sell stocks, bonds or other securities
Regulatory Agencies	Compliance with regulations, need for regulatory action
Labor and Labor Unions	Collective bargaining decisions
Bondholders	Buy or sell bonds
Court System	Assess the financial position of a company in litigation involving valuation
Vendors	Assess credit risk
Retired Employees	Protect employees from surprises concerning pensions and other post-retirement benefits due to accounting restatements

TRANSPARENCY 1-4

What is Assurance?

The AICPA's Special Committee on Assurance Services defines assurance as:

“Independent professional services that improve the quality of information, or its context, for decision makers”.

TRANSPARENCY 1-5

Exhibit 1.4 Interrelationships of Assurance, Attestations, and Audit Services

Type of Service	Report to Third Party	Scope of Items Reported On
Assurance Service	Optional, but not required Can include report only to party requesting the assurance	Broad, can include: <ul style="list-style-type: none"> • business processes • control processes • risk analysis • non-financial performance data • financial information
Attestation Service	Independent Auditor's Report is used by third party as part of the decision-making process	Same as assurance services Can be broad as long as objective criteria exist on which to evaluate fairness of management's report or information reported on
Audit Service	Third parties are primary users of the audit report	Audit of financial statements and related financial information

TRANSPARENCY 1-6

Exhibit 1.5 Attributes Needed to Perform Assurance Services

The attributes of individuals providing assurance services include:

- Subject-matter knowledge, such as information system knowledge
- Independence
- Agreed-upon criteria to evaluate quality of presentation, such as standards for internal control, or agreed-upon standards between the auditor and the user of the service
- Expertise in the process of gathering and evaluating evidence related to the subject matter

TRANSPARENCY 1-7

The Audit Process

Initial Planning

Obtain an understanding of the client's business and industry by:

Reviewing current developments affecting the client's business and industry,
and

Performing an overall analytical review of financial condition and
profitability, then

Assess the effect of environmental factors (inherent risk) and develop the
overall audit plan.

Program Development

Document and evaluate the accounting system,

Perform a detailed analytical review of accounts and transactions, then

Assess the likelihood of material error (internal control risk), develop the
preliminary audit approach, and prepare the audit program.

Program Execution

Perform tests of transactions,

Perform direct tests of account balances, including analytical review, then

Evaluate the sufficiency of the audit approach (detection risk).

Reporting

Issue audit report on financial statements.