

Solutions for Chapter 1

The Market for Auditing and Assurance Services

Review Questions:

- 1-1 The two main types of reports that management prepares that are subject to audit are:
- Annual financial statements
 - Reports on internal control over financial reporting (public companies only)
- 1-2 Assurance services are needed because there is a:
- Potential bias in providing information
 - Remoteness between a user and the organization or trading partner
 - Complexity of the transaction, information, or processing systems such that it is difficult to determine their proper presentation without a review by an independent expert
 - Need to minimize financial surprises

Interested parties need to have confidence that the information they are using to make choices is reliable and not subjective. The public accounting profession has strict independence rules and has traditionally been in a position of high trust with the investing public, which gives them an important competitive advantage. The public accounting profession also has expertise in a variety of different kinds of business processes to have the ability to deal with many types of transactions.

- 1-3 The primary reference points (criteria) to determine fairness of presentation are:
- IFRS – IFRS provide criteria for financial statement audits.
 - COSO – Internal Control, Integrated Framework for reports on internal control over financial reporting.

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

- 1-4 The audit enhances the quality of financial statements because the user has the assurance that an *independent, qualified professional* has examined the financial statements and has rendered an opinion on their fairness. The independence and expertise of the auditor serves as a quality control function to overcome the potential bias of management in presenting the financial statements in a manner that most flatters an assessment of their performance. The audit is designed to add credibility to the financial statements.

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

- a. Fairness is judged within a framework of IFRS. Some question whether IFRS result in the fairest possible presentations when there are significant changes in market values of investments or assets. For example, it is encouraged financial institutions to move from

using historical cost required by IFRS to market values for all investments in securities because it is believed that market value presents a better picture of economic reality than does historical cost.

- b. Although designed to detect fraud, it might be possible that a well-executed audit may still fail to detect fraud.

- 1-5 Organizational governance occurs when one party provides resources to an entity or to another party to utilize for the business purposes agreed-upon by the parties. In turn, the party providing the resources requires accountability on whether those resources were safeguarded, whether they were used for the purposes agreed-upon, and how well those resources have been used. Corporate governance is the same principle applied to corporations.

The audit process is a very important element of corporate governance. Through an audit, parties who have provided resources to the organization can be provided with a level of assurance that the resources were properly utilized.

An effective Board of Directors and more specifically an effective audit committee that can interact with auditors is very important to corporate governance. Directors can be trusted by third parties more so than management to effectively oversee the audit process and the overall processes of the business because they lack the incentives to misstate operating results.

- 1-6 Independence is the cornerstone of auditing because there is a great diversity of users. The interests of the various users may conflict, so it is very important that the audit function be trusted to not favor any one party. Independence must exist because there may be a natural conflict between management and the users. For example, management may want to portray the best possible results while users want the results that best portray economic reality and predict future earnings and cash flow.

The third parties who choose whether or not to rely on the auditor's opinion will ultimately be the judge of the auditor's independence. If the public perceives the auditor as not being fully independent, they will not rely on the auditor's work, meaning it is not adding any value. If the work does not add value, it will not be in demand and CPAs risk losing their competitive advantage in the audit market – and their unique franchise!

- 1-7 The company that is the subject of the assurance services usually pays for them. These companies are willing to pay for services because there is a measurable benefit due to the increased confidence in their processes or they are able to raise more capital because of confidence in their financial results.

- 1-8 The auditing profession is uniquely qualified to expand into the broader arena of assurance services because they have:

- access to knowledge resources
- an independence from the companies or processes on which the services are provided
- experience in the establishment of standards regarding assurance subjects
- expertise in the area of providing assurance

- 1-9 Auditing services is a subset of assurance services which require a report to third parties. Specifically, auditing services address assertions of management. More specifically, we tend

to think of auditing services as audits of a company's financial statements in which management asserts that the financial statements accurately portray the company's financial results. However, as indicated in the chapter, auditing services are not necessarily confined to financial statements.

Assurance services don't necessarily evaluate assertions, but are aimed at improving the quality of information for decision making without an assertion by management about the existing quality.

- 1-10 An attestation service always involves a third party. The auditor providing a report to a third party on assertions made by the first party. Financial statement audits represent one type of an attestation service. Attestation services always require agreed upon criteria by which to evaluate management's or the organization's assertions. For example, a report on internal controls requires agreed upon criteria by which the quality of internal control is evaluated.

The attest function involves an independent third party testing and evaluating an assertion or communication by one party to another party. The attest function consists of gathering evidence to form an opinion on the correctness of the communication and then communicating that opinion to the third party user. The attest function is driven by the demand for reliable financial information as a basis for decision making in most business communities. The need for an independent assessment of the reliability of the financial information is caused by:

- Potential management bias in providing financial information.
- Remoteness of most users from the organization (i.e., users do not have access to the records or operations).
- Complexity of transactions affecting the financial statements,
- Need to minimize financial surprises.

- 1-11 Auditing services are a subset of assurance services. Specifically, auditing services address assertions of management. More specifically, we tend to think of auditing services as audits of a company's financial statements in which management asserts that the financial statements accurately portray the company's financial results. However, as indicated in the chapter, auditing services are not necessarily confined to financial statements. Assurance services don't necessarily evaluate assertions, but are aimed at improving the quality of information for decision making. Assurance services are needed because there is a:

- Potential bias in providing information
- Remoteness between a user and the organization or trading partner
- Complexity of the transaction, information, or processing systems such that it is difficult to determine their proper presentation without a review by an independent expert
- Need to minimize financial surprises

A market for assurance services already exists. CPAs have a monopoly on the assurance on the quality of financial statements, and laws exist requiring an audit for any publicly traded company. There is also an existing market for other assurance services, but CPAs must continually attempt to gain market share as they do not hold a monopoly on those services.

In addition to gaining market share over their competition, CPAs can also benefit from further developing a market for assurance services that can create value for organizations.

1-12 Management is responsible for choosing the accounting principles that are used to portray an entity's financial position and results of operation. Management is constrained, however, by:

- a) IFRS, including new authoritative pronouncements issued by the IASB.
- b) The consistency standard requires the use of the same accounting principles from year to year. If management wishes to change accounting principles, it must justify the change on the grounds that the new principle is "preferable" and the auditor is required to assess whether management's justification of the change is reasonable.
- c) The independent auditor's assessment of the economic substance of transactions (especially new transactions) and therefore an assessment of whether the principles chosen fairly present the economic substance, not just the form, of the transactions.
- d) The audit committee's assessment of the accounting principles.

1-13 All three of these parties are important users. Arguments can be made for each group as follows:

- *Shareholders*: They are owners of the organization and thus they represent the group to which management is ultimately accountable (i.e., management serves only per the wishes of shareholders). Owners as a group depend on an independent audit to inform them of the stewardship and overall performance of management. Shareholders are also represented through the Board of Directors whom they elect to represent their best interests.
- *Creditors*: They invest capital in the organization in the form of short-- or long--term loans. Creditors are concerned with the safety of their loans and look to audited reports to provide information on the basis of assets and the earning power of the organization to assess the relative safety of their loans or their decision to grant credit to an organization.
- *Management*: They are interested in seeing that the financial statements show their performance, and if possible, to do so in a way that is most favorable to them. Many members of management now have bonus (salary) agreements tied to reported profits. Additionally, management may have stock options or stock investments that are significantly affected by the reported profits of the company.

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

The auditors resolve potential conflicts by:

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

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

- 1-14 Complexity affects the demand for auditing services in that both users and management need the expertise of professionals who understand the underlying economic substance of transactions and financial instruments and, thus, who have the ability to determine the appropriate accounting best to "fairly" portray the economic substance of an organization's activities and financial condition.

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

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

- 1-15 The audit should be designed to avoid material misstatements that would cause the financial statements to be restated. If the audit is designed and performed properly, these surprises should occur very rarely. It is very important that the audit function work to avoid surprises because the market has a tendency to overreact to financial surprises which can lead to an unnecessary substantial loss in equity or even bankruptcy for a firm.

- 1-16 The special function performed by the public accounting profession is the attestation to the fairness of the financial statements of clients. The special function ensures the reliability and integrity of the financial reporting system. Judge Burger described the special function as "certifying the public reports that collectively depict a corporation's financial status," which involves "a public responsibility transcending any employment relationship with the client."

The auditing profession exists to serve the users of an organization's financial statements. These include lenders, investors, management, government, and (indirectly) all individuals who are ultimately affected by the integrity of the financial reporting process.

- 1-17 The five elements of an assurance services are:

1. A three-party relationship involving a practitioner, a responsible party and intended users

2. An appropriate subject matter
3. Suitable criteria
4. Sufficient appropriate evidence and
5. A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement

1-18 Internal auditing exists as a separate audit function within an organization with a reporting responsibility to management, the board of directors, and the audit committee of the board of directors. The scope of internal audits is generally much broader than that of the external auditor. Internal auditing is viewed as an integral part of the organization's risk, governance, and control processes. The internal auditor often performs operational audits, compliance audits, and computer system audits in addition to financial--type audits. The internal auditing function must strive to achieve independence while working within the organization. This is usually accomplished by reporting to a high management level and the audit committee of the board of directors to ensure that no audit findings are suppressed.

Persons are licensed as CPA's by state regulatory agencies. Only CPAs are licensed to render an audit opinion. Internal auditors are not so licensed, but many internal auditors are either Certified Internal Auditors or CPAs and adhere to the same level of standards, as do the external auditors.

Public accounting firms have recently begun to perform internal audit work for clients, thus resulting in an expansion of the type of audit work performed by many firms.

1-19 The Public accounting firm that has no listed audit client can provide consulting, tax planning, and internal audit services to non-audit clients. Most CPA firms still provide such services and have targeted non-audit clients as their potential market for such services. The amounts are still substantial and have the potential to exceed audit revenues for the firms.

1-20 Yes, local CPA firms are subject to the same auditing and accounting standards as the large international CPA firms. There are no differences in auditing standards for any of the firms.

1-21 A network is a body to which individual CPA firms come together to pursue common interests. The services generally provided by the network include:

- centralized staff that provides accounting and auditing expertise to its members on a world-wide basis,
- a referral service for audit firms that have clients in different parts of the world, or different parts of the country,
- a referral service for a firm to utilize when clients desire expertise or consulting services that the audit firm does not provide.
- standard audit programs for each of the member audit firms, if they desire to use, can use.

In some cases, the network can be a network of firms that are not otherwise affiliated. In other cases, the network firms all operate under one common name, e.g. Grant Thornton International.

- 1-22 In a primarily self-regulating profession, such as public accounting, there must be some method to ensure that the profession is looking out for the best interests of the parties whom it serves. The court system acts as a check and balance on the profession to ensure that it does not ignore the needs of clients and third--party users and allow misleading financial reports to be issued or the performance of substandard audits.

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

Multiple Choice Questions:

- 1-23 b.
1-24 c. (assurance services don't always require a third party)
1-25 d.
1-26 a.
1-27 b.

Discussion and Research Questions:

1-28 (Purposes of an External Audit)

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

An audit may specifically benefit the auditee in the following ways:

- i. An independent assessment of the fairness of presentation enhances the perceived reliability of the financial report and assists the company in obtaining loans or new capital because the investing and lending public will have confidence in the financial figures.
- ii. The auditor's expertise in related areas may help the client in
 - (a) Tax planning.
 - (b) Preparing tax returns.
 - (c) Selecting and implementing accounting information systems.
 - (d) Identifying sources of capital or loans.
 - (e) Preparing financial forecasts or analyses that may assist the company in obtaining loans or new capital.
 - (f) Determining the efficiency of existing accounting operations.
 - (g) Observing areas in which efficiency and effectiveness of operations might be improved.
- iii. The auditor's testing and evaluations of controls may provide insights into areas in which improvements could be made.
- iv. The independent assessment and testing of transactions represent a management control device because individuals know that their work will be tested and evaluated.
- v. The threat, as well as the performance, of an audit may act to deter potential fraud.

- vi. The auditor's expertise may lead to improved financial presentations because of the application of accounting principles or improved financial statement disclosure.
 - vii. The auditor's knowledge may lead to improved reporting for regulatory purposes.
- b. Some of the points that might be discussed by management in determining the nature of the CPA firm to engage to conduct the audit:
- 1. The audit fees for conducting the audit.
 - 2. The reputation of the auditor in the community and potential impact of auditor reputation in securing loans or capital.
 - 3. The ability of the auditor to assist the firm in expanding the scope of its operations beyond the immediate geographic area.
 - 4. The industry--specific knowledge of the potential auditors.
 - 5. The individual personnel servicing the company, that is, the involvement of a partner versus other personnel on the engagement.
 - 6. Perceived audit expertise in ancillary areas such as tax, financial projections and analysis, mergers and acquisitions, and systems.
 - 7. The outcome of any recent peer review performed on the public accounting firm.
 - 8. The satisfaction of other clients with the level of service obtained from the firm.
 - 9. The need for national support staff for complex issues.
 - 10. Plans by the company to issue stock.
 - 11. The ability of the audit firm to use state-of-the art technology on the engagement and to introduce that technology to the client.
- (Note: The above list is not inclusive. Students are generally quite good in identifying other factors that may or may not be important and thus provide for excellent classroom discussion.)
- c. As a small, privately-held firm, the company is not required to have an audit committee. However, an audit committee is recommended by the AICPA. Further, as the company plans to grow, it will be important to establish all elements of effective internal control over financial reporting. Thus, an audit committee will be valuable to the company if it considers going public in the future.

1-29 (Purposes of an External Audit)

- a. The value of the audit to external users, e.g. investors and creditors is to that the audit provides an informed and unbiased report on the company's operations, and for public companies, its internal controls.
- b. An audit of internal controls provides value to the public in three ways:
 - it informs users of the accountability that management has assumed in fulfilling its stewardship function,
 - it provides confidence in the company's processes to control its information and to provide reliable information on an interim basis, and
 - it helps ensure investors that management has reliable information on which to makes its internal decisions.

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

1-30 (Users of Financial Statements)

- a. IFRS have been designed as standards that are neutral for users and are applicable to all financial statements. IFRS are required for all client financial statements that must be filed with the SEC. Some small companies prepare financial statements on a tax or cash basis. In such instances, there must be disclosure that such statements are on a comprehensive basis of accounting other than IFRS.

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

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

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

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

- *Lenders:* This group includes bank loan officers, bondholders, and vendors who supply credit to the organization. Lenders are primarily interested in the safety of their loans and look to the audited financial statements to provide information on assets, profitability, and potential overextension of the company with too much debt outstanding. Lenders generally prefer that the company take a conservative approach to accounting. A lender would prefer that assets be depreciated over the shortest possible life thereby encouraging more conservative balance sheet presentation of assets.
- *Management and board of directors:* Management is an important user because it receives an objective overview of the quality of its internal accounting system. Additionally, management needs objective, verifiable information on which to make decisions affecting other users. The audit provides an independent analysis of the financial reporting system and enhances the reliability of data affecting management

decisions. Management is generally motivated to use accounting principles that boost income because management bonuses are often tied with income.

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

Indirect users are concerned about the accuracy of economic presentation of financial results and current position.

- *Governmental regulatory agencies:* Governmental regulatory agencies at both the state and federal level exist to protect various constituencies. The free flow of reliable information is important to these agencies in identifying situations in which action should be taken to protect other groups. For example, a state insurance commission may review the financial reports of insurance companies reporting to them as a basis to determine whether regulatory action is required to protect the investments of various insurance policyholders. An agency's objectives dictate its views toward accounting principles. Insurance commissions, for example, dictate a conservative identification of admissible assets in filings with the state insurance commissions. Most other agencies have similar objectives that dictate the form in which financial statements are filed for regulatory purposes.
- *Labor and labor unions:* Labor increasingly negotiates contracts with bonuses or other payments contingent on the level of reported profitability of an employer. Additionally, labor is interested in past profitability as a basis for negotiating current wage levels.

1-31 (*Nature of Auditing and the Public Accounting Profession*)

- a. Disagree, the primary purpose of the Audit is to provide accurate and reliable data that portray the economic nature of an entity's business and in turn provide a base to judge current progress toward long-term objectives.
- b. There is an independence problem, in some views, because the primary purpose of the audit is to furnish financial statements to a bank or to another investor in order to raise capital for the firm. Thus, the control of hiring and firing by the management is seen by some as an impairment of the auditor's independence.
- c. As time has passed, most observers have come to the conclusion that the expectations are not too high. However, they do need some fine tuning in relationship to how much users want to pay for an audit.
- d. This is true. Auditors need to provide clear guidance to the board, the audit committee, and to management as to whether they believe the financial statements best portray the economic events of the entity being audited.
- e. This should generate good discussion. Most practitioners do not feel this constitutes a problem.

1-32 (*Understanding the Business*)

- a. Understanding a business helps the auditor identify accounts that may be misstated. This is particularly true when the misstatements may not be related to the actual recording of transactions; but are due to changes in valuation that take place over time. The auditor should understand:
- competitive actions that could possibly obsolete a product or service,
 - competitive effects on pricing,
 - changes in the economy or industry that could affect the collectability of receivables,
 - use of products that may affect warranty claims,
 - whether current technology utilized by the firm is up to date,
 - changes made by competitors in their warranties.

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

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

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

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

- b. The auditor brings a perspective to a privately-held company that is often broader than that held by management. The auditor sees a number of different clients, different industries, and differing strategies. The perspectives developed by the auditor may provide insight to the client's management that they otherwise would not have.

1-33 (*Internal Audit Profession*)

- a. Internal auditing is defined as follows:

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

It is defined as both an assurance and a consulting activity. Assurance is designed to add value to an organization by providing management, the board of directors, and operating management with independent analysis regarding company operations as well as compliance with company policies and procedures. As companies enter into more trading partner agreements, internal auditors may be called upon to provide assurance on controls

and operating procedures to the company's trading partners. Assurance services have been the historical base of internal auditing and will continue to play a major role in the future development of the profession as the demand for an increasing array of assurances continues to increase.

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

- b. The internal audit focus is on the risk management, control, and governance processes in an organization. The role regarding risk management and control is as follows:
- Determine whether the company has a systematic process to identify, measure, control, or otherwise manage or take risks.
 - Determine whether the company manages risks according to a company approved risk policy.
 - Determine whether the company has sufficient controls in place to identify and manage risk.
 - Determine if the controls are working properly.

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

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

- c. Internal auditing is a wide process and hence individuals who are not CPA or trained accountant can also be included pursuing a career in internal auditing in view of below points :
1. Internal auditing is a broad discipline. An internal audit department will be composed of individuals with a wide variety of industry and company experience.
 2. Internal auditing is one of the fastest growth areas of public accounting firms. Most of the large public accounting firms, as well as other firms, are developing strong practices in outsourcing the internal audit function.
 3. An internal auditor has the opportunity to develop a keen understanding of all aspects of a business by rotating audits through various areas. The auditor's knowledge obtained in one operational audit can usually be transferred to other operational audits.
 4. Internal auditing presents an excellent training ground for future management positions. The internal auditor performing operational auditing is developing a broad perspective of the organization that provides excellent background for

promoting the auditor into management positions. It must be recognized that public accounting firms are moving to perform internal audit work on an outsourcing basis (sometimes referred to as “extended audit work”.) The public accounting firms argue that they can provide the same quality of work more efficiently, in many cases, because they can bring experienced personnel with a fresh view to the audit. They can also bring wide industry expertise and technology that often is not available within the internal audit department.

1-34 (Implementing an Assurance Service)

a. Assurances and Evidence

Assurance Tested	Evidence to be Gathered to Test Assurance
a. All goods are shipped in a timely fashion.	Take an electronic sample of orders and trace to shipping evidence, e.g. shipping documents, UPS documents, or other evidence of shipment. Take a sample of customer complaints or inquiries and determine if there is a pattern of customers complaining that goods are not received in a timely fashion.
b. Goods are as advertised.	Take a sample of advertisements and compare the qualities advertised with a sample of products.
c. Company stands behind goods that are damaged in transit.	Take a sample of complaints or credit adjustment requests submitted by customers. Determine whether or not the requests were handled consistently with advertised company policy.
d. Company fulfills promises made in its credit policies.	Take a sample of credit sales. Determine that sales are billed according to company policy. Determine that interest, if applicable, is billed according to company policy.
e. Credit card and billing information is kept safe and not sold to other electronic retailers.	Inquire of company policies designed to safeguard customer information. Inquire of management as to (a) any sales of customer information; and (b) policies and procedures in place to protect the privacy of customer information. Review customer complaints to determine if any relate to customer privacy issues. Determine that company data are protected. Attempt accesses to such data to determine if unauthorized users can access such data.

- b. The assurances should be provided frequently enough to assure customers that the policies and procedures continue to be effective, perhaps every three or six months.
- c. The assurances should be evident on the company's Web page with something like the UL or good housekeeping seal. The seal could also be used on hardcopy promotional material.
- d. The CPA has objectivity and integrity along with the skills needed to provide such assurances.
- e. Old-line companies with a long history of good business practices probably do not need such assurances.
- f. Other potential providers include industry associations, Internet provider companies, Web browser companies such as AOL, companies that provide e-commerce Web services, etc. Alternatively, the companies may provide the assurances by promoting the quality of its processes, soliciting testimonials from customers, and promoting a reputation of quality of services.

1-35 (Internal Auditing)

- a. A career starting within internal auditing would most likely differ from a career starting in public accounting in the following ways:
 - 1. The internal auditor would audit a number of different functions within one organization rather than audit the same type of function within a larger number of organizations. If the organization is large and diverse, the internal auditor will likely have very wide experiences across both functional areas and industry types.
 - 2. The internal auditor will most likely perform operational audits rather than, or in addition to, financial audits and will be looking for potential recommendations to improve the operations of the organization.
 - 3. The internal auditor would develop expertise in risk management and controls, including controls designed to evaluate the efficiency of operations.
 - 4. The internal auditor will pursue certification as a Certified Internal Auditor to exhibit professional competence in the area of internal auditing. Many individuals will also sit for the CPA exam to enhance their professional recognition and to obtain recognition that they may perform some financial audit work in connection with the annual audit of the company.
- b. Internal auditing provides an excellent starting point for a career in management because the internal auditor is in a position to understand all aspects of an organization and how it comes together to accomplish its objectives. By performing operational audits, the internal auditor learns about the "best" kind of procedures to accomplish organizational objectives and then compares actual company performance with the "best" types of procedures. The auditor is always looking for constructive ways in which organizational objectives can be performed more efficiently or where cost savings can be realized. Finally, the new internal auditor can make a strong impression with existing management by demonstrating insight on the effectiveness of operations. To be successful, the internal auditor must learn how to deal with people who do not necessarily want to be reviewed and then convince them that the auditor's recommendations can help them accomplish their own task. Much of management involves working with people, and internal auditors find out about the importance this very early in their career. It is not a desk job!

1-36 (*Nature of Auditing and the Public Accounting Profession*)

1. Auditing does not involve the creation of goods. However, it does serve a worthwhile purpose in our society because it enhances the flow of reliable financial information needed to conduct commerce in our economy. It also assists in the conduct of government by providing reliable information for tax purposes and regulatory purposes. Audits have been legally mandated to ensure objective information. However, research has indicated that audits would be required even if not mandated. The initial audits performed in conjunction with the settlement of the new world arose because of owners' need to have an independent assessment of the returns earned by their managers.
2. The accounting profession *did* provide early warning signals of the potential problems within many industries. However, it clearly failed in other areas. Some of the problems were related to the impreciseness of accounting principles (e.g. Enron) while others were more closely related to regulatory failures (e.g. Savings & Loan Industry). This may not be resold, copied, or distributed without the prior consent of the publisher.
3. Finding fraud may be important. However, many misstatements that are made in conjunction with an organization's financial statements are not intentional but are simply the result of errors. The audit function is designed to detect *material misstatements* -- whether they are due to errors or fraud. Thus, the audit function is actually broader than the colleague had desired. Ensuring that a financial statement contains no material misstatements also ensures that the auditor addresses the likelihood that material fraud may also have occurred.
4. There is a potential problem with the auditors being hired by management. The audit committee should exist to present the views and interests of outside owners of the organization and provide effective insulation against undue pressure by management on the audit function. The SEC is very cognizant of independence issues and periodically addresses actions or relationships that they believe may impair the auditor's independence.
5. It seems that this individual really wants to have a career in auditing. External auditing has changed; in today's environment, the auditor must thoroughly understand a company's business in order to audit it. .
6. The external audit is designed to present an opinion on the fairness of a company's financial statement in accordance with IFRS. It is not directly designed to assess the performance of management, although the financial statements may provide some evidence on the performance of management.
7. Auditors operate in an environment in which they must have a sense of trust with management – at least to the extent that confidential or proprietary information is not made public. Thus, if all recommendations made to management were to be made public, management might simply ask that recommendations no longer be made. Further, it must be recognized that many of the recommendations made to improve operations are informal in nature and might not be based on thorough study of a particular area. Auditors may justifiably fear litigation from recommendations made public that were made only on informal observations.
8. Maintaining adequate controls is a significant part of corporate governance. The owner (shareholder) should receive reports on the quality of controls implemented by management this will help to have insight of the overall management of the corporate. This will enhance the value of Audit.

9. Audits are conducted by gathering evidence to persuade the auditor as to the correctness of the company's financial statements. It is not economically possible, or even desirable, to examine every transaction of an organization. Rather, the auditor needs to design and utilize effective scientific samples of evidence to evaluate. An audit is very systematic and proceeds by first identifying areas in which misstatements are more likely to occur and then planning most of the audit to discover the existence of any material misstatements.

1-37 (Internal Auditing)

An operational audit of the following functions would address the following

- a. *Treasury function.* The auditor would attempt to determine the policies and procedures in place to ensure that funds are handled in a manner to meet the organization's needs and maximize its return. The auditor would attempt to determine the "best" type of practices as indicated by good finance theory as a basis for understanding the efficiency with which the treasury function carries out its activities.
- b. *Inventory management and control.* Similar to the discussion of the treasury function above, the auditor consults textbooks or other sources to understand the types of procedures that have been developed to accomplish efficient management and control of inventory. These "best" procedures will be compared with the procedures actually utilized by the company. The auditor also attempts to understand and evaluate the effectiveness with which current policies and procedures are implemented to determine whether cost problems are associated with current approaches.
- c. *Customer service.* Most organizations have objectives as to customer service including the timeliness of response, the satisfaction of customers with the response, and the cost of delivering the services. The auditor gathers evidence related to these objectives.
- d. *Computerized order entry.* Companies implement sophisticated computer systems to eliminate errors, speed order entry, and better serve customers. Unfortunately, over time, most systems degrade. The auditor gathers data on these criteria and seeks to understand the causes of any problems.

1-38 (Types of Internal Audits)

Nature of Audit Procedure	Type of Audit	Most likely performed by
1. Evaluate policies HDB	Compliance	AGO
2. Audit of a Town Council	Financial	CPA firm
3. Service department responsiveness	Operational	Internal Audit Dept.
4. Town Council's Cost Analysis	Operational	CPA Firm, or Internal Audit Department
5. Temporary Investments	Compliance	Internal Audit
6. Analyze waste.	Operational	Internal Audit
7. Computer Security	Operational	Internal Audit; might also be the AGO if it is a governmental entity
8. Entity that received governmental grant	Compliance	CPA Firm (usually on contract with the granting agency)
9. Analyze financial statements of a company targeted for take-over	Operational/ Financial	CPA Firm. Could also be performed by an internal audit

		department.
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1-39 (*Public Accounting Profession*)

- a. There seems to be a misinterpretation on the part of many users that a "clean" audit opinion means that the company is in good health. This, unfortunately, is a miscommunication. A "clean" audit opinion means only that the financial statements are fairly presented, not that they represent a company that is in good financial health. The audit function provides data that are "fairly presented" in accordance with IFRS, but such information alone does not constitute all the information an informed user should know about a company.
- b. The auditor is a guarantor *only* of following auditing standards in determining whether the statements are fairly presented, in all material respects, in accordance with IFRS. Fair presentation is guaranteed only within the context of IFRS.
- c. The auditing functions attempt to communicate reasonable expectations by defining the auditor's responsibilities and management's responsibilities in the audit report. The audit function has worked to standardize the communication in audit reports. However, as was proven by the changes in the past few years, it is not sufficient for the profession to communicate what it believes are reasonable expectations. The profession must also listen to what the public expects and adjust to meet their needs.
- d. This is a discussion question and should encourage a widely ranging discussion by users. Topics that might be addressed include these:
 1. The potential deficiencies in IFRS.
 2. The ability to detect fraud when management has attempted to cover it up.
 3. The responsibilities of users to perform their own work and to not expect someone else to make decisions for them.
 4. The overall responsibility of management for the integrity of the financial statements.
 5. The value of reports on internal control.
 6. The difficulty of measuring the economics of complex transactions.

1-40 (*Internet Activity*)

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

1-41 (*Research Question*)

This is one of a number of research problems we want students to start exploring. The intent is to get the student into the library and to think about issues beyond the textbook. We are in an important time in which dramatic changes have taken place in the last decade. The student should review some of these changes and evaluate the current status, and changes in, auditor responsibilities.