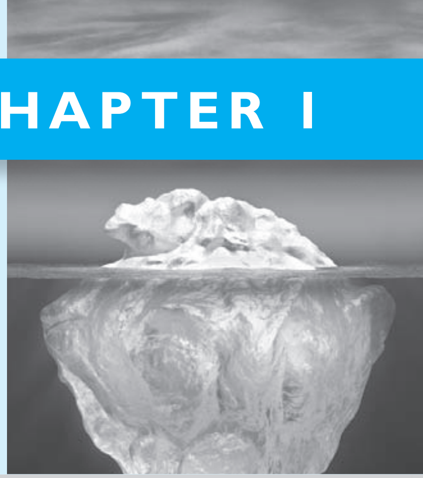


CHAPTER 1

Auditing and Assurance Services

Our system of capital formation relies upon the confidence of millions of savers to invest in companies. The auditor's opinion is critical to that trust.

James R. Doty, Chairman, Public Company Accounting Oversight Board (PCAOB)

Professional Standards References

Topic	AU/ISA Section	PCAOB Reference*
Overall Objectives of the Independent Auditor and the Conduct of an Audit	200	AU 110, AU 150, AU 201, AU 220, AU 230
Consideration of Fraud in a Financial Statement Audit	240	AU 316
Audit Evidence	500	*AS 15*
Attestation Standards	AT 50	AT 50
Compliance Audits of Governmental Entities and Recipients of Governmental Assistance	935	AU 801

*AU and AT references represent standards issued by the ASB prior to April 16, 2003, that have not been superseded or amended by the PCAOB.

LEARNING OBJECTIVES

You are about to embark on a journey of understanding how auditors work to keep the capital markets safe and secure for the investing public. You should know that students demonstrate success in the auditing course quite differently than they do in other accounting courses. For example, when taking financial accounting, students typically demonstrate success by correctly identifying the proper journal entry for a given set of facts and circumstances. In auditing, success is typically demonstrated by completing multiple-choice and short-answer questions based on the professional standards that regulate the auditing process. Overall, this book provides you with a comprehensive set of materials that will allow you to master these professional auditing standards. Chapter 1 provides an introduction to the auditing and assurance profession.

Your objectives are to be able to:

LO 1-1 Define *information risk* and explain how the financial statement auditing process helps to reduce this risk, thereby reducing the cost of capital for a company.

LO 1-2 Define and contrast *financial statement auditing, attestation,* and *assurance services.*

LO 1-3 Describe and define the assertions that management makes about the recognition, measurement, presentation, and disclosure of the financial statements and explain why auditors use them as the focal point of the audit.

LO 1-4 Define professional skepticism and explain its key characteristics.

LO 1-5 Describe the organization of public accounting firms and identify the various services that they offer.

LO 1-6 Describe the audits and auditors in governmental, internal, and operational auditing.

LO 1-7 List and explain the requirements for becoming a certified public accountant (CPA) and other certifications available to an accounting professional.

USER DEMAND FOR RELIABLE INFORMATION

LO 1-1
Define *information risk* and explain how the financial statement auditing process helps to reduce this risk, thereby reducing the cost of capital for a company.

Enron, WorldCom, HealthSouth, Bernard Madoff Investments, Parmalat, Satyam, Tyco, Fannie Mae—the list of financial accounting frauds that have been uncovered in recent years has been shocking to the business community. Investor confidence was understandably shaken because investors depend on reliable financial statement information to make their investment decisions about a company. So, where were the auditors? How could they have missed such high-profile frauds? These questions are not easy to answer. Before we attempt to address these, we must first explain the vital role that information assurance providers (such as financial statement auditors) play in supplying key decision makers (management, investors, and creditors) with useful, understandable, and timely information. When you have a better understanding of why auditing has been so critical in establishing America's capital markets as the strongest in the world, we will explore the issues surrounding the financial accounting frauds identified here. Because many of you are likely planning to enter the public accounting profession, we hope that you will equip yourself with this knowledge so that you may help avoid similar problems in the future and play a key role in maintaining public confidence in both the auditing profession and the capital markets.

Information and Information Risk

All businesses make a countless number of decisions each and every day. Decisions to purchase or sell goods or services, lend money, enter into employment agreements, or buy or sell investments depend in large part on the quality of useful information. These decisions affect *business risk,* the chance a company takes that customers will buy from competitors, that product lines will become obsolete, that taxes will increase, that government contracts will be lost, or that employees will go on strike. In other words, **business risk** is *the risk that an entity will fail to meet its objectives.* If the company fails to meet its objectives enough times, the company may ultimately fail. To minimize these risks and take advantage of other opportunities presented in today's competitive business environment, decision makers such as chief executive officers (CEOs) demand *timely, relevant,* and *reliable* information. Similarly, investors and creditors demand high-quality information to make educated financial decisions. Information professionals (such as accountants, auditors, and other information assurance providers) help satisfy this demand.

Four environmental conditions increase user demand for relevant, reliable information:

1. *Complexity.* Events and transactions in today's global business environment are numerous and often very complicated. You may have studied derivative securities and hedging activities in other accounting courses, but investors and other decision makers may not have your level of expertise when dealing with these complex transactions. Furthermore, they are not trained to collect, compile, and summarize the key operating information themselves. They need the services provided by information professionals to help make the information more understandable for their decision processes.
2. *Remoteness.* Decision makers are usually separated from current and potential business partners not only by a lack of expertise but also by distance and time. Investors may not

be able to visit distant locations to check up on their investments. They need to employ full-time information professionals to do the work they cannot do for themselves.

3. *Time-sensitivity.* Today's economic environment requires businesses, investors, and other financial information users to make decisions more rapidly than ever before. The ability to promptly obtain high-quality information is essential to businesses that want to remain competitive in our global business environment.
4. *Consequences.* Decisions can involve significant investment of resources. The consequences are so important that reliable information, obtained and verified by information professionals, is an absolute necessity. Enron's aftermath provides a graphic example of how decisions affect individuals' (as well as companies') financial security and well-being. Enron's stock dropped from $90 to $0.90 in little more than a year, leaving employees who had invested their life savings in the company virtually penniless. To put this drop in perspective, an investor's $5 million investment in Enron stock in 2000 (enough for an enjoyable retirement) was worth only $50,000 a year later.

AUDITING INSIGHT — The Consequences of Fraudulent Financial Information

Bernard Madoff, a former chairman of the NASDAQ stock market and a respected Wall Street adviser and broker for 50 years, was arrested after his sons turned him in for running "a giant Ponzi scheme," bilking investors out of billions of dollars. Many investors, including actors, investment bankers, politicians, and sports personalities, lost their life savings. Some who had already retired, now in their 70s and 80s, were forced to go back to work. Others lost their retirement homes. Charities and pensions that had invested heavily were wiped out.

Although some of the world's most knowledgeable investors fell prey to the scam, numerous red flags were present for all who were wise enough to see them. First, Madoff's fund returned 13–16% per year, every year, no matter how the markets performed. Second, his stated strategy of buying stocks and related options to hedge downside risk could not have occurred because the number of options necessary for such a strategy did not exist. Third, although his firm claimed to manage billions of dollars, its auditing firm had only three employees, including a secretary and a 78-year-old accountant who lived in Florida.

Sources: "Fund Fraud Hits Big Names," *The Wall Street Journal,* December 13, 2008, pp. A1, A7; "Fees, Even Returns and Auditor All Raised Flags," *The Wall Street Journal,* December 13, 2008, p. A7; "Top Broker Accused of $50 Billion Fraud," *The Wall Street Journal,* December 12, 2008, pp. A1, A14; "Probe Eyes Audit Files, Role of Aide to Madoff," *The Wall Street Journal,* December 23, 2008, A1, A14.

A further complication in effective decision making is the presence of information risk. **Information risk** is *the probability that the information circulated by a company will be false or misleading.* Decision makers usually obtain their information from companies or organizations with which they want to conduct business, to provide loans, or to buy or sell stock. Because the primary source of information is the target company itself, an incentive exists for that company's management to make their business or service appear to be better than it actually is, to put their best foot forward. As a result, preparers and issuers of financial information (directors, managers, accountants, and other people employed in a business) might benefit by giving false, misleading, or overly optimistic information. This potential *conflict of interest* between information providers and users, along with financial statement frauds such as those of Enron and WorldCom, leads to a natural skepticism on the part of users. Thus, they depend on information professionals to serve as independent and objective intermediaries who will lend credibility to the information. This *lending of credibility* to information is known as providing **assurance**. When the assurance is provided for specific assertions made by management, we refer to the assurance provided as **attestation**. When the assertions are embodied in a company's financial statements, we refer to the attestation as **auditing**. More specifically, when their work is completed, the auditors supply an opinion as to whether the financial statements and related footnotes are presented fairly in all material respects. The actual compilation and creation of the financial statements is completed by the company's accountants.

REVIEW CHECKPOINTS

1.1 What is a business risk?

1.2 What conditions increase the demand for reliable information?

1.3 What risk creates a demand for independent and objective outsiders to provide assurance to decision makers?

AUDITING, ATTESTATION, AND ASSURANCE SERVICES

LO 1-2
Define and contrast *financial statement auditing, attestation,* and *assurance services.*

Now that you understand why decision makers need independent information professionals to provide assurance on key information, we further define auditing and expand the discussion of attestation and assurance services in this section and explain their roles in today's information economy.

Definition of Financial Statement Auditing

The focus of this book is on the financial statement auditing process, by far and away the most common type of auditing and assurance service provided in today's market. Many years ago, the American Accounting Association (AAA) Committee on Basic Auditing Concepts provided a very useful general definition of *auditing* as follows:

> *Auditing* is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established criteria and communicating the results to interested users.[1]

A closer look at the definition reveals several ideas that are important to any type of auditing engagement. Auditing is a *systematic process.* It is a purposeful and logical process and is based on the discipline of a structured approach to reaching final decisions. It has a logical starting point, proceeds along established guidelines, and has a logical conclusion. It is not haphazard, unplanned, or unstructured.

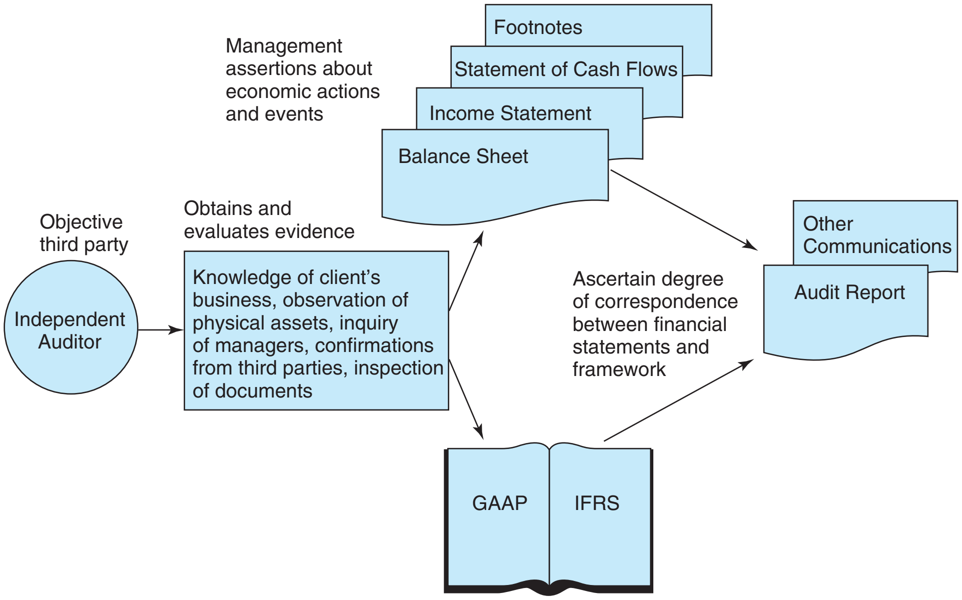
The process involves obtaining and evaluating *evidence.* Evidence consists of all types of influences that ultimately guide auditors' decisions and relates to *assertions made by management about economic actions and events.* When beginning a financial statement audit engagement, an independent auditor is provided with financial statements and other disclosures by management. In doing so, management essentially makes assertions about the financial statement balances (that the inventory on the balance sheet really does exist, that revenue recorded on the income statement really did occur, that the list of liabilities on the balance sheet is complete, etc.) as well as assertions that the financial statement disclosures are fairly presented.

External auditors generally begin their work with a focus on these assertions (explicit representations) made by management about the financial statement amounts and information disclosed in footnotes, and then set out to obtain and evaluate evidence to prove or disprove these assertions or representations. Other auditors, however, often are not provided with explicit representations. An internal auditor may be assigned to evaluate the cost effectiveness of the company's policy to lease, rather than to purchase, heavy equipment. A governmental auditor may be assigned to determine whether goals of providing equal educational opportunities have been achieved with federal grant funds. Oftentimes, these latter two types of auditors must develop the explicit performance criteria or benchmarks for themselves.

The purpose of obtaining and evaluating evidence is to ascertain the degree of correspondence between the assertions made by the information provider and established

[1]American Accounting Association Committee on Basic Auditing Concepts, *A Statement of Basic Auditing Concepts* (Sarasota, FL: American Accounting Association, 1973).

EXHIBIT 1.1
Overview of Financial Statement Auditing



criteria. Auditors will ultimately communicate their findings to interested users. To communicate in an efficient and understandable manner, auditors and users must have a common basis for measuring and describing financial information. This basis is the established criteria essential for effective communication.

Established criteria may be found in a variety of sources. For independent auditors, the criterion is whatever the applicable financial reporting framework is, whether it is generally accepted accounting principles (GAAP) in the United States or international financial reporting standards (IFRS). Internal Revenue Service (IRS) auditors rely heavily on criteria specified in the Internal Revenue Code. Governmental auditors may rely on criteria established in legislation or regulatory agency rules. Bank examiners and state insurance board auditors look to definitions, regulations, and rules of law. Internal and governmental auditors rely a great deal on financial and managerial models of efficiency and effectiveness. All auditors rely to some extent on the sometimes elusive criteria of general truth and fairness. Exhibit 1.1 depicts an overview of financial statement auditing.

The AAA definition already presented is broad and general enough to encompass external, internal, and governmental auditing. The more specific viewpoint of external auditors in public accounting practice is reflected in the following statement about the financial statement audit made by the American Institute of Certified Public Accountants (AICPA), the public accounting community's professional association:

> The purpose of an audit is to enhance the degree of confidence that intended users can place in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, in accordance with the framework. An audit conducted in accordance with generally accepted auditing standards and relevant ethical requirements enables the auditor to form that opinion. (AU 200.11).[2]

[2]The *Statements on Auditing Standards (SASs)* and *Statements on Standards for Attestation Engagements (SSAEs)* are authoritative AICPA pronouncements on auditing and attestation theory and practice. *Statements on Auditing Procedure (SAPs)* numbers 1–54 were codified into *SAS 1* in 1972. Statements on Auditing Standards are issued periodically by the Auditing Standards Board (ASB). Taken together, the SASs form the basis for U.S. generally accepted auditing standards (GAAS). You can find the number of the most recent *SAS* or *SSAE* by referring to the AICPA website (www.aicpa.org). Throughout this text, *SAS* references are followed by parenthetical section numbers (e.g., AU 200), which refer to the Codification of Statements on Auditing Standards published by the AICPA. *SSAE* references are followed by parenthetical section numbers (e.g., AT 101), which refer to the Attestation Standards published by the AICPA.

As your study of external auditing continues, you will find that auditors perform many tasks designed to reduce the risk of giving an inappropriate opinion on financial statements. Auditors are careful to work for trustworthy clients, to gather and analyze evidence about the assertions in financial statements, and to take steps to ensure that audit personnel report properly on the financial statements when adverse information is known.

AUDITING INSIGHT

Although most of the largest public accounting firms (collectively referred to as the "Big Four") trace their roots to the turn of the 19th century, auditing in the United States has a rich history. When the Pilgrims had a financial dispute with the English investors who financed their trip, an "auditor" was sent to resolve the difference. George Washington sent his financial records to the Comptroller of the Treasury to be audited before he could be reimbursed for expenditures he made during the Revolutionary War. One of the first Congress's actions in 1789 was to set up an auditor to review and certify public accounts. Even the "modern" concept of an audit committee is not so modern; the bylaws of the Potomac Company, formed in 1784 to construct locks on the Potomac River to increase commerce, required that three shareholders annually examine the company's records.

Source: D. Flesher, G. Previts, and W. Samson, "Auditing in the United States: A Historical Perspective," *Abacus* 41 (2005), pp. 21–39.

Attestation Engagements

Many people appreciate the value of auditors' attestations on historical financial statements, and, as a result, they have found other types of information to which certified public accountants (CPAs) can *attest*. The all-inclusive definition of an **attestation engagement** is

> An engagement in which a practitioner is engaged to issue a report on subject matter, or an assertion about subject matter that is the responsibility of another party. (AT 101.01)

By comparing the AAA's earlier definition of auditing with the definition of attestation, you can see that the auditing definition is a specific type of attestation engagement. According to the earlier definition, in an audit engagement, an auditor (more specific than a *practitioner*) issues a report on assertions (financial statements) that are the responsibility of management. For example, as more and more companies and organizations seek to demonstrate their efforts related to corporate social responsibility, demand is growing for attestation services related to sustainability reporting. The following Auditing Insight indicates the significance of this emerging market for public accounting firms.

In today's global business environment, activist shareholders are increasingly pressuring board of director members and upper management teams regarding issues of social responsibility, the environment, and other matters related to sustainability. As a direct

AUDITING INSIGHT — Sustainability Reporting—An Emerging Market for CPAs

The Global Reporting Initiative (GRI) is a nonprofit organization that was established to promote environmental sustainability to organizations throughout the world. Perhaps most importantly, the GRI has established a reporting framework that leading companies use to report key information about their efforts to promote sustainability in their business practices. The GRI last issued its Sustainability Reporting Guidelines in March 2011 (G3.1) and the next generation of Guidelines (G4) are currently in process. KPMG LLP reported that as of the end of 2011, 95 percent of the 250 largest global companies issue some type of corporate responsibility report.

Sources: https://www.globalreporting.org/resourcelibrary/GRI-Annual-Report-2011-2012.pdf; www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/corporate-responsibility/Documents/2011-survey.pdf

EXHIBIT 1.2

Corporate Sustainability Report 2011 *Logistics at the Core : Profile*

Independent Accountants' Report

Profile | Page 19

Deloitte & Touche LLP

Board of Directors, Shareowners, and Stakeholders
United Parcel Service, Inc.
Atlanta, Georgia

We have reviewed the accompanying Corporate Sustainability Report of United Parcel Service, Inc. (the "Company") for the year ended December 31, 2011. The Company's management is responsible for the Corporate Sustainability Report.

We conducted our review in accordance with attestation standards established by the American Institute of Certified Public Accountants, which includes AT Section 101, Attest Engagements. A review consists principally of applying analytical procedures, considering management assumptions, methods, and findings, and making inquiries of and evaluating responses from persons responsible for corporate social and operational matters. It is substantially less in scope than an examination, the objective of which is the expression of an opinion on the Corporate Sustainability Report. Accordingly, we do not express such an opinion. A review of the Corporate Sustainability Report is not intended to provide assurance on the entity's compliance with laws or regulations.

The preparation of the Corporate Sustainability Report requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Different entities may make different but acceptable interpretations and determinations. The Corporate Sustainability Report includes information regarding the Company's corporate social responsibility initiatives and targets, the estimated future impact of events that have occurred or are expected to occur, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

Based on our review, nothing came to our attention that caused us to believe that the Corporate Sustainability Report does not include, in all material respects, the required elements of the Global Reporting Initiative G3.1 Sustainability Reporting Framework for Application Level A; that the 2011, 2010, and 2009 data, and the 2007 Transportation Index baseline included therein have not been accurately derived, in all material respects, from the Company's records, or that the underlying information, determinations, estimates, and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

The comparative disclosures for periods prior to 2009, other than the 2007 Transportation Index baseline information, were not reviewed by us and, accordingly, we do not express any form of assurance on them.

June 26, 2012

Deloitte & Touche LLP

result, more companies than ever are directly integrating their sustainability initiatives into their overall business strategy and then seeking to quantify their sustainability and social responsibility efforts with measurable outputs. These measurements might help to quantify the company's performance in areas such as the environment, labor, and human rights. Exhibit 1.2 provides an example of the 2011 Sustainability Report for UPS. Although sustainability is a prominent example of an attestation engagement, other examples of attestation engagements completed by CPAs (discussed more in Module A) appear in the following box.

Examples of Attestation Engagements

- **Agreed Upon Procedures Engagements** (AT 201), such as verifying inventory quantities and locations.
- **Financial Forecasts and Projections** (AT 301), such as analysis of prospective or hypothetical "what-if" financial statements for some time period *in the future.*
- **Reporting on Pro Forma Financial Information** (AT 401), such as retroactively analyzing the effect of a proposed or consummated transaction on the *historical* financial statements "as if" that transaction had already occurred.
- **An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated with an Audit of Its Financial Statements** (AT 501), focused on the design and operating effectiveness of an entity's internal control over financial reporting.
- **Compliance Attestation** (AT 601), such as ascertaining a client's compliance with debt covenants.
- **Examination of Management's Discussion and Analysis** (AT 701), prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).
- **Reporting on Controls at a Service Organization** (AT 801), such as organizations that provide outsourced processes that are likely to be relevant to the user entities' internal control over financial reporting.

Assurance Services

Although *auditing* refers specifically to expressing an opinion on financial statements and *attestation* refers more generally to expressing an opinion on any type of information or subject matter that is the responsibility of another party (such as sustainability measures), *assurance services* includes an even broader set of information, including nonfinancial information. The following Auditing Insight indicates how the quality of information can assist both buyers and sellers in today's market.

AUDITING INSIGHT

Exhibit 1.3 shows two 1976 **Topps** Mike Schmidt baseball cards. The card on the right was offered on eBay with the seller's representation that the card was in Near Mint/Mint condition. This representation is a standard description and is the equivalent of a grade 8 on a standard 10-point scale used in grading the quality of a trading card. The card was purchased on **eBay** for $11.55.

Within a week, a second 1976 Topps Mike Schmidt baseball card was sold on eBay. Again, this card was offered with the seller's representation that the card was in Near Mint/Mint condition (card on the left). The only difference was that this card had been sent to **Professional Sports Authenticator** (PSA), a company that verifies the authenticity and quality of sports items. Note that PSA does not buy or sell sports merchandise; it acts only as an independent third party expressing a professional opinion regarding the merchandise in question. This card sold for $22.53.

The only difference between the two transactions was that the buyers of the card on the right had more information concerning the risk inherent in the transaction. Why was the first transaction riskier? What were the buyers' concerns? Were the concerns only from intentional misstatements? How did the grading of the card by PSA reduce these concerns? What are the incentives for PSA to grade the card accurately? How does the business of PSA relate to the profession of auditing?

EXHIBIT 1.3
Professional Sports Authenticator as Third-Party Assuror

Although the primary focus of our earlier discussion of information risk was in the context of economic decisions, information risk is present whenever someone must make a decision without having complete knowledge. The AICPA expanded the profession's traditional focus on accounting information to include all types of information, both financial and nonfinancial. The expanded services are collectively referred to as **assurance services**, which the AICPA defines as independent professional services that improve the quality of information, or its context, for decision makers. The major elements, and boundaries, of the definition are

- *Independence.* CPAs want to preserve their attestation and audit reputations and competitive advantages by preserving integrity and objectivity when performing assurance services.[3]
- *Professional services.* Virtually all work performed by CPAs (accounting, auditing, data management, taxation, management, marketing, finance) is defined as a professional service as long as it involves some element of judgment based on education and experience.
- *Improving the quality of information, or its context.* The emphasis is on information, CPAs' traditional stock in trade. CPAs can enhance quality by assuring users about the reliability and relevance of information, and these two features are closely related to the familiar credibility-lending products of attestation and auditing services. *Context* is relevance in a different light. For assurance services, improving the context of information refers not to the information itself but to how the information is used in a decision-making context. An example would be providing key information in a database that management could use to make important decisions.
- *For decision makers.* They are the consumers of assurance services, and they personify the consumer focus of different types of professional work. The decision makers are the beneficiaries of the assurance services. Depending upon the assignment, decision makers may be a very small, targeted group (e.g., managers of a database) or a large targeted group (e.g., potential investors interested in a mutual fund manager's performance).

Examples of Assurance Services

Although they are subsets of assurance services, attestation and auditing services are highly structured and intended to be useful for large groups of decision makers (e.g., investors, lenders). On the other hand, assurance services other than audit and attestation services tend to be more customized for use by smaller, targeted groups of decision makers. For example, many companies and organizations have used public accounting firms to conduct a comprehensive assessment of the risks the enterprise faces. This type of enterprise risk assessment can then be used to show stakeholders that the management team understands and is properly managing the risks the enterprise faces. We also present a few more examples of assurance services to illustrate the variety of services that fall under the assurance service umbrella. Some will look familiar and others may defy imagination. Be aware, however, that public accounting firms must pick and choose the services that they wish to provide to the market based on the expertise that lies within the firm. Nobody maintains that all public accounting firms will want or be able to provide all types of assurance services.

- XBRL (eXtensible Business Reporting Language) reporting.
- Information risk assessment and assurance.
- Third-party reimbursement maximization.
- Rental property operations review.
- Customer satisfaction surveys.
- Evaluation of investment management policies.

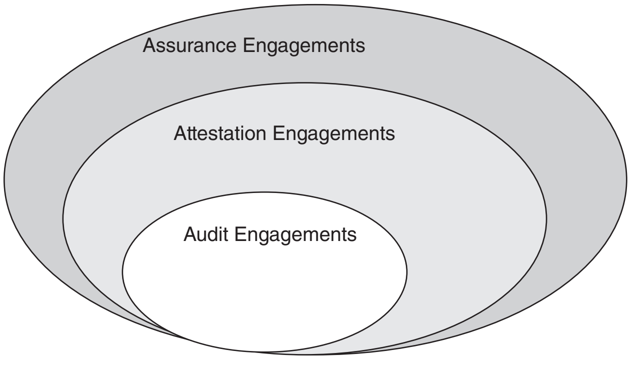
[3] A survey commissioned by the AICPA found that CPAs are viewed more positively than any other business professional by both business decision makers and investors. Sixty-nine percent of investors and 74 percent of business decision makers feel that "CPAs have a unique perspective that is valuable when making business and financial decisions, even when those decisions are not directly related to accounting." In terms of attributes ascribed to CPAs, they are most associated with integrity, competence, and objectivity ("Brand Research Shows CPAs Viewed Positively in Marketplace," *AICPA News Update,* October 20, 2008).

- Fraud and illegal acts prevention and deterrence.
- Accounts receivable review and cash enhancement.
- Internal audit outsourcing.

Attestation and auditing services are special types of assurance services, but consulting services are not. In providing consulting services, CPAs use their professional skills and experiences to provide recommendations to a client for outcomes such as information system design and operation; in assurance services, the focus is entirely on the information that decision makers use. However, like consulting services, assurance services do have a "customer focus," and CPAs develop assurance services that add value for customers (decision makers). Exhibit 1.4 depicts the relationships among assurance, attestation, and auditing services.

Although audits are specific types of assurance engagements and auditors can be described more generally as information assurors, hereafter we will use the term *auditor* instead of *information assuror* because of the specific responsibilities that auditors have under GAAS as well as under regulatory bodies such as the SEC and the Public Company Accounting Oversight Board (PCAOB). However, many of the procedures that auditors perform as part of an audit engagement are similar to those performed as part of other information assurance engagements. We will point out these shared procedures when appropriate.

EXHIBIT 1.4
The Relationships among Audit, Attestation, and Assurance Engagements



AUDITING INSIGHT — XBRL Reporting

Advances in information technology have allowed for more efficient reporting platforms that better meet the needs of decision makers. In that spirit, the AICPA is currently focused on a number of initiatives to help auditors meet the needs of their clients. Among the initiatives, the need to help companies with XBRL implementations for SEC reporting has taken center stage. XBRL (also referred to by the SEC as *interactive data*) is an information format designed specifically for business reporting. Through the "tagging" of specific data items (cash, inventory, sales transactions, etc.), XBRL facilitates the collection, summarization, and reporting of financial information in a medium that users can easily transform for their own decision-making purposes. For example, once the XBRL-formatted data is downloaded, users are able to easily compare information across companies, across financial reporting frameworks (such as IFRS and U.S. GAAP), and even across countries using different currency denominations. Information can be tagged early in the data collection process (at point of sale) such that preparers can easily collect and summarize financial information. Combining financial information from multiple accounting information systems in different company divisions is no longer the nightmare that it once was. The SEC now requires all U.S. public companies and foreign private issuers listed with the SEC to use XBRL for SEC filings. The "tagged" disclosures must include the companies' balance sheet, income statement, statement of comprehensive income, statement of cash flows, statement of owners' equity, footnote disclosures, and financial statement schedules.

Sources: "The Shifting Paradigm in Business Reporting and Assurance," AICPA Assurance Services Executive Committee, 2008; *SOP 09-01*, "Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data"; "SEC Rules for Reporting Financial Statements in XBRL Format." All three are available through the AICPA's Website (www.aicpa.org).

REVIEW CHECKPOINTS

1.4 Define and explain auditing. What would you answer if asked by an anthropology major, "What do *auditors* do?"

1.5 What is an *attestation engagement?*

1.6 What is an *assurance service engagement?*

1.7 In what ways are assurance services similar to attestation services (including audits of financial statements)?

1.8 What are the four major elements of the broad definition of assurance services?

MANAGEMENT'S FINANCIAL STATEMENT ASSERTIONS

LO 1-3
Describe and define the assertions that management makes about the recognition, measurement, presentation, and disclosure of the financial statements and explain why auditors use them as the focal point of the audit.

From your earlier studies, you know that accounting is the process of recording, classifying, and summarizing a company's transactions into financial statements that will create assets, liabilities, equities, revenues, expenses, and related disclosures. It is the means of satisfying users' demands for financial information that arise from the forces of complexity, remoteness, time-sensitivity, and consequences.

Auditing does not include the function of financial report production. The function of **financial reporting** is to provide statements of financial position (balance sheets), results of operations (income statements, statements of shareholders' equity, and statements of comprehensive income), changes in cash flows (statements of cash flows), and accompanying disclosures (footnotes) to outside decision makers who do not have access to management's internal sources of information. A company's accountants, under the direction of its management, perform this function. In fact, auditing standards emphasize that the financial statements are the responsibility of a company's management. Thus, the financial statements contain management's assertions about the *transactions and events* that occurred during the period being audited (primarily the income statement, statement of shareholders' equity, statement of comprehensive income, and statement of cash flows), assertions about the *account balances* at the end of the period (primarily the balance sheet), and assertions about the financial statement *presentation and disclosure* (primarily the footnote disclosures).

AUDITING INSIGHT

Sarbanes-Oxley and Management's Responsibility for Financial Reporting

Congress passed the Sarbanes-Oxley Act in 2002 in an attempt to address a number of weaknesses found in corporate financial reporting as a result of the frauds at companies such as WorldCom and Enron. Although the preparation of the financial statements has always been the responsibility of management, Sarbanes-Oxley has enhanced the disclosure provisions to create a heightened sense of accountability. One of its most important provisions (Section 302) states that key company officials must certify the financial statements. Certification means that the company's chief executive officer and chief financial officer must sign a statement indicating

1. They have read the financial statements.
2. They are not aware of any false or misleading statements (or any key omitted disclosures).
3. They believe that the financial statements present an accurate picture of the company's financial condition.

Management must also make assertions regarding the effectiveness of the company's internal controls over financial reporting using the COSO framework as its benchmark for effectiveness. The auditors are also required to issue an attestation report (Section 404) on the system of internal controls to provide assurance that the system of internal controls over financial reporting has been designed and is operating effectively.

Source: U.S. Congress, *Sarbanes-Oxley Act of 2002,* Pub. L. No. 107-204, 116 Stat. 745 (2002).

As the Auditing Insight about Sarbanes-Oxley makes clear, the upper management team at public companies must certify the correctness of the financial statement and the effectiveness of the internal control system for financial reporting. Given the current focus on internal controls, first-year audit professionals are expected to understand the relationship between a company's internal control activities and the relevant financial statement assertions about the financial statement account balances. We suggest that as a new auditing professional, detailed understanding of this relationship will provide you with the opportunity to immediately contribute to the audit team. As a result, we are hopeful that this book can provide a foundation of knowledge to help simplify the relationship, which is paramount in the post-Sarbanes-Oxley environment.

When planning the audit engagement, auditors use management's assertions to assess external financial reporting risks by determining the different types of misstatements that could occur for each of the relevant management assertions identified and then develops audit procedures that are appropriate in the circumstances. The auditing procedures are completed to provide the evidence necessary to persuade the auditor that there is no material misstatement related to each of the relevant assertions. Once the auditor is satisfied that the evidence has supported the assertions, the auditor issues a report to provide assurance to financial statement users that the financial statements are free of material misstatement in accordance with generally accepted accounting principles. As an auditor, you must keep in mind the importance of understanding the management assertions about the financial statements and related disclosures and always remember that you are serving the entire public interest, including stakeholders such as bankers, investors, and employees in asserting that the financial statements are free of material misstatement.

Exhibit 1.5 provides a list of all of management's assertions and some of the key questions that the audit team must address about each assertion. Note that column 1 in Exhibit 1.5 denotes the management assertions currently identified by the PCAOB for public company audits.[4] The PCAOB auditing standards do allow auditors to use a finer classification of the management assertions at their discretion. Importantly, the Auditing Standards Board (ASB)[5] provided an additional classification of management assertions (columns 2 through 4 in Exhibit 1.5). You will note that the ASB assertion classification, while in direct alignment with the PCAOB assertions, does provide greater detail and clarity for students of auditing to conceptualize. As a result, largely all of the firms auditing public companies with international operations feature the ASB assertions as a starting point to guide their auditing processes. The key questions (column 5) indicate how each of these assertions must be thought about when evaluating specific aspects of management's financial statements and disclosures. Each of the assertions is defined and described in detail in the following sections, organized along the lines of the PCAOB assertions identified in column 1, with the aligned ASB assertion following in parentheses.

Existence or Occurrence (Existence, Occurrence)

The numbers listed on the financial statements have no meaning to financial statement users unless they *faithfully represent* the actual transactions, assets, and liabilities of the company. *Existence* asserts that each of the balance sheet and income statement balances actually exist. *Occurrence* asserts that each of the income statement events and transactions actually did occur. (As a general rule, the *occurrence* transaction relates to events,

[4]The Public Company Accounting Oversight Board (PCAOB) is a nonprofit corporation established by Congress to oversee the audits of public companies. The Securities and Exchange Commission (SEC) has oversight authority, including approval of all standards and rules. The PCAOB is discussed in more detail in Chapter 2.

[5]The ASB was established by the profession to issue auditing standards. Standards issued by the ASB apply to audits of all companies. The ASB is discussed in more detail in Chapter 2.

EXHIBIT 1.5 **Management Assertions**

(1) PCAOB Assertions	(2) Assertions about Events and Transactions	(3) Assertions about Account Balances	(4) Assertions about Presentation and Footnote Disclosures	(5) Key Questions
	ASB Assertions			
Existence or **occurrence**	Occurrence	Existence	Occurrence	Do the assets listed really exist?
				Did the recorded sales transactions really occur?
Rights and obligations		Rights and obligations	Rights and obligations	Does the company really own the assets?
				Are related legal responsibilities identified?
Completeness	Completeness	Completeness	Completeness	Are the financial statements (including footnotes) complete?
				Were all transactions recorded?
	Cutoff			Are transactions at the beginning or end of a period included in the proper period?
Valuation or allocation	Accuracy	Valuation and allocation	Accuracy	Are the accounts valued correctly?
			Valuation and allocation	Are expenses allocated to the period(s) benefited?
Presentation and disclosure	Classification		Classification	Were all transactions recorded in the correct accounts?
			Understandability	Are the disclosures understandable to users?

transactions, presentations, and footnote disclosures (as indicated in columns 2 and 4 of Exhibit 1.5), and the *existence* assertion relates to account balances (as indicated in column 3). Therefore, auditors must test whether the balance sheet amounts reported as assets, liabilities, and equities actually *exist.* To test the existence assertion, auditors typically confirm cash and count the physical inventory, confirm receivables and insurance policies with customers, and perform other procedures to obtain evidence whether management's assertion is in fact supported. Similarly, management asserts that each of the revenue and expense transactions summarized on the income statement or disclosed in the financial statement footnotes really did occur during the period being audited. To

AUDITING INSIGHT

Q: When Is a Sale of Computer Disk Drives Not a Sale? A: When They Are Bricks.

Miniscribe was a manufacturer of computer disk drives. When sales did not occur at a sufficient level to support the company's efforts to obtain outside financing, management generated fictitious sales to fraudulently boost the company's net income. After first sending obsolete inventory to customers who never ordered the goods, the company packaged bricks (about the same size and shape as the company's disk drives of that time) in disk drive boxes and shipped them to "customers" that were in fact company-owned warehouses.

test the occurrence assertion, auditors complete procedures to ensure that the reported sales transactions really did occur and were not created to fraudulently inflate the company's profits.

Rights and Obligations (Rights and Obligations)

In the financial statements, management asserts that they have property rights for all amounts reported as assets on the company's balance sheet and that the amounts reported as liabilities represent the company's own obligations. In simpler terms, the objective for an auditor is to obtain evidence that the assets are really owned by and the liabilities are really owed by the company being audited. You should be careful about *ownership,* however, because the assertion extends to include assets for which a company may not actually hold title. For example, an auditor will have a specific objective of obtaining evidence about the amounts capitalized for leased property. Likewise, *owing* includes accounting liabilities a company may not yet be legally obligated to pay. For example, specific objectives would include obtaining evidence about the estimated liability for product warranties. The auditor also has an obligation to ensure that the details of the company's obligations are disclosed in the footnotes to the financial statements.

Completeness (Completeness, Cutoff)

In the financial statements, management asserts that all transactions, events, assets, liabilities, and equities that should have been recorded have been recorded. In addition, management asserts that all disclosures that should have been included in the footnotes have been presented. Thus, auditors' specific objectives include obtaining evidence to determine whether, for example, all inventory is included, all accounts payable are included, all notes payable are included, all expenses are recorded, and so forth. A verbal or written management representation saying that all transactions are included in the accounts is not considered a sufficient basis for deciding whether the completeness assertion is true. Auditors need to obtain persuasive evidence about completeness.

Cutoff is a special classification of completeness. **Cutoff** refers to accounting for revenue, expense, and other transactions in the *proper period* (neither postponing some recordings to the next period nor accelerating next-period transactions into the current-year accounts). Simple cutoff errors can occur when (1) a company records late December sales invoices for goods not actually shipped until early January; (2) a company records cash receipts through the end of the week (e.g., Friday, January 4) and the last batch for the year should have been processed on December 31; (3) a company fails to record accruals for expenses incurred but not yet paid, thus understating both expenses and liabilities; (4) a company fails to record purchases of materials shipped FOB shipping point but not yet received and, therefore, not included in the ending inventory, thus understating both inventory and accounts payable; and (5) a company fails to accrue unbilled revenue through the fiscal year-end for customers on a cycle billing system, thus understating both revenue and accounts receivable. In auditor's jargon, the *cutoff date* generally refers to the client's year-end balance sheet date.

Valuation and Allocation (Accuracy or Valuation)

In the financial statements, management asserts that the transactions and events have been recorded accurately and that the assets, liabilities, and equities listed on the balance sheet have been valued in accordance with GAAP (or IFRS). The audit objective related to valuation and allocation is to determine whether proper values have been assigned to assets, liabilities, and equities. *Allocation* refers to the appropriate percentage of an asset or liability balance being recorded on the income statement in accordance with GAAP (or IFRS). For example, has the proper depreciation expense been calculated for each fixed asset amount? *Accuracy* refers to the appropriate recording of the transactions involving these items. Auditors obtain evidence about specific valuations and mathematical accuracy by comparing vendors' invoices to inventory prices, obtaining lower-of-cost-or-market data, evaluating collectability of receivables, recalculating depreciation schedules, and so forth. Many valuation, accuracy, and allocation decisions amount to making decisions about the proper application of GAAP (or IFRS). For example, due to a recent shift in the accounting standards related to fair value (i.e., *ASC Topic 820*), there has been an increased focus on the valuation assertion.

Presentation and Disclosure (Classification, Understandability)

In the financial statements, management asserts that all transactions and events have been presented correctly in accordance with GAAP (or IFRS) and that all relevant information has been disclosed to financial statement users, usually in the footnotes to the financial statements. This assertion embodies several different components. First, disclosures must be relevant, reliable, and understandable or transparent to financial statement users. In addition, auditors will test to make sure that all have the proper disclosures made in accordance with GAAP (or IFRS). To complete this step, auditors will often use a disclosure checklist that highlights all the disclosures that should be made for a particular entity.

Second, transactions must be classified in the correct accounts (e.g., proper current and long-term balance sheet classification of assets and liabilities). To test this assertion, auditors perform audit procedures such as analyzing repair and maintenance expenses to ensure that that they should in fact have been expensed rather than capitalized. Similarly, auditors will test from the opposite direction, examining additions to buildings and equipment to ensure that transactions that should have been expensed were not in fact capitalized in error. The auditing insight about WorldCom provides an example of the importance of this financial statement assertion.

AUDITING INSIGHT — Is Your Telephone Bill an Asset?

WorldCom routinely leased telephone lines from local telephone companies (basically the last segment entering a subscriber's home). However, rather than record the cost of these lines as an expense on the income statement, the company capitalized them as assets on the balance sheet, resulting in an estimated $11 *billion* fraudulent overstatement of net income. WorldCom management argued that because the leased lines were not fully used to capacity, the expense should be deferred until the lines started to produce revenue (i.e., the matching concept). Moreover, because they controlled the telephone lines as a result of the long-term lease agreements, no one else could use the telephone lines and, therefore, the exclusivity rights should be treated as an asset. (This explanation is analogous to your saying that your monthly phone bill expense is really an asset because no one else can use your phone number while you use it.) An internal auditor uncovered the fraud and reported her findings to the company's board of directors.

Source: WorldCom Board of Directors' Special Investigative Committee Report, June 9, 2003.

Third, to be useful to decision makers, information must be understandable. *Statement of Financial Accounting Concepts (SFAC) No. 2,* "Qualitative Characteristics of Accounting Information," defines *understandability* as "the quality of information that enables users to perceive its significance." The responsibility levied on auditors is to make sure that the financial statements are "transparent." In other words, investors should be able to understand how the company is doing by reading its financial statements and footnotes and should not have to rely on financial experts or lawyers to help them figure out what the fine print is saying. Another way to regard this assertion is to ask whether the disclosures have been written in *plain English.* Consider the following Auditing Insight highlighting the financial disclosures at Enron.

AUDITING INSIGHT Say What?

Financial analysts generally regarded Enron's financial disclosures in its annual report as incomprehensible. In fact, Enron's management took pride in the fact that no one could figure out what they were doing to generate incredibly high revenues. A 2003 Congressional Joint Committee on Taxation concluded that Enron's tax avoidance schemes (including 692 partnerships in the Cayman Islands) were "so complex that the IRS has been unable to understand them" (*The New York Times,* February 13, 2003). Following is an excerpt from *Enron's 2001 Annual Report* describing some of its business activities:

> Trading Activities. Enron offers price risk management services to wholesale, commercial and industrial customers through a variety of financial and other instruments including forward contracts involving physical delivery, swap agreements, which require payments to (or receipt of payments from) counterparties based on the differential between a fixed and variable price for the commodity, options and other contractual arrangements. Interest rate risks and foreign currency risks associated with the fair value of the commodity portfolio are managed using a variety of financial instruments, including financial futures.

Source: Enron 2001 Annual Report.

Unfortunately, due in large part to the incomprehensibility of its financial disclosures, no one realized the extreme risks that Enron was taking until it was too late. The company, which reported the fifth-highest revenues in the United States in 2000, filed for bankruptcy in 2001.

Importance of Assertions

The financial statement assertions are important and at times can be difficult to comprehend. A student of auditing must remember that the key questions that must be answered about each assertion become the *focal points* for the audit procedures to be performed. In other words, audit procedures are the means to answer the key questions posed by management's financial statement assertions. When evidence-gathering audit procedures are specified, you need to be able to relate the evidence produced by each procedure to one or more specific assertions. In essence, the secret to writing and reviewing a list of audit procedures is to ask, "Which assertion(s) does this procedure produce evidence about?" Then ask, "Does the list of procedures (the *audit plan*) cover all the assertions?" Exhibit 1.6 illustrates how the assertions relate to the financial statements.

Although standards-setting bodies such as the PCAOB and ASB try to neatly categorize transactions, balances, and disclosures according to the different assertions, the *real world* is seldom as orderly. For example, although cutoff procedures provide evidence about completeness, they also provide evidence about valuation and existence. Prematurely recording sales transactions inflates revenue and/or asset values because the transaction did not *occur* by the income statement date. Similarly, if a cutoff test shows a delay in recording a liability, the liability is not only incomplete but *undervalued* as well. Thus, errors in financial statements may affect multiple management assertions.

REVIEW CHECKPOINTS

1.9 What is the difference between financial statement auditing and financial accounting?

1.10 List and briefly explain each of the Auditing Standards Board's management assertions. List at least one key question that auditors must answer with evidence related to each management assertion.

1.11 Why is the Auditing Standards Board's set of management assertions important to auditors? Do these assertions differ from those included in PCAOB standards? If so, how are they different?

EXHIBIT 1.6 Management Assertions and Their Relationship to the Financial Statements

STATEMENT OF FINANCIAL CONDITION
APOLLO SHOES INC.
in thousands

As of December 31	2014	2013
Assets		
Cash	$3,245	$3,509
Accounts Receivable (Net of Allowances of $1,263 and 210, respectively) (Note 3)	15,148	2,738
Inventory (Note 4)	15,813	13,823
Prepaid Expenses	951	352
Current Assets	$35,157	$20,422
Property, Plant, and Equipment (Note 5)	1,174	300
Less Accumulated Depreciation	(164)	(31)
	$1,010	$269
Investments (Note 6)	613	613
Other Assets	14	0
Total Assets	$36,794	$21,304
Liabilities and Shareholders' Equity		
Accounts Payable and Accrued Expenses	$4,675	$3,556
Short-Term Liabilities (Note 7)	10,000	0
Current Liabilities	$14,675	3,556
Long-Term Debt (Note 7)	0	0
Total Liabilities	$14,675	3,556
Common Stock	8,105	8,105
Additional Paid-in Capital	7,743	7,743
Retained Earnings	6,271	1,900
Total Shareholders' Equity	$22,119	$17,748
Total Liabilities and Shareholders' Equity	$36,794	$21,304

The accompanying notes are an integral part of the consolidated financial statements.

Existence—Does this cash really exist?

Rights and Obligations—Does the company really own this inventory?

Valuation or Allocation—Are these investments properly valued?

STATEMENTS OF INCOME
APOLLO SHOES INC.
in thousands (except per share data)

For year ended December 31,	2014	2013
Net Sales (Note 2)	$240,575	$236,299
Cost of Sales	$141,569	$120,880
Gross Profit	$99,006	$115,419
Selling, General and Administrative Expenses	$71,998	$61,949
Interest Expense (Note 7)	$875	0
Other Expense (Income)	($204)	($1,210)
Earnings from Continuing Operations Before Taxes	$26,337	$54,680
Income Tax Expense (Note 10)	$10,271	$21,634
Earnings from Continuing Operations	$16,066	$33,046
Discontinued Operations, Net of tax benefit		($31,301)
Extraordinary Item, Net of tax benefit (Note 11)	($11,695)	
Net Income	$4,371	$1,745
Earnings Per Common Share		
From Continuing Operations	$1.98	$4.08
Other	($1.44)	($3.86)
Net Income	$0.54	$0.22
Weighted shares of common stock outstanding	8,105	8,105

The accompanying notes are an integral part of the consolidated financial statements.

Occurrence—Did these sales transactions really take place?

Completeness—Are all the expenses included? Are they recorded in the correct period?

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
APOLLO SHOES, INC.

1. Summary of Significant Accounting Policies

Business activity The Company develops and markets technologically superior podiatric athletic products under various trademarks, including *SIREN, SPOTLIGHT*, and *SPEAKERSHOE*.

Marketable Securities Investments are valued using the market value method for investments of less than 20%, and by the equity method for investments greater than 20% but less than 50%.

Cash equivalents Cash equivalents are defined as highly liquid investments with original maturities of three months or less at date of purchase.

Inventory valuation Inventories are stated at the lower of First-in, First-out (FIFO) or market.

Property and equipment and depreciation Property and equipment are stated at cost. The Company uses the straight-line method of depreciation for all additions to property, plant, and equipment.

Intangibles Intangibles are amortized on the straight-line method over periods benefited.

Net Sales Sales for 2014 and 2013 are presented net of sales returns and allowances of $4.5 million, and $0.9 million, respectively, and net of warranty expenses of $ 1.1 million, and $0.9 million, respectively.

Income taxes Deferred income taxes are provided for the tax effects of timing differences in reporting the results of operations for financial statements and income tax purposes, and relate principally to valuation reserves for accounts receivable and inventory, accelerated depreciation and unearned compensation.

Net income per common share Net income per common share is computed based on the weighted average number of common and common equivalent shares outstanding for the period.

Reclassification Certain amounts have been reclassified to conform to the 2013 presentation.

2. Significant Customers

Approximately 15%, and 11% of sales are to one customer for years ended December 31, 2014 and 2013, respectively.

Presentation and Disclosure—Are these disclosures understandable? Has everything been disclosed that should be?

PROFESSIONAL SKEPTICISM

LO 1-4
Define professional skepticism and explain its key characteristics.

"Doveryai, no Proveryai" (Trust, but Verify)

—President Ronald Reagan to Soviet Prime Minister Mikhail Gorbachev during Cold War missile reduction talks

Professional skepticism is defined in the professional auditing standards as having an attitude that "includes a questioning mind and a critical assessment of evidence." Essentially, it is an auditor's responsibility to *not* accept management assertions without corroboration.

AUDITING INSIGHT Why be Skeptical?

When **Lehman Brothers** filed for bankruptcy in September 2008, it was reportedly the largest bankruptcy in U.S. history. How could such a large firm seem to collapse so suddenly? Auditors at **Ernst & Young** (EY) have been identified, along with other investment banks and senior Lehman executives, for having played a role in the firm's demise. In fact, the attorney general of New York filed a civil fraud lawsuit against EY in December 2010 and is claiming that the accounting firm helped to "disguise" the financial condition of Lehman for at least seven years. The lawsuit describes a "cozy" relationship between Lehman and EY. The reason? "Two of Lehman's chief financial officers were former EY employees during much of the seven-year period when the transactions occurred" and "Ernst & Young charged Lehman $150 million in audit fees over a seven-year period of time."

Source: "Ernst Accused of Lehman Whitewash," *The Wall Street Journal,* December 22, 2010, p. C1.

Stated differently, an auditor must ask management to "prove" each of the relevant assertions with documentary evidence. The occurrence of errors and fraud in financial reports highlights the following basic premise, which underlies the importance of professional skepticism: *A potential conflict of interest always exists between the auditors and the management of the company being audited.* This potential conflict arises because management wants to present the company in the best possible light whereas auditors must ensure that the information about the company's financial condition is "presented fairly."

With full awareness of this potential conflict of interest, auditors must always remain professional in their relationships with management, not adversarial or confrontational. Nevertheless, knowing that a potential conflict of interest always exists causes auditors to perform procedures to search for errors and frauds that could have a material effect on the financial statements. And, even though the vast majority of audits do not contain fraud, auditors have no choice but to exercise professional skepticism at all times and on all audits because of misdeeds perpetrated by just a few people in a few companies. The professional standards emphasize the importance of maintaining and then applying an attitude of professional skepticism throughout the entire audit process.

Auditing firms have long recognized the importance of exercising professional skepticism when making professional judgments. In fact, as illustrated in the following Auditing Insight, firms have increasingly stressed the importance of being skeptical when evaluating documentary evidence. As an auditing student, you can definitely expect to encounter difficult economic transactions as an auditor. When auditors encounter a difficult transaction they must take the time to fully understand the economic substance of that transaction and then critically evaluate, with skepticism, the evidence provided by the client to justify its accounting treatment. No shortcuts are allowed. Rather, auditors are required to be unbiased and objective when making their professional judgments.

AUDITING INSIGHT Overcoming Judgment Biases: The Importance of Professional Judgment

Judgment and decision-making researchers in auditing have long known about common biases that can interfere with or obstruct auditors from making excellent professional judgments. One example is the *anchoring bias,* which recognizes the possibility that an auditor might "anchor" on a number provided by a client manager (e.g., an estimate for the allowance for doubtful accounts) and then have difficulty adjusting to the economically correct amount. In their recent monograph entitled "Elevating Professional Judgment in Accounting and Auditing," KPMG (2011) outlines a professional judgment framework designed to help auditors to mitigate professional judgment biases like the anchoring bias. In order to do so, auditors must first be aware of the possibility that these biases might interfere with their professional judgment. Beyond awareness, the monograph argues that auditors must follow a disciplined process that includes (1) clarifying the issues and objectives, (2) considering the possible alternatives, (3) gathering and evaluating the relevant evidence, (4) reaching an audit conclusion, and (5) carefully documenting their rationale for the professional judgment reached. And, perhaps most importantly, the monograph emphasizes the importance of an auditor to exercise professional skepticism throughout the entire process.

Source: "Elevating Professional Judgment in Accounting and Auditing: The KPMG Professional Judgment Framework" (Montvale, NJ: KMPG, 2011).

AUDITING INSIGHT Professional Skepticism

In a recent Staff Audit Practice Alert, the PCAOB expressed serious concern about "whether auditors consistently and diligently apply professional skepticism." The alert recognizes that there are a number of factors that could "impede" the application of professional skepticism but stresses the importance of taking whatever actions are necessary to make sure that professional skepticism is applied in an appropriate manner throughout the audit process.

THE HURTT SKEPTICISM SCALE

How skeptical are you? Answer the following 30 questions to find out. As a benchmark, business students typically fall between 90 to 150 points; auditors score much higher.

Questions	Strongly Disagree					Strongly Agree
1. I often accept other people's explanations without further thought.	1	2	3	4	5	6
2. I feel good about myself.	1	2	3	4	5	6
3. I wait to decide on issues until I can get more information.	1	2	3	4	5	6
4. The prospect of learning excites me.	1	2	3	4	5	6
5. I am interested in what causes people to behave the way that they do.	1	2	3	4	5	6
6. I am confident of my abilities.	1	2	3	4	5	6
7. I often reject statements unless I have proof that they are true.	1	2	3	4	5	6
8. Discovering new information is fun.	1	2	3	4	5	6
9. I take my time when making decisions.	1	2	3	4	5	6
10. I tend to immediately accept what other people tell me.	1	2	3	4	5	6
11. Other people's behavior does not interest me.	1	2	3	4	5	6
12. I am self-assured.	1	2	3	4	5	6
13. My friends tell me that I usually question things that I see or hear.	1	2	3	4	5	6
14. I like to understand the reason for other people's behavior.	1	2	3	4	5	6
15. I think that learning is exciting.	1	2	3	4	5	6
16. I usually accept things I see, read, or hear at face value.	1	2	3	4	5	6
17. I do not feel sure of myself.	1	2	3	4	5	6
18. I usually notice inconsistencies in explanations.	1	2	3	4	5	6
19. Most often I agree with what the others in my group think.	1	2	3	4	5	6
20. I dislike having to make decisions quickly.	1	2	3	4	5	6
21. I have confidence in myself.	1	2	3	4	5	6
22. I do not like to decide until I've looked at all of the readily available information.	1	2	3	4	5	6
23. I like searching for knowledge.	1	2	3	4	5	6
24. I frequently question things that I see or hear.	1	2	3	4	5	6
25. It is easy for other people to convince me.	1	2	3	4	5	6
26. I seldom consider why people behave in a certain way.	1	2	3	4	5	6
27. I like to ensure that I've considered most available information before making a decision.	1	2	3	4	5	6
28. I enjoy trying to determine if what I read or hear is true.	1	2	3	4	5	6
29. I relish learning.	1	2	3	4	5	6
30. The actions people take and the reasons for those actions are fascinating.	1	2	3	4	5	6

Sources: Kathy Hurtt, "Development of a Scale to Measure Professional Skepticism," *Auditing: A Journal of Practice & Theory 29,* no. 1 (May 2010), pp. 149–171 and Public Company Accounting Oversight Board (PCAOB); *Staff Audit Practice Alert No. 10: Maintaining and Applying Professional Skepticism in Audits* (Washington, DC: PCAOB, 2012).

Persuading a skeptical auditor is not impossible, just somewhat more difficult than persuading a normal person in an everyday context. Skepticism is a manifestation of objectivity, holding no special concern for preconceived conclusions on any side of an issue. In fact, the auditor should not care about the impact that an economic transaction has on the "bottom line" of a company, only that the accounting rules were followed and were properly applied and that the financial statements are appropriate for the user's needs. Skepticism is not being cynical, hypercritical, or scornful. The properly skeptical auditor asks questions such as the following: (1) What do I need to know? (2) How well do I know it? (3) Does it make sense? (4) What can go wrong?

Auditors understand that receiving explanations from an entity's management is merely the first step in the professional judgment process, not the last. Listen to the explanation, and then examine or test it by looking at sufficient competent audit evidence. The familiar phrase "healthy skepticism" should be viewed as a show-me attitude, not a predisposition to accepting unsubstantiated explanations. Auditors must gather the evidence needed, uncover all the implications from the evidence, and then arrive at the most appropriate and supportable conclusion. Time pressure to complete a financial statement audit engagement is no excuse for failing to exercise professional skepticism. Too many auditors have gotten themselves into trouble by accepting a manager's glib explanation and stopping too early in an investigation without seeking corroborating evidence.

Although the SEC places constraints on the common practice of auditors' joining public clients that they have previously audited, often close relationships exist between former colleagues now employed by the client and members of the audit team. In these cases, the audit team must guard against being too trusting in accepting representations about the client's financial statements. Of more concern is the fact that former colleagues have inside knowledge of the firm's practices and procedures, knowing where the audit team will probably look (and where they might not look).

To summarize, due care requires an auditor to be professionally skeptical and question all material representations made by management (whether written or oral) during the professional judgment process. Although this attitude must be balanced by maintaining healthy client relationships, auditors should never assume management to be perfectly honest. The key lies in auditors' skeptical attitude toward gathering and evaluating the evidence necessary to reach supportable conclusions.

REVIEW CHECKPOINT

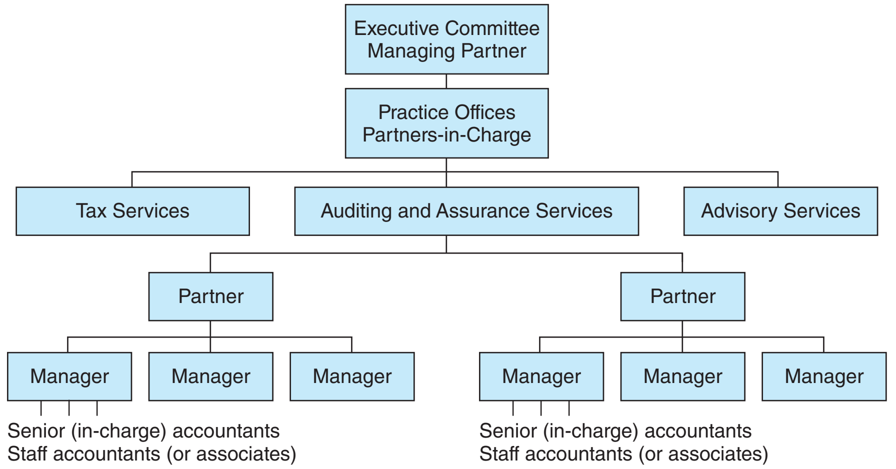
1.12 Why should auditors act as though there is always a potential conflict of interest between the auditor and the management of the enterprise under audit?

PUBLIC ACCOUNTING

LO 1-5
Describe the organization of public accounting firms and identify the various services that they offer.

Many people think of public accounting, financial statement auditing, and information assurance services in terms of the largest international accounting firms. Notwithstanding this perception, the practice of public accounting is conducted in thousands of practice units ranging in size from sole proprietorships (individuals who "hang out a shingle" in front of their homes) to the largest international firms with thousands of professionals. Furthermore, many public accounting firms no longer designate themselves as *CPA firms.* Many of them describe their businesses and their organizations as *professional services firms* or some variation on this term. Exhibit 1.7 shows an organization for a typical public accounting firm. However, some firms differ in their organization. Some have other departments such as small business advisory and forensic accounting. Other firms may be organized by industry (e.g., entertainment, oil and gas, health care, financial institutions) to take advantage of firmwide expertise. Some firms have other names for their staff and management positions.

EXHIBIT 1.7
Public Accounting Firm Organization



Assurance Services

Generally speaking, assurance services involve lending credibility to information, whether financial or nonfinancial. CPAs have assured vote counts (Academy Awards), dollar amounts of prizes that sweepstakes have claimed to award, accuracy of advertisements, investment performance statistics, and characteristics claimed for computer software programs. Although assurance services (separate and distinct from auditing) currently represent a fairly small part of a normal firm's operating revenues, the AICPA continues to make an effort to market these additional services to the public and businesses.

AUDITING INSIGHT — Pushing the Envelopes

On Oscar night, Hollywood's Best Kept Secret Award surely goes to the hard-working team of accountants from **PwC**. For 79 years running, PwC has maintained its role of overseeing the validity of the entire voting process and making sure that integrity is upheld. The system employed by PwC includes the exact tallying of each and every ballot case by voters and making sure that the results are kept confidential from the press. In fact, the two partners assigned to lead the team even commit the winners to memory in case one of the starry-eyed presenters loses the envelope. And, as you may have guessed, these two partners are positioned backstage during the entire event, handing the official ballot to the award presenters as they approach the podium.

Source: www.pwc.com.

At the present time, assurance services primarily include financial statement audit engagements and attestation engagements. We discuss these services as a component of assurance services that public accounting firms offer.

Auditing Services

Most of the large, international accounting (Big Four) firms were founded around the turn of the 20th century (late 1800s/early 1900s) during the Industrial Revolution as European financiers sent representatives (individuals whom we now refer to as *auditors*) to check up on their investments (mostly railroads) in the United States. As such, the primary focus of their practice has been traditional accounting and auditing services. Audits of traditional financial statements remain the most frequent type of assurance engagement that public companies (and most large and medium nonpublic companies) demand. Exhibit 1.8 shows the auditing (and other assurance services) revenues of the Big Four accounting firms based on their 2012 annual reports. This level of auditing activity dramatically drops as the size of the public accounting firm decreases. In other words, smaller firms usually provide more of the other types of nonaudit attestation engagements.

EXHIBIT 1.8 Revenues for the Big Four CPA Firms

	Deloitte[1]	EY[2]	KPMG[3]	PwC[4]
Total revenues (in billions)	$31.3	$24.4	$23.0	$31.5
Auditing and assurance services revenues (in billions and as a percent of revenue)	$13.0 41%	$10.9 45%	$10.3 45%	$14.9 47%
Tax revenues (in billions and as a percent of revenue)	$5.9 19%	$6.4 26%	$4.9 21%	$7.9 25%
Consulting and advisory services revenues (in billions and as a percent of revenue)	$12.4 40%	$7.1 29%	$7.8 34%	$8.7 28%

[1]Deloitte, Annual Review 2012.
[2]Ernst & Young Global Review 2012.
[3]KPMG International Annual Review 2012.
[4]PwC, Annual Review 2012.

Nonaudit Attestation Engagements

Basic accounting and review services are "nonaudit" services, performed frequently for medium and small businesses and not-for-profit organizations. Small public accounting firms perform a great deal of this type of nonaudit work. For example, CPAs can perform a *compilation,* which consists of preparing financial statements from a client's books and records, without performing any evidence-gathering work. They can also perform a *review,* in which limited evidence-gathering work is performed but which is narrower in scope than an audit. Although these are the most common attestation engagements, CPAs also can attest to the accuracy of management's discussion and analysis (MD&A) that accompanies the financial statements in an annual report, an entity's internal controls, and hypothetical "what-if" projections relating to mergers or acquisitions.

Tax Services

Local, state, national, and international tax laws are often called "accountant and attorney full-employment acts"! The laws are complex and CPAs perform tax planning services and tax return preparation in the areas of income, gift, estate, property, and other taxation. A large proportion of the practice in small public accounting firms is tax related. Tax laws change frequently, and tax practitioners must spend considerable time in continuing education and self-study to keep current. Exhibit 1.8 shows the tax revenues of the Big Four accounting firms based on their 2012 annual reports. Smaller public accounting firms tend to do more tax consulting engagements and fewer audit engagements.

The role of tax consulting in a professional services firm has at times faced scrutiny. The *Statements on Responsibilities in Tax Practice* specifically state that "A CPA has both the right and responsibility to be an advocate for the client" in arguing tax positions with the IRS [TX 112.04]. Can the CPA be an advocate for the client with respect to tax matters and maintain objectivity with regard to other audit matters? Recent guidance from the Public Company Accounting Oversight Board (PCAOB) prohibits an accounting firm from providing auditing services to a public company if the accounting firm provides tax consulting on aggressive interpretations of tax laws or "listed" transactions (those included on the U.S. Treasury Department's list of questionable tax strategies), if contingent fees (i.e., fees depending on a certain outcome) are involved, or if the public accounting firm provides tax services for key company executives. In all three cases, the PCAOB argues that auditor independence would be impaired. Providing normal corporate tax return preparation and advice is permissible as long as the audit committee discusses with the accounting firm the implications of the tax consulting fees on auditor independence and pre-approves the relationship in writing.

Consulting and Advisory Services

Prior to the turn of this century (the 1990s), the largest public accounting firms handled a great deal of consulting business. Consulting and management advisory services seemed to present a great new revenue opportunity, and the field appeared to be virtually unlimited. Public accounting firms tried to become "one-stop shopping centers" for clients' auditing, taxation, and business advice needs.

The Securities and Exchange Commission (SEC), the governmental agency charged with investor protection, expressed reservations as to whether the performance of nonaudit services (such as consulting) impaired a public accounting firm's ability to conduct an independent audit. The SEC's concern was that the large amount of revenues generated from consulting services might sway the auditor's opinion on the company's financial statements. The public accounting firms, on the other hand, argued that the provision of consulting services allowed them a closer look at the client's operations, providing a synergistic, positive effect on the audit.

In response to the spate of corporate frauds, Congress resolved this difference of opinion, in part, by passing the Sarbanes-Oxley Act of 2002 (hereafter referred to as *Sarbanes-Oxley*), a broad accounting and corporate governance reform measure. Sarbanes-Oxley prohibits public accounting firms from providing any of the following services to a public audit client: (1) bookkeeping and related services; (2) design or implementation of financial information systems; (3) appraisal or valuation services; (4) actuarial services; (5) internal audit outsourcing; (6) management or human resources services; (7) investment or broker/dealer services; and (8) legal and expert services (unrelated to the audit). Public accounting firms may provide general corporate tax return preparation and advice and other nonprohibited services to public audit clients if the company's audit committee has approved them in advance. To briefly summarize these restrictions, Sarbanes-Oxley prohibits public accounting firms from performing any client services in which the auditors may find themselves making managerial decisions or auditing their own firm's work (e.g., auditing financial records, documents, or journal entries that they themselves created).

Although consulting services approached almost 50 percent of a professional service firm's business in the 1990s, firm consulting revenues are now between 28 and 40 percent of the Big Four firms' total revenues in 2012 (see Exhibit 1.8). As a result of Sarbanes-Oxley, most of the large firms now provide consulting only for companies that they do not audit. Small public accounting firms are not required to follow Sarbanes-Oxley guidelines for their non-SEC clients. Often, private businesses regard their public accounting firms as business partners that can provide an array of services and a wealth of business information.

REVIEW CHECKPOINTS

1.13 What are some examples of assurance services performed on nonfinancial information?

1.14 What are some of the major areas of public accounting services?

OTHER KINDS OF ENGAGEMENTS AND INFORMATION PROFESSIONALS

LO 1-6
Describe the audits and auditors in governmental, internal, and operational auditing.

The AAA and the AICPA definitions of auditing clearly apply to the financial audit practice of independent external auditors who practice auditing in public accounting firms. The word *audit,* however, is used in other contexts to describe broader types of work.

The variety of engagements performed by different kinds of information assurors causes some problems with terminology. In this textbook, *independent auditor, external auditor,* and *CPA* will refer to people doing audit work with public accounting firms. In the internal and governmental contexts discussed here, auditors are identified as *operational auditors, internal auditors,* and *governmental auditors*. Although all of these professionals are information assurors (and many are certified public accountants), the term *CPA* in this book will refer to auditors in public practice.

Internal Auditing

The Board of Directors of the Institute of Internal Auditors (IIA) defines **internal auditing** and states its objective as follows:

> Internal auditing is 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.[6]

Internal auditors are employed by organizations such as banks, hospitals, city governments, and industrial companies or work for CPA firms that provide internal auditing services. Internal auditors often perform *operational audits*. **Operational auditing** refers to the study of business operations for the purpose of making recommendations about the efficient and effective use of resources, effective achievement of business objectives, and compliance with company policies. The goal of operational auditing is to help managers discharge their management responsibilities and improve profitability.

Internal auditors also perform audits of financial reports for internal use or limited external distribution (e.g., reports to regulatory agencies) much like external auditors audit financial statements distributed to outside users. Thus, some internal auditing work is similar to the auditing described elsewhere in this textbook. In addition, the services provided by internal auditors include (1) reviews of internal control systems to ensure compliance with company policies, plans, and procedures; (2) compliance with laws and regulations; (3) appraisals of the *economy* and *efficiency* of operations; and (4) reviews of effectiveness in achieving program results in comparison to established objectives and goals.

It should be noted that the AICPA defines operational auditing performed by independent CPA firms as a distinct type of management consulting service whose goal is to help a client improve the use of its capabilities and resources to achieve its objectives. So, internal auditors consider operational auditing integral to internal auditing and external auditors define it as a type of assurance service offered by public accounting firms. Providing these types of internal auditing services has been a growing business for many large CPA firms. However, both the SEC and the PCAOB prohibit CPA firms from providing these services to their own public audit clients.

Governmental Auditing

The U.S. Government Accountability Office (GAO) is an accounting, auditing, and investigating agency of the U.S. Congress, headed by the U.S. comptroller general. In one sense, GAO auditors are the highest level of internal auditors for the federal government. Many states have audit agencies similar to the GAO. These agencies answer to state legislatures and perform the same types of work described in the following GAO definition. In another sense, GAO and similar state agencies are really external auditors with respect to government agencies they audit because they are organizationally independent.

Many government agencies have their own internal auditors and inspectors general. Well-managed local governments also have internal audit departments. For example, most federal agencies (Department of Defense, Department of Human Resources, Department of the Interior), state agencies (education, welfare, controller), and local governments (cities, counties, tax districts) have internal audit staffs. Governmental and internal auditors have much in common.

[6]This definition and other information about internal auditing may be found on the Institute of Internal Auditors' website (www.theiia.org).

The GAO shares with internal auditors the same elements of *expanded-scope* services. The GAO, however, emphasizes the accountability of public officials for the efficient, economical, and effective use of public funds and other resources. The generally accepted government auditing standards (GAGAS) define and describe *expanded-scope* governmental auditing as follows:

> The term "audit" includes both financial and performance audits. . . . Financial related audits include determining whether (1) financial information is presented in accordance with established . . . criteria [e.g. GAAP], (2) the entity has adhered to specific financial compliance requirements [with laws and regulations], and (3) the entity's internal control . . . over financial reporting and/or safeguarding assets is suitably designed and implemented to achieve the control objectives. . . . Performance audits include economy and efficiency audits and program audits.[7]

In this definition, you can see the attest function applied to financial reports and a compliance audit function applied with respect to laws and regulations. All government organizations, programs, activities, and functions are created by law and are surrounded by regulations that govern the things they can and cannot do. For example, a program established to provide school meals to low-income students must comply with regulations about the eligibility of recipients. A compliance audit of such a program involves a study of schools' policies, procedures, and performance in determining eligibility and handing out meal tickets.

Also in this definition, you see *performance audits* referring to a category that includes two types: (1) economy and efficiency audits and (2) program audits. Governments are concerned about accountability for the appropriate use of taxpayers' resources; performance audits are a means of seeking to improve accountability for the efficient and economical use of resources and the achievement of program goals. In addition, the program audit helps determine whether the financial resources being spent are helping the government truly achieve its stated objectives. Performance audits, like internal auditors' operational audits, involve studies of the management of government organizations, programs, activities, and functions.

Regulatory Auditors

For the sake of clarity, other kinds of auditors deserve separate mention. The U.S. Internal Revenue Service employs auditors. They take the "economic assertions" of taxable income made by taxpayers in tax returns and determine their correspondence with the standards found in the Internal Revenue Code. They also audit for fraud and tax evasion. Their reports can either clear a taxpayer's return or claim that additional taxes are due.

State and federal bank examiners audit banks, savings and loan associations, and other financial institutions for evidence of solvency and compliance with banking and other related laws and regulations. In the 1980s and early 1990s and even more recently, these examiners made news as a result of the large number of failures of U.S. financial institutions.

Some GAO Engagement Examples

- *Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue* (GAO-11-318SP).
- *USDA's Oversight of the McGovern-Dole Food Education Program Needs Improvement* (GAO-11-544).
- *Enhanced Guidance on Commercial Real Estate Risks Needed* (GAO-11-489).
- *Information Security: Further Efforts Needed to Address Significant Weaknesses at the Internal Revenue Service* (GAO-07-364).
- *NASA: Issues Surrounding the Transition from the Space Shuttle to the Next Generation of Human Space Flight Systems* (GAO-07-595T).

[7] The complete Government Auditing Standards can be found on the GAO's website (www.gao.gov).

REVIEW CHECKPOINTS

1.15 What is *operational* auditing? How does the AICPA view operational auditing?

1.16 What are the elements of *expanded-scope* auditing according to the GAO?

1.17 What is *compliance* auditing?

1.18 Name some other types of auditors in addition to external, internal, and governmental auditors.

BECOME A PROFESSIONAL AND GET CERTIFIED!

LO 1-7
List and explain the requirements for becoming a certified public accountant (CPA) and other certifications available to an accounting professional.

If you plan a career in accounting (which we hope you do given that you are reading this book!), you are on your way to being known as an accounting professional. Congratulations. To do so, it is absolutely essential that you acquire the knowledge required to do your job and certification indicates that you have acquired that knowledge. While being certified as a certified public accountant (CPA) is generally regarded as the highest mark of distinction in the public accounting profession, other certifications may be more applicable to your chosen career aspirations. For example, a certified internal auditor (CIA) certification or certified management accountant (CMA) certification may be equally acceptable for those individuals working with companies to achieve specific goals, both financial and nonfinancial. Other certifications available in the fraud auditing and forensic accounting fields include the certified fraud examiner (CFE) and the certified forensic accountant (CFA) certifications. If you enjoy information systems, key certifications include the certified information systems auditor (CISA), the certified information systems security professional (CISSP), and the certified information technology professional (CITP). Regardless of your career choice, a certification adds credibility that will assist you throughout your career.

Education

Education requirements vary across certifying organizations. For the CPA certification, state boards of accountancy, the regulatory agencies in each state, set the education requirements for taking the CPA examination and receiving a CPA certificate. Most states presently require 150 semester hours of college education before receiving a CPA certificate, but a few states will allow you to sit for the CPA examination after only 120 semester hours of college education. Other certifications (such as the CIA) allow you to take the exam before you have graduated.

In addition to entry-level education requirements, all certifying organizations have regulations about *continuing professional education* (CPE). At present, the AICPA and most states require 120 contact hours (not semester or quarter college hours) over three-year reporting periods with no less than 20 hours in any one year. Once certified, you can obtain CPE hours in a variety of ways: continuing education courses, in-house training, college courses, and private-provider courses. Many CPAs obtain CPE by joining a professional accounting organization's local chapter. These types of courses range in length from one hour to two weeks, depending on the subject. Many CPE providers offer courses online.

Examination

The AICPA Board of Examiners administers the Uniform CPA Examination. The 14-hour computer-based examination covers Auditing and Attestation (AUD), Financial Accounting and Reporting (FAR), Regulation (REG) and Business Environment and Concepts (BEC). In the AUD section, beyond mastery of U.S. auditing standards, you will now also need to demonstrate an understanding of the International Auditing and Assurance

Standards Board (IAASB) and its role in establishing international standards on auditing (ISAs) and the difference between ISAs and the U.S. auditing standards. Candidates are also expected to demonstrate an awareness of the International Ethics Standards Board for Accountants (IESBA) and its role in establishing requirements of the International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants and the independence requirements that apply. The content specific outline (CSO) for the auditing section are (with rough approximations of weights given to each area):

Topic	Weight	M/C Questions (60% of grade)	Task–Based Simulations (40% of grade)
Auditing & Attestation (AUD) (4 hours)	100%	90	7
• Engagement Acceptance and Understanding the Assignment	12–16%		
• Understanding the Entity and its Environment (including Internal Control)	16–20%		
• Performing Audit Procedures and Evaluating Evidence	16–20%		
• Evaluating Audit Findings, Communications, and Reporting	16–20%		
• Accounting and Review Services Engagements	12–16%		
• Professional Responsibilities	16–20%		

Source: www.cpa-exam.org; Content Specific Outlines (CSOs) for REG, FAR, and BEC can also be found at this site.

The Uniform CPA Examination consists of multiple-choice question "testlets" (24–30 questions each) as well as task-based simulations introduced by the Board of Examiners in 2011. These task-based simulations are short case studies in which you will have to apply your accounting and auditing knowledge. A simulation may involve identifying a potential problem, electronically researching the topic using a database of authoritative standards, and reporting your findings. As you would expect, the exam is kept "top secret," but we have provided task-based simulations from Kaplan CPA Review in the end-of-chapter materials in subsequent chapters.

General information about the examination can be obtained from the CPA Candidate Bulletin (available at www.cpa-exam.org). Because qualifications for taking the CPA examination vary from state to state, you should contact your state board of accountancy for an application or more information. You can find your state board of accountancy website through the National Association of State Boards of Accountancy (NASBA) website (www.nasba.org). Exhibit 1.9, found on the next page, lists the requirements for the most commonly recognized professional certifications.

Experience

Although not required to *sit* for a professional exam, experience is required to *become certified*. Most states and territories require a person who has attained the education level and passed the CPA examination to have a period of experience working under a practicing CPA before awarding a CPA certificate. Experience requirements vary across states, but most jurisdictions require two to three years of experience. A few states require that the experience be obtained in a public accounting firm, but most of them accept experience in other organizations (GAO, internal audit, management accounting, Internal Revenue Service, and the like) as long as the applicant performs work requiring accounting judgment and is supervised by a competent accountant, preferably a CPA. Other certifying organizations also have experience requirements.

EXHIBIT 1.9 Certification Requirements

	Certified Public Accountant (CPA)	Certified Information Systems Auditor (CISA)	Certified Internal Auditor (CIA)	Certified Fraud Examiner (CFE)	Certified Management Accountant (CMA)
Education Level	Varies by state; Check with your state board of accountancy	No specific degree requirement	Bachelor's degree or its educational equivalent	Bachelor's degree or its educational equivalent	Bachelor's degree, or pass the CPA examination, or score in the 50th percentile on the GMAT
Experience	Varies by state; Check with your state board of accountancy	5 years of professional IS auditing, control, or security work experience for certification	2 years of internal auditing experience or its equivalent for certification	2 years of professional experience for certification	2 continuous years of professional experience in management accounting and/ or financial management
Exam Coverage	1. Auditing and attestation (AUD) 2. Financial accounting and reporting (FAR) 3. Regulation (REG) 4. Business envi-ronment and concepts (BEC)	1. The process of auditing information systems 2. Governance and management of IT 3. Information systems acquisition, development and implementation 4. Information sys-tems operations, maintenance and support 5. Protection of information assets	1. The internal audit activity's role in governance, risk, and control 2. Conducting the internal audit engagement 3. Business analy-sis and informa-tion technology 4. Business management skill	1. Fraud prevention and deterrence 2. Legal elements of fraud 3. Fraud investigation 4. Financial transactions	1. Financial planning, performance and control 2. Financial decision making
Test Length	4 parts, 14 hours	1 part, 4 hours (200 mc questions)	4 parts (100 mc questions each), 11 hours	4 parts (125 mc questions each), 10 hours	2 parts (100 mc questions and two 30-minutes essays, each) 8 hours
Passing Score	75%	450 (on a 800-point scale)	600 (on a 750-point scale)	75%	360 per part (on a 500-point scale)
Test Dates	On demand in 1st two months of each calendar quarter	June, December	On demand	Self-administered	On demand during the months of Jan, Feb, May, Jun, Sep, and Oct
Administering Body	American Institute of Certified Public Accountants	Information Systems Audit and Control Association	Institute of Internal Auditors	Association of Certified Fraud Examiners	Institute of Management Accountants
Website	www.aicpa.org	www.isaca.org	www.theiia.org	www.acfe.com	www.imanet.org

State Certificate and License

The AICPA does not issue CPA certificates or licenses to practice. Rather, all states and territories have state accountancy laws and state licensing boards to administer them. After satisfying state requirements for education and experience, successful candidates receive their CPA *certificate* from their state board of accountancy. At the same time, new CPAs must pay a fee to obtain a state *license* to practice or work for a CPA firm that is licensed to practice in their state. Thereafter, state boards of accountancy regulate the behavior of CPAs under their jurisdiction (enforcing state codes of ethics) and supervise the continuing education requirements.

After becoming a CPA licensed in one state, a person can obtain a CPA certificate and license in another state by filing the proper application with the second state board of accountancy, meeting that state's requirements, and obtaining another CPA certificate. Many CPAs hold certificates and licenses in several states. From a global perspective, individuals must be licensed in each country. Similar to CPAs in the United States, *chartered accountants* (CAs) practice in Australia, Canada, Great Britain, and India.

AUDITING INSIGHT — Auditors Make a Run for the Border

Efforts are currently underway through the AICPA and NASBA to streamline the licensing process so that CPAs can practice across state lines without having to have 50 different licenses. Under the concept of **substantial equivalency** as long as the licensing (home) state requires (1) 150 hours of education, (2) successful completion of the CPA exam, and (3) one year of experience, a CPA can practice (either in person or electronically) in another substantial equivalency state without having to obtain a license in that state. As of April 2013, 49 states and the District of Columbia have enacted provisions to allow CPAs licensed in other states to practice without notification (but agreeing to be under the state's automatic jurisdiction). This *uniform mobility* arrangement is temporary though as a CPA who relocates to another state must ultimately seek licensing in that state.

Source: AICPA State Regulation and Legislation Team at www.aicpa.org.

Skill Sets and Your Education

The requirements to become certified are rather strenuous, but they may not be enough! Let us take you on a brief tour of the core competencies listed by the AICPA, the Association of Certified Fraud Examiners (ACFE), the Institute of Internal Auditors (IIA), the Institute of Management Accountants (IMA), the Information Systems Audit and Control Association (ISACA), and other guidance-providing groups: history, international culture, psychology, economics, mathematics (calculus and statistics), national and international political science, art, literature, inductive and deductive reasoning, ethics, group dynamic processes, legal-political-social forces impinging on business, finance, capital markets, managing change, history of accounting, regulation, information systems, taxation, and (oh, yes) accounting and auditing. And administrative capability, analytical skills, business knowledge, communication skills (writing and speaking), efficiency, intellectual capability, marketing and selling, model building, people development, capacity for putting client needs first, and more.

We hope you are suitably impressed by this recitation of virtually all of the world's knowledge. You will be very old when you accomplish a fraction of the skill development and education suggested. Now the good news: (1) not everyone needs to be completely knowledgeable in all of these areas upon graduation from college; (2) learning and skill development evolve over a lifetime; and (3) no one expects you to know everything and operate as a "Lone Ranger." Audit teams composed of members specializing in some areas with other members specializing in others seem to work best in practice. We do, however, stress the need to continue your education even after you leave school. Learning should be a lifelong pursuit, not something that ends when you receive your diploma.

REVIEW CHECKPOINTS

1.19 Why is continuing education required to maintain certification?

1.20 Why do you think experience is required to become certified?

1.21 What are some of the functions of a state board of public accountancy?

1.22 What are some of the limitations to practicing public accounting across state and national boundaries?

Summary

Decision makers need more than just information; they need reliable and credible information that they can rely upon. Internet buyers rely on website information when purchasing online. Financial analysts and investors use financial reports to help make stock investment decisions. Suppliers and creditors use financial reports to decide whether to give trade credit and bank loans. Labor organizations use financial reports to help determine a company's ability to pay wages. Government agencies and Congress use financial information in preparing analyses of the economy and in making laws concerning taxes, subsidies, and the like. These various users rely on independent information assurors such as CPAs to reduce information risk. Auditors (and other information assurance providers) assume the role of certifying (or attesting to) published financial information, thereby offering users the valuable service of providing assurance that information risk is low.

This chapter begins by defining information risk and explains how auditing and assurance services play a role in minimizing this risk. The financial statements are explained in terms of the primary assertions that management makes in them, and these assertions are identified as the focal points of the auditors' procedural evidence-gathering work. Auditing is practiced in numerous forms by various practice units, including public accounting firms, the Internal Revenue Service, the U.S. Government Accountability Office, internal audit departments in companies, and several other types of regulatory auditors. Fraud examiners, many of whom are internal auditors and inspectors, have found a niche in auditing-related activities.

The public accounting profession recognizes that, in today's information economy, information risk exists in areas outside of financial transactions. Assurance services is a broad category of information-enhancement services that build on CPAs' auditing, attestation, accounting, and consulting skills to create products useful to a wide range of decision makers (customers). While reliable information helps make capital markets efficient and helps people know the consequences of a wide variety of economic decisions, CPAs practicing the assurance function are not the only information professionals at work in the economy. Bank examiners, IRS auditors, state regulatory agency auditors (e.g., auditors in a state's insurance department), internal auditors employed by a company, and federal government agency auditors all practice information assurance in one form or another.

Most auditors aspire to become certified public accountants, which involves successfully completing a rigorous examination, obtaining practical experience, and maintaining competence through continuing professional education. Auditors also obtain credentials as certified internal auditors, certified management accountants, certified information systems auditors, and certified fraud examiners. Each of these fields has large professional organizations that govern the professional standards and quality of practice of its members.

Key Terms

assurance: The *lending of credibility* to information, 3
assurance services: Independent professional services that improve the quality of information or its context for decision makers, 8
attestation engagement: The provision of an opinion on subject matter or an assertion about the subject matter that is the responsibility of another party, 6
attestation: The lending of credibility to assertions made by a third party, 3
auditing: The systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established criteria and communicating the results to interested users, 3
business risk: The risk that an entity will fail to meet its objectives. If the company fails to meet its objectives enough times, the company may ultimately fail, 2
completeness: All of the transactions, events, assets, liabilities, equity interests, and other disclosures that should have been recorded in the financial statements have been recorded, 13
cutoff: Refers to accounting for revenue, expense and other transactions in the proper period. The cutoff date generally refers to the audit client's year-end balance sheet date, 14
existence: All assets, liabilities, and equity interests do actually exist, 13
financial reporting: Process of providing statements of financial position (balance sheets), results of operations (income statements, statements of shareholders' equity, and statements of comprehensive income), changes in cash flows (statements of cash flows), and accompanying disclosure (footnotes) to outside decision makers who do not have access to management's internal sources of information. A company's accountants, under the direction of its management, perform this function, 11

information risk: The probability that the information circulated by a company will be false or misleading, 3

internal auditing: An independent, objective assurance and consulting activity designed to add value and improve an organization's operations, 24

occurrence: All of the transactions and events that have been recorded are valid, pertain to the entity, and have actually taken place, 13

operational auditing: The study of business operations for the purpose of making recommendations about the efficient use of resources, effective achievement of business objectives, and compliance with company policies, 24

presentation and disclosure: Management assertion that all transactions and events have been presented correctly and that all relevant information has been disclosed to financial statement users, usually in the footnotes to the financial statements, 13

professional skepticism: Defined in the professional auditing standards as having an attitude that "includes a questioning mind and a critical assessment of evidence." Essentially, it is an auditor's tendency to *not* believe management's assertions without corroboration, 17

rights and obligations: The entity is entitled to all rights of the assets, the liabilities are the legal responsibility of the entity, and all of the disclosed events and transactions pertain to the entity, 13

substantial equivalency: The process through which CPAs licensed in one state can practice in another state, 29

valuation or allocation: All assets, liabilities, and equity interests of the entity have been valued in accordance with the relevant financial reporting standards (e.g., GAAP) and are listed in the financial statements at the proper amount and any resulting valuation adjustments have been appropriately recorded in the financial statements, 13

Multiple-Choice Questions for Practice and Review

connect All applicable questions are available with McGraw-Hill's *Connect® Accounting*

LO 1-2

1.23 Which of the following would be considered an assurance engagement?
- a. Giving an opinion on a prize promoter's claims about the amount of sweepstakes prizes awarded in the past.
- b. Giving an opinion on the conformity of the financial statements of a university with generally accepted accounting principles.
- c. Giving an opinion on the fair presentation of a newspaper's circulation data.
- d. Giving assurance about the average drive length achieved by golfers with a client's golf balls.
- e. All of the above.

LO 1-4

1.24 It is always a good idea for auditors to begin an audit with the professional skepticism characterized by the assumption that
- a. A potential conflict of interest always exists between the auditor and the management of the enterprise under audit.
- b. In audits of financial statements, the auditor acts exclusively in the capacity of an auditor.
- c. The professional status of the independent auditor imposes commensurate professional obligations.
- d. Financial statements and financial data are verifiable.

LO 1-2

1.25 In an attestation engagement, a CPA practitioner is engaged to
- a. Compile a company's financial forecast based on management's assumptions without expressing any form of assurance.
- b. Prepare a written report containing a conclusion about the reliability of a management assertion.
- c. Prepare a tax return using information the CPA has not audited or reviewed.
- d. Give expert testimony in court on particular facts in a corporate income tax controversy.

LO 1-6

1.26 A determination of cost savings obtained by outsourcing cafeteria services is most likely to be an objective of
- a. Environmental auditing.
- b. Financial auditing.
- c. Compliance auditing.
- d. Operational auditing.

LO 1-6

1.27 The primary difference between operational auditing and financial auditing is that in operational auditing

a. The operational auditor is not concerned with whether the audited activity is generating information in compliance with financial accounting standards.

b. The operational auditor is seeking to help management use resources in the most effective manner possible.

c. The operational auditor starts with the financial statements of an activity being audited and works backward to the basic processes involved in producing them.

d. The operational auditor can use analytical skills and tools that are not necessary in financial auditing.

LO 1-2

1.28 According to the AICPA, the purpose of an audit of financial statements is to

a. Enhance the degree of confidence that intended users can place in the financial statements.

b. Express an opinion on the fairness with which they present financial position, results of operations, and cash flows in conformity with accounting standards promulgated by the Financial Accounting Standards Board.

c. Express an opinion on the fairness with which they present financial position, results of operations, and cash flows in conformity with accounting standards promulgated by the U.S. Securities and Exchange Commission.

d. Obtain systematic and objective evidence about financial assertions and report the results to interested users.

LO 1-1

1.29 Bankers who are processing loan applications from companies seeking large loans will probably ask for financial statements audited by an independent CPA because

a. Financial statements are too complex for the bankers to analyze themselves.

b. They are too far away from company headquarters to perform accounting and auditing themselves.

c. The consequences of making a bad loan are very undesirable.

d. They generally see a potential conflict of interest between company managers who want to get loans and the bank's needs for reliable financial statements.

LO 1-5

1.30 The Sarbanes-Oxley Act of 2002 prohibits public accounting firms from providing which of the following services to an audit client?

a. Bookkeeping services.

b. Internal auditing services.

c. Valuation services.

d. All of the above.

LO 1-1

1.31 Independent auditors of financial statements perform audits that reduce

a. Business risks faced by investors.

b. Information risk faced by investors.

c. Complexity of financial statements.

d. Timeliness of financial statements.

LO 1-6

1.32 The primary objective of compliance auditing is to

a. Give an opinion on financial statements.

b. Develop a basis for a report on internal control.

c. Perform a study of effective and efficient use of resources.

d. Determine whether client personnel are following laws, rules, regulations, and policies.

LO 1-7

1.33 What requirements are *usually* necessary to become licensed as a certified public accountant?

a. Successful completion of the Uniform CPA Examination.

b. Experience in the accounting field.

c. Education.

d. All of the above.

LO 1-6

1.34 The organization primarily responsible for ensuring that public officials are using public funds efficiently, economically, and effectively is the

a. Governmental Internal Audit Agency (GIAA).

b. Central Internal Auditors (CIA).

c. Securities and Exchange Commission (SEC).

d. Government Accountability Office (GAO).

LO 1-6

1.35 Performance audits usually include [two answers]

a. Financial audits.
b. Economy and efficiency audits.
c. Compliance audits.
d. Program audits.

LO 1-3

1.36 The objective in an auditor's review of credit ratings of a client's customers is to obtain evidence related to management's assertion about

a. Completeness.
b. Existence.
c. Valuation and allocation.
d. Rights and obligations.
e. Occurrence.

LO 1-4

1.37 Jones, CPA, is planning the audit of Rhonda's Company. Rhonda verbally asserts to Jones that all expenses for the year have been recorded in the accounts. Rhonda's representation in this regard

a. Is sufficient evidence for Jones to conclude that the completeness assertion is supported for expenses.
b. Can enable Jones to minimize the work on the gathering of evidence to support Rhonda's completeness assertion.
c. Should be disregarded because it is not in writing.
d. Is not considered a sufficient basis for Jones to conclude that all expenses have been recorded.

LO 1-1

1.38 The risk to investors that a company's financial statements may be materially misleading is called

a. Client acceptance risk.
b. Information risk.
c. Moral hazard.
d. Business risk.

LO 1-3

1.39 When auditing merchandise inventory at year-end, the auditor performs audit procedures to ensure that all goods purchased before year-end are received before the physical inventory count. This audit procedure provides assurance about which management assertion?

a. Cutoff.
b. Existence.
c. Valuation and allocation.
d. Rights and obligations.
e. Occurrence.

LO 1-3

1.40 When auditing merchandise inventory at year-end, the auditor performs audit procedures to obtain evidence that no goods held on consignment are included in the client's ending inventory balance. This audit procedure provides assurance about which management assertion?

a. Completeness.
b. Existence.
c. Valuation and allocation.
d. Rights and obligations.
e. Occurrence.

LO 1-3

1.41 When an auditor reviews additions to the equipment (fixed asset) account to make sure that repair and maintenance expenses are not understated, she wants to obtain evidence as to management's assertion regarding

a. Completeness.
b. Existence.
c. Valuation and allocation.
d. Rights and obligations.
e. Occurrence.

LO 1-5

1.42 The Sarbanes-Oxley Act of 2002 generally prohibits public accounting firms from
a. Acting in a managerial decision-making role for an audit client.
b. Auditing the firm's own work on an audit client.
c. Providing tax consulting to an audit client without audit committee approval.
d. All of the above.

LO 1-7

1.43 Substantial equivalency refers to
a. An auditor's tendency not to believe management's assertions without sufficient corroboration.
b. Providing consulting work for another firm's audit client in exchange for the other firm's providing consulting services to one of your clients.
c. The waiving of certification exam parts for an individual holding an equivalent certification from another professional organization.
d. Permitting a CPA to practice in another state without having to obtain a license in that state.

LO 1-2

1.44 Which of the following best describes the relationship between auditing and attestation engagements?
a. Auditing is a subset of attestation engagements that focuses on the certification of financial statements.
b. Attestation is a subset of auditing that provides lower assurance than that provided by an audit engagement.
c. Auditing is a subset of attestation engagements that focuses on providing clients with advice and decision support.
d. Attestation is a subset of auditing that improves the quality of information or its context for decision makers.

LO 1-3

1.45 During an audit of a company's cash balance on a company with operations in only one country, the auditor is most concerned with which management assertion?
a. Existence.
b. Rights and Obligations.
c. Valuation or Allocation.
d. Occurrence.

LO 1-3

1.46 When auditing an investment in another company, an auditor most likely would seek to conduct which audit procedure to help satisfy the valuation assertion?
a. Inspect the stock certificates evidencing the investment.
b. Examine the audited financial statements of the investee company.
c. Review the broker's advice or canceled check for the investment's acquisition.
d. Obtain market quotations from *The Wall Street Journal* or another independent source.

LO 1-3

1.47 Cutoff tests designed to detect valid sales that occurred before the end of the year but have been recorded in the subsequent year would provide assurance about management's assertion of
a. Presentation and Disclosure.
b. Completeness.
c. Rights and Obligations.
d. Existence.

LO 1-3

1.48 Which of the following audit procedures probably would provide the most reliable evidence related to the entity's assertion of rights and obligations for the inventory account?
a. Trace test counts noted during physical count to the summarization of quantities.
b. Inspect agreements for evidence of inventory held on consignment.
c. Select the last few shipping advices used before the physical count and determine whether the shipments were recorded as sales.
d. Inspect the open PO file for significant commitments to consider for disclosure.

LO 1-3

1.49 In auditing the accrued liabilities account on the Balance Sheet, an auditor's procedures most likely would focus primarily on management's assertion of
a. Existence or occurrence.
b. Completeness.
c. Presentation and disclosure.
d. Valuation or allocation.

LO 1-2

1.50 Which of the following *best* describes the focus of the following engagements?

Auditing Engagement	Attestation Engagement	Assurance Engagement	Consulting Services Engagement
a. Any information	Financial statements	Advice and decision support	Financial information
b. Financial information	Advice and decision support	Financial statements	Any information
c. Advice and decision support	Any information	Financial information	Financial statements
d. Financial statements	Financial information	Any information	Advice and decision support

LO 1-7

1.51 Which of the following is a reason to obtain professional certification?
a. Certification provides credibility that an individual is technically competent.
b. Certification often is a necessary condition for advancement and promotion within a professional services firm.
c. Obtaining certification is often monetarily rewarded by an individual's employer.
d. All of the above.

Exercises and Problems

LO 1-2

1.52 **Audit, Attestation, and Assurance Services.** Following is a list of various professional services. Identify each by its apparent characteristics as audit engagement, attestation engagement, or assurance engagement. Because audits are a subset of attestation engagements, which are a subset of assurance engagements, choose the most specific description. In other words, if you believe the engagement is an audit engagement, select only audit engagement rather than checking all three. Similarly, the choice of assurance engagement for an audit, while technically correct, would not be the best choice.

	Audit Engagement	Attestation Engagement	Assurance Engagement
Real estate demand studies			
Ballot for awards show			
Utility rates applications			
Newspaper circulation audits			
Third-party reimbursement maximization			
Annual financial report to stockholders			
Rental property operation review			
Examinations of financial forecasts and projections			
Customer satisfaction surveys			
Compliance with contractual requirements			
Benchmarking/best practices			
Evaluation of investment management policies			
Information systems security reviews			
Productivity statistics			
Internal audit strategic review			
Financial statements submitted to a bank loan officer			

LO 1-4

1.53 **Controller as Auditor.** The chairman of the board of Hughes Corporation proposed that the board hire as controller a CPA who had been the manager of the team that conducted Hughes Corporation's audit engagement. The chairman thought that hiring this person would make the annual audit unnecessary and would consequently result in saving the professional fee paid to the auditors. The chairman proposed to give this new controller a full staff to conduct such investigations of accounting and operating data as necessary. Evaluate this proposal.

LO 1-3

1.54 **Management Assertions.** Complete the following chart indicating the corresponding Auditing Standards Board assertions and whether the assertion relates to transactions, balances, or disclosures.

<table>
<tr><th>PCAOB Assertion</th><th>Corresponding ASB Assertion</th><th>Nature of Assertion</th></tr>
<tr><td>Existence or Occurrence</td><td></td><td></td></tr>
<tr><td rowspan="3"></td><td></td><td></td></tr>
<tr><td rowspan="2"></td><td></td></tr>
<tr><td></td></tr>
<tr><td rowspan="2">Rights and Obligations</td><td rowspan="2"></td><td></td></tr>
<tr><td></td></tr>
<tr><td rowspan="4">Completeness</td><td rowspan="4"></td><td></td></tr>
<tr><td></td></tr>
<tr><td></td></tr>
<tr><td></td></tr>
<tr><td rowspan="4">Valuation and Allocation</td><td rowspan="3"></td><td></td></tr>
<tr><td></td></tr>
<tr><td></td></tr>
<tr><td></td><td></td></tr>
<tr><td rowspan="3">Presentation and Disclosure</td><td rowspan="2"></td><td></td></tr>
<tr><td></td></tr>
<tr><td></td><td></td></tr>
</table>

LO 1-3

1.55 **Management Assertions.** Your audit manager has asked you to explain the PCAOB Assertions by using an account on the balance sheet at your audit client. For the accounts receivable account, please define each of the PCAOB assertions, using the accounts receivable account as a way to illustrate each assertion. You are encouraged to reference Exhibit 1.5 to help you answer this question.

LO 1-5, 1-6

1.56 **Operational Auditing.** Bigdeal Corporation manufactures paper and paper products and is trying to decide whether to purchase Smalltek Company. Smalltek has developed a process for manufacturing boxes that can replace containers that use fluorocarbons for expelling a liquid product. The price may be as high as $45 million. Bigdeal prefers to buy Smalltek and integrate its products while leaving the Smalltek management in charge of day-to-day operations. A major consideration is the efficiency and effectiveness of Smalltek's operations. Bigdeal wants to obtain a report on the operational efficiency and effectiveness of the Smalltek sales, production, and research and development departments.

Required:

Who can Bigdeal engage to produce the report resulting from this operational audit? Several possibilities exist. Are there any particular advantages or disadvantages in choosing from among them?

LO 1-1, 1-2

1.57 **Auditor as Guarantor.** Your neighbor Loot Starkin invited you to lunch yesterday. Sure enough, it was no "free lunch" because Loot wanted to discuss the annual report of Dodge Corporation. He owns Dodge stock and just received the annual report. Loot says, "Our auditors prepared the audited financial statements and gave an unqualified opinion, so my investment must be safe."

Required:

What misconceptions does Loot Starkin seem to have about the auditor's role with respect to Dodge Corporation?

LO 1-6

1.58 **Identification of Audits and Auditors.** Audits may be characterized as (a) financial statement audits, (b) compliance audits, (c) economy and efficiency audits, and (d) program results audits. The work can be done by independent (external) auditors, internal auditors, or governmental auditors (including IRS auditors and federal bank examiners). Following is a list of the purposes or products of various audit engagements:

	Type of Audit	Type of Auditor
1. Analyze proprietary schools' spending to train students for low-demand occupations.		
2. Determine whether an advertising agency's financial statements are fairly presented in conformity with GAAP.		
3. Study the effectiveness of the Department of Defense's expendable launch vehicle program.		
4. Compare costs of municipal garbage pickup services to comparable service subcontracted to a private business.		
5. Investigate financing terms of tax shelter partnerships.		
6. Study a private aircraft manufacturer's test pilot performance in reporting on the results of test flights.		
7. Conduct periodic examinations by the U.S. Comptroller of Currency of a national bank for solvency.		
8. Evaluate the promptness of materials inspection in a manufacturer's receiving department.		
9. Report on the need for the states to consider reporting requirements for chemical use data.		
10. Render a public report on the assumptions and compilation of a revenue forecast by a sports stadium/racetrack complex.		

Required:

For each of the engagements listed, indicate (1) the type of audit (financial statement, compliance, economy and efficiency, or program results) and (2) the type of auditors you would expect to be involved.

LO 1-3

1.59 **Financial Assertions and Audit Objectives.** You are engaged to examine the financial statements of Spillane Company for the year ended December 31. Assume that on November 1, Spillane borrowed $500,000 from Second National Bank to finance plant expansion. The long-term note agreement provided for the annual payment of principal and interest over five years. The existing plant was pledged as security for the loan. Due to the unexpected difficulties in acquiring the building site, the plant expansion did not begin on time. To use the borrowed funds, management decided to invest in stocks and bonds and on November 16, invested the $500,000 in publicly traded securities.

Required:

Develop specific assertions (audit objectives) related to securities (assets) based on management's five (PCAOB) general assertions.

LO 1-7

1.60 **Internet Exercise: Professional Certification.** Each state has unique rules for certification concerning education, work experience, and residency. Visit the website for your state board of accountancy and download a list of the requirements for becoming a CPA in your state. Although not all of the state boards of accountancy have websites, you can find those of most states by accessing the National Association of State Boards of Accountancy at its website (www.nasba.org).

LO 1-7

1.61 **Internet Exercise: Professional Certification.** Visit the website of the Institute of Internal Auditors (www.theiia.org), the Institute of Management Accountants (www.imanet.org), The Association of Certified Fraud Examiners (www.acfe.com), or the Information Systems Audit and Control Association (www.isaca.org). Review the information regarding the certifications available. Does the organization explain the benefits of having its certification? What topics are covered on the certification exam? What are the minimum requirements to take the exam? What additional experience is required to receive the certification?

LO 1-5

1.62 **Mini-Case: The Market for Auditing Services.** Refer to the mini-case "KPMG: How Many Firms?" shown on page C17 and respond to question 4.