SOLUTIONS MANUAL

Copyrighted Material

Auditing

A Business Risk Approach

RITTENBERG/SCHWIEGER/JOHNSTONE

Copyrighted Material

Solutions for Chapter 2

Corporate Governance, Audit Standards

Review Questions:

2-1. An audit committee is a subcommittee of the board of directors that is composed of independent, outside directors. The audit committee has oversight responsibility (on behalf of the full board of directors and its stockholders) for the outside reporting of the company (including annual financial statements); risk monitoring and control processes; and both internal and external audit functions.

2-2. An outside director is not a member of management, legal counsel, a major vendor, outside service provider, former employee, or others who may have a personal relationship with management that might impair their objectivity or independence.

The audit committee is responsible for assessing the independence of the external auditor and engage only auditors it believes are independent. Auditors are now hired and fired by audit committee members, not management. The intent is to make auditor accountability more congruent with stockholder and third-party needs.

2-3. The primary point of this question is for students to understand that the audit committee's role is one of oversight rather than direct responsibility. For example, management is responsible for the fairness of the financial statements. Auditors are responsible for their audit and independent assessment of financial reporting. The audit committee is not designed to replace the responsibility of either of these functions. The audit committee's oversight processes are to see that the management processes for financial reporting are adequate and the auditor's carry out their responsibilities in an independent and competent manner.

2-4. The audit committee has the ability to hire and fire both the internal auditor and the external auditor. However, in the case of the internal audit function, the audit committee has the ability to hire and fire the head of internal audit as well as set the audit plan and budget. The audit committee does not control regulatory auditors, but should meet with regulatory auditors to understand the scope of their work and to discuss audit findings with them.

2-5. The Sarbanes-Oxley Act was designed to "clean-up" corporate America, especially in the realms of financial reporting. The overall intent was to encourage better corporate governance; to make the audit committee the auditor's client; encourage the independence and oversight of the board, and improve the independence of the external audit profession. There were certainly many factors that led to the Sarbanes-Oxley Act, but the failures at Enron and WorldCom will probably be pointed to in the future as the major factors that led to the act being passed when it was.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

THOMSON
SOUTH-WESTERN

2-6. The PCAOB is the Public Companies Accounting Oversight Board. It is mandated by Congress to set standards for audits of public companies and perform quality control of accounting firms that audit public companies.

2-7. The studies conducted by the GAO and the SEC include:

- Effect of consolidation of the accounting profession on the competitiveness of the profession
- An analysis of "principles-based" accounting versus "rules-based" accounting and what it would take to implement principles-based accounting approach in the U.S.
- An analysis of public company failures in the last decade and the implications for the public accounting profession and for corporations
- An analysis of mandatory audit firm rotation provision and whether there are serious impediments to implementing mandatory rotation requirements

Instructors may want to consider assigning some parts of these studies as independent readings. The studies were quite comprehensive. The studies conclusions were as follows:

- There is sufficient competition in auditing today, but the GAO will undertake a subsequent study. That subsequent study was commenced in 2007 and was not complete when we went to press.
- The study endorsed the principles based approach to accounting. The study on "principles-based accounting" by the SEC is one of the better discussions of the issues anywhere.
- The study of economic failures identified many of the same causes that were addressed by the Sarbanes-Oxley Bill.
- The study concluded that audit firm rotation would be costly without significant further benefits. Many frauds take place when new audit firms are put into place.

2-8. Management has always been responsible for fairness, completeness, and accuracy of financial statements, but the Sarbanes-Oxley Act goes a step further by requiring the CEO and CFO to certify the accuracy of financial statements with criminal penalties as a punishment for materially misstated statements. The CEO and CFO must make public their certifications and assume responsibility for the fairness of the financial presentations. It thereby encourages organizations to improve their financial reporting functions.

2-9. Rule 201 of the Act which prohibits any registered public accounting firms from providing many non-audit services to their *public* audit clients. In addition, the audit committee became the "client" instead of management, and audit partners are required to rotate every five years.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

2-10. The creation of the Public Companies Accounting Oversight Board (PCAOB) changed the oversight of the accounting profession. Before, the oversight was by private peer organizations like the AICPA. The PCAOB, in contrast, is a government body. The PCAOB has the power to dictate audit standards for audits of financial statements and public reports on internal control. It also is responsible for quality control reviews of the profession.

The PCAOB only has the power to regulate audits of public firms however. As of press date, audit firms that audit non-public clients are not ruled by anybody. The AICPA is trying to position themselves as the oversight body of these firms.

2-11. The Sarbanes-Oxley Act of 2002 requires public companies to establish an effective whistleblowing program. The intent is to reinforce the commitment of financial integrity from the top of the organization and to facilitate the reporting of improper acts within the organization by an employee without the threat of retribution.

Whistleblowing is an act by an employee, or someone outside the organization that is knowledgeable about the entity's activities, whereby the employee or other individual reports the wrong-doing by the organization (usually anonymously) to an independent group within the organization that has responsibility to follow up on the allegations to determine their authenticity. In many cases, a summary of the whistleblowing complaints will be presented to the audit committee along with an analysis of the complaints and actions taken by management. There is a great deal of research that shows that many corporate frauds were first uncovered by someone utilizing the whistleblowing function in an organization.

2-12. Management is responsible for issued financial statements. Although other parties may be sued for what is contained in the statements, management is ultimately responsible. Ownership is important because it establishes responsibility and accountability. Management must set up and monitor financial reporting systems that help it meet its reporting obligations. It cannot delegate this responsibility to the auditors.

2-13. Corporate governance is defined as:

> "a process by which the owners and creditors of an organization exert control and require accountability for the resources entrusted to the organization. The owners (stockholders) elect a board of directors to provide oversight of the organization's activities."

The key players in corporate governance are the stockholders (owners), board of directors, audit committees, management, regulatory bodies, and both internal and external auditors.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

2-14. In the past decade, all parties failed to a certain extent. For detailed analysis, see exhibit 2.2 in the chapter and repeated here:

Corporate Governance Responsibilities and Failures

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
Stockholders	**Broad Role:** Provide effective oversight through election of Board process, approve major initiatives, buy or sell stock.	Focused on short-term prices; failed to perform long-term growth analysis; abdicated all responsibilities to management as long as stock price increased.
Board of Directors	**Broad Role**: the major representative of stockholders to ensure that the organization is run according to the organization charter and there is proper accountability. **Specific activities** include: • Selecting management. • Reviewing management performance and determining compensation. • Declaring dividends • Approving major changes, e.g. mergers • Approving corporate strategy • Overseeing accountability activities.	• Inadequate oversight of management. • Approval of management compensation plans, particularly stock options that provided perverse incentives, including incentives to manage earnings. • Non-independent, often dominated by management. • Did not spend sufficient time or have sufficient expertise to perform duties. • Continually re-priced stock options when market price declined.
Management	**Broad Role:** Operations and Accountability. Managing the organization effectively and provide accurate and timely accountability to shareholders and other stakeholders. **Specific activities** include: • Formulating strategy and risk appetite. • Implementing effective internal controls. • Developing financial reports. • Developing other reports to meet public, stakeholder, and regulatory requirements.	• Earnings management to meet analyst expectations. • Fraudulent financial reporting. • Pushing accounting concepts to achieve reporting objective. • Viewed accounting as a tool, not a framework for accurate reporting.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
Audit Committees of the Board of Directors	**Broad Role:** Provide oversight of the internal and external audit function and the process of preparing the annual accuracy financial statements and public reports on internal control. **Specific activities** include: • Selecting the external audit firm. • Approving any non-audit work performed by audit firm. • Selecting and/or approving the appointment of the Chief Audit Executive (Internal Auditor), • Reviewing and approving the scope and budget of the internal audit function. • Discussing audit findings with internal auditor and external auditor and advising the Board (and management) on specific actions that should be taken.	• Similar to Board members – did not have expertise or time to provide effective oversight of audit functions. • Were not viewed by auditors as the 'audit client'. Rather the power to hire and fire the auditors often rested with management.
Self-Regulatory Organizations: AICPA, FASB	**Broad Role:** Setting accounting and auditing standards dictating underlying financial reporting and auditing concepts. Set the expectations of audit quality and accounting quality. **Specific roles** include: • Establishing accounting principles • Establishing auditing standards • Interpreting previously issued standards • Implementing quality control processes to ensure audit quality. • Educating members on audit and accounting requirements.	• AICPA: Peer reviews did not take a public perspective; rather than looked at standards that were developed and reinforced internally. • AICPA: Leadership transposed the organization for a public organization to a "trade association" that looked for revenue enhancement opportunities for its members. • AICPA: Did not actively involve third parties in standard setting. • FASB: Became more rule-oriented in response to (a) complex economic transactions; and (b) an auditing profession that was more oriented to pushing the rules rather than enforcing concepts.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
		• FASB: Pressure from Congress to develop rules that enhanced economic growth, e.g. allowing organizations to not expense stock options.
Other Self-Regulatory Organizations, e.g. NYSE, NASD	**Broad Role:** Ensuring the efficiency of the financial markets including oversight of trading and oversight of companies that are allowed to trade on the exchange. **Specific activities** include: • Establishing listing requirements – including accounting requirements, governance requirements, etc. • Overseeing trading activities,	• Pushed for improvements for better corporate governance procedures by its members, but failed to implement those same procedures for its governing board, management, and trading specialists.
Regulatory Agencies: the SEC	**Broad Role:** Ensure the accuracy, timeliness, and fairness of public reporting of financial and other information for public companies. **Specific activities** include: • Reviewing all mandatory filings with the SEC, • Interacting with the FASB in setting accounting standards, • Specifying independence standards required of auditors that report on public financial statements, • Identify corporate frauds, investigate causes, and suggest remedial actions.	• Identified problems but was never granted sufficient resources by Congress or the Administration to deal with the issues.
External Auditors	**Broad Role:** Performing audits of company financial statements to ensure that the statements are free of material misstatements including misstatements that may be due to fraud. **Specific activities** include: • Audits of public company financial statements, • Audits of non-public company financial statements,	• Pushed accounting concepts to the limit to help organizations achieve earnings objectives. • Promoted personnel based on ability to sell "non-audit products". • Replaced direct tests of accounting balances with a greater use of inquiries, risk

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
	• Other accounting related work such as tax or consulting.	analysis, and analytics. • Failed to uncover basic frauds in cases such as WorldCom and HealthSouth because fundamental audit procedures were not performed.
Internal Auditors	**Broad Role:** Perform audits of companies for compliance with company policies and laws, audits to evaluate the efficiency of operations, and audits to determine the accuracy of financial reporting processes. **Specific activities** include: • Reporting results and analyses to management, (including operational management), and audit committees, • Evaluating internal controls.	• Focused efforts on 'operational audits' and assumed that financial auditing was addressed sufficiently by the external audit function. • Reported primarily to management with little effective reporting to the audit committee. • In some instances (HealthSouth, WorldCom) did not have access to the corporate financial accounts.

2-15. The board of directors is often at the top of the list when it comes to responsibility for corporate governance failures. Some of the problems with the board of directors included:

- Inadequate oversight of management
- Poor decision-making, especially when it came to compensation plans
- Lack of independence, many times the board was comprised of company management
- Inadequate amount of time and effort to duties

2-16. Some of the ways the accounting profession was responsible were:

- Were too concerned about creating "revenue enhancement" opportunities for the firm, and less concerned about their core services or talents
- Were willing to "push" accounting standards to the limit to help clients achieve earnings goals
- Began to use more audit "shortcuts" such as inquiry and analytical procedures instead of direct testing of account balance.
- Relied on management representations instead of testing management representations.
- Were too often 'advocates' of management rather than protectors of users.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

2-17. Stock options were used widely as a form of compensation in the last decade. The general rule is that people will do what they are incentivized to do. In the case of stock options, management was encouraged to achieve a high stock price immediately, which meant short-term decisions that were not necessarily beneficial to business in the long-term. Stock options also led some management's to manage earnings to increase short-term stock prices. Unfortunately, some of the 'earnings management' was fraudulent while much of it failed to recognize economic substance.

2-18. Cookie jar reserves are essentially liabilities that companies have overestimated in previous years to use when times are tougher to smooth earnings. The rationale is that the funds are then used to "smooth" earnings in the years when earnings needs a boost. "Smooth" earnings typically are looked upon more favorably by the stock market.

An example of a cookie jar reserve would be over-estimating an allowance account, such as allowance for doubtful accounts. The allowance account is then written down (and into the income statement) in a bad year.

2-19. The Public Oversight Board's (POB) primary criticism of the audit profession was that they were "cutting corners" to make audits more cost effective and thus allow audit partners to be compensated at levels comparable to consulting partners. Overall, however, the POB felt that the auditing profession was working up to the standards that had been set for the profession. The lack of criticism of the profession by the POB led to its demise.

2-20. The Sarbanes-Oxley Act does not require non-public companies to have audit committees. That is not to say that it does not happen or is not a good idea, however. Most stakeholders want an independent party to ensure that their interests are being considered.

2-21. The audit committee must explicitly approve all such services in advance of the performance of the services. The audit committee may permit some of the services if it considers the services to be de minimus, i.e. not important in the grand scheme of things.

2-22. The external auditor should discuss any controversial accounting choices with the audit committee and must communicate all significant adjustments made to the financial statements during the course of the audit. In addition, the processes used in making judgments and estimates as well as any disagreements with management should be communicated. Other items that need to be communicated include:

- All adjustments that were not made during the course of the audit,
- Difficulties in conducting the audit,
- The auditor's assessment of the accounting principles used and overall fairness of the financial presentation,
- The client's consultation with other auditors,
- Any consultation with management before accepting the audit engagement,
- Significant deficiencies in internal control.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

2-23. The audit committee has oversight responsibilities for both financial reporting and public reporting on internal accounting control. These responsibilities are exercised by:

- Requiring internal and external audit evaluation of internal controls,
- Assessing the quality of financial reporting processes,
- Inquiring of financial reporting decisions,
- Meeting periodically with the CFO, management, external auditors, and internal auditors.

2-24. Good governance is important to the external auditor for a number of reasons, including, but not limited to the following. Good governance

- usually leads to better corporate performance,
- reflects a commitment to a high level of ethics, integrity, and sets a strong tone for the organization's activities,
- requires a commitment to financial reporting competencies and to good internal controls,
- reduces the risks that the company will have materially misstated financial statements.

If a company has not committed to good governance processes, the auditor must seriously consider whether they should be associated with the client. As will be discussed more thoroughly in chapter 4, a company without good governance provides much greater risk to the auditor. Many audit firms are systematically eliminating high risk clients from their client portfolio.

2-25. The auditor might utilize the following procedures in determining the actual level of governance in an organization:

- observe the functioning of the audit committee by participating in the meetings, noting the quality of the audit committee questions and responses,
- observation and interaction with management regarding issues related to the audit, e.g.
    - providing requested information on a timely basis,
    - quality of financial personnel in making judgments,
    - accounting choices that tend to 'push the limits' towards aggressiveness or creating additional reported net income,
    - the quality of internal controls within the organization.
- review the minutes of the board of directors meetings to determine that they are consistent with good governance,
- review internal audit reports and especially determine the actions taken by management,
- review the compensation plan for top management,
- review management expense reimbursements to determine (a) completeness of documentation, (b) appropriateness of requested reimbursement, and (c) extent of such requests.
- review management's statements to the financial press to determine if they are consistent with the company's operations.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

2-26. The three categories of attestation standards are general standards, fieldwork standards, and reporting standards. General standards cover the characteristics of the auditor – technical training and proficiency, independence, and due professional care. Fieldwork standards provide guidance concerning the conduct of the audit, including planning and performing the audit. Reporting standards cover the essential elements of the auditor's communication, including the opinion, the criteria against which the assertions were tested, and an explanation of the basis for the attester's opinion.

2-27. The standard of due professional care plays a role in litigation against auditors. Plaintiffs will try to show that the auditor did not do what a reasonably prudent auditor would have done. To evaluate the standard, a third-party also decides whether someone with similar skills in a similar situation would have acted in the same way.

2-28. Independence means objectivity and freedom from bias. The auditor can favor neither the client nor the third party in evaluating the fairness of the financial statements. Independence in fact means the auditor is unbiased and objective. Independence in appearance means that a third party with knowledge of the auditor's relationship with the client would consider the auditor to be independent. An auditor could be independent in fact if he or she owned a few shares of common stock in an audit client, but might not appear independent to a third party.

2-29. Supervision and review of audit work by employees at higher levels is done by public accounting firms to ensure that audits are conducted with due professional care. The supervision and review is preceded by (a) careful selection of employees; (b) employee training, and (c) development of carefully articulated audit programs and processes. These steps are supplemented by a concurring partner review before the audit report is issued.

2-30. The reporting standards provide guidelines to:

- indicate compliance with GAAP
- report any material change in the application of GAAP
- report any inadequacies in the client's disclosures
- Require the auditor to express an opinion on the subject matter examined or indicate all substantive reasons why an opinion could not be rendered

2-31. **PCAOB**

- sets audit standards for the audits of all public companies that are registered with the SEC

AICPA

- sets audit standards for audits of small, non-public companies
- attestation standards for areas other than public company reports on internal control
- assurance services that are less in scope than an audit such as reviews and compilations

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

GAO

- sets auditing standards for audits of all governmental entities in the U.S.

IASC

- sets standards for financial statement audits on an international basis. Right now, the international standards are being increasingly accepted by all political jurisdictions, but particularly in Europe and many developing countries. Harmonization with U.S. will continue to be an objective.

IASB

- sets standards for the professional practice of internal auditing around the world. Incorporates other standards by reference where applicable.

2-32. An audit program follows good corporate governance in the following way: Good governance is critical to the development of sound controls in an organization. The stronger the controls, the less risk the financial statements will be misstated.

The development of audit programs follow the standards in determining that sufficient evidence is gathered in order to evaluate the assertions being addressed in the audit engagement. Further, the gathering and evaluation of that evidence must be done by auditors who are independent of the client – in both fact and in appearance. Finally, the work must be carried out by auditors that understand the standards and exercise due professional care in the conduct of the audit engagement.

2-33. The major planning steps are:

- Meeting with the audit client
- Developing an understanding of the industry
- Develop an understanding of the client's financial reporting processes and controls
- Develop an understanding of materiality
- Develop a preliminary audit program that identifies the audit objectives defined in chapter 1.

2-34. The auditor would take a statistical sample of all additional to PP&E and verify the cost through reference to vendor invoices to determine that cost is accurately recorded and that title has passed to the company. If the company was considered high risk, the auditor might choose to physically verify the existence of the asset.

2-35. Audit procedures are designed to test the representations made in the financial statements. In other words, the financial statements contain assertions about the entity's assets, liabilities, and income producing activities. For example, the account balance called inventory implies that the inventory that is represented by the dollar figures in the financial statements:

- exist,
- is owned by the company,

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

- is properly valued at the lower of cost or market, and at an acceptable methodology to compute cost,
- is all recorded in the correct period, and
- contains adequate disclosure about the nature and the pricing of the inventory.

2-36. Materiality is defined as the

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

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

Multiple Choice Questions:

2-37. d.
2-38. a.
2-39. a.
2-40. d.
2-41. c.
2-42. f.
2-43. d.
2-44. b.
2-45. d.
2-46. d.

Discussion and Research Questions:

2-47. *(Corporate Governance)*

a. The auditor might use the following approaches to determine whether a corporate code of ethics is actually followed:

- observe corporate behavior in tests performed during the audit, e.g. approaches the company takes to purchasing goods, promoting personnel, and so forth,
- observe criteria for promoting personnel; for example does performance always take on greater importance than how things are done,
- observe corporate plans to communicate the importance of ethical behavior, e.g. webcasts, emails, and so forth to communicate the importance of ethics,
- review activity on the client's whistleblowing website, or a summary of whistleblowing activities reported by the internal auditor,

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

- read a sample of self-evaluations by corporate officers, the board, and the audit committee and compare with the auditor's observations of behavior,
- examine sales transactions made during the end of quarters to determine if the sales reflect 'performance goals' as opposed to the company's code of ethics.

b. Are auditors equipped to make subjective judgments? This should be a great discussion question because many young people are attracted to the accounting profession because there are rules and relative certainty as to how things are done. However, as the profession is evolving, more judgments are required in both auditing and accounting. Audit personnel need to be equipped to make judgments on whether the company's governance structure operates as intended and whether there are deficiencies in internal control when it does not operate effectively. The profession believes that auditors can make such judgments.

2-48. *(Auditor Expectations)*

ab&c. **Cookie jar reserves** are essentially funds that companies have "stashed away" to use when times get tough. The rationale is that the reserves are then used to "smooth" earnings in the years when earnings needs a boost. "Smooth" earnings typically are looked upon more favorably by the stock market. An example of a cookie jar reserve would be over-estimating an allowance account, such as allowance for doubtful accounts. The allowance account is then written down (and into the income statement) in a bad year.

Auditors may have allowed cookie jar reserves because they are known to smooth earnings, and smooth earnings are rewarded by the market. On the flip side, fluctuating earnings are penalized, and present more risk to the company of bankruptcy or other problems.

The Sarbanes-Oxley Act addressed the issue by creating an oversight body, the PCAOB, but also addressed the issue in other ways. For example, Congress felt that creating more effective Boards would decrease the use of earnings management.

Allowing improper revenue recognition is one thing that auditors may have done in their unwillingness to say "no" to clients. For example, companies shipped out goods to customers at the end of the year for deep discounts and allowed returns at the beginning of the next year. This practice is known as channel stuffing. Since the goods had a great chance of being returned, it would be improper to recognize all as revenue.

Again, auditors were unwilling to say "no" to clients or believe they are adding value for the clients. Greed is probably the reason here. If companies claim more revenue, their stock would grow in the short-term, making management richer, and making management more willing to give pay raises to their auditors.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

With the establishment of stronger audit committees and certification of financial statements in the Sarbanes-Oxley Act, this kind of accounting trickery will certainly decrease.

Creative accounting for M&A included the use of the "pooling" method of accounting. Pooling allowed acquiring companies to value existing assets at historical costs and did not require the recognition of goodwill for the acquisition. Because true costs (values) were not shown on the financial statements, management was often encouraged to bid up prices for acquisitions with the result that many of them were not economic. The creative accounting also shielded the income statement from charges that would have otherwise hit income including: goodwill amortization, depreciation, and depletion expenses.

The auditor believes he/she is adding value to the client or just plain greed. These are similar to the reasons for pushing revenue recognition.

Discussion between an educated audit committee and auditor plus certification of financial statements required by Sarbanes-Oxley will certainly address this issue.

Assisting management to meet earnings: Too often, auditors confused 'financial engineering' with value-adding. In other words, auditors often sought to add value to their clients by finding ways to push accounting to achieve earnings objectives sought by management. These earnings objectives then played a major role in escalating stock prices – all desired because of the heavy emphasis of management compensation on stock options.

Misalignment of Management Incentives: Incentives were misaligned. Most of management compensation came in the form of stock options which provided motivation to misstate earnings to boost stock prices.

The Sarbanes-Oxley Act of 2002 requires more financially literate and independent audit committees, increased auditor responsibility for reporting on internal control, the identification of users as the client of the auditor, and management certification of both financial statements and reports on internal control. All of these factors address the problems first identified by Arthur Levitt.

2-49. *(Public Accounting and Corporate Governance)*

a. External auditors are supposed to perform audits of financial statements to ensure that the statements are free of material misstatements. They work for each of the parties to a certain extent and since they are independent, they will not favor any party over the other. The auditors are an independent and objective attestor that evaluates the quality of financial reporting and conveys an opinion to all parties involved in corporate governance.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

b. Some of the ways the accounting profession was responsible were:
- Were too concerned about creating "revenue enhancement" opportunities, and less concerned about their core services or talents
- Were willing to "push" accounting standards to the limit to help clients achieve earnings goals
- Began to use more audit "shortcuts" such as inquiry and analytical procedures instead of direct testing of account balance.
- Relied on management representations instead of testing management representations.

c. The term "public watchdog" implies that auditors will look over the business world and stop bad things from happening. In terms of financial statements, Arthur Levitt said, "We rely on auditors to put something like the good housekeeping seal of approval on the information investors receive." The term "public watchdog" places a great deal of responsibility on the shoulders of auditors to protect the public's interests.

2-50. *(Corporate Governance)*

a. Corporate governance is defined as:

> "a process by which the owners and creditors of an organization exert control and require accountability for the resources entrusted to the organization. The owners (stockholders) elect a board of directors to provide oversight of the organization's activities."

The key players in corporate governance are the stockholders (owners), board of directors, audit committees, management, regulatory bodies, and auditors.

b. In the past decade especially, all parties failed to a certain extent. For detailed analysis, see exhibit 2.2 in the chapter and reproduced on the next page:

Corporate Governance Responsibilities and Failures

Party	**Overview of Responsibilities**	**Overview of Corporate Governance Failures**
Stockholders	**Broad Role:** Provide effective oversight through election of Board process, approve major initiatives, buy or sell stock.	Focused on short-term prices; failed to perform long-term growth analysis; abdicated all responsibilities to management as long as stock price increased.
Board of Directors	**Broad Role**: the major representative of stockholders to ensure that the organization is run according to the organization charter and there is proper	• Inadequate oversight of management. • Approval of management compensation plans, particularly

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
	accountability. **Specific activities** include: • Selecting management. • Reviewing management performance and determining compensation. • Declaring dividends • Approving major changes, e.g. mergers • Approving corporate strategy • Overseeing accountability activities.	stock options that provided perverse incentives, including incentives to manage earnings. • Non-independent, often dominated by management. • Did not spend sufficient time or have sufficient expertise to perform duties. • Continually re-priced stock options when market price declined.
Management	**Broad Role:** Operations and Accountability. Managing the organization effectively and provide accurate and timely accountability to shareholders and other stakeholders. **Specific activities** include: • Formulating strategy and risk appetite. • Implementing effective internal controls. • Developing financial reports. • Developing other reports to meet public, stakeholder, and regulatory requirements.	• Earnings management to meet analyst expectations. • Fraudulent financial reporting. • Pushing accounting concepts to achieve reporting objective. • Viewed accounting as a tool, not a framework for accurate reporting.
Audit Committees of the Board of Directors	**Broad Role:** Provide oversight of the internal and external audit function and the process of preparing the annual accuracy financial statements and public reports on internal control. **Specific activities** include: • Selecting the external audit firm. • Approving any non-audit work performed by audit firm. • Selecting and/or approving the appointment of the Chief Audit Executive (Internal Auditor), • Reviewing and approving the scope and budget of the internal audit function.	• Similar to Board members – did not have expertise or time to provide effective oversight of audit functions. • Were not viewed by auditors as the ‘audit client’. Rather the power to hire and fire the auditors often rested with management.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
	• Discussing audit findings with internal auditor and external auditor and advising the Board (and management) on specific actions that should be taken.	
Self-Regulatory Organizations: AICPA, FASB	**Broad Role:** Setting accounting and auditing standards dictating underlying financial reporting and auditing concepts. Set the expectations of audit quality and accounting quality. **Specific roles** include: • Establishing accounting principles • Establishing auditing standards • Interpreting previously issued standards • Implementing quality control processes to ensure audit quality. • Educating members on audit and accounting requirements.	• AICPA: Peer reviews did not take a public perspective; rather than looked at standards that were developed and reinforced internally. • AICPA: Leadership transposed the organization for a public organization to a "trade association" that looked for revenue enhancement opportunities for its members. • AICPA: Did not actively involve third parties in standard setting. • FASB: Became more rule-oriented in response to (a) complex economic transactions; and (b) an auditing profession that was more oriented to pushing the rules rather than enforcing concepts. • FASB: Pressure from Congress to develop rules that enhanced economic growth, e.g. allowing organizations to not expense stock options.
Other Self-Regulatory Organizations, e.g. NYSE, NASD	**Broad Role:** Ensuring the efficiency of the financial markets including oversight of trading and oversight of companies that are allowed to trade on the exchange. **Specific activities** include: • Establishing listing requirements – including accounting requirements, governance requirements, etc. • Overseeing trading activities,	• Pushed for improvements for better corporate governance procedures by its members, but failed to implement those same procedures for its governing board, management, and trading specialists.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
Regulatory Agencies: the SEC	**Broad Role:** Ensure the accuracy, timeliness, and fairness of public reporting of financial and other information for public companies. **Specific activities** include: • Reviewing all mandatory filings with the SEC, • Interacting with the FASB in setting accounting standards, • Specifying independence standards required of auditors that report on public financial statements, • Identify corporate frauds, investigate causes, and suggest remedial actions.	• Identified problems but was never granted sufficient resources by Congress or the Administration to deal with the issues.
External Auditors	**Broad Role:** Performing audits of company financial statements to ensure that the statements are free of material misstatements including misstatements that may be due to fraud. **Specific activities** include: • Audits of public company financial statements, • Audits of non-public company financial statements, • Other accounting related work such as tax or consulting.	• Pushed accounting concepts to the limit to help organizations achieve earnings objectives. • Promoted personnel based on ability to sell "non-audit products". • Replaced direct tests of accounting balances with a greater use of inquiries, risk analysis, and analytics. • Failed to uncover basic frauds in cases such as WorldCom and HealthSouth because fundamental audit procedures were not performed.
Internal Auditors	**Broad Role:** Perform audits of companies for compliance with company policies and laws, audits to evaluate the efficiency of operations, and audits to determine the accuracy of financial reporting processes. **Specific activities** include: • Reporting results and analyses to management, (including operational management), and audit committees,	• Focused efforts on 'operational audits' and assumed that financial auditing was addressed sufficiently by the external audit function. • Reported primarily to management with little effective reporting to the audit committee. • In some instances (HealthSouth,

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
	• Evaluating internal controls.	WorldCom) did not have access to the corporate financial accounts.

2-51. *(Sarbanes-Oxley Act of 2002)*

a. Some ways that the impact of THE SARBANES-OXLEY ACT affects the external audit profession:

- The creation of the PCAOB puts a watchful eye on the accounting industry.
- Reporting on internal controls is required by the external auditor, adding to their workload but also strengthening their value to organizations and giving them more assurance when giving an audit opinion.
- Auditors can now feel more comfortable taking issues to the audit committee
- Audit partners must rotate off every five years. This will create a difficult transition at every client every five years.
- With the cooling off period, audit partners or managers cannot take jobs with clients as easily.

b. The Sarbanes-Oxley Act encourages effective internal audit functions for all public companies. Further, the NYSE and NASDAQ require all listed companies to have effective internal audit functions. The internal audit profession has been active in assisting companies in complying with the internal control provisions of the Act.

Internal auditors will be affected by the legislation through:

- Greater emphasis on assisting management in the evaluation of the effectiveness of internal control over financial reporting,
- Increased access to the audit committee,
- [Implied, but not required] greater interaction with the external auditor in planning and coordinating audit activities.
- Greater review of areas previously neglected by internal auditors, especially in the areas of accounting estimates and the accounting closing process.

c. This could be argued either way. On one side, the legislation clearly creates a "watchdog" of the accounting industry, which decreases the power and prestige as the profession is no longer self-regulated. On the other hand, the Act and recent business press has brought a lot of attention to the accounting industry, which has educated the world about the role of accountants in the economy, and possibly increased their power and prestige.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

Now, after 4 years of the Sarbanes-Oxley Act, there is a general feeling that the public accounting profession has reestablished itself as a watchdog for investors and see the audit committee as their primary client. Overall, the consensus seems to be that the profession has regained a great deal of its prestige.

2-52. *(Sarbanes-Oxley – Management Implications)*

a. Some of the ways that the Sarbanes-Oxley Act has changed the responsibilities of management are:
   - Requirement that CEO and CFO certify the financial statements and disclosures
   - Requirement that companies provide a comprehensive report on internal controls over financial reporting
   - Requirement to describe whether they have implemented a Corporate Code of Conduct, including provisions for whistleblowing, and processes to ensure that corporate actions are consistent with the Code of Conduct.

b. Under The Sarbanes-Oxley Act, management is no longer the "client." The auditor reports to the audit committee, who is independent of management. With these changes, the auditor should be able to be "tougher" on management because the audit committee will be demanding it. However, the auditor still has to work with management to gain access to needed information, as well as understanding management intent as management intent drives some accounting treatments.

c. The CEO and CFO, as members of management, are ultimately responsible for the financial statements. The chair of the audit committee and the external auditor are then responsible to a certain extent, probably more in the minds of the public than in reality. Finally, the Director of Internal Audit is the least responsible of the group, as they are essentially employees of management and the audit committee.

2-53. *(Audit Committees and Auditor Independence)*

a. This is intended to be an open-ended discussion. There are a number of factors that have been mentioned in the discussions regarding auditor independence. The following is representative of some issues discussed:

   - The audit firm's policy for rotating auditors in charge of the engagement,
   - Whether or not the client has hired personnel from the audit firm for significant financial or management positions in the company, such as the Chief Financial Officer was the former partner in charge of the audit engagement,
   - The nature of non-audit services provided by the audit firm,
   - The existence of any social or other relationships with management,
   - Audit committee experience with the audit firm in other situations, such as the auditor provides services for other entities with which the audit committee member has an association,

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

- The existence of any charges brought against the auditing firm by the SEC,
- The audit firm's involvement in significant lawsuits where their judgment has been questioned,
- The amount of fees charged by the auditing firm. If the audit fees are too low, the audit committee should question the thoroughness and independence of the work. If fees from non-audit work are high, the audit committee will want to question that relationship and possible effect on judgments made by the auditor.
- The manner in which individual audit partners are compensated by the public accounting firm. For example, if an audit partner's compensation is determined significantly by whether or not a client is retained, then there might be questions about what the auditor would do to retain the client.
- The general reputation of the firm.
- The firm's policies and procedures for attracting and retaining talented audit personnel.
- The process of assigning personnel to an audit.
- The firm's expertise in the industry.

b. The main way that the audit committee can influence the independence of the internal audit department is by choosing who is in charge of the department. The "tone at the top" in the internal audit department will go a long way. Further, the audit committee ought to approve the scope of the internal audit charter, approve annual audit plans, as well as annual budgets.

c. 1. **Tax Return for Company:** *Approval argument*. The auditor is already aware of all the information, so can efficiently prepare the return. Tax accounting is different than audit accounting, so accounting treatments can be different in both settings and will not affect each other. Such an approval must require the audit committee's approval, thus there is effective oversight of the independence of the auditor in preparing the tax return.

Non-Approval: On the other hand, some argue that tax preparation is a consulting activity, i.e. the auditor would need to be a client advocate and thereby should not prepare the tax return.

2. **Tax Return for Management and Board Members:** *Approval:* The auditor is an expert. The services can be viewed as a benefit or management and the board.

Not Approve: Performance of the tax services too closely aligns the auditor with management and the board. The auditor has to be a client advocate in developing the tax returns. This may mentally conflict with the auditor's need to be objective in all other work involving the client.

3. **Tax Return paid for by Managers, not company:** *Approval:* This is an independent service not paid for by the company.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

Not Approve: The argument is the same as #2 above. Although paid for by the individuals, there is still the possibility of conflict.

4. **Overseas Assistance for Internal Audit Department:** *Do not approve*. It is the responsibility of management to prepare a review of internal control, and the auditor does an independent analysis. Further, the performance of internal audit work is one of the areas that have been explicitly prohibited by the SEC.

5. **Security Audit of Information Systems:** *Approve*. This is an assurance service in an area in which the auditor has competence. The work also provides information that is useful to the auditor in reporting on the financial statements.

   Not Approve: There are two reasons to not approve the service.
   - First, there could be a perception on the part of some that the service is more a consulting service rather than an assurance service. However, both the auditor and the audit committee can protect against this by confining the engagement to the security audit.
   - Second, there could be a potential problem if management uses the auditor's evaluation as a major part of their assessment of internal controls over financial reporting. Since they are using the auditor's work as a basis for forming part of their opinion, the auditor could be perceived as auditing his or her own work.

6. **Train Operating Personnel on Internal Controls:** *Approve*. Auditors are experts on this area. There is no direct conflict with the performance of the audit. Better trained personnel should imply better internal controls – beneficial for both management and the auditor.

   Not Approve. The PCAOB is explicit that management has the responsibility to design, implement, and evaluate internal control. Thus, training personnel is a management task that cannot be performed by the auditor. It could, however, be performed by a different public accounting firm.

7. **Perform Internal Audit Work for the Company:** *Do not approve*. It is the responsibility of management to prepare a review of internal control, and the auditor does an independent analysis. Usually internal audit is responsible for "management's" end of assessing internal controls.

2-54. *(Audit Committees)*

a. An **audit committee** is a subcommittee of the board of directors; it is responsible for monitoring audit activities and serves as a surrogate for the interests of shareholders. Audit committees should preferably be composed of outside members of the board, that is, members who do not hold company management positions or are closely associated with management.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

b. The following information should be discussed with the audit committee:

- A summary of the auditor's responsibilities under GAAS. Auditor responsibilities change over time as new standards are issued. The audit committee should always be aware of the nature of the audit function within the organization.
- Initial selection or major changes in *significant accounting policies* that could have a material affect on financial statement presentation. The audit committee needs to know how the choice may affect both current reports and future financial reports as well as the rationale for the choice because it is presumed that companies select the accounting principles that best reflect the economic substance of their transactions and are thus changed only when dictated by standard-setting bodies or when the economics of the situation change.
- The process utilized by management to make *significant estimates* and other management judgments such as loan loss reserves in banks and savings and loans and insurance reserves in insurance companies.
- *Significant audit adjustments* that may reflect on the stewardship and accountability of management, even if management agreed to make the adjustments.
- The auditor's review of and responsibility for *other information* contained in an annual report (outside of the audited financial statements).
- All major *accounting disagreements with management,* even if such disagreements are eventually resolved to the auditor's satisfaction.
- The auditor's knowledge of *management's consultation with other auditors* regarding accounting or auditing issues.
- Any significant accounting or auditing *issues discussed with management prior to the acceptance of the audit engagement* - in particular, any positions taken regarding the proper accounting of controversial areas should be disclosed.
- Any *difficulties encountered* in performing the audit, especially any activities undertaken by management that might be considered an impairment of the audit function.
- *Internal audit plans and reports* and management's responses to those reports.
- The extent to which the client has implemented a comprehensive *plan of risk assessment* and the organization's plans to mitigate, share, control, or otherwise address those risks.
- Any known *internal control weaknesses* that could significantly affect the financial reporting process.

The rationale for this communication is that the board of directors through its audit committee is responsible for the client's financial reporting and a thorough discussion of these issues will help them fulfill that responsibility.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

c. Although they do not have stockholders, non-public entities would still want to have audit committees comprised of independent members. No matter what the organization, there are always stakeholders that want to make sure the company is being run properly. In the example of a school, taxpayers and parents want to know what is happening with public funds. Without an audit committee, the stakeholders would be trusting management to do everything properly, and in their best interests. There is a need for accountability and independent reporting for charities, governmental agencies, and other public-interest organizations. Audit committees help fill that role.

2-55. *(Audit Committees)*

a. The audit committee must be comprised of “outside” independent directors, one of whom must be a financial expert. The audit committee now has the authority to hire and fire the external auditor, and will therefore serve as the auditor’s primary contact, especially for accounting and audit related issues. In addition, the audit committee sets the scope for and hires internal auditors. They must review the work of both parties.

b. The audit committee certainly takes on much more responsibility under Sarbanes-Oxley. The audit committee must be much more informed about the audit function and financial reporting processes within their company. The auditor must report all significant problems to the audit committee. For auditors, the reporting relationship should reinforce the need to keep the third-party users in mind in dealing with reporting choices.

c. The audit committee is basically in a position of mediator, but not problem solver. One member must be a financial expert, but all members must be well versed in the field. This financial knowledge can help the audit committee to understand the disagreement. Ultimately, the auditor has to be able to give a clean audit opinion. If they believe a certain accounting treatment to be wrong, they do not have to give that clean opinion. In this way, neither the audit committee nor management can necessarily solve a dispute.

d. Management is responsible for the financial statements. If they don’t agree with the auditor’s treatment, they do not have to go along with it. That being said, this will rarely happen because it would most likely lead to something other than an unqualified (clean) audit opinion.

2-56. *(The PCAOB)*

a. Congress thought that the profession was no longer capable of setting its own standards to protect the public.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

b. The PCAOB will set standards for audits of public companies and will define the professions responsibilities for detecting fraud and other financial misdeeds. They will also establish and test quality control guidelines for public accounting firms that audit public companies.

c. The rationale for the requirement was probably to get people from diverse disciplines to comprise the Board. This way, more thoughts are generated. Congress probably was under the impression that CPA's tend to think alike. The disadvantage to having only two CPA's on the board is that they do not form a majority. The Board sets standards for an industry made up almost entirely of CPA's, yet the strongest voice may not be that of a CPA.

d. Not at this time. The AICPA is trying to position the organization to set the audit standards for non-public companies.

2-57. *(Materiality)*

a. Materiality is defined as the

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

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

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

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

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

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

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

2-58. *(Audit Standards for Non-Public Companies)*

a. For the most part, it is reasonable to expect harmonization between audit standards for public and audit standards for non-public clients. For example, all audits should be risk-based and should require sufficient evidential matter in order for the auditor to render an opinion on the financial statements. Thus far, the standards issued by the AICPA and the PCAOB are quite similar. Areas in which differences are most likely to take place include:

- Public reports on internal control as required by the PCAOB,
- Independence standards may differ; however, the differences should be subtle and reflective of the nature of the client (audit committee vs. no audit committee) and generally should not be substantive.
- Differences in types of reports that can be issued (non-public reports can be issued for other comprehensive bases of accounting, as well as for compilations and reviews as issued by the accounting and review service statements),
- Risk based standards may focus on different things as there may be differing risk factors for public vs. non-public clients.
- Required review of internal control may differ as public companies have more integrated audits while non-public companies have traditionally focused on substantive tests of account balances.

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

c. The audit committee determines the nature of the audit to be performed. Thus the audit committee can specify whether the audit is conducted according to PCAOB standards, international auditing standards, or in the case of a non-public company, AICPA standards. The audit committee has some leeway unless specified by regulation. For governmental entities and for public-traded companies, there is no choice: governmental entities must follow GAO standards; public traded companies must follow PCAOB standards.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

2-59. *(Auditing Standards)*

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

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

c. Professional skepticism is a trait that all auditors must have, all the time. Declining professional skepticism as a result of greater comfort with the client is a major cause of many past audit failures. The attitude of integrity and independence that the auditor should bring to the audit is represented in the audit working papers by adequate planning and supervision and the gathering of sufficient competent evidential matter to support the opinion that is rendered. Professional skepticism is maintained in the audit process through the audit firm having an adequate quality control process and the extensive review of the work and conclusions reached.

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

2-60. *(Generally Accepted Auditing Standards)*

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

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

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

2-61. *(Research – Sarbanes-Oxley Studies)*

The goal of this assignment is to deliver the most up-to-date information on the status of the important GAO studies to the class.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

2-62. *(Attestation Standards)*

a. There is little doubt that the public accounting profession has the expertise to perform such a function. However, the services should not be allowed because it would lead to a situation where auditors are auditing their own work, not that of others.

b. The public accounting profession would probably have a competitive advantage in performing such services because of their knowledge of providing auditing and attestation services and because they spend so much time with the client that they have built a solid foundation of knowledge of them. Any investment banker would most likely be starting with a clean slate. Some could view this as an advantage for using the investment banking industry, however.

2-63. *(Accounting and Audit Procedures)*

Sales

Existence or occurrence – the sales mentioned did occur
Completeness – the total sales amount represents all sales made in the year
Valuation and allocation – the total sales amount is correct and represents real prices for the transactions and the amounts are collectible.
Disclosure and presentation – sales are presented in the proper part of the income statement.
Rights and obligations – the sales transactions represents assets that belong to the company

Inventory

Existence or occurrence – the inventory exists
Completeness – the inventory amount represents all inventory on hand
Valuation and allocation – the inventory amount is valued correctly at the lower of cost or market.
Disclosure and presentation – inventory is presented in the proper part of the balance sheet.
Rights and obligations – the inventory amount represents an asset that is owned by the company

Accounts Receivable

Existence or occurrence – the receivables do exist, others owe the company money
Completeness – the amount of A/R represents all that the company is owed
Valuation and allocation – the A/R amount represents the amount the company expects to collect from the receivables.
Rights and obligations – the A/R amount represents an asset that is owed to the company, the company has a right to it
Disclosure and presentation – A/R is presented in the proper part of the balance sheet

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

2-64. *(Audit Framework – Audit Procedures)*

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

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

c. If the number of leased equipment pieces is small, examine each lease agreement using the four-step method (i.e. 90% fair value).

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

e. The auditor should question the method and calculations for the current year depreciation entries and make an assessment if the method, the number of years of useful life, and the calculations are reasonable.

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

2-65. *(Group Research – Audit Committees)*

The goal of this exercise is to allow the student to see how audit committees actually function in the "real world." The differences between the various companies will prove that all audit committees, charters, and company goals are different. The latter part of the assignment will serve as a chance to hear student opinions on a yet unsettled issue.

2-66. (*Evaluating Corporate Governance)*

The purpose of this project is to get students out into the business community and acquaint them with the process of gathering evidence about corporate governance and evaluating the effectiveness of corporate governance. Another alternative is to discuss what students have observed in their part-time jobs.

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.

Cases:

2-67. *(Audit Committees)*

a. Important stakeholders that might serve on an audit committee could include:

- Representative of financial institutions with whom the organization does business.
- Other members of the family owning the company.
- Independent people in the community, e.g. civic leaders.
- Representatives of the workers.

Other potential audit committee members could include:

- Academics – skilled in auditing and/or financial reporting.

b. Some possibilities are: financial expertise, general business expertise, independence, diversity of experience in the business world, and a pre-existing knowledge of the company.

c. There are a number of audit charters that can be downloaded from almost any annual report. The students should identify some and the key characteristics of the audit committee charter.

d. We hope the students identify a number of key points beyond those outlined below. Some items for the students to consider as key elements of an effective information system include:

Information	Frequency	Source of the Information
Financial Statements	Quarterly and Monthly	CFO and accounting function.
Internal Audit Reports	Quarterly, and as warranted by the findings	Internal Audit Activity
External Audit Reports	Quarterly, and as warranted by the findings	External Audit
Key Performance Indicators	Sales Data – by product line or key factor. Quarterly. Production Data – by product line. Returns and analysis of any increase in returns. Quality of Credit	Accounting and Production System.
Regulatory Reports	As occurs	Regulatory Auditors
Risk Analysis	Summary of Key Risks and Approach to managing those risks – quarterly.	Risk Manager, CEO

This edition is intended for use outside of the U.S. only, with content that may be different from the U.S. Edition. This may not be resold, copied, or distributed without the prior consent of the publisher.