PART 1

THE PROFESSION OF AUDITING

CHAPTERS 1 – 5

These first five chapters in **Part I** provide background for performing financial audits, which is our primary focus. This background will help you understand why auditors perform audits the way they do.

- **Chapters 1 and 2** describe assurance services, including auditing and the role of certified public accounting (CPA) firms and other organizations in performing audits.
- **Chapter 3** provides a detailed discussion of audit reports, which are the final products of audits.
- **Chapters 4 and 5** emphasize the regulation and control of CPA firms through ethical standards and the legal responsibilities of auditors.

CHAPTER 1

THE ASSURANCE SERVICES MARKET

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- **1-1** Describe auditing.
- **1-2** Distinguish between auditing and accounting.
- **1-3** Explain the importance of auditing in reducing information risk.
- **1-4** List the causes of information risk, and explain how this risk can be reduced.
- **1-5** Describe assurance services and distinguish audit services from other assurance and nonassurance services provided by CPAs.
- **1-6** Differentiate the three main types of audits.
- **1-7** Identify the primary types of auditors.
- **1-8** Describe the requirements for becoming a CPA.

Where Were the Auditors?

In August 2000, the shareholders of Enron Holdings were riding high. Andy thought so anyway. He had invested in Enron at the beginning and poured a great majority of his life savings into the promising company. Every week he invested 10% of his paycheck into Enron stock. Enron was the next Microsoft, they all said. Enron was named "America's Most Innovative Company" by *Fortune* magazine for six consecutive years, from 1996 to 2001. During the 1997–2000 period, Enron's share price quadrupled as investors saw remarkable revenue growth. Enron's price was up to $90 per share, the company was profitable, and the investment seemed solid. Management was promising share prices of $130 per share in the near future. With such a solid record and blue chip status, thousands of other investors and pension management funds had holdings in the company as well. Andy was well on his way to purchasing his first house and setting himself up for retirement one day. Then, on November 28, 2001, Enron's stocks tumbled to just cents per share when news of the losses went public. Andy's savings disappeared.

All of his hard earned money used to purchase these shares had simply vanished. Now, instead of purchasing that new house, Andy had lost everything. "What are we going to do?" he asked Martha, his wife. "I don't know," she said. "I guess we start over." Andy followed the developments online with each accusation as unbelievable as the next. Enron had created fake offshore entities, which allowed Enron to sell its own assets that it couldn't sell elsewhere to itself at an inflated price, hiding untold losses. Loans were made to look like profit from sales, sales of contracts were secretly repurchased but not reported, and transactions were made to look like swaps but were actually loans. Overseas companies were also affected; Enron had spent millions investing in global companies like gas pipe lines in South America, and clean energy plants in Indonesia and India. The list goes on and on.

What's worse is that outside parties like banks and law firms had a hand in the deception all for their own personal gain. With the help of banks, Enron sold phony assets at an overvalued price—assets which never even changed hands. With the help of law firms, Enron structured favorable transactions and prepared false submissions to the SEC. Securities analysts made false, rosy assessments of Enron's condition to entice investors. Underwriters approved incomplete and incorrect financial statements when approving the sale of $2 billion in securities to investors. All in all, losses to investors are estimated at $25 billion. "What had happened? Aren't there people out there who are supposed to catch this kind of thing?" Andy and the other investors asked in disbelief. The answer to their question is yes, and one of those people was the auditing firm, Arthur Anderson. An auditor's ultimate responsibility is to the *users of the financial statements*, which in this case were the investors—investors who were sorely let down by the auditors and so many other parties.

Sources: Guma, Greg. "Toward Freedom—Enron's Global Game." Toward Freedom; Dec, 2001. http://www.towardfreedom.com/home/content/view/80/69/.

Each chapter's opening story illustrates important auditing principles based on realistic situations. Some of these stories are based on public information about the audits of real companies, whereas others are fictitious. Any resemblance in the latter stories to real firms, companies, or individuals is unintended and purely coincidental.

The opening story illustrates the importance of the role of auditors and their responsibility to the users of financial statements. In the aftermath of Enron and other major financial reporting frauds, Congress passed the **Sarbanes–Oxley Act**, called by many the most significant securities legislation since the 1933 and 1934 Securities Acts. The provisions of the Act apply to publicly held companies and their audit firms. Section 404 of the Act expanded the audit of public companies to include reporting on the effectiveness of the company's internal control over financial reporting.

This chapter introduces auditing and other assurance services provided by auditors, as well as auditors' role in society. These services provide value by offering assurance on financial statements, the effectiveness of internal control, and other information. There is also a discussion of the types of audits and auditors, including the requirements for becoming a certified public accountant (CPA).

NATURE OF AUDITING

OBJECTIVE 1-1

Describe auditing.

We have introduced the role of auditors in society and how auditors' responsibilities have increased to include reporting on the effectiveness of internal control over financial reporting for larger public companies. We now examine auditing more specifically using the following definition:

> **Auditing** is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent, independent person.

The definition includes several key words and phrases. For ease of understanding, we'll discuss the terms in a different order than they occur in the description.

Information and Established Criteria

To do an audit, there must be information in a *verifiable form* and some standards (*criteria*) by which the auditor can evaluate the information. Information can and does take many forms. Auditors routinely perform audits of quantifiable information, including companies' financial statements and individuals' federal income tax returns. Auditors also audit more subjective information, such as the effectiveness of computer systems and the efficiency of manufacturing operations.

The criteria for evaluating information also vary depending on the information being audited. In the audit of historical financial statements by CPA firms, the criteria may be U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS). This means that in an audit of Boeing's financial statements, the CPA firm will determine whether Boeing's financial statements have been prepared in accordance with GAAP. For an audit of internal control over financial reporting, the criteria will be a recognized framework for establishing internal control, such as *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (widely known as COSO).

For the audit of tax returns by the Internal Revenue Service (IRS), the criteria are found in the Internal Revenue Code. In an IRS audit of Boeing's corporate tax return, the internal revenue agent uses the Internal Revenue Code as the criteria for correctness, rather than GAAP.

For more subjective information, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts. For example, in an audit of the effectiveness of specific aspects of computer operations, the criteria might include the allowable level of input or output errors.

Accumulating and Evaluating Evidence

Evidence is any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including:

- Electronic and documentary data about transactions
- Written and electronic communication with outsiders
- Observations by the auditor
- Oral testimony of the auditee (client)

To satisfy the purpose of the audit, auditors must obtain a sufficient quality and volume of evidence. Auditors must determine the types and amount of evidence necessary and evaluate whether the information corresponds to the established criteria. This is a critical part of every audit and the primary subject of this book.

Competent, Independent Person

The auditor must be qualified to understand the criteria used and must be *competent* to know the types and amount of evidence to accumulate in order to reach the proper conclusion after examining the evidence. The auditor must also have an *independent mental attitude*. The competence of those performing the audit is of little value if they are biased in the accumulation and evaluation of evidence.

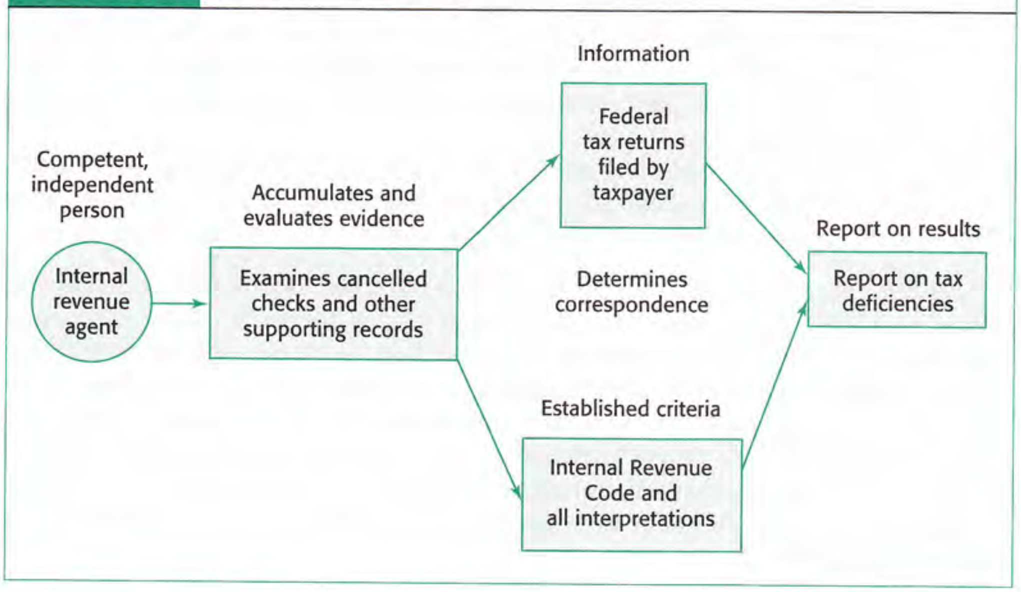
Auditors strive to maintain a high level of independence to keep the confidence of users relying on their reports. Auditors reporting on company financial statements are often called **independent auditors**. Even though such auditors are paid fees by the company, they are normally sufficiently independent to conduct audits that can be relied on by users. Even internal auditors—those employed by the companies they audit—usually report directly to top management and the board of directors, keeping the auditors independent of the operating units they audit.

Reporting

The final stage in the auditing process is preparing the **audit report**, which communicates the auditor's findings to users. Reports differ in nature, but all must inform readers of the degree of correspondence between the information audited and established criteria. Reports also differ in form and can vary from the highly technical type usually associated with financial statement audits to a simple oral report in the case of an operational audit of a small department's effectiveness.

The key parts in the description of auditing are illustrated in Figure 1-1 using an IRS agent's audit of an individual's tax return as an example. To determine whether the tax return was prepared in a manner consistent with the requirements of the federal Internal Revenue Code, the agent examines supporting records provided by the taxpayer and from other sources, such as the taxpayer's employer. After completing

FIGURE 1-1 Audit of a Tax Return



the audit, the internal revenue agent issues a report to the taxpayer assessing additional taxes, advising that a refund is due, or stating that there is no change in the status of the tax return.

DISTINCTION BETWEEN AUDITING AND ACCOUNTING

OBJECTIVE 1-2

Distinguish between auditing and accounting.

Many financial statement users and the general public confuse auditing with accounting. The confusion results because most auditing is usually concerned with accounting information, and many auditors have considerable expertise in accounting matters. The confusion is increased by giving the title "certified public accountant" to many individuals who perform audits.

Accounting is the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making. To provide relevant information, accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting information. In addition, accountants must develop a system to make sure that the entity's economic events are properly recorded on a timely basis and at a reasonable cost.

When auditing accounting data, auditors focus on determining whether recorded information properly reflects the economic events that occurred during the accounting period. Because U.S. or international accounting standards provide the criteria for evaluating whether the accounting information is properly recorded, auditors must thoroughly understand those accounting standards.

In addition to understanding accounting, the auditor must possess expertise in the accumulation and interpretation of audit evidence. It is this expertise that distinguishes auditors from accountants. Determining the proper audit procedures, deciding the number and types of items to test, and evaluating the results are unique to the auditor.

ECONOMIC DEMAND FOR AUDITING

OBJECTIVE 1-3

Explain the importance of auditing in reducing information risk.

To illustrate the need for auditing, consider the decision of a bank officer in making a loan to a business. This decision will be based on such factors as previous financial relationships with the business and the financial condition of the business as reflected by its financial statements. If the bank makes the loan, it will charge a rate of interest determined primarily by three factors:

1. *Risk-free interest rate.* This is approximately the rate the bank could earn by investing in U.S. treasury notes for the same length of time as the business loan.
2. *Business risk for the customer.* This risk reflects the possibility that the business will not be able to repay its loan because of economic or business conditions, such as a recession, poor management decisions, or unexpected competition in the industry.
3. *Information risk.* **Information risk** reflects the possibility that the information upon which the business risk decision was made was inaccurate. A likely cause of the information risk is the possibility of inaccurate financial statements.

Auditing has no effect on either the risk-free interest rate or business risk, but it can have a significant effect on information risk. If the bank officer is satisfied that there is minimal information risk because a borrower's financial statements are audited, the bank's risk is substantially reduced and the overall interest rate to the borrower can be reduced. The reduction of information risk can have a significant effect on the borrower's ability to obtain capital at a reasonable cost. For example, assume a large company has total interest-bearing debt of approximately \$10 billion. If the interest rate on that debt is reduced by only 1 percent, the annual savings in interest is \$100 million.

Causes of Information Risk

OBJECTIVE 1-4

List the causes of information risk, and explain how this risk can be reduced.

As society becomes more complex, decision makers are more likely to receive unreliable information. There are several reasons for this: remoteness of information, biases and motives of the provider, voluminous data, and the existence of complex exchange transactions.

Remoteness of Information In a global economy, it is nearly impossible for a decision maker to have much firsthand knowledge about the organization with which they do business. Information provided by others must be relied upon. When information is obtained from others, the likelihood of it being intentionally or unintentionally misstated increases.

Biases and Motives of the Provider If information is provided by someone whose goals are inconsistent with those of the decision maker, the information may be biased in favor of the provider. The reason can be honest optimism about future events or an intentional emphasis designed to influence users. In either case, the result is a misstatement of information. For example, when a borrower provides financial statements to a lender, there is considerable likelihood that the borrower will bias the statements to increase the chance of obtaining a loan. The misstatement could be incorrect dollar amounts or inadequate or incomplete disclosures of information.

Voluminous Data As organizations become larger, so does the volume of their exchange transactions. This increases the likelihood that improperly recorded information is included in the records—perhaps buried in a large amount of other information. For example, if a large government agency overpays a vendor's invoice by $2,000, it is unlikely to be uncovered unless the agency has instituted reasonably complex procedures to find this type of misstatement. If many minor misstatements remain undiscovered, the combined total can be significant.

Complex Exchange Transactions In the past few decades, exchange transactions between organizations have become increasingly complex and therefore more difficult to record properly. The increasing complexity in transactions has also resulted in increasingly complex accounting standards. For example, the correct accounting treatment of the acquisition of one entity by another poses relatively difficult accounting problems, especially as it relates to fair value estimations. Other examples include properly combining and disclosing the results of operations of subsidiaries in different industries and properly valuing and disclosing derivative financial instruments.

Reducing Information Risk

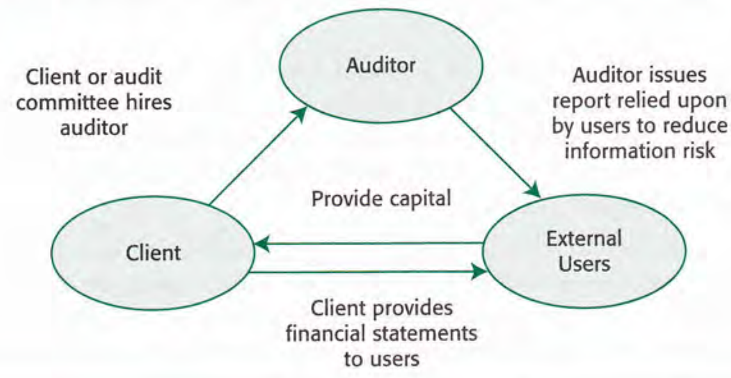
After comparing costs and benefits, business managers and financial statement users may conclude that the best way to deal with information risk is simply to have it remain reasonably high. A small company may find it less expensive to pay higher interest costs than to increase the costs of reducing information risk.

For larger businesses, it is usually practical to incur costs to reduce information risk. There are three main ways to do so.

User Verifies Information The user may go to the business premises to examine records and obtain information about the reliability of the statements. Normally, this is impractical because of cost. In addition, it is economically inefficient for all users to verify the information individually. Nevertheless, some users perform their own verification. For example, the IRS does considerable verification of business and individual tax returns to determine whether the tax returns filed reflect the actual tax due the federal government. Similarly, if a business intends to purchase another business, it is common for the purchaser to use a special audit team to independently verify and evaluate key information of the prospective business.

User Shares Information Risk with Management There is considerable legal precedent indicating that management is responsible for providing reliable information to users. If users rely on inaccurate financial statements and as a result

FIGURE 1-2 **Relationships Among Auditor, Client, and External Users**



incur a financial loss, they may have a basis for a lawsuit against management. A difficulty with sharing information risk with management is that users may not be able to collect on losses. If a company is unable to repay a loan because of bankruptcy, it is unlikely that management will have sufficient funds to repay users.

Audited Financial Statements Are Provided The most common way for users to obtain reliable information is to have an independent audit. Typically, management of a private company or the audit committee for a public company engages the auditor to provide assurances to users that the financial statements are reliable.

External users such as stockholders and lenders who rely on those financial statements to make business decisions look to the auditor's report as an indication of the statements' reliability. Decision makers can then use the audited information on the assumption that it is reasonably complete, accurate, and unbiased. They value the auditor's assurance because of the auditor's independence from the client and knowledge of financial statement reporting matters. Figure 1-2 illustrates the relationships among the auditor, client, and financial statement users.

ASSURANCE SERVICES

OBJECTIVE 1-5

Describe assurance services and distinguish audit services from other assurance and nonassurance services provided by CPAs.

An **assurance service** is an independent professional service that improves the quality of information for decision makers. Such services are valued because the assurance provider is independent and perceived as being unbiased with respect to the information examined. Individuals who are responsible for making business decisions seek assurance services to help improve the reliability and relevance of the information used as the basis for their decisions.

Assurance services can be done by CPAs or by a variety of other professionals. For example, Consumers Union, a nonprofit organization, tests a wide variety of products used by consumers and reports their evaluations of the quality of the products tested in *Consumer Reports*. The organization provides the information to help consumers make intelligent decisions about the products they buy. Many consumers consider the information in *Consumer Reports* more reliable than information provided by the product manufacturers because Consumers Union is independent of the manufacturers. Similarly, the Better Business Bureau (BBB) online reliability program, the BBB Accredited Business Seal, allows Web shoppers to check BBB information about a company and be assured the company will stand behind its service. Other assurance services provided by firms other than CPAs include the Nielsen television and Internet ratings and Arbitron radio ratings.

The need for assurance is not new. CPAs have provided many assurance services for years, particularly assurances about historical financial statement information. CPA firms have also performed assurance services related to lotteries and contests to provide assurance that winners were determined in an unbiased fashion in accordance with contest rules. More recently, CPAs have expanded the types of assurance services they perform to include forward-looking and other types of information, such as company financial forecasts and Web site controls. For example, businesses and consumers using the Internet to conduct business need independent assurances about the reliability and security of electronic information. The demand for assurance services continues to grow as the demand increases for real-time electronic information.

Attestation Services

One category of assurance services provided by CPAs is attestation services. An **attestation service** is a type of assurance service in which the CPA firm issues a report about a subject matter or assertion that is made by another party. Attestation services fall into five categories:

1. Audit of historical financial statements
2. Audit of internal control over financial reporting
3. Review of historical financial statements
4. Attestation services on information technology
5. Other attestation services that may be applied to a broad range of subject matter

Audit of Historical Financial Statements

In an **audit of historical financial statements**, management asserts that the statements are fairly stated in accordance with applicable U.S. or international accounting standards. An audit of these statements is a form of attestation service in which the auditor issues a written report expressing an opinion about whether the financial statements are fairly stated in accordance with the applicable accounting standards. These audits are the most common assurance service provided by CPA firms.

Publicly traded companies in the United States are required to have audits under the federal securities acts. Auditor reports can be found in all public companies' annual financial reports. Most public companies' audited financial statements can be accessed over the Internet from the Securities and Exchange Commission (SEC) EDGAR database or directly from each company's Web site. Many privately held companies also have their annual financial statements audited to obtain financing from banks and other financial institutions. Government and not-for-profit entities often have audits to meet the requirements of lenders or funding sources.

Audit of Internal Control over Financial Reporting

For an audit of **internal control over financial reporting**, management asserts that internal controls have been developed and implemented following well established criteria. Section 404 of the Sarbanes–Oxley Act requires public companies to report management's assessment of the effectiveness of internal control. The Act also requires auditors for larger public companies to attest to the effectiveness of internal control over financial reporting. This evaluation, which is integrated with the audit of the financial statements, increases user confidence about future financial reporting, because effective internal controls reduce the likelihood of future misstatements in the financial statements.

"AND THE OSCAR GOES TO . . ."
"THERE SHE IS, MISS AMERICA . . ."
"WELCOME TO THE NEW YORK STATE LOTTERY . . ."

You probably recognize these statements from the Academy Awards, the Miss America Pageant, and the New York State Lottery drawing. What you may not recognize is what these well-known events have to do with assurance services. Each event is observed by CPAs from a major accounting firm to assure viewers that the contests were fairly conducted. So when you become a member of a CPA firm, you might not win an Oscar—but you could be on the Oscars!

Review of Historical Financial Statements For a **review of historical financial statements,** management asserts that the statements are fairly stated in accordance with accounting standards, the same as for audits. The CPA provides a lower level of assurance for reviews of financial statements compared to a high level for audits, therefore less evidence is needed. A review is often adequate to meet financial statement users' needs. It can be provided by the CPA firm at a much lower fee than an audit because less evidence is needed. Many nonpublic companies use this attestation option to provide limited assurance on their financial statements without incurring the cost of an audit.

Attestation Services on Information Technology For attestations on information technology, management makes various assertions about the reliability and security of electronic information. Many business functions, such as ordering and making payments, are conducted over the Internet or directly between computers using electronic data interchange (EDI). As transactions and information are shared online and in real time, businesspeople demand even greater assurances about information, transactions, and the security protecting them. *WebTrust* and *SysTrust* are examples of attestation services developed to address these assurance needs.

- *WebTrust services.* The AICPA and the Canadian Institute of Chartered Accountants (CICA) jointly created the *WebTrust* attestation service. CPA firms that are licensed by the AICPA to perform this service provide assurance to users of Web sites through the CPA's electronic *WebTrust* seal displayed on the Web site. This seal assures the user that the Web site owner has met established criteria related to business practices, transaction integrity, and information processes.
- *SysTrust services.* The AICPA and CICA jointly created the *SysTrust* attestation service to evaluate and test system reliability in areas such as security and data integrity. Whereas the *WebTrust* assurance service is primarily designed to provide assurance to third-party users of a Web site, *SysTrust* services might be done by CPAs to provide assurance to management, the board of directors, or third parties about the reliability of information systems used to generate real-time information.

The AICPA and CICA have developed five principles related to online privacy, security, processing integrity, availability, and confidentiality to be used in performing services such as *WebTrust* and *SysTrust*. These services and principles are discussed further in Chapter 25.

Other Attestation Services CPAs provide numerous other attestation services. Many of these services are natural extensions of the audit of historical financial statements, as users seek independent assurances about other types of information. Typically, the CPA is engaged to provide written assurance about the reliability of an assertion made by management. For example, when a bank loans money to a company, the loan agreement may require the company to engage a CPA to provide assurance about the company's compliance with the financial provisions of the loan. The company requesting the loan must assert the loan provisions to be attested to before the CPA can accumulate the evidence needed to issue the attestation report. CPAs can also provide assurance about the reliability of subject matter when there is no written assertion from another party. However, in those situations, the auditor's written assurance is restricted to management or other specified parties. For example, CPAs can attest to the information in a client's forecasted financial statements, which are often used to obtain financing. We discuss attestation services further in Chapter 25.

Other Assurance Services

CPAs also provide other assurance services that do not meet the definition of attestation services, but the CPA must still be independent and must provide assurance about information used by decision makers. These assurance services differ from attestation

GREEN INITIATIVES BRING ASSURANCE OPPORTUNITIES, COMPETITION	Global interest in sustainability and corporate responsibility has triggered a surge in corporate reports that address these topics. In a 2011 KPMG survey, 95 percent of the Global Fortune 250 released environmental, social, and governance data in separate reports or integrated into annual financial reports, up from 80 percent in the last survey three years earlier. Approximately half of these reports included some form of commentary or formal assurance on the reports. Reports with formal assurance increased from 40 percent to 46 percent over the three-year period. Major accounting firms were the most common choice of assurance provider. Other assurance providers included certification bodies and technical expert firms. Source: *KPMG International Survey of Corporate Responsibility Reporting 2011*, KPMG Sustainability Services, KPMG, LLP.

services in that the CPA is not required to issue a written report, and the assurance does not have to be about the reliability of another party's assertion about compliance with specified criteria. These other assurance service engagements focus on improving the quality of information for decision makers, just like attestation services.

CPA firms face a larger field of competitors in the market for other assurance services. Audits and some types of attestation services are limited by regulation to licensed CPAs, but the market for other forms of attestation and assurance is open to non-CPA competitors. For example, CPAs must compete with market research firms to assist clients in the preparation of customer surveys and in the evaluation of the reliability and relevance of survey information. However, CPA firms have the competitive advantage of their reputation for competence and independence.

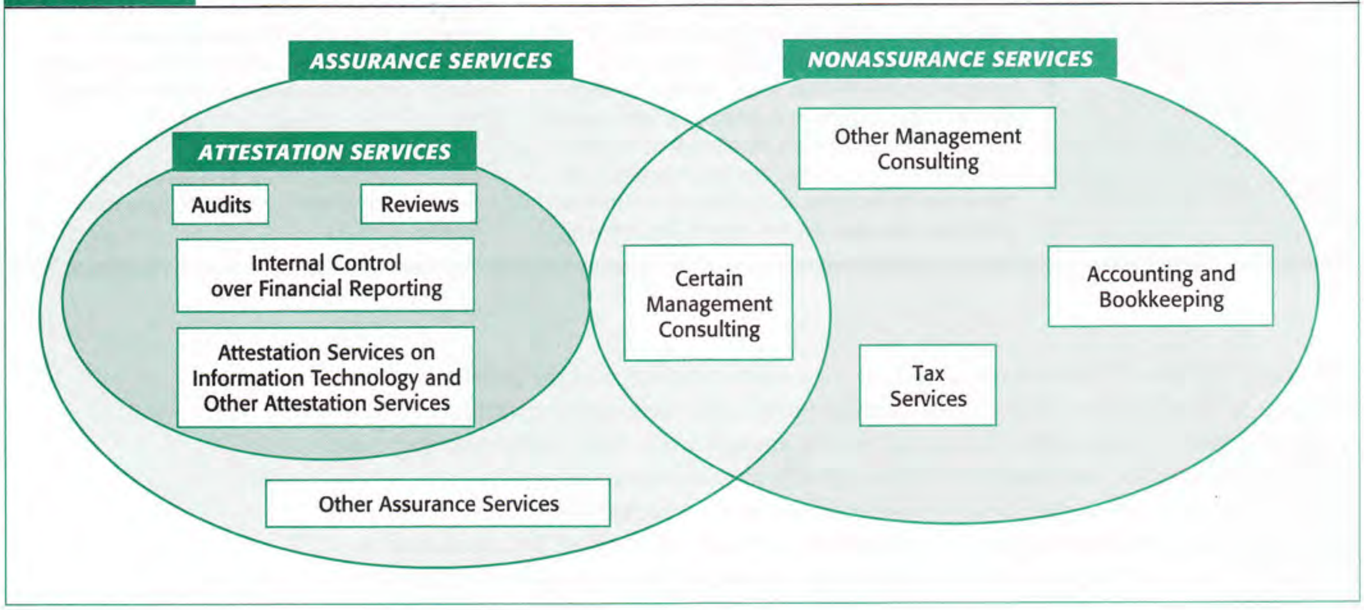
The types of assurance services that CPAs can provide are almost limitless. A survey of large CPA firms identified more than 200 assurance services that are currently being provided. Table 1-1 lists some of the other assurance service opportunities for CPAs. Additional information on the performance of assurance services is included in Chapter 25.

TABLE 1-1 Other Assurance Services Examples

Other Assurance Services	Service Activities
Controls over and risks related to investments, including policies related to derivatives	Assess the processes in a company's investment practices to identify risks and to determine the effectiveness of those processes
Mystery shopping	Perform anonymous shopping to assess sales personnel dealings with customers and procedures they follow
Assess risks of accumulation, distribution, and storage of digital information	Assess security risks and related controls over electronic data, including the adequacy of backup and off-site storage
Fraud and illegal acts risk assessment	Develop fraud risk profiles, and assess the adequacy of company systems and policies in preventing and detecting fraud and illegal acts
Organic ingredients	Provide assurance on the amount of organic ingredients included in a company's products
Compliance with entertainment royalty agreements	Assess whether royalties paid to artists, authors, and others comply with royalty agreements
ISO 9000 certifications	Certify a company's compliance with ISO 9000 quality control standards, which help ensure company products are of high quality
Corporate responsibility and sustainability	Report on whether the information in a company's corporate responsibility report is consistent with company information and established reporting criteria

Source: *AICPA Special Committee on Assurance Services.*

FIGURE 1-3 **Relationships Among Assurance Services, Attestation Services, and Nonassurance Services**



Nonassurance Services Provided by CPAs

CPA firms perform numerous other services that generally fall outside the scope of assurance services. Three specific examples are:

1. Accounting and bookkeeping services
2. Tax services
3. Management consulting services

Most accounting and bookkeeping services, tax services, and management consulting services fall outside the scope of assurance services, although there is some common area of overlap between consulting and assurance services. While the primary purpose of an assurance service is to improve the quality of information, the primary purpose of a management consulting engagement is to generate a recommendation to management.

Although the quality of information is often an important criterion in management consulting, this goal is normally not the primary purpose. For example, a CPA may be engaged to design and install a new information technology system for a client as a consulting engagement. The purpose of that engagement is to install the new system, with the goal of improved information being a by-product of that engagement.

Figure 1-3 reflects the relationship between assurance and nonassurance services. Audits, reviews, reports on the effectiveness of internal control over financial reporting, attestation services on information technology, and other attestation services are all examples of attestation services, which fall under the scope of assurance services. Some assurance services, such as *WebTrust* and *SysTrust*, also meet the criteria of attestation services.

TYPES OF AUDITS

OBJECTIVE 1-6

Differentiate the three main types of audits.

CPAs perform three primary types of audits, as illustrated with examples in Table 1-2 (p. 33) :

1. Operational audit
2. Compliance audit
3. Financial statement audit

TABLE 1-2	Examples of the Three Types of Audits			
Type of Audit	**Example**	**Information**	**Established Criteria**	**Available Evidence**
Operational audit	Evaluate whether the computerized payroll processing for a Chinese subsidiary is operating efficiently and effectively	Number of payroll records processed in a month, costs of the department, and number of errors made	Company standards for efficiency and effectiveness in payroll department	Error reports, payroll records, and payroll processing costs
Compliance audit	Determine whether bank requirements for loan continuation have been met	Company records	Loan agreement provisions	Financial statements and calculations by the auditor
Financial statement audit	Annual audit of Boeing's financial statements	Boeing's financial statements	Generally accepted accounting principles	Documents, records, and outside sources of evidence

Operational Audits

An **operational audit** evaluates the *efficiency* and *effectiveness* of any part of an organization's operating procedures and methods. At the completion of an operational audit, management normally expects recommendations for improving operations. For example, auditors might evaluate the efficiency and accuracy of processing payroll transactions in a newly installed computer system. Another example, where most accountants feel less qualified, is evaluating the efficiency, accuracy, and customer satisfaction in processing the distribution of letters and packages by a company such as Federal Express.

In operational auditing, the reviews are not limited to accounting. They can include the evaluation of organizational structure, computer operations, production methods, marketing, and any other area in which the auditor is qualified. Because of the many different areas in which operational effectiveness can be evaluated, it is impossible to characterize the conduct of a typical operational audit. In one organization, the auditor might evaluate the relevancy and sufficiency of the information used by management in making decisions to acquire new fixed assets. In a different organization, the auditor might evaluate the efficiency of the information flow in processing sales.

It is more difficult to objectively evaluate whether the efficiency and effectiveness of operations meets established criteria than it is for compliance and financial statement audits. Also, establishing criteria for evaluating the information in an operational audit is extremely subjective. In this sense, operational auditing is more like management consulting than what is usually considered auditing. Operational auditing is discussed in greater depth in Chapter 26.

Compliance Audits

A **compliance audit** is conducted to determine whether the auditee is following specific procedures, rules, or regulations set by some higher authority. Following are examples of compliance audits for a private business.

XBRL ELECTRONIC DATA TO IMPROVE FINANCIAL REPORTING

Extensible Business Reporting Language (XBRL) is a language for the electronic communication of business and financial data developed by a non-profit consortium of companies and government agencies to enhance the usability of financial information. XBRL is used to encode financial statements using data tags so that the financial information can be read automatically by XBRL-enabled software and more easily sorted and compared.

In 2009 the SEC adopted rules requiring public companies to provide interactive financial statement data in XBRL format. Although auditors may attest to this data under attestation standards, companies are not required to obtain assurance from auditors or other parties on the interactive data.

Sources: 1. "Interactive Data to Improve Financial Reporting," SEC Final Rules (sec.gov/rules/final/2009/33-9002.pdf); 2. XBRL International (www.xbrl.org).

- Determine whether accounting personnel are following the procedures prescribed by the company controller.
- Review wage rates for compliance with minimum wage laws.
- Examine contractual agreements with bankers and other lenders to be sure the company is complying with legal requirements.
- Determine whether a mortgage bank is in compliance with newly-enacted government regulations.

Governmental units, such as school districts, are subject to considerable compliance auditing because of extensive government regulation. Many private and not-for-profit organizations have prescribed policies, contractual agreements, and legal requirements that may require compliance auditing. Compliance audits for federally funded grant programs are often done by CPAs and are discussed in detail in Chapter 26.

Results of compliance audits are typically reported to management, rather than outside users, because management is the primary group concerned with the extent of compliance with prescribed procedures and regulations. Therefore, a significant portion of work of this type is often done by auditors employed by the organizational units. When an organization such as the IRS wants to determine whether individuals or organizations are complying with its requirements, the auditor is employed by the organization issuing the requirements.

Financial Statement Audits

A **financial statement audit** is conducted to determine whether the financial statements (the information being verified) are stated in accordance with specified criteria. Normally, the criteria are U.S. or international accounting standards, although auditors may conduct audits of financial statements prepared using the cash basis or some other basis of accounting appropriate for the organization. In determining whether financial statements are fairly stated in accordance with

FRAUD FIGHTERS: DEMAND FOR FORENSIC ACCOUNTANTS REMAINS STRONG THROUGH ECONOMIC DOWNTURN

When Ron Forster conducts interviews, he watches his subjects as much as he listens to them. Even a seemingly innocuous gesture—an interviewee moving his hand away from his face before answering a sensitive question—could be a sign the subject is lying. Mr. Forster is a forensic accountant, a growing subset of the accounting field that is focused on uncovering and investigating financial fraud.

There are over 50,000 worldwide members of the Association of Certified Fraud Examiners (ACFE) who perform a variety of forensic investigations such as examining books and records to detect and trace fraudulent transactions, interviewing suspects to obtain information and confessions, writing investigation reports, testifying at trials, and understanding factors that motivate individuals to commit fraud. Forensic accountants may be specialists in external auditing, internal auditing, information systems, private investigation, tax accounting, or other disciplines.

And while forensic accountants do their share of number crunching and computer analysis, they also do work that resembles television crime-show investigations. Forensic accountants work side-by-side with criminal justice and law enforcement personnel, as well as computer specialists, in conducting fraud examinations. Such examinations may relate to financial statement fraud, asset misappropriations, money laundering, bribery, or more recently, theft of information via computer hacking, and a long list of other fraudulent activities.

Forensic accounting is booming and continues to expand through the recent global recession. Annual global fraud losses are projected to be more than $3.5 trillion, based on an average fraud loss per organization of 5% of revenues. Fraudulent activity typically increases during a recession, but also often simply comes to light when the fraud can no longer be sustained, as was the case with Bernie Madoff's investment Ponzi scheme. Of course, an increase in fraudulent activity drives an even further increase in demand for forensic accountants. Sam E. Antar, the former CFO for the now-defunct Crazy Eddie consumer-electronics chain and convicted felon, agrees that corporate fraud is experiencing a resurgence. While he is no longer in the fraud game, he boasts, "If I were out of retirement today, I'd be bigger than Bernie Madoff."

Sources: 1. Laton McCartney "Where There's Smoke, There's Fraud," *CFO Magazine* (March 1, 2011); 2. Anya Sostek, "Fraud Fighters: Forensic Accountants on Front Line in Fight Against Fraud," *Pittsburgh Post Gazette* (March 29, 2009); 3. The Association of Certified Fraud Examiners Web site (www.acfe.org).

accounting standards, the auditor gathers evidence to determine whether the statements contain material errors or other misstatements. The primary focus of this book is on financial statement audits.

As businesses increase in complexity, it is no longer sufficient for auditors to focus only on accounting transactions. An integrated approach to auditing considers both the risk of misstatements and operating controls intended to prevent misstatements. The auditor must also have a thorough understanding of the entity and its environment. This understanding includes knowledge of the client's industry and its regulatory and operating environment, including external relationships, such as with suppliers, customers, and creditors. The auditor also considers the client's business strategies and processes and critical success factors related to those strategies. This analysis helps the auditor identify business risks associated with the client's strategies that may affect whether the financial statements are fairly stated.

TYPES OF AUDITORS

OBJECTIVE 1-7

Identify the primary types of auditors.

Several types of auditors are in practice today. The most common are certified public accounting firms, government accountability office auditors, internal revenue agents, and internal auditors.

Certified Public Accounting Firms

Certified public accounting firms are responsible for auditing the published historical financial statements of all publicly traded companies, most other reasonably large companies, and many smaller companies and noncommercial organizations. Because of the widespread use of audited financial statements in the U.S. economy, as well as businesspersons' and other users' familiarity with these statements, it is common to use the terms *auditor* and *CPA firm* synonymously, even though several different types of auditors exist. The title *certified public accounting firm* reflects the fact that auditors who express audit opinions on financial statements must be licensed as CPAs. CPA firms are often called *external auditors* or *independent auditors* to distinguish them from internal auditors.

Government Accountability Office Auditors

A **government accountability office auditor** is an auditor working for the U.S. Government Accountability Office (GAO), a nonpartisan agency in the legislative branch of the federal government. Headed by the Comptroller General, the GAO reports to and is responsible solely to Congress.

The GAO's primary responsibility is to perform the audit function for Congress, and it has many of the same audit responsibilities as a CPA firm. The GAO audits much of the financial information prepared by various federal government agencies before it is submitted to Congress. Because the authority for expenditures and receipts of governmental agencies is defined by law, there is considerable emphasis on compliance in these audits.

An increasing portion of the GAO's audit efforts are devoted to evaluating the operational efficiency and effectiveness of various federal programs. Also, because of the immense size of many federal agencies and the similarity of their operations, the GAO has made significant advances in developing better methods of auditing through the widespread use of highly sophisticated statistical sampling and computer risk assessment techniques.

In many states, experience as a GAO auditor fulfills the experience requirement for becoming a CPA. In those states, if an individual passes the CPA examination and fulfills the experience stipulations by becoming a GAO auditor, he or she may then obtain a CPA certificate.

As a result of their great responsibility for auditing the expenditures of the federal government, their use of advanced auditing concepts, their eligibility to be CPAs, and their opportunities for performing operational audits, GAO auditors are highly regarded in the auditing profession.

Internal Revenue Agents

The IRS, under the direction of the Commissioner of Internal Revenue, is responsible for enforcing the *federal tax laws* as they have been defined by Congress and interpreted by the courts. A major responsibility of the IRS is to audit taxpayers' returns to determine whether they have complied with the tax laws. These audits are solely compliance audits. The auditors who perform these examinations are called **internal revenue agents.**

It might seem that the audit of returns for compliance with the federal tax laws is a simple and straightforward problem, but nothing is farther from the truth. Tax laws are highly complicated, and there are hundreds of volumes of interpretations. The tax returns being audited vary from the simple returns of individuals who work for only one employer and take the standard tax deduction to the highly complex returns of multinational corporations. Taxation problems may involve individual income taxes, gift taxes, estate taxes, corporate taxes, trusts, and so on. An auditor involved in any of these areas must have considerable tax knowledge and auditing skills to conduct effective audits.

Internal Auditors

Internal auditors are employed by all types of organizations to audit for management, much as the GAO does for Congress. Internal auditors' responsibilities vary considerably, depending on the employer. Some internal audit staffs consist of only one or two employees doing routine compliance auditing. Other internal audit staffs may have more than 100 employees who have diverse responsibilities, including many outside the accounting area. Many internal auditors are involved in operational auditing or have expertise in evaluating computer systems.

To maintain independence from other business functions, the internal audit group typically reports directly to the president, another high executive officer, or the audit committee of the board of directors. However, internal auditors cannot be entirely independent of the entity as long as an employer–employee relationship exists. Users from outside the entity are unlikely to want to rely on information verified solely by internal auditors because of their lack of independence. This lack of independence is the major difference between internal auditors and CPA firms.

In many states, internal audit experience can be used to fulfill the experience requirement for becoming a CPA. Many internal auditors pursue certification as a certified internal auditor (CIA), and some internal auditors pursue both the CPA and CIA designations.

CBT-e: THE CPA EXAM GETS A MAKEOVER

The CPA examination changed to computer-based testing (CBT) in 2004. The next generation of the exam, known as CBT-e (the "e" is for evolution), became effective January 1, 2011. The revision included new content and skill specification, changes in the structure of the exam and weighting of individual exam components, coverage of international auditing and financial reporting standards, and new task-based simulations.

"CBT-e – the next generation of the CPA Examination – represents a significant advancement," says Colleen Conrad, Chair of the AICPA Board of Examiners. "More than a series of examination improvements, CBT-e is a leap into a more advanced technological environment – an environment that is necessary in order to enhance the operational and psychometric quality of the CPA Examination, improve the candidate experience, and provide a platform for further innovation."

Effective August 2011, the exam is now administered internationally at test centers in a few select countries around the world. Requirements for testing at these centers are strict in order to maintain control over the exam while attempting to make it easier for U.S. citizens living abroad and citizens in these countries to take the exam without having to travel to the U.S.

Sources: *The Uniform CPA Examination Alert* (Fall 2009 and 2011) (www.aicpa.org).

FIGURE 1-4 **Three Requirements for Becoming a CPA**

Educational Requirement

Normally, an undergraduate or graduate degree with a major in accounting, including a minimum number of accounting credits. Most states now require 150 semester credit hours (225 quarter credits) for licensure as a CPA. Some states require fewer credits before taking the examination but require 150 semester credits before receiving the CPA certificate.

Uniform CPA Examination Requirement

Computer-based examination offered at various testing centers. Examination sections are as follows:

- *Auditing and Attestation (AUD)* – 4 hours
- *Financial Accounting and Reporting (FAR)* – 4 hours
- *Regulation (REG)* – 3 hours
- *Business Environment and Concepts (BEC)* – 3 hours

Some states also require a separate ethics examination.

Experience Requirement

Varies widely from no experience to 2 years, including auditing. Some states include experience working for governmental units or in industry, including internal auditing.

CERTIFIED PUBLIC ACCOUNTANT

OBJECTIVE 1-8

Describe the requirements for becoming a CPA.

Use of the title **certified public accountant** (CPA) is regulated by state law through the licensing departments of each state. Within any state, the regulations usually differ for becoming a CPA and retaining a license to practice after the designation has been initially achieved. To become a CPA, three requirements must be met. These are summarized in Figure 1-4.

For a person planning to become a CPA, it is essential to know the requirements in the state where he or she plans to obtain and maintain the CPA designation. The best source of that information is the State Board of Accountancy for the state in which the person plans to be certified. The National Association of State Boards of Accountancy (NASBA) Web site (www.nasba.org) provides information on licensure requirements and links to the Web site of each state board. It is possible to transfer the CPA designation from one state to another, but additional requirements often must be met for formal education, practice experience, or continuing education.

Most young professionals who want to become CPAs start their careers working for a CPA firm. After they become CPAs, many leave the firm to work in industry, government, or education. These people may continue to be CPAs but often give up their right to practice as independent auditors. To maintain the right to practice as independent auditors in most states, CPAs must meet defined continuing education and licensing requirements. Therefore, it is common for accountants to be CPAs who do not practice as independent auditors.

Information about the CPA examination can be found in *The Uniform CPA Examination Candidate Bulletin* and the *Content and Skill Specifications for the Uniform CPA Examination*, both of which can be downloaded from the CPA Examination site found on the AICPA Web site (www.aicpa.org). The AICPA also publishes selected examination questions with unofficial answers indexed to the content specification outlines of the examination.

Some of the questions and problems at the end of the chapters in this book have been taken from past CPA examinations. They are designated "AICPA" or "AICPA adapted." This copyrighted material is used with the permission of the AICPA.

SUMMARY

This chapter defined auditing and distinguished auditing from accounting. Audits are valuable because they reduce information risk, which lowers the cost of obtaining capital. The chapter also described attestation and assurance services, including reports on the effectiveness of internal control over financial reporting, and described the relationships among audits, attestation services, and assurance services. The chapter also described different types of audits and auditors and requirements for becoming a CPA.

ESSENTIAL TERMS

Accounting—the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making

Assurance service—an independent professional service that improves the quality of information for decision makers

Attestation service—a type of assurance service in which the CPA firm issues a report about a subject matter or assertion that is the responsibility of another party

Audit of historical financial statements—a form of attestation service in which the auditor issues a written report stating whether the financial statements are in material conformity with accounting standards

Audit report—the communication of audit findings to users

Auditing—the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria

Certified public accountant—a person who has met state regulatory requirements, including passing the Uniform CPA Examination, and has thus been certified; a CPA may have as his or her primary responsibility the performance of the audit function on published historical financial statements of commercial and noncommercial financial entities

Compliance audit—(1) a review of an organization's financial records performed to determine whether the organization is following specific procedures, rules, or regulations set by some higher authority; (2) an audit performed to determine whether an entity that receives financial assistance from the federal government has complied with specific laws and regulations

Evidence—any information used by the auditor to determine whether the information being audited is stated in accordance with established criteria

Financial statement audit—an audit conducted to determine whether the overall financial statements of an entity are stated in accordance with specified criteria (usually U.S. or international accounting standards)

Government accountability office auditor—an auditor working for the U.S. Government Accountability Office (GAO); the GAO reports to and is responsible solely to Congress

Independent auditors—certified public accountants or accounting firms that perform audits of commercial and noncommercial financial entities

Information risk—the risk that information upon which a business decision is made is inaccurate

Internal auditors—auditors employed by a company to audit for the company's board of directors and management

Internal control over financial reporting—an engagement in which the auditor reports on the effectiveness of internal control over financial reporting; such reports are required for accelerated filer public companies under Section 404 of the Sarbanes–Oxley Act

Internal revenue agents—auditors who work for the Internal Revenue Service (IRS) and conduct examinations of taxpayers' returns

Operational audit—a review of any part of an organization's operating procedures and methods for the purpose of evaluating efficiency and effectiveness

Review of historical financial statements—a form of attestation in which a CPA firm issues a written report that provides less assurance than an audit as to whether the financial statements are in material conformity with accounting standards

Sarbanes–Oxley Act—a federal securities law passed in 2002 that provides for additional regulation of public companies and their auditors; the Act established the Public Company Accounting Oversight Board and also requires auditors of larger public companies to audit the effectiveness of internal control over financial reporting

REVIEW QUESTIONS

1-1 (Objective 1-5) Explain the relationships among audit services, attestation services, and assurance services, and give examples of each.

1-2 (Objective 1-3) Discuss the major factors in today's society that have made the need for independent audits much greater than it was 50 years ago.

1-3 (Objective 1-3) Distinguish among the following three risks: risk-free interest rate, business risk, and information risk. Which one or ones does the auditor reduce by performing an audit?

1-4 (Objective 1-4) Identify the major causes of information risk and identify the three main ways information risk can be reduced. What are the advantages and disadvantages of each?

1-5 (Objective 1-1) Explain what is meant by determining the degree of correspondence between information and established criteria. What are the information and established criteria for the audit of Jones Company's tax return by an internal revenue agent? What are they for the audit of Jones Company's financial statements by a CPA firm?

1-6 (Objectives 1-1, 1-7) Describe the nature of the evidence the internal revenue agent will use in the audit of Jones Company's tax return.

1-7 (Objective 1-2) In the conduct of audits of financial statements, it would be a serious breach of responsibility if the auditor did not thoroughly understand accounting. However, many competent accountants do not have an understanding of the auditing process. What causes this difference?

1-8 (Objective 1-6) What are the differences and similarities in audits of financial statements, compliance audits, and operational audits?

1-9 (Objectives 1-6, 1-7) Define and explain in brief, operational audits that can be conducted by an internal auditor in a manufacturing company.

1-10 (Objectives 1-5, 1-6) What essentials about the client's business does the auditor need in an audit of financial statements? Explain how this knowledge may be useful in performing other assurance or consulting services for the client.

1-11 (Objective 1-7) What are the major differences in the scope of the audit responsibilities for CPAs, GAO auditors, IRS agents, and internal auditors?

1-12 (Objective 1-8) Identify the four parts of the Uniform CPA Examination.

1-13 (Objective 1-4) Explain how the information risk is reduced, and what the importance of auditing is in reducing information risk.

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

1-14 (Objectives 1-1, 1-3, 1-5) The following questions deal with audits by CPA firms. Choose the best response.

a. Which of the following best describes why an independent auditor is asked to express an opinion on the fair presentation of financial statements?
   (1) It is difficult to prepare financial statements that fairly present a company's financial position, operations, and cash flows without the expertise of an independent auditor.
   (2) It is management's responsibility to seek available independent aid in the appraisal of the financial information shown in its financial statements.

(3) The opinion of an independent party is needed because a company may not be objective with respect to its own financial statements.
(4) It is a customary courtesy that all stockholders of a company receive an independent report on management's stewardship of the affairs of the business.

b. Independent auditing can best be described as
(1) a branch of accounting.
(2) a discipline that attests to the results of accounting and other functional operations and data.
(3) a professional activity that measures and communicates financial and business data.
(4) a regulatory function that prevents the issuance of improper financial information.

c. Which of the following professional services is an attestation engagement?
(1) A consulting service engagement to provide computer-processing advice to a client.
(2) An engagement to report on compliance with statutory requirements.
(3) An income tax engagement to prepare federal and state tax returns.
(4) The preparation of financial statements from a client's financial records.

d. Which of the following attributes is likely to be unique to the audit work of CPAs as compared to the work performed by practitioners of other professions?
(1) Independence.
(2) Competence.
(3) Due professional care.
(4) Complex body of knowledge.

1-15 (Objectives 1-6, 1-7) The following questions deal with types of audits and auditors. Choose the best response.

a. Operational audits generally have been conducted by internal auditors and governmental audit agencies but may be performed by certified public accountants. A primary purpose of an operational audit is to provide
(1) a means of assurance that internal accounting controls are functioning as planned.
(2) a measure of management performance in meeting organizational goals.
(3) the results of internal examinations of financial and accounting matters to a company's top-level management.
(4) aid to the independent auditor, who is conducting the audit of the financial statements.

b. In comparison to the external auditor, an internal auditor is more likely to be concerned with
(1) internal administrative control.
(2) cost accounting procedures.
(3) operational auditing.
(4) internal control.

c. Which of the following best describes the operational audit?
(1) It requires the constant review by internal auditors of the administrative controls as they relate to the operations of the company.
(2) It concentrates on implementing financial and accounting control in a newly organized company.
(3) It attempts and is designed to verify the fair presentation of a company's results of operations.
(4) It concentrates on seeking aspects of operations in which waste could be reduced by the introduction of controls.

d. Compliance auditing often extends beyond audits leading to the expression of opinions on the fairness of financial presentation and includes audits of efficiency, economy, effectiveness, as well as
(1) accuracy.
(2) adherence to specific rules or procedures.
(3) evaluation.
(4) internal control.

DISCUSSION QUESTIONS AND PROBLEMS

1-16 (Objective 1-5) The list below indicates various audit, attestation, and assurance engagements involving auditors.

1. A report on the effectiveness of internal control over financial reporting as required by Section 404 of the Sarbanes–Oxley Act.
2. An auditor's report on whether the financial statements are fairly presented in accordance with International Financial Reporting Standards.
3. A report stating whether the company has complied with restrictive covenants related to officer compensation and payment of dividends contained in a bank loan agreement.
4. An electronic seal indicating that an electronic seller observes certain practices.
5. Evaluating the voting process and certifying the outcome for Rolling Stone Magazine's "Greatest Singer of All Time" poll.
6. A report indicating whether a governmental entity has complied with certain government regulations.
7. A report on the examination of a financial forecast.
8. A review report that provides limited assurance about whether financial statements are fairly stated in accordance with U.S. GAAP.
9. Assess risks related to greenhouse gas emissions and regulatory compliance.
10. A report about management's assertion on the effectiveness of controls over the availability, reliability, integrity, and maintainability of its accounting information system.
11. An evaluation of the effectiveness of key measures used to assess an entity's success in achieving specific targets linked to an entity's strategic plan and vision.

Required

a. Explain or use a diagram to indicate the relationships among audit services, attestation services, and assurance services.

b. For each of the services listed above, indicate the type of service from the list that follows.
   (1) An audit of historical financial statements.
   (2) An attestation service other than an audit service.
   (3) An assurance service that is not an attestation service.

1-17 (Objective 1-3) Busch Corporation has an existing loan in the amount of $6 million with an annual interest rate of 6.0%. The company provides an internal company-prepared financial statement to the bank under the loan agreement. Two competing banks have offered to replace Busch Corporation's existing loan agreement with a new one. United National Bank has offered to loan Busch $6 million at a rate of 5.0% but requires Busch to provide financial statements that have been reviewed by a CPA firm. First City Bank has offered to loan Busch $6 million at a rate of 4.0% but requires Busch to provide financial statements that have been audited by a CPA firm. Busch Corporation's controller approached a CPA firm and was given an estimated cost of $35,000 to perform a review and $60,000 to perform an audit.

Required

a. Explain why the interest rate for the loan that requires a review report is lower than that for the loan that did not require a review. Explain why the interest rate for the loan that requires an audit report is lower than the interest rate for the other two loans.

b. Calculate Busch Corporation's annual costs under each loan agreement, including interest and costs for the CPA firm's services. Indicate whether Busch should keep its existing loan, accept the offer from United National Bank, or accept the offer from First City Bank.

c. Assume that United National Bank has offered the loan at a rate of 4.5% with a review, and the cost of the audit has increased to $80,000 due to new auditing standards requirements. Indicate whether Busch should keep its existing loan, accept the offer from United National Bank, or accept the offer from First City Bank.

d. Discuss why Busch may desire to have an audit, ignoring the potential reduction in interest costs.

e. Explain how a strategic understanding of the client's business may increase the value of the audit service.

1-18 (Objectives 1-3, 1-4, 1-5) Consumers Union is a nonprofit organization that provides information and counsel on consumer goods and services. A major part of its function is the testing of different brands of consumer products that are purchased on the open market and then the reporting of the results of the tests in *Consumer Reports*, a monthly publication. Examples of the types of products it tests are middle-sized automobiles, residential dehumidifiers, flat-screen TVs, and boys' jeans.

Required

a. In what ways are the services provided by Consumers Union similar to assurance services provided by CPA firms?

b. Compare the concept of information risk introduced in this chapter with the information risk problem faced by a buyer of an automobile.

c. Compare the four causes of information risk faced by users of financial statements as discussed in this chapter with those faced by a buyer of an automobile.

d. Compare the three ways users of financial statements can reduce information risk with those available to a buyer of an automobile.

1-19 (Objective 1-1) Gregor Olson works at the National Bank branch in Copenhagen. According to the bank's records, there is currently an outstanding loan of $380,000 to Danville Bus Services, a company that schedules charter bus trips between Copenhagen and other cities in Scandinavia. The company recently missed a loan payment, and Olson is becoming concerned about whether Danville will be able to repay the full amount of the loan. According to the documents held by the bank, the collateral on the loan consists of 20 large buses. Each bus has an average estimated value of $25,000. As part of his investigation of the company, Olson wants to make sure that these buses still exist. Olson decides that the best way to handle the situation would be to hire an auditor to count the buses. Olson therefore engages the services of Annaliese Haraldsson, CPA, who Olson knows has an extensive background in auditing automobile, bus, and trucking companies. Olson gives Haraldsson the buses' registration information, which was provided to the bank when the original loan documents were signed. He then asks her to investigate the company and write a report that includes the following information:

1. Which of the 20 registered buses is parked in Danville's parking lot on the night of August 31, 2013.
2. If Danville Bus Services actually owns or is responsible for maintaining the buses.
3. The physical condition of each bus, using the guidelines poor, good, and excellent.
4. The fair market value of each bus, using the current "blue book" for buses, which estimates the approximate wholesale prices of all used bus models, using the poor, good, and excellent conditions guidelines established in Part 3.

Required

a. For each of the following parts of the definition of auditing, state which part of the preceding narrative fits the definition:
   (1) Information
   (2) Established criteria
   (3) Accumulating and evaluating evidence
   (4) Competent, independent person
   (5) Reporting results

b. What difficulties might Haraldsson encounter when performing this audit?

1-20 (Objective 1-7) A group of accounting students in the U.K. is discussing their future plans as part of an activity at a Career Day workshop sponsored by the school. Gina shares that she dreams of becoming an auditor for the Central Auditing Organization because she believes that this career will provide excellent experience in risk assessment and management techniques. Akhom mentions that he is interested in income taxes and believes a career working for HM Revenues and Customs would best fulfill his interest. Jonathan is considering working for a CPA firm for the next five years. He believes the variety of experience in auditing might provide a wide range of opportunities and allow for personal growth. However, he does not want to plan beyond five years, because he is not sure that he wants to make it a permanent career. Minh is planning for a career in internal auditing within an international manufacturing company because she is drawn by the many different aspects of the organization with which internal auditors become involved. Jordan knows that he wants to pursue some aspect of auditing as a career, but tells the group that he has not yet decided on the type of organization he wants to enter. He desires an opportunity for professional development, and he also believes his employment should be interesting and meaningful.

Required

a. What are the major advantages and disadvantages of each of the types of auditing careers mentioned by the students?

b. What other types of auditing careers might the students pursue?

1-21 (Objectives 1-6, 1-7) In the normal course of performing their responsibilities, auditors often conduct audits or reviews of the following:

1. Federal income tax returns of an officer of the corporation to determine whether he or she has included all taxable income in his or her return.
2. Financial statements for use by stockholders when there is an internal audit staff.
3. A bond indenture agreement to make sure a company is following all requirements of the contract.
4. Internal controls at a casino to ensure the casino is in compliance with federal and state regulations.
5. Computer operations of a corporation to evaluate whether the computer center is being operated as efficiently as possible.
6. Annual statements for the use of management.
7. Operations of the IRS to determine whether the internal revenue agents are using their time efficiently in conducting audits.
8. Statements for bankers and other creditors when the client is too small to have an audit staff.
9. Financial statements of a branch of the federal government to make sure that the statements present fairly the actual disbursements made during a period of time.
10. Federal income tax returns of a corporation to determine whether the tax laws have been followed.
11. The computer operations of a large corporation to evaluate whether the internal controls are likely to prevent misstatements in accounting and operating data.
12. Disbursements of a branch of the federal government for a special research project to determine whether the expenditures were consistent with the legislative bill that authorized the project.

Required

a. For these 12 examples, state the most likely type of auditor (CPA, GAO, IRS, or internal) to perform each.

b. In each example, state the type of audit (financial statement audit, operational audit, or compliance audit).

1-22 (Objectives 1-3, 1-5) Dave Czarnecki is the managing partner of Czarnecki and Hogan, a medium-sized local CPA firm located outside of Chicago. Over lunch, he is surprised when his friend James Foley asks him, "Doesn't it bother you that your clients don't look forward to seeing their auditors each year?" Dave responded, "Well, auditing is only one of several services we provide. Most of our work for clients does not involve financial statement audits, and our audit clients seem to like interacting with us."

Required

a. Identify ways in which a financial statement audit adds value for clients.

b. List other services other than audits that Czarnecki and Hogan likely provides.

c. Assume Czarnecki and Hogan has hired you as a consultant to identify ways in which they can expand their practice. Identify at least one additional service that you believe the firm should provide and explain why you believe this represents a growth opportunity for CPA firms.

RESEARCH PROBLEM 1-1: CPA REQUIREMENTS

Individuals are licensed as CPAs by individual states. Information on the requirements for each state can be found on the National Association of State Boards of Accountancy (NASBA) Web site (www.nasba.org). The Uniform CPA Examination is administered by the American Institute of Certified Public Accountants (AICPA), and information on CPA examination requirements can be found on the AICPA Web site (www.aicpa.org).

Required

a. Identify the education requirements to be eligible to sit for the CPA exam in your state. Include any specific educational content requirements.

b. List the work experience requirements in your state. Is experience in industry as an accountant or an internal auditor sufficient to be eligible to become a CPA?

c. List any frequently asked questions (FAQ) for your state, if there are any.

d. What are the Elijah Watts Sells awards?

e. What was the passing rate for each exam section in the most recent quarter?