Chapter 2

The Financial Statement Auditing Environment

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| **Learning Objectives** | **Review Questions** | **Multiple-**  **Choice Questions** | **Problems** | **Discussion**  **Cases** | **Internet**  **Assignments** |
| **LO 2-1:** Be familiar with the different types of auditors. | 1 | 15 | 24 |  | 28 |
| **LO 2-2:** Be familiar with the various types of audit, attest, and assurance services offered by accounting professionals. | 2 | 16,17 | 24 | 26 | 28 |
| **LO 2-3:** Understand the organization of public accounting firms and the composition of audit teams. |  |  |  |  |  |
| **LO 2-4**: Understand the significant changes that have taken place in the auditing profession over the past two decades. | 3,4 | 18 |  |  |  |
| **LO 2-5:** Know that management is primarily responsible for the entity’s financial statements and understand the auditor’s responsibility for detecting errors, material fraud, and illegal acts. | 5 | 19 |  |  |  |
| **LO 2-6:** Recognize that an audit is shaped by the auditee’s business, industry, and economic environment and understand essential components and processes characteristic of most business entities. | 6,7 | 20 |  |  |  |
| **LO 2-7**: Be familiar with a model of business processes used to organize an audit. |  |  |  |  |  |
| **LO 2-8:** Identify and be familiar with the major organizations that affect the public accounting profession’senvironment. | 8,9,10,11 | 21 |  |  | 28, 29,30 |
| **LO 2-9**: Understand that auditing standards are established by both U.S. and international standard setters. |  | 22 |  |  |  |
| **LO 2-10:** Be familiar with the “principles underlying an audit conducted in accordance with generally accepted auditing standards.” | 12,13 | 23 | 25,26 | 26, 27 |  |
| **LO 2-11:** Understand the nature of auditing standards. |  |  |  |  |  |

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| **LO 2-12:** Understand that the auditing profession places a premium on ethical behavior and is governed by a Code of Professional Conduct. | 14 |  |  | 26, 27 |  |

NOTE: References to auditing standards in the instructor manual follow a similar convention to that followed in the text: AICPA standards will be referenced by clarified AU section and PCAOB standards will be referenced by Auditing Standard (AS) number.

**END OF CHAPTER MATERIALS COMPARISON CHART**

|  |  |  |
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| **Number**  **in 10th edition** | **Comparison** | **Number**  **in 11th edition** |
| 2-1 | Unchanged | 2-1 |
| 2-2 | Unchanged | 2-2 |
| 2-3 | Unchanged | 2-3 |
| 2-4 | Unchanged | 2-4 |
| 2-5 | Unchanged | 2-5 |
| 2-6 | Revised | 2-6 |
| 2-7 | Unchanged | 2-7 |
| 2-8 | Unchanged | 2-8 |
| 2-9 | Unchanged | 2-9 |
| 2-10 | Unchanged | 2-10 |
| 2-11 | Unchanged | 2-11 |
| 2-12 | Revised | 2-12 |
| 2-13 | Revised | 2-13 |
| 2-14 | Unchanged | 2-14 |
| 2-15 | Unchanged | 2-15 |
| 2-16 | Unchanged | 2-16 |
| 2-17 | Revised | 2-17 |
| 2-18 | Unchanged | 2-18 |
| 2-19 | Unchanged | 2-19 |
| 2-20 | Unchanged | 2-20 |
| 2-21 | Unchanged | 2-21 |
| 2-22 | Unchanged | 2-22 |
| 2-23 | Revised | 2-23 |
| 2-24 | Unchanged | 2-24 |
| 2-25 | Revised | 2-25 |
| 2-26 | Removed | 2-26 |
| 2-27 | Revised | 2-26 |
| 2-28 | Unchanged | 2-27 |
| 2-29 | Unchanged | 2-28 |
| 2-30 | Unchanged | 2-29 |

Chapter 2 covers the context, or environment, in which auditors function, starting with an overview of the recent changes in the public accounting profession.

**[LO 2-1, 2-2] Types of Auditors and Services**

We spend a few minutes discussing the different types of audits and services (e.g., internal control audits, compliance audits, operational audits, forensic audits, attest services, and assurance services) firms can provide and the different types of auditors (e.g., external auditors, internal auditors, government auditors, and forensic auditors). Chapter 21 discusses attestation services more thoroughly. **Problem 24** could be covered here.

**[LO 2-3] Public Accounting Firms**

We briefly review the organization of firms (e.g., proprietorship, general or limited liability partnerships, or corporation), the categorization of the firms (e.g., Big 4, mid-tier firms, regional firms, and local firms), the types of services (e.g., audit, tax, management advisory services, and accounting and review services), and the internal organization (e.g., partner, manager, senior, and associate) that describes the public accounting firms.

**[LO 2-4] Two Decades of Challenge and Change for Financial Statement Auditors**

The time we spend with this topic depends on what was covered in the earlier class. We try to continue the discussion, emphasizing to the students issues facing the profession today or the overall environment the profession is operating in. We focus on

* Events leading up to the current landscape.
* The explosion of scandals that took place.
* Government intervention (i.e., Sarbanes-Oxley Act 2002, Dodd-Frank Act 2010).
* The profession’s response (a healthy move back to the basics).

**[LO 2-5] Society’s Expectations and the Auditor’s Responsibility**

Students generally find this topic very interesting. We focus on the auditor’s responsibility to detect errors, fraud, and illegal acts. Many students falsely believe that auditors have the responsibility to detect all errors, fraud, and illegal acts. Sometimes, we have a guest speaker come into this class to discuss the growing field of forensic accounting.

**[LO 2-6] The Context of Financial Statement Auditing**

We spend a few minutes emphasizing to the students the importance of an auditor knowing his/her auditees’ business and industry characteristics since that is the context or environment within which a particular business operates. We emphasize that it is difficult for an auditor to effectively audit something which he/she does not fully understand. We end this section with a short introduction to a high-level model of a business entity and then spend more time with the five cycles used to break the audit down into manageable pieces covered in LO 2-7.

**[LO 2-7] A Model of Business**

With the high-level model, we make sure everyone knows how a business operates at the highest level by including the roles of corporate governance, the board of directors, and the audit committee. Then we discuss briefly with the students how objectives are formed and what strategies might be designed to achieve those objectives by asking the students to come up with related examples of each and writing them on the board. Then we write down specific processes that might be set up so that the strategies are implemented. Last, we ask them for specific risks that might threaten the achievement of the objectives we came up with and write these down as well.

We then spend more time with the process part of the above exercise. We ask the students to list the five cycles and relate them to what we discussed above using Figure 2-1. Next, we briefly discuss each of the five cycles individually as well as how they are interrelated:

* The financing process.
* The purchasing process.
* The human resource management process.
* The inventory management process.
* The revenue process.

**Use Figure 2-1**

Finally, we relate the process components to the “business model.” Management establishes processes in the five categories discussed above to implement the organization’s strategies and achieve its objectives, as well as integrating internal controls to mitigate enterprise risks. The financial statements report the financial results of those efforts to outside parties (the organization’s performance and its external reporting and accountability).

**[LO 2-8] Organizations that Affect the Public Accounting Profession**

We use Figure 2-2 as a framework for discussing the various organizations that affect financial statement audits. We tend to focus on the SEC, the PCAOB, the FASB, and the AICPA.

**Use Figure 2-2**

**[LO 2-9, LO 2-10] Auditing Standards**

Auditing standards provide a systematic approach to auditing and thus should be emphasized to the students. We begin the discussion with the current state of audit standard-setting: ASB and PCAOB. We discuss how the PCAOB issued AS1 to adopt all existing audit standards as of 2003, but we remind the students that standards for audits of private companies are beginning to diverge from those applicable to audits of public companies since both standard-setting bodies are still active.

We also discuss the principles underlying a financial statement audit by referring back to the ASB’s auditing standards. Our intention by discussing the purpose and premise of the audit, responsibilities, performance, and reporting is to help students realize how a solid understanding of the framework of the audit can inform their approach regardless of which set of standards they find themselves using. **Problems 25 and/or 26** could be covered here.

**Use Exhibit 2-2**

**[LO 2-11] Auditing Standards and the Codification of Standards**

Here, we discuss recent updates the PCAOB has made to update and improve the codification of their auditing standards, reorganizing them into topical categories and subcategories like the FASB’s GAAP codification. We also mention the similar coverage, although differing structure, of the ISA.

**[LO 2-12] Ethics, Independence, and the Code of Professional Conduct**

We try to demonstrate to the students why it is important for auditors to be independent and act ethically. The key point for the students to learn is that the value in the audit lies in the auditor’s reputation for integrity and objectivity, which of course involves independence from the auditee. Users of the financial statements will place little value on the auditor’s report if the auditor is not perceived to be honest and objective. We also might spend a little time discussing the issues of low-balling and opinion shopping. We use this section to alert the students to the existence of the Code of Professional Conduct and the importance of independence for auditors (Chapter 19 discusses this topic in greater detail).

**Discussion Cases**

**Discussion Cases 27 and 28** present Merry-Go-Round, a real world company that sued its consultants over poor advice. The case covers Ernst & Young’s consulting work for the company and provides the instructor an opportunity to expand the discussion of audit versus consulting services. The case also provides an opportunity to talk about how work for one company may affect the objectivity and independence of work on another company.

##### Internet Assignments

The Internet assignments included in this chapter provide ample opportunity to have the students use the Internet to search for information. If you have access to the Internet in your classroom, show students the AICPA home page (<http://www.aicpa.org>). **Internet Assignment 30** has the students go to this site as well as the SEC, PCAOB, IAASB, and IFRS websites. **Internet Assignment 29** provides the students with the opportunity to examine the types of audits conducted by the GAO.

**Practice Insight**

Practice Insights provide real-world integration. Practice Insight scenarios are included in each chapter to highlight important and interesting real-world trends and practices. These self-contained insights or scenarios focus on current events, student decision-making, and professional problem solving.

**Hands-On Cases**

**IDEA and TABLEAU**

The Chapter 2 **IDEA** and **TABLEAU** problems are an excellent hands-on supplement to the textbook material. Please go to Connect for chapter assignments.