FINANCIAL STATEMENTS, AN AUDIT AND AUDITED FINANCIAL STATEMENTS

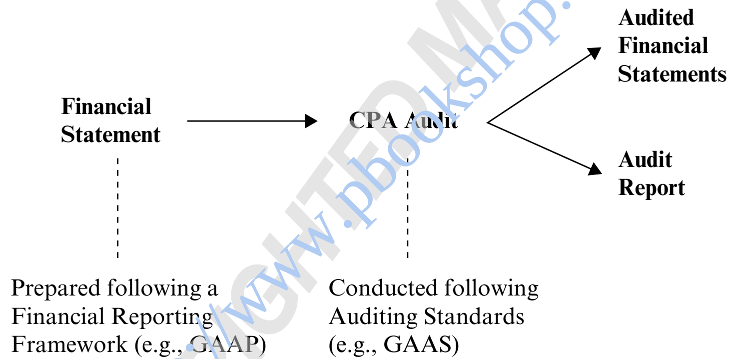

DIAGRAM OF AN AUDIT

Plan Audit

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Obtain Understanding of
Client and Its Environment
Including Internal Control

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Assess Risks of Misstatement
and Design Further Tests → Perform Tests of Controls

↓

Perform Substantive
Procedures

↓

Complete the Audit

↓

Issue Audit Report

Principles Underlying an Audit

- **Purpose of audit**—Provide an opinion.
- **Premise of audit**—Management has responsibility for preparing financial statements and providing auditor with all needed information.
- **Personal responsibilities of auditor**—Competence, follow ethical requirements, maintain professional skepticism.
- **Auditor actions in audit**—Provide procedures to obtain reasonable assurance about whether financial statements are free from material misstatements.
- **Reporting results of an audit**—Written report with an opinion, or a statement that an opinion cannot be obtained.

Auditing Standard Requirement Categories

- **Unconditional requirement**—The auditor must comply with the requirement in all cases in which the circumstances exist. SAS use the words *must* or *is required* to indicate an unconditional requirement.
- **Presumptively mandatory requirement**—Similarly, the auditor must comply with the requirement, but, in rare circumstances, the auditor may depart from such a requirement. In such circumstances, the auditor documents the departure, the justification for the departure, and how the alternative procedures performed in the circumstances were sufficient. SAS use the word *should* to indicate a presumptively mandatory requirement.

Note: The PCAOB includes a third level, **Responsibility to Consider**, in which the auditor follows, depends upon the exercise of professional judgment in the circumstances. Terms such as may, might, or could, indicate a responsibility to consider.

CODE OF PROFESSIONAL CONDUCT

Sections

- Preface, applicable to all members
- Part 1: Applicable to Members in Public Practice
- Part 2: Applicable to Members in Business
- Part 3: Applicable to other members (retired and unemployed)

Structure

- Principles (6 general statements)
- Rules of conduct (11 overall standards)
- Interpretations of the rules
- Other guidance (e.g., definitions, pending revisions)

CODE OF PROFESSIONAL CONDUCT (CONTINUED)

Principles

1. Responsibilities
2. Public Interest
3. Integrity
4. Objectivity and Independence
5. Due Care
6. Scope and Nature of Services

RULES AND APPLICABILITY

Rules	Public Practice	Business	Other
Integrity and Objectivity	X	X	
Independence	X		
General Standards	X	X	
Compliance with Standards	X	X	
Accounting Principles	X	X	
Acts Discreditable	X	X	X
Fees and Other Types of Remuneration			
• Contingent Fees	X		
• Commissions and Referral Fees	X		
Advertising and Other Forms of Solicitation	X		
Confidential Client Information	X		
Form of Organization and Name	X		

Conceptual Frameworks

Code includes 3 conceptual frameworks for situations not explicitly addressed by a Rule.

1. **Members in public practice**—1 independence conceptual framework and 1 general conceptual framework to address issues other than independence.
2. **Members in business**—a general conceptual framework.
3. All frameworks use an approach of considering seriousness of threats and whether safeguards reduce the risk to an acceptable level.

Threats and Safeguards Considered by Conceptual Frameworks

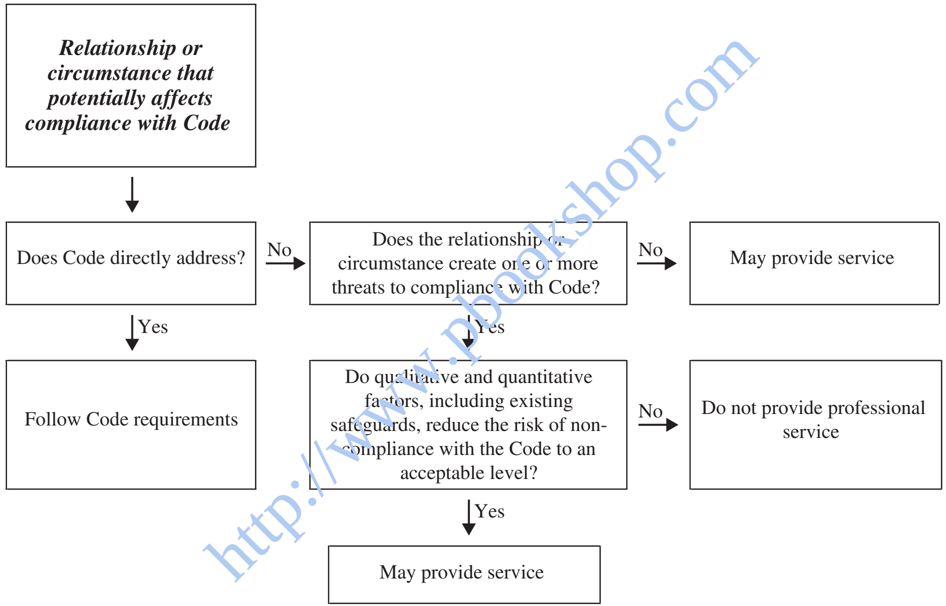
Threats

- Adverse interest
- Advocacy
- Familiarity
- Management participation
- Self-interest
- Self-review
- Undue influence

Safeguards

- Created by the profession, legislation or regulation
- Implemented by the client
- Implemented by the CPA firm

General Conceptual Framework Code of Professional Conduct Approach



Independence Rule

- Only applies to members in public practice and their attest clients
- The concept of a **covered member** is important because, in general, covered members must be independent for the firm to retain its independence. Covered members include:
  - Members of attest engagement team
  - Person who may influence attest engagement (e.g., partner who supervisor the partner in charge of the engagement)
  - All partners in the office in which the lead attest partner practices
  - Certain partners or managers who perform nonattest services to the client
  - The firm, including its benefit plans

Independence Requirements for all Partners and Staff

1. No partner or professional employee (or their immediate family members) or group acting together may own more than 5% of attest client's equity securities.
2. No partner or professional employee may be director, officer, employee etc. of the client.
3. CPAs previously employed by a client, but now employed by CPA firm, must not be involved with the audit of any period during which they were employed by that client.

If any of the above situations occur, the CPA firm's independence is impaired and it may not provide attest services to that client.

Additional Independence Requirements for Covered Members—Financial

Financial relationships that *impair the independence of both the member and the firm* include:

(1) All direct financial interests (e.g., stock or debt investment in attest client)

(2) Material indirect financial interests (e.g., investment in a mutual fund heavily invested in the attest client)

(3) A material joint closely held investment held with an attest client (or one of the client's officers or directors, or any owner with significant influence over the attest client)

Additional Independence Requirements for Covered Members—Family

Interests of relatives and friends

(1) *Immediate family* (spouse, spousal equivalent, dependents)—same requirements as covered member, with limited exceptions.

(2) *Close relatives* (e.g., parents, siblings, or nondependent children)—overall, CPA firm independence is impaired if close relative has (a) a key position with the client, or (b) Is material to the close relative of which the accountant has knowledge.

(3) *Other considerations for all relatives and friends*. Independence is only impaired unless a reasonable person aware of the facts would conclude there is an unacceptable risk.

Examples of Activities that Impair Independence

- Supervising client's personnel
- Signing client's checks
- Acting as client's stock transfer agent
- Accepting gifts from client

Independence—Unpaid Fees

- Unpaid fees may impair independence
  - May not extend beyond one year
  - Audit may be performed, but report may not be issued until prior year fees paid

Independence—Auditor on Engagement Considers or Takes Employment with Audit Client

- Individual must inform the audit firm when seeking or discussing potential employment with client.
- Individual's independence impaired (should be taken off job) until employment by client is no longer being considered by that individual.
- Once individual accepts employment with audit client, the audit firm should consider the need to modify the audit plan or change members of the audit.
- In any audit performed within a year of the professional joining the client, a member of the audit firm with no connection to the audit must review all work to ensure it takes into account independence issues.

Independence—Nonattest Services

- May provide advice, research materials, and recommendations
- Client must accept responsibility for making all decisions
- Specific client personnel must be designated to oversee services
- Client must be responsible for establishing and maintaining all internal controls and may not "outsource" such services to the auditor
- An understanding of the objectives of the engagement and client responsibilities must be documented prior to performing the nonattest services for an attest client

A member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

- Misrepresentation of facts: Member is forbidden to knowingly (or let someone else)
  - Make materially false and misleading entries
  - Fail to correct financial statements or records that are materially false and misleading
  - Sign a document containing materially false and misleading information

Independence—Nonattest Services (continued)

- A conflict of interest may exist if member performing a service and the member/ member's firm has a relationship that could in the member's judgment be viewed as impairing the member's objectivity. For example,
    - Suggest that the client invest in a business in which he or she has a financial interest.
    - Provide tax services for several members of a family who may have opposing interests.
    - Have a significant financial interest or influence with a major competitor of a client.
- Obligations of a member to his or her employer's external accountant
    - Must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts

Responsibilities to Clients

A member in public practice shall not

- Disclose any confidential client information without the specific consent of the client
- Accept a contingent fee for
    - An audit or review of a financial statement
    - A compilation of a financial statement
    - An examination of prospective financial information
- Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client

A CPA must maintain client information as confidential. May disclose client information to

- Comply with a subpoena
- Cooperate with a quality control review

Other Responsibilities and Practices

A CPA should not perform acts discreditable to the profession, such as

- Retaining client records
- Understating anticipated fees for services
- Accepting a commission in relation to an attest client
- Practice under a misleading name

A CPA shall be competent.

- Agreeing to perform professional services implies that the member has the necessary competence to complete those professional services but is not infallible
- Involves both the technical qualifications of the member and staff and the ability to supervise and evaluate the quality of the work performed
- If the member does not have the necessary competence, may perform additional research or consult with others
- But if cannot attain competence, should recommend client seek help from someone else

Quality Control

CPA firms should establish quality controls to ensure compliance with professional standards

Nature and extent of quality control policies and procedures will depend on

- Size of firm and number of offices
- Knowledge and experience of personnel and authority allowed to personnel
- Nature and complexity of firm's practice
- Cost-benefit considerations

Quality Control Elements

- Leadership responsibilities for quality within the firm
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

Tax Preparer

Actions by an accountant preparing a client's tax return can result in penalties for

- Not providing client with copy of return
- Failing to sign return as a preparer
- Endorsing and cashing client's refund check
- Failing to file a timely return
- Not advising client of tax elections
- Neglecting evaluation of joint versus separate returns

A CPA performing tax services

- May not recommend a tax position that lacks merit
- Must make a reasonable effort to answer applicable questions on the return
- May rely on client information when preparing the return
- Must make reasonable inquiries about questionable or incomplete information
- May use estimates

Standards for Consulting Services

When performing consulting services, a CPA must adhere to certain general standards

- Professional competence
- Due professional care
- Planning and supervision
- Obtaining sufficient relevant data

GAO Code of Ethics

Federal auditors, or CPA firms auditing federal dollars, should not perform management functions or make management decisions.

Federal auditors, or CPA firms auditing federal dollars, should not audit their own work.

Federal auditors, or CPA firms auditing federal dollars, should not provide nonaudit services that are material to the subject matter of an audit.

Emphasis:

- Accountability of government officials to the Congress
- Accountability of the auditor to conduct work professionally
- No requirement to evaluate management controls
- Executive leadership of the audited agencies is not the primary customer
- Management input not solicited as part of the audit process
- Management input not solicited in development of solutions
- Management is presented with “findings” to which it must “respond”

Institute of Internal Auditors Code of Ethics

The IIA Standards focus on *improvement of risk management, control and governance processes* within an organization so that issues of concern can be *identified* and *corrected* before they become persistent or pervasive problems.

- Mandate organizational independence of the audit department and mandate individual auditor objectivity.
  - Internal auditors (IA) must report to a level within the organization that permits the audit department to fulfill its responsibilities.
  - IA must not perform management functions or make management decisions.
  - IA must not audit their own work.
  - IA must determine the nature and scope of their work.

Sarbanes-Oxley Act

Regulation S-K requires companies to disclose:

- Whether they have a written code of ethics that applies to their CEO, CFO, Controller, or persons performing similar functions
- Any waivers of the code of ethics for these individuals
- Any changes to the code of ethics

Code must be designed to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest
- Full, fair, accurate, timely, and understandable disclosure in company filings and publications
- Compliance with applicable governmental laws, rules, and regulations
- Prompt internal reporting of violations of the code to the appropriate person or persons identified
- Accountability for adherence to the code

Sarbanes-Oxley Act (continued)

Audit committee (AC) responsible for the appointment, compensation, and oversight of audit firm

- Each member of the AC is a member of the board of directors and independent
- One financial expert required on AC
- AC reports directly to Board

CEO and CFO must certify accuracy and truthfulness of financial statements

- Civil ($5,000,000) and criminal (10 years) liability
- Any person who knowingly attempts to or commits fraud in sale of securities has civil and criminal liability (up to 25 years)

International Ethics Standards

The International Ethics Standards Board for Accountants (IESBA) is a standard-setting body within the International Federation of Accountants (IFAC) that issues ethical standards for accountants throughout the world. The *IESB Framework* applies to all professional accountants

- **I**ntegrity
- **O**bjectivity
- **P**rofessional competence and due care
- **C**onfidentiality
- **P**rofessional behavior

Department of Labor Independence Requirements for Employee Benefit Plans

An accountant is not independent with respect to the plan if he/she

- Has direct financial interest or any material indirect financial interest in the plan or plan sponsor
- Is a promoter, underwriter, investment advisor, voting trustee, director, officer, or employee of the plan
- Maintains financial records for the employee benefit plan

International Auditing and Assurance Standards

International auditing standards are developed by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC)

- International standards do not require an audit of internal control, while PCAOB standards do so require
- International standards do not allow reference to another audit firm involved in a portion of the audit
- International standards for documentation are less detailed than PCAOB standards, leaving more to professional judgment
- International standards in the area of going concern include a time horizon of at least, but not limited to, twelve months
- International standards are based on a risk assessment of effectiveness of quality control policies and procedures