External Auditors Roles and Responsibilities

By,

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Chapter Objectives:

- Recognize the role independent auditors play in achieving effective corporate governance and reliable financial reports.
- Understand the history of auditing, the traditional roles of auditors, and regulations recently placed on them.
- Address the expectation gap regarding what auditors can provide in the way of reasonable assurance and the expectations of investors for a higher level of assurance.
- Identify the roles and responsibilities of the PCAOB, and discuss the auditing standards published by the PCAOB.
- Demonstrate the importance of auditor independence both in fact and in appearance.
- Discuss an integrated audit of both financial statements and ICFR.
- Address the issue of a liability cap for independent auditors and understand the rationale on both sides of the issue.

Key Terms

The Accountancy Investigation & Discipline Board (AIDB)
Audit quality
Audit risk
Audit strategy
Auditor independence
Control risk
Detection risk
Expectation gap
Inherent risk
Integrated audit approach
Internal Revenue Service (IRS)
International Standards on Auditing (ISAs)
PCAOB-US
Professional Ethics Executive Committee (PEEC)
Standing Advisory Group (SAG)
Statements on Auditing Standards

Internal Auditing and Corporate Governance

Prereforms	Postreforms
• Auditor dependency on nonaudit fees from major clients	• More restricted auditor independence
• Performance of nonaudit services	• Auditors not immune from economic pressures
• Auditors influenced by economic pressures	• Regulatory framework for the auditing profession
• Management hires, compensates, and fires auditors	• A five-member Public Company Accounting Oversight Board (PCAOB)
• No proper communication with audit committees	• PCAOB empowered to register, inspect, and review registered public accounting firms and impose disciplinary actions
• Do the minimum to meet GAAS	• PCAOB responsible for issuing auditing, quality controls, and ethics standards
• Reduce the cost of audit	• More effective communication with the audit committee
• Employment relationship	• Nine nonaudit services prohibited (bookkeeping, financial information system design and implementation, actuarial services, appraisal, management function, broker/dealer and investment advising, legal services, expert witness services)
• Self-regulation of auditing profession	• Audit of internal control over financial reporting (ICFR)
• Ineffective public oversight board	• Report on management's assessment of the effectiveness of ICFR
• Inadequate and ineffective disciplinary and monitoring process of the auditing profession	• Promotion of an integrated audit approach for audit of internal controls and financial statements
	• Shareholder vote on the ratification of the auditor
	• Rotation of the lead and reviewing auditor every five years

External Auditor Responsibility

Current auditing standards require that independent auditors provide *reasonable assurance* that the financial statements are free from material misstatements, whether caused by error or fraud, to render an unqualified opinion on the financial statements.

External auditors are not and should not be expected to provide absolute assurance regarding reliability of financial statements, but the public expectations concerning external auditors performance are high.

Users of audited financial statements generally expect external auditors to detect financial statement fraud and employees' illegal acts and fraud, which affects the integrity of financial reports. External auditors, however, are more concerned with material misstatements in the audited financial statements.

Auditor Competency

1. **Professional competencies.** To audit public companies, auditors should register with the PCAOB and meet all registration and inspection requirements.
2. **Technical competencies.** Auditors should be knowledgeable in professional standards, rules, laws and regulations, and understand their clients' industry and business, corporate governance, financial reporting process, and internal controls.
3. **Process competencies.** Auditor's ability to choose appropriate evidence-gathering procedures (tests of controls, substantive tests) and execute auditing procedures.
4. **Reporting competencies.** Reporting competencies refer to auditors' ability and willingness to discover and report material misstatements.

Audit Failures and Audit Quality

List of the initiatives that have been suggested to improve audit quality as well as the transparency.

1. Publication of audit engagement letters
2. Shareholders' rights to question auditors
3. Publication of auditor resignation statements
4. Lead audit partner's signature on audit reports
5. Active audit committee participation in evaluating the scope and results of the integrated audit of both ICFR and financial statements.
6. Mandatory rotation of the audit firm every seven to twelve years in the context of the quality of audit work performed by the firm and the audit efficacy.
7. Mandatory shareholder vote on the ratification of the independent auditor each year.

Public Company Accounting Oversight Board

The PCAOB → created by SOX to regulate the auditing profession.

The PCAOB's primary functions are to:

1. Register public accounting firms that audit public companies.
2. Inspect the registered public accounting firms on a regular basis.
3. Establish auditing, attestation, ethics, quality control, and independence standards.
4. Conduct investigations and disciplinary proceedings.

PCAOB Auditing Standards

The PCAOB has issued five auditing standards as of September 2007

1. PCAOB Auditing Standard No. 1 (audit is conducted in accordance with auditing standards of PCAOBUS, the city and state has to be disclosed)
2. PCAOB Auditing Standards No. 2 and 5 (New PCAOB AS No. 5 superseded AS No. 2 and requires the independent audit to opine only on the effectiveness of ICFR, not the management processes and assessments concerning ICFR) .
3. PCAOB Auditing Standard No. 3 (auditors are required to maintain the audit documentation is sufficient manner and keep the records for at least seven years).
4. PCAOB Auditing Standard No. 4 (voluntarily engagement for the auditor's report on the company's elimination of previously reported material weaknesses in its ICFR).

PCAOB Auditors Independence

The new rules restrict public accounting firms in performing a variety of tax services to their audit clients → the new rules are intended to prevent the selling of abusive tax shelters.

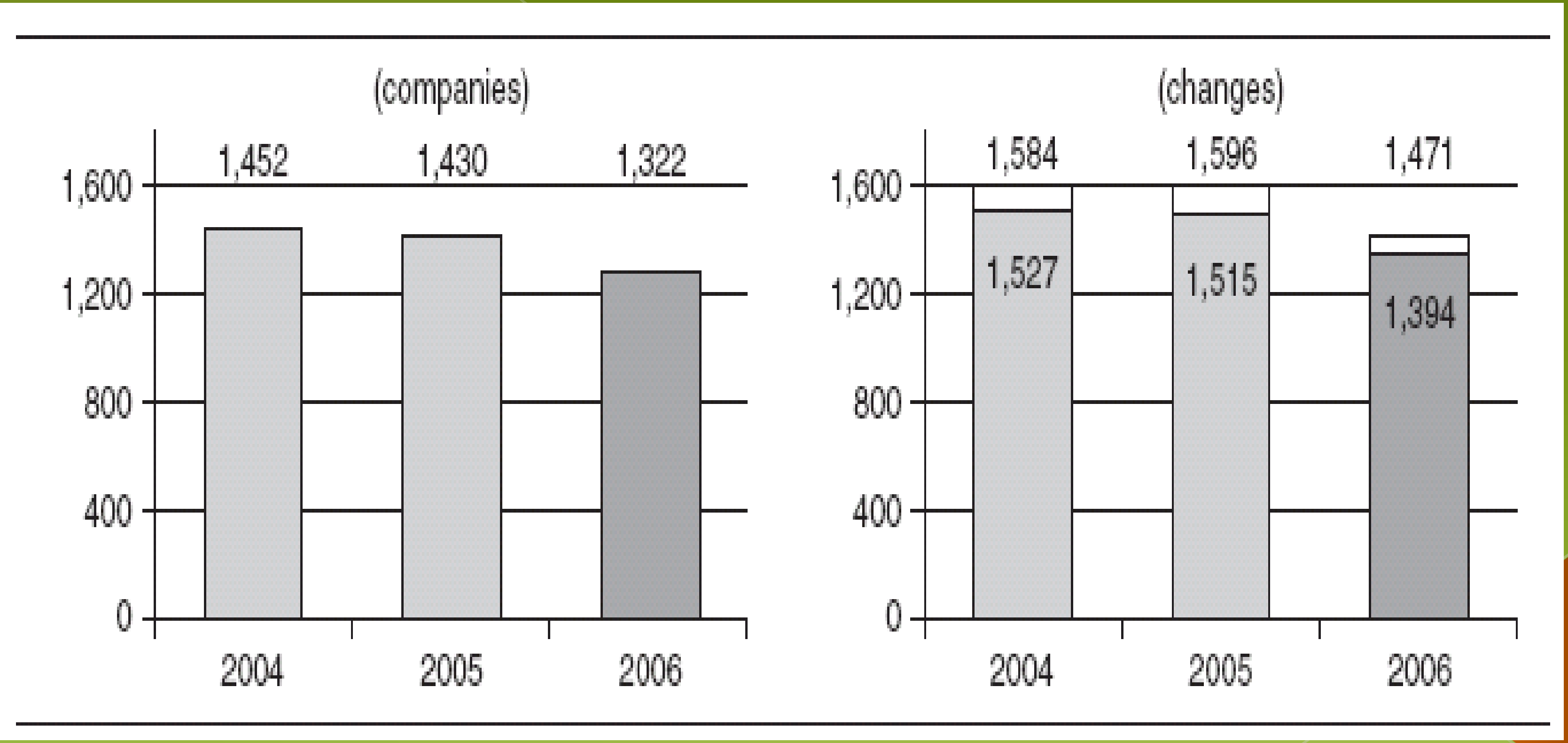
Audit Committee Oversight of External Auditors

The extended oversight responsibilities for the audit committee are:

1. Appointment, compensation, and retention of registered public accounting firms
2. Preapproval of audit services and permissible nonaudit services
3. Review of the independent auditor's plan for an integrated audit of both ICFR and annual financial statements
4. Review and discussion of financial statements audited or reviewed by the independent auditor
5. Monitoring the auditor's independence
6. Auditor rotation requirement

Audit Committee Oversight of External Auditors

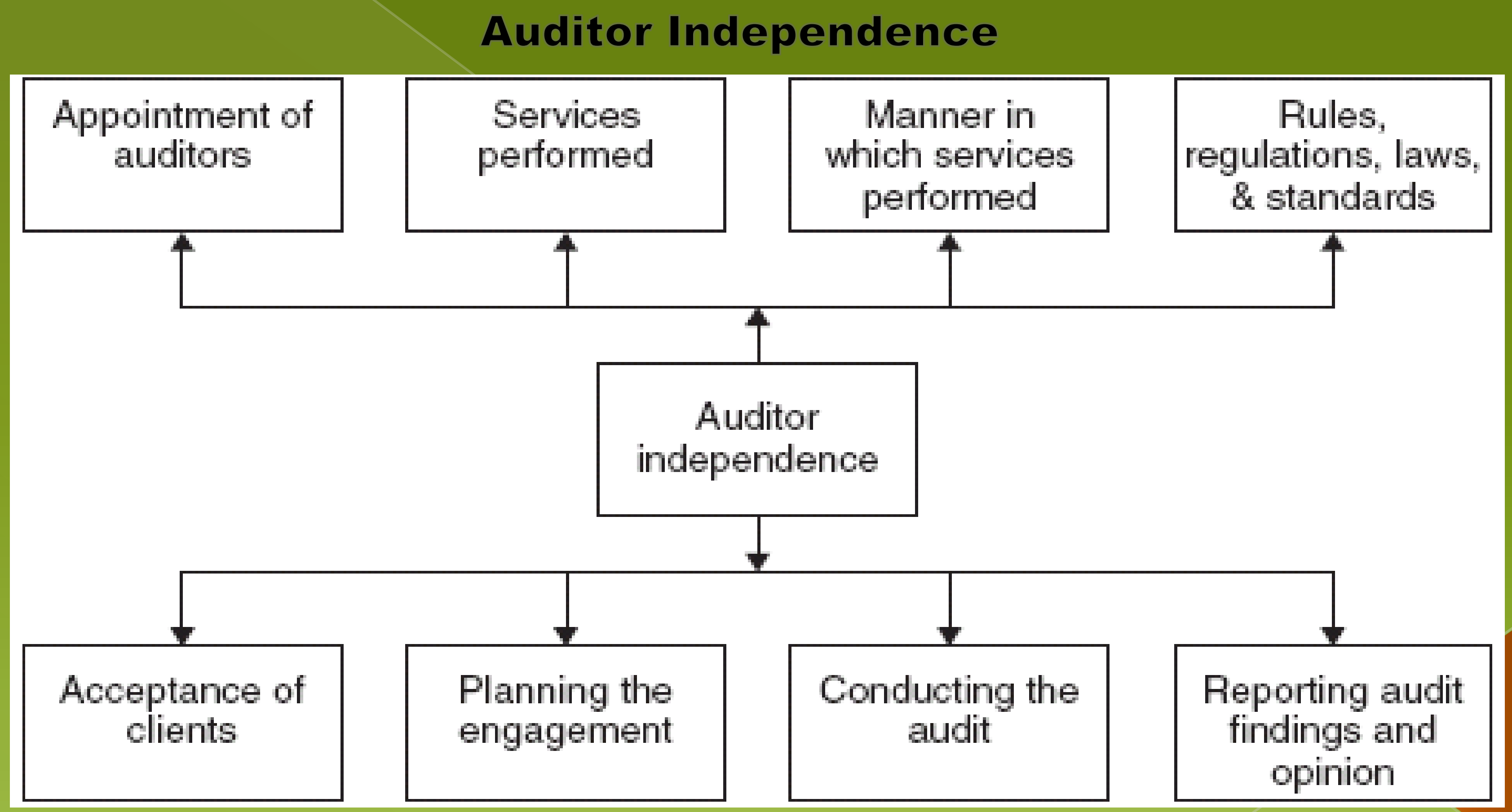
The number of companies that change auditors, and number of auditors changed.



Independent Auditors Communications with the Audit Committee

Communications from the committee to the independent auditor:	Communications from the independent auditor to the audit committee:
1. Appointment and retention approval of the independent auditor 2. Formal approval of audit and permissible nonaudit services 3. Formal approval of fees for both audit and nonaudit services with a keen focus on improving the quality of audit and nonaudit services 4. Any concerns or risks threatening management's reputation and integrity, and etc. 5. Allegations of financial statement fraud	1. Seeking committee preapproval of all audit and nonaudit services in a timely manner 2. The critical accounting policies and practices used by management in the preparation of financial statements 3. All alternative treatments of financial information within GAAP 4. Any accounting disagreements between the independent auditor and the company's management 5. Any material written communications between the independent auditor and the company's management throughout the course of the audit 6. Significant deficiencies and material weaknesses of ICFR 7. The audit report on annual financial statements 8. The review report on quarterly financial statements 9. The audit report on management's assessment of the effectiveness of ICFR 10. The audit report on the effectiveness of ICFR 11. Financial risks associated with financial reports

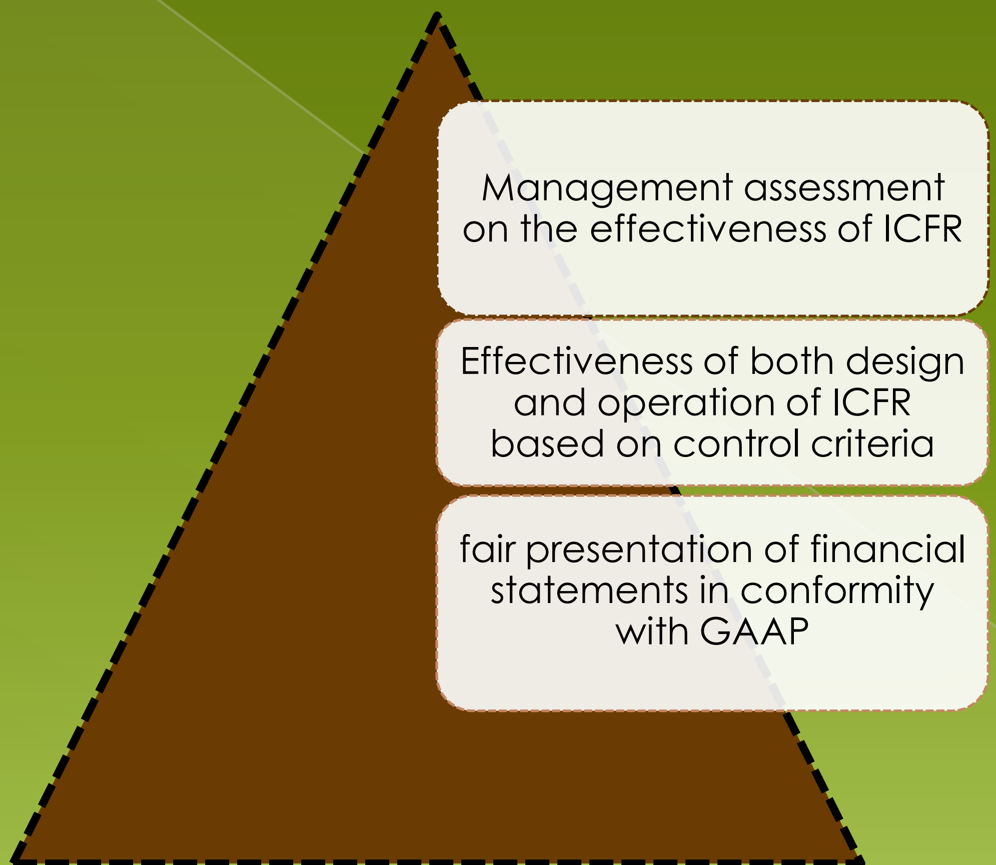
Auditor Independence



Consolidation and Competition in Public Accounting Firms

SEC rules require public companies that change their public accounting firms to file a Form 8-K, Item 4.01, to disclose changes within four days, whereas auditors are required to provide standard letters within ten days stating whether they agree with the company's disclosure without specifying any reasons

Integrated Audit Approach



Audit Strategy

Audit Strategy:

1. No limited tests of controls.
2. No use of cycle rotation in tests of controls.
3. Dual testing of controls and substantive audit procedures.

Auditors should focus on prevention, detection, and correction of controls at both the company level and the transaction level. Auditors should perform tests of controls as a basis for forming an opinion on the effectiveness of ICFR. Auditors should also perform substantive tests as a basis for expressing an opinion on the fair presentation of financial statements, regardless of the identified significant deficiencies and material weaknesses in internal controls.

Audit of Defined Benefit Pensions

Employer-defined benefit pension reforms, as proposed by the administration and introduced by both the House and the Senate, would require plan sponsors to make minimum funding contributions equal to the greater of:

(1) the contributions required under the plan's funding standard account estimated based on the plan's actuarial accrued liability,

(2) deficient reduction contributions calculated under current liability rules.

These reforms would replace the current law's "double-barrel" system with a single measure of assets and liabilities and required funding method.

Auditors Liability Limitation Agreement

In February 2006, the Federal Financial Regulatory Agencies issued an interagency advisory that raised concerns regarding the negative impacts on the quality and reliability of audits when financial institutions agree to limit their independent auditors' liability.

The advisory, while observing an increase in the types and extent of provisions in financial institutions' external audit engagement letters that limit auditor liability, informs financial institutions that they should not enter into an audit engagement that includes unsafe and unsound limitation of liability provisions relevant to an integrated audit of their financial statements and ICFR.

Auditors Liability Limitation Agreement

Type of clause*	AICPA proposed interpretation*	FFIEC proposed advisory*	2006 interagency advisory**
Auditor indemnified against claims based on auditor's negligence	Impairs independence	Unsafe and unsound practice	Unsafe and unsound practice
Auditor indemnified against claims based on knowing misrepresentation by audit client's management	Does not impair independence	Unsafe and unsound practice	Unsafe and unsound practice
Auditor indemnified against claims based on audit client's negligence	Impairs independence	Unsafe and unsound practice	Unsafe and unsound practice
Auditor's liability limited to the amount of fees paid	May impair independence	Unsafe and unsound practice	Unsafe and unsound practice
Limitation of period during which audit client could otherwise file claim	Impairs independence	Unsafe and unsound practice	Unsafe and unsound practice
Limitation on audit client's right to assign or transfer claim	Impairs independence	Unsafe and unsound practice	Unsafe and unsound practice
Exclusion of punitive damages	Does not impair independence	Unsafe and unsound practice	Does not impair independence as long as fully disclosed
Agreement to use ADR	Impairs independence only if it also limits the auditor's liability for actual damages or incorporates a provision that would impair independence	Presents safety and soundness concerns if it incorporates additional limitations of liability or if ADR rules may limit auditor liability	Does not present a threat to safety and soundness given that such arrangements do not constitute auditor limitation of liability provisions.
Unsuccessful party to pay adversary's legal fees	Does not impair independence	Silent	Silent
Auditor's liability limited to the amount of losses occurring during periods audited	May impair independence	Unsafe and unsound practice	Unsafe and unsound practice

Conclusion

- The audit function should be regarded as an external corporate governance mechanism that serves to protect investors from receiving incomplete, inaccurate, or misleading financial information and thus adds value to the effectiveness of corporate governance.
- SOX drastically changed the characteristics of the accounting profession by connecting the audit function to the corporate governance structure by requiring that the audit committee be directly responsible for not only hiring, compensating, and firing external auditors, but also overseeing their work, monitoring their independence, and avoiding potential conflicts of interest.
- In the auditing profession, the so-called expectation gap is referred to as the difference between (1) what the investing public and other users of audited financial statements believe the responsibilities of auditors are, and (2) what auditors are willing to assume as responsibilities according to their professional standards.
- New PCAOB AS No. 5 superseded AS No. 2 and requires the independent audit to opine only on the effectiveness of ICFR, not the management processes and assessments concerning ICFR.

Conclusion

- Sections 201 and 202 of SOX require that all audit and permissible nonaudit services to be performed by the company's independent auditor be approved by the audit committee.
- Auditor independence is the backbone of the auditing profession, affecting the auditor's planning, evidence-gathering procedures, findings, judgment, and credibility, and public trust in the auditor's opinion.\
- Auditor independence is derived and guided by the three principles of (1) independent auditors may not audit their own work, (2) independent auditors may not function in the role of their client's management, and (3) independent auditors may not serve in an advocacy role for their audit clients.
- Tests of controls must be broadened to include understanding of ICFR, and provide reasonable assurance about the effectiveness of both the design and operation of internal controls.
- Any contractual provisions that limit the external auditor's liability or require waiving the right to a jury trial may have detrimental effects on auditor impartiality, objectivity, and quality.