EXTERNAL AUDITOR AUDITS, WHO THEN AUDIT THE AUDITORS?

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Abstract

This study focuses on the function of external auditor also known as independent auditors' job, the auditor's report, and the systematic way of financial audit. Also, this study will give an insight about some curiosity on who audit the external auditor. We all know that an external audit expresses an opinion on the fairness of the financial statements presented by the client (auditee). Audit opinion is issued as a proof that a certain company has been audited and the result is written thereof. Auditor is assuring that the audited financial statement can be relied upon in making a decision. On the other hand, a peer review is conducted for external auditor to check if the auditor are following certain quality control standards, and after that a recommendation for improvement is issued about the services rendered by the external auditor.

Key words: *External Auditor, Peer review, PCAOB, AICPA, unqualified opinion, qualified opinion, adverse opinion, disclaimer opnion.*

Introduction

Auditors nowadays are increasing in number. Most of the practitioners build their own Certified Public Accountants (CPA) firms. While businesses are mushrooming, accountants too are booming. Accounting professionals have their firm, be it in a form of sole proprietorship or partnership. It is known that these professionals are not only liable to their clients but to the public as well. They are trusted to evaluate the financial status and financial condition of one's entity or company. CPAs possesses independence and competence. He must be a prudent person. An auditor should have this basic criterion in order to be considered as independent auditor. Why must be independent? Of course, in order to be objective in assessing the company's situation. Once an auditor starts his/her audit, he/she must do it with due care and diligence. And for what are these audited financial statements? Audited financial statements are for the users especially the decision makers. Users believe that an audited financial statement give a reliable and relevant information.

Since users are relying on the audited financial statements, there is a need for every professional to be monitored. Professionals are monitored to see to it that they follow the standards in auditing, and this is called peer review. Peer review checks the quality of its services rendered by the CPA firm. Quality services are essential to ensure that the profession meets its responsibilities to the general public, clients, and regulators. The peer review team must also do this by observing independence from the CPA firm being reviewed.

Review of Related Literature

The Origin of Audit and Its Nature

The term “audit” is derived from Latin word meaning “a hearing”. Auditing originated over 2,000 years ago when, firstly in Egypt, and subsequently in Greece, Rome and elsewhere, citizens (or, sometimes, slaves) entrusted with the collection and disbursement of public funds were required to present themselves publicly, before a responsible official (an auditor), to give an oral account of their handling of those funds. The practice of auditing commenced on the day that one individual assumed stewardship over another's property. In reporting on his stewardship, the accuracy and reliability of that information would have been subjected to some sort of critical review.

Auditing may be defined a systematic, integrated process of accumulating and evaluating evidence by competent, independent persons about economic information, actions and events of an entity; the purpose of which is to assess and report on the degree of correspondence between the information and established criteria for the entity's actions and/or the reporting thereof. *Auditing* involves gathering and evaluating evidence relating to management's assertions as reflected in the financial statements.

Auditing is a form of “attestation” wherein the Certified Public Accountant communicates to the interested users whether the representations of management regarding financial statements are fair.

The Demand for Audit

Why there is a demand for audit? What then is the value of an audit? There is demand for audit because of some reasons. One, to minimize risk of materially misstated financial statements and second, there might be an unbiased monitor reports on quality of information. Its value are to reduce information risk to stakeholders and to reduce cost of capital to company.

External auditor's job is not that easy task. They audit client rigorously in order for them to issue opinion in accordance to their findings. Clients depend on the auditor about the result of the audit, and users of audited financial statement need reliable information. Auditors are guided by generally accepted auditing standards (GAAS) in doing an audit. GAAS are recognized as the measures of an audit's quality, it can also be argued that the quality of a CPA firm's audit practice is therefore dependent upon the application of generally accepted auditing standards. After the CPA firms finished their responsibility to a certain company, they don't stop there but to continually do the audit as long as there are demands from other company.

Systematic Process of Financial Statements Audit

Phase I - Pre-engagement and Audit Planning Activities

Audit process begins with the preliminary arrangements with the client. Once the client has signed the *engagement letter*, the planning process starts as the auditor concentrates his efforts in obtaining a detailed understanding of the client's business and an overall audit strategy. Audit planning includes understanding client's (1) industry environment, (2) business and management, (3) accounting and reporting systems, and (4) internal control. On the basis of the initial information gathered by the auditor, he then assesses the "audit risk" relative to the engagement. Based on the initial understanding, the auditor may decide to assess control risk at the *maximum* level for some assertions and *below maximum* for others. Maximum control risk is defined at the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control structure. Assessments of materiality, acceptable audit risk, inherent risk and control risk are used to develop an overall audit plan and audit program.

Phase II-Gathering and Evaluating Audit Evidence

When gathering and evaluating audit evidence, auditors perform two basic types of audit tests: *test of control* and *substantive tests.*

The tests of controls involve the following types of procedures:

1) Inquiries of client personnel.
2) Inspection of documents and records
3) Observation of the application of specific policies and procedures
4) Re-performance of the application of specific policies and procedures.

Performance of the substantive tests of transaction may also be conducted at this stage. In fact, many of both types of tests, tests of controls and tests of transactions are done simultaneously on the same transactions. When controls are not considered effective, or when control deviations are discovered, substantive tests can be expanded in this phase or in the final audit phase. Results of the auditor's tests of control whether obtained through reprocessing of transactions, observation or document testing and examination must be fully documented. Documentation is a necessary part of the overall evidence describing the thought processes leading to design of *substantive tests* and this is especially critical when the auditor assesses control risk to be below the maximum level.

This phase also involves *substantive tests of details of balances* and *analytical* *procedures*. Substantive audit testing is the process of obtaining evidence in support of transactions and balance. The nature, timing and extent of substantive testing is a function of the auditor's judgment concerning audit risk and materiality.

The final audit phase will also include accumulation of some additional evidence for the financial statements, summarization of the result that will enable the auditor to prepare his audit report. This will include review for contingent liabilities, review for subsequent events performing final analytical procedures, evaluating the going concern assumption and obtaining a client representation letter.

Phase III - Issuing the Audit Report

The culminating step in the audit process is the preparation of the audit report. Expressing an audit opinion is the auditor's overriding goal. The type of audit report issued depends on the evidence accumulated and the audit findings.

The audit report concisely describes the auditor's responsibility, the nature of the examination, the audit finding and his opinion on the financial statements. If upon completion of the audit field work, the auditor decides that an opinion cannot be rendered, he must clearly disclaim an opinion and give reasons for the *disclaimer***.** If an opinion can be rendered, the auditor must decide whether to issue an *unqualified, qualified, or adverse.*

Economic Benefits of an Audit

Auditors are not hired if there are no advantages of hiring them. Following are some of the benefits to gain if financial statements are audited:

**Access to capital markets* – public companies must satisfy statutory audit requirements under the federal securities acts in order to register securities and have them traded on securities markets.

**Lower cost of capital* – small companies often have financial statement audits to obtain bank loan on more favorable borrowing terms. Because of the reduced information risk associated with audited financial statements, creditors may offer loans with lower interest rates.

**Deterrent to inefficiency and fraud* – research has demonstrated that when employees know that independent audit is to be made, they take care to make fewer errors in performing accounting functions are less likely to misappropriate assets. Thus, the data in company records will be more reliable, and losses from embezzlements and the like will be reduced.

Control and operational improvements – based on observations made during a financial statement audit, the independent auditor often makes suggestions to improve internal control, to evaluate management's assessments of business risks, to recommend improved performance measures, and to make recommendations to achieve greater operational deficiencies within the client's organization.

A certain company gets all these benefits if they subject their financial statements to audit by the professionals engage in audit.

Limitations of an Audit

To some extent, there are some limitations related to audit, these are,

Reasonable cost – a limitation on the cost of an audit results in selective testing, sampling, of the accounting records and supporting data. In additions, the auditor may choose to test internal controls and may obtain assurance from a well-functioning system of internal controls.

Reasonable length of time – the auditor's report on many public companies is usually issued three to five weeks after the balance sheet date. This time constraint may affect the amount of evidence that can be obtained concerning events and transactions after the balance sheet date that may have an effect on the financial statements. Moreover, there is relatively short time period available for resolving uncertainties existing at the statement date.

Although there are limitations to audit, still the benefits prevails over it. Also, credibility is still maintained when financial statements are audited.

The External Auditor

External auditor also known as Independent auditor plays a vital role in the business enterprises. Their service is most needed by companies be it private or public. Most of them are from a certain Certified Public Accountant firms. To name a few international CPA firm, this include *Deloitte & Touche*, *Ernst & Young, PricewaterhouseCoopers, and KPMG.* Also to name a few of local CPA firm, we have *Dra. S. Griselda & Co., and Bismar, Salmon & Rekan.* Auditor gives an assurance services which means that they offer a professional service that improve the quality of information for decision makers. To be more specific, the service they offer is called an *attestation service* in which the CPA firm issues a report about the reliability of an assertion that is the responsibility of another party.

External auditor is an independent party from the client that evaluates the financial statements of a certain company. It has it uniqueness as compared to internal auditor. Nevertheless, both must comply with the standards set by the regulatory bodies.

The Primary Objective of External Auditor

External auditor focuses on the financial statement audit. They are known as independent auditor. The primary objective of financial audit is to express an opinion on the fairness of the financial statements. Opinion expressed is classified into four types, unqualified opinion, qualified opinion, adverse opinion, and disclaimer opinion. Unqualified opinion is said to be the best opinion followed by qualified. Any one of this opinion can be issued by the auditor depending on what the result of the audit.

The Types of Opinion

Type of Opinion	**Definition**
1. Unqualified	-Means management's assertions are fairly presented in the attester's opinion. -Communicates a favorable a signal and means the financial statements present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.
2. Qualified	-assertions fairly presented *except for* certain matter(s). - Means that "except for" the effects of particular matter, the financial statements present financial position, result of operations, and cash flows in conformity with generally accepted accounting principles. Only the term "except for" or some variation –like "except", "exception", or with the exception of" – may be used to qualify an opinion. Qualified opinions are issued when there is a lack of evidence or restrictions on the scope of an audit, or the auditor believes the financial statements contain a material departure from generally accepted accounting principle.

3. Adverse	-assertions are *not fairly presented* -Means the financial statements do not present the financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Adverse opinions are issued when the effect of a departure from generally accepted accounting principles is so material that a qualified opinion is unwarranted.
4. Disclaimer	-attester does not express an opinion usually due to insufficient evidence -A disclaimer is issued when the auditor has not performed an audit sufficient in scope to provide a basis for an opinion on the financial audit.

Audit report is issued based on the findings of the auditor and after performing all the necessary steps in audit. Most companies aim for a unqualified opinion, or clean bill report.

Who Then Audit the External Auditor (CPA Firms)?

Would be it be fair enough for the auditor to just do the audit? Who then audit the CPA firms? Would there be a certain group responsible to audit the CPA firms? An important feature of American Institute of Certified Public Accountant (AICPA) Division is the mandatory *peer reviews* that are required periodically of members of both sections, the *SEC Practice Section and Private Companies Practice Section*. CPA firms voluntarily join either or both sections based on the type of clients that they serve. Every three (3) years, member firms must subject their practice to a peer review. A *peer review* involves a study of the adequacy of the firm's established quality control policies and test to determine the extent of the firm's compliance with the policies. A *peer review* is essentially a study and evaluation of a CPA firm's quality control system by an independent (outside the CPA firm) peer reviewer. The peer reviewer may be another CPA firm or a review team specially formed for the purpose. In large part, these tests consist of a review of working paper files and reports for selected engagements. These engagements are evaluated for compliance with established quality control policies and professional standards. The reviewers also examine many internal records of the CPA firm. They are especially interested in records concerning the promotions of employees, continuing education of firm personnel, staffing of engagements, client acceptance, and the employment of professional personnel. Based on the reviewer's study and test of quality controls, they issue a report that includes an opinion as to adequacy of the reviewed firm's quality control system. Suggestions for improvement to the system are outlined in a “letter of comments” issued by the reviewers to the reviewed firm. The executive committees of the two sections have the power to sanction member firm for substandard performance. These sanctions may include additional education requirements for firm personnel, special peer reviews, fines, and suspension or expulsion from the Division.

The Quality Control Standards

CPA firm are required to follow Quality Control Standards. Quality control is the vehicle used by CPA firms to assure that GAAS are followed on each engagement. Following are the nine elements of Quality Control:

Element of Quality Control	Basic Objective	Example of Procedure
1. Independence	Firm personnel meet the independence requirements of the AICPA Code of Professional Conduct.	An investigation is made to determine the firm’s independence before accepting a new audit client.
2. Assigning Personnel to Engagements	Work should be done by personnel with appropriate technical training and proficiency.	Periodic meetings of audit managers are held to assist staff to upcoming jobs.
3. Consultation	Advice should be sought from appropriate sources to help resolve complex problems.	A ‘technical center” is maintained by a large CPA firm to provide research and consulting services to any practice office in the firm.

4. Supervision	Personnel should be properly supervised.	Working papers are reviewed by the manager and any deficiencies are discussed with the preparer.
5. Hiring	New employees should possess the characteristics and qualifications to handle their jobs.	Prospective employees are interviewed by both the personnel partner and by a technical partner in the area in which they will work.
6.Professional development	Personnel should continue to expand their knowledge as required to meet their responsibilities.	Each professional must annually receive at least 40 hours of continuing education.
7. Advancement	Persons promoted should be qualified to assume their new responsibilities.	Professional are evaluated by their supervisors at the end of each engagement; the evaluation are placed in their personnel files.
8. Acceptance and continuation of clients	Care should be taken to avoid association with clients lacking in integrity.	Background information gathered on all prospective audit clients and is discussed at a partner's meeting before accepting the client.
9. Inspection	Controls should exist to provide reasonable assurance that established quality control procedures are being effectively applied.	A quality control partner periodically tests the application of quality control procedures.

Inspection and Peer Review

Quality control standards provide the basis for firm regulation and the performance of high-quality audit and attest services. Inspection and peer review provide an external review whether a firm is in fact meeting quality control standards. Public Company Accounting Oversight Board (PCAOB) monitors the public companies while AICPA's practice monitoring (peer review) for private companies.

PCAOB Inspection Program

The Sarbanes-Oxley Act of 2002 instruct the PCAOB to conduct a continuing program of inspection to assess the degree of compliance of each accounting firm registered to audit public companies with the rules of the PCAOB, the SEC, and other professional standards in connection with its performance of audits, issuance of audit reports, and related matters. In conducting inspections, the Sarbanes-Oxley Act of 2002 states that the PCAOB should:

- Inspect and review selected audit and review engagements of the firm.
- Evaluate the sufficiency of the firm's quality control systems and the firm's documentation and communication of that system.
- Perform such other testing of the audit, supervisory, and quality control procedures of the firm as are necessary or appropriate in light of the purpose of the inspection and the responsibilities of the board.

AICPA Practice Monitoring (Peer Review) Program

CPA firm should submit its accounting and auditing practice to review by independent peers every three years. Participation is required for all members of the AICPA, and many state boards of accountancy require that an auditor of private companies undergo a form of peer review equivalent to AICPA program. The purpose of peer review is to determine whether:

- The reviewed firm's system of quality control for its accounting and auditing practice has been designed in accordance with quality control standards established by the AICPA.
- The reviewed firm's quality control policies and procedures were being complied with to provide the firm with reasonable assurance of conforming with professional standards.
- The reviewed firm has demonstrated the knowledge, skills, and abilities necessary to perform accounting, auditing, and attestation engagements in accordance with

professional standards, in all material respects.

At the end of the peer, review, the independent peer review team will issue a report on the firm's compliance with quality control standards, if applicable, a letter of comment with recommendations for improvement. The firm may then file the report with the state board of accountancy, and clients can ask to see the results of a firm's peer review.

Conclusion

The services of CPA Firms or known as the external auditors are invaluable. They issue report that is relevant to the financial users for decision making. External auditor can issue auditor's report, unqualified, qualified, adverse or disclaimer. Its primary objective of the auditor is to express an opinion on the fairness of the financial statements. Opinion expressed is expressed in four types, unqualified, qualified, adverse and disclaimer. There is a demand for audit become of some information risks.

PCAOB and AICPA established a group that would be responsible to audit the CPA firms, and this is called *peer review*. PCAOB is responsible to monitor the public companied while AICPA is responsible for reviewing private companies. Peer review involves a study of the adequacy of the firm's established quality control policies and test to determine the extent the firm's compliance with the policies. If there is any suggestion for improvement, it would be written in “letter of comments”. If the member firm is found out to be performing not in accordance with the standards, sanctions may be given to the CPA firm.

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