

4.2: The Role of the Independent Auditor in Financial Reporting

Learning Objectives

At the end of this section, students should be able to meet the following objectives:

1. Understand the purpose of an independent audit.
2. List the two primary components of an independent audit.
3. Explain the function of an independent audit firm.
4. Describe the steps required to become a Certified Public Accountant (CPA).
5. List the various services provided by many public accounting firms.
6. Discuss the necessity for the creation of the Public Company Accounting Oversight Board (PCAOB) and describe its function.

Question: The SEC allows FASB to set U.S. GAAP. Does the SEC physically visit each company that issues securities to the public to ensure that periodic financial statements properly follow the rules and guidelines of U.S. GAAP?

Answer: A detailed examination of the financial statements produced by thousands of publicly traded companies around the world would require a massive work force with an enormous cost. Therefore, this very essential role in the financial reporting process has been left by the SEC to auditing (also known as public accounting) firms that operate both inside and outside the United States. Before submitting their statements to the SEC and then to the public, reporting companies such as IBM and Wells Fargo must hire one of these independent auditing organizations to

- perform an **audit** (examination) of the financial statements,
- report on whether sufficient supporting evidence was gathered to enable the auditor to provide reasonable assurance that the statements are presented fairly because they contain no material misstatements according to U.S. GAAP.

This written report by the company's independent auditor is then attached to the financial statements for all to see. The report is essential to the integrity of the reporting process. It provides the auditor's expert opinion as to whether decision makers should feel safe in relying on the financial information to make their decisions. The report is a legal requirement for statements provided to the SEC. Even many companies that are not affected by the rules of the SEC have their statements audited by an independent firm to enhance credibility. For example, a convenience store seeking a bank loan could pay for an audit in hopes of increasing the chances that the application will be approved (or because bank officials have required the audit for the bank's own protection).

Not surprisingly, companies that have audits are able to get loans at lower interest rates than comparable organizations that do not have their financial statements subjected to examination (Blackwell, et. al., 1998). The audit serves to reduce the lender's risk of loss. Thus, a lower interest rate is needed to convince banks and other institutions to provide financial resources.

In the United States, **independent auditing firms** can only be operated by individuals who have been formally recognized by a state government as **Certified Public Accountants (CPAs)**. Such firms range in size from massive (KPMG employs over 227,000 individuals working in 147 countries and generated annual revenues of approximately \$29.2 billion for the year ended September 30, 2020²) to organizations comprised of just one or two people.

Obviously, for the financial statements of the biggest clients (the ExxonMobils and Wal-Marts of the world), only a public accounting firm of significant size could effectively perform an audit engagement. Consequently, four firms (known collectively as the **Big Four**) are truly huge global organizations:

- Deloitte
- Ernst & Young
- KPMG
- PricewaterhouseCoopers

However, thousands of smaller independent CPA firms exist providing numerous services, such as **audit, tax planning and preparation**, and **advisory work** for a wide range of clients. Ernst & Young indicates on its Web site (<http://www.ey.com>) that the following services are provided to its clients with each explained in detail: consulting, assurance, tax and transaction/corporate finance.

Check Yourself

A financial audit is performed by a certified public accountant as required by the SEC and its purpose is to:

- A. Recommend an investor buy stock in a particular company.
- B. Indicate whether or not the company will be hiring more employees in the near future.
- C. Check to see if the company's stock price will be going down over the next year.
- D. Provide an opinion as to whether the company is following GAAP appropriately.

The correct answer is D. The independent auditor's role is to enhance the credibility of the financial statements and indicate that they show what is actually happening with the business according to GAAP. They are not to recommend or provide any opinion on the stock price or future of the company.

Question: FASB creates U.S. GAAP, the official standards for the preparation of financial statements. What group sets the examination and reporting rules to be followed by independent auditors? Their work is not in accordance with accounting principles. Instead, they are seeking to determine whether U.S. GAAP was applied properly. These auditing firms clearly provide a vital service by adding credibility to reported financial information. How do independent auditors know what actions should be taken in assessing the data reported by a company such as Uber or Bank of America?

Answer: When an audit is performed on the financial statements of any organization that issues securities to the U.S. public, the examination and subsequent reporting is regulated by the **Public Company Accounting Oversight Board (PCAOB)**. The PCAOB was brought into existence by the U.S. Congress through the [Sarbanes-Oxley Act of 2002](#), a measure passed in response to a number of massive accounting scandals, including Enron and WorldCom. Members of Congress apparently felt that the auditing profession had failed to provide adequate protection for the decision makers who were relying on published financial information. Consequently, the federal government became more involved. The PCAOB was established under the oversight and enforcement authority of the SEC. It holds wide-ranging powers that include the creation of official guidelines for the performance of a proper audit. Its mission is stated as follows: "The PCAOB is a private-sector, nonprofit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports."³

If an audit is performed on financial statements that are produced by an organization that does not issue securities to the public, the PCAOB holds no authority. For such smaller engagements, the **Auditing Standards Board (ASB)** officially sets the rules for an appropriate audit. The ASB is a technical committee within the **American Institute of Certified Public Accountants (AICPA)**, a national professional organization of CPAs.

A local convenience store, as mentioned previously, or a medical practice or law firm might choose to have an audit on its financial statements. These audits fall under the guidelines provided by the ASB rather than the PCAOB because the organizations do not issue publicly traded securities. Thus, the rules for performing an audit on a large public company can differ somewhat from those applied to a smaller private one.

Question: If FASB sets U.S. GAAP and the PCAOB (and the ASB) establishes rules for performing an audit, what function does the SEC actually serve?

Answer: The goal of the work done by the SEC is summed up in the following statement from its Web site: "The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it."⁴

Thus, the SEC strives to make certain that the organizations that fall under its jurisdiction are in total compliance with all laws so that decision makers have ready access to information viewed as relevant. It reviews the required filings submitted by each organization to ensure that the rules and regulations are followed. The SEC also has the power to enforce securities laws and punish companies and individuals who break them. (The FASB has no enforcement power – it only sets the rules but cannot punish those who break them). For example, if a company fails to disclose a significant transaction or other event that the SEC believes is necessary, trading of that company's securities can be halted until the matter is resolved. Such regulatory actions can cause a huge financial loss for a business; thus, compliance is viewed as vital.

In addition, if corporate officials provide false or misleading data, fines and jail time are also possible: "The Securities and Exchange Commission recently charged Silicon Valley-based private company Theranos Inc., its founder and CEO Elizabeth Holmes, and its former President Ramesh "Sunny" Balwani with raising more than \$700 million from investors through an elaborate, years-long fraud in which they exaggerated or made false statements about the company's technology, business, and financial performance. "As a result of Holmes' alleged fraudulent conduct, she is paying \$500,000 in fines, being stripped of

control of the company she founded, is returning millions of shares to Theranos, and is barred from serving as an officer or director of a public company for 10 years,” said Stephanie Avakian, Co-Director of the SEC’s Enforcement Division.⁵

Check Yourself

Providing rules for the auditing process and making sure they are followed is the charge of which institution?

- A. FASB
- B. PCAOB
- C. GAAP
- D. IFRS

The correct answer is B. For those auditing publicly traded companies, the Public Company Accounting Oversight Board sets the rules to be followed during the audit and performs inspections of auditors to promote compliance with those rules. For non publicly traded companies the rules are set by the Auditing Standards Board of the AICPA.

Key Takeaway

Independent auditing firms provide credibility to financial statements by examining the evidence that underlies the information provided and then reporting on those findings. Official oversight of the rules for this process is in the hands of the Public Company Accounting Oversight Board (PCAOB) if the audited company issues securities to the public and the Auditing Standards Board (ASB) if not. The role of the Securities and Exchange Commission (SEC) is to ensure that this reporting process is working as intended by the government. The SEC examines the filings of the various companies and can take disciplinary action if either the company or its officials fail to act appropriately.

¹The rules for becoming a CPA vary by state but usually include a specific amount and level of education as well as a passing grade on each of the four parts of the uniform CPA Exam. Some states also require a defined length of practical experience such as one or two years. Information about the CPA Exam and state requirements for applying are available at <http://www.cpa-exam.org>.

²See <http://www.kpmg.com> as of Sept 30, 2020.

³See <http://www.pcaob.com>.

⁴See <http://www.sec.gov>.

⁵www.sec.gov/news/press-release/2018-41

References

Blackwell, D. W., Thomas R. Noland, and Drew B. Winters, “The Value of Auditor Assurance: Evidence from Loan Pricing,” *Journal of Accounting Research*, Spring 1998, 57–70.

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