KPMG

What's an audit?

A guide to the auditing process and why it's important

audit.kpmg.us

Whether you are an investor in a public or private company, an academic or someone who is curious about what a financial audit is, we hope you will find "What's an audit: A guide to the auditing process and why it's important" to be helpful.

Our KPMG Audit professionals understand that our foremost responsibility is to serve the public interest through integrity, professionalism, and high performance. Quality is the cornerstone of all we do at KPMG; it is the foundation upon which our firm was built more than a century ago and the very essence of our Audit practice.

We transform our pledge to audit quality into action through our dedication to objectivity and independence, transparent and ongoing dialogue with stakeholders and investments in our people and the tools and resources that support their work.

In an increasingly complex global marketplace and regulatory environment, we are investing significantly and steadily in people, technology, and programs to promote audit quality to the benefit of both the capital markets and the profession.

Sincerely,

KPMG LLP

For more information, contact us at **us-audquality@kpmg.com** or visit us at **audit.kpmg.us**

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Accounting provides information that guides investors and business executives in making sound decisions about their companies' performance and their future. As one analyst puts it, "Accounting is the language of business."[1]

Yet, these records would mean very little if one could not depend, as much as possible, on their accuracy. That's where auditing comes in. Where accounting focuses on the creation of financial data, auditing focuses on checking the data to determine if it was created in accordance with accounting rules and that it accurately reflects financial information created during the reporting period being examined.[2]

This document provides a short overview of auditing—why and how it's done, what information is examined, what kinds of reports are provided…and why it's all important.

[1] Wayne A. Label, CPA, MBA, PhD., Accounting for Non-Accountants. Naperville, Illinois: Sourcebooks, Inc., 2013, p. 1.

[2] Label, p. 153.

What is an audit?

According to the American Accounting Association, an audit is "a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users."[3]

More simply, an audit is an examination of a company's financial records to determine if they are fairly represented, free from material error and in accord with what are called Generally Accepted Accounting Principles (GAAP).

GAAP represents the common set of accounting standards and procedures that companies use to compile their financial statements. GAAP is a combination of authoritative standards (set by policy boards) and, simply, the practices of recording and reporting financial information.

You could say that auditors are the ones who evaluate where money is coming from, where it's going, and what it's doing each step of the way.

[3] A Statement of Basic Auditing Concepts, American Accounting Association, 1973.

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Why are audits performed?

For public companies, it's the law. According to the U.S. Securities and Exchange Commission (SEC), public companies' annual financial statements must be audited each year by independent auditors.

Beyond that, audits are intended to provide a variety of stakeholders with the confidence that a company's financial statements can be relied upon. These stakeholders include investors and shareholders, as well as employees, lenders, and creditors. For large companies in particular, those interested in accurate and credible financial reports extend to the larger public and to governments.[4]

Without independent audits, these stakeholders would have to rely on management's assertions as to the accuracy and completeness of a company's financial statements.

There is an additional business value to an audit: Companies can gain valuable insight into how their business is performing. So audits are much more than "rearview mirror" reports on the business; they can also help companies plan better for the future.

The SEC requires that public companies' annual financial statements be audited each year by **independent auditors**.

[4] Nobes, Christopher. Current Debates in International Accounting, 2011. P. 82.

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What about private companies?

How are they different and do they also need to be audited?

Privately held companies are owned by the company's founders, management or a group of private investors. Unlike a public company, a private company has not sold a portion of itself to the public via an initial public offering (IPO) of some of its stock.

Private companies are not required to disclose their financial information via the SEC since they do not trade stock on a stock exchange. However, these companies may choose to have their financial statements examined by an external auditor for reasons such as:

- The company plans to become public in the future.
- The company has borrowed from lenders that require audited financial statements.
- The company's board of directors or primary investors and owners believe it is necessary from a governance perspective.

Who's in charge of the audit?

How does a company select an auditor?
Let's talk first about the **Board of Directors** for a company, because it plays a big role in choosing the firm that will perform the audit and then making decisions as the audit proceeds. All publicly traded companies are required to have a board of directors, with members elected by the company's shareholders. The board oversees the company's management and represents the interests of the shareholders. It is the highest governing authority at any publicly traded company.

From that board, at least three members are chosen to form an Audit Committee. That committee is responsible for the integrity of the company's financial reporting process. In that role, they choose the independent auditor, oversee that firm's work, and monitor any disagreements between management and the auditor.[5]

Other crucial players here include a company's own internal audit group—something found in particular at larger companies. These internal auditors work closely with the external auditor, often reducing the time required for the independent auditing firm to conduct the audit.[6]

All publicly traded companies are required to have a **Board of Directors**, with members elected by the company's shareholders.

[5] Center for Audit Quality, "Guide to Public Company Auditing," p. 4.

[6] Label, p. 154.

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Who performs the audit?

The team charged with auditing a public company consists of accountants and other professionals under the leadership of senior certified public accountants (CPAs) employed by an accounting firm. The team is directed by an experienced CPA, often designated as the "lead engagement partner."

CPAs are accountants who, in addition to their college degree, have passed the Uniform Certified Public Accountant Examination and a special examination on ethics and have relevant work experience. They also take at least 20 hours of appropriate professional education each year.

In the United States, auditing firms must be registered with the Public Company Accounting Oversight Board (PCAOB) if they audit public companies.

Auditing firms can range in size from one person to international networks of firms with thousands of employees. The audit of a smaller business may be conducted by a relatively small team of accountants assembled by one of the hundreds of audit firms registered with the PCAOB.

However, about 85 percent[7] of the audits of the largest corporations in the world are performed by what is called the "Big Four":

— KPMG
— Deloitte
— EY
— PwC

The Big Four, including KPMG, are professional services firms—meaning that they provide a broad range of accounting, audit, business, financial, strategic, and consulting services to clients. KPMG, for example, provides audit services and tax services, as well as advisory services, which include offerings such as strategy, management consulting, restructuring, and risk consulting.

[7] Label, p. 154.

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What is the audit process like?

An audit proceeds through a number of phases. Initially, prior to even accepting the audit assignment, the audit firm will look into the nature of the client's business and its complexity and conduct an assessment of the potential risks and the resources needed to proceed.

If the audit firm accepts the engagement, its team will meet with the client's audit committee and other management to create an audit plan. A key consideration at this stage is the question of "materiality"—that is, how big does an error or misstatement have to be before it "matters"? Answering this question is important because it determines what work is needed to provide the desired level of assurance about the financial records.[8]

Another factor at this planning stage will come from the consideration of the client's internal controls and its accounting information systems. If it is determined that the systems and controls are likely to produce accurate information, this may have an effect on the audit work.

The examination of the financial records forms the bulk of the audit work—analysis, testing, and verification of the statements. Materials examined include a company's accounting books, transaction records, and other relevant documents and activities—sales, cash receipts, inventory levels and valuation, outstanding bills, liabilities, payroll, and other operating expenses.[9]

Auditors might take the receivables the company plans to report and compare them with actual orders that customers have placed and goods shipped.

Because good auditors have a deep understanding of the company they are auditing as well as its industry, an audit may also compare the company's financial data and records against general industry patterns (benchmarking) to see if everything makes sense. Metrics that seem noticeably different from other similar types of companies may merit special attention.[10]

In addition to the focus on financial statements, auditors often assess the effectiveness of a company's internal control over financial reporting. That is, auditors will seek to ensure that the company has established effective procedures to reduce the chances of errors or fraud. Having an auditor attest that a company's controls are effective can boost the confidence of investors.[11]

As the audit nears completion, senior members of the auditing firm will meet to discuss any questions of judgment that have arisen—that is, beyond validation of the numbers. A review of the audit will also be conducted by another executive of the audit firm.

Finally, the auditor issues its report or "opinion." The auditor's opinion is filed with the SEC and is available to investors and other interested parties.

How long does it all take? An audit engagement can take anywhere from a few months to a year depending on the size of the client and the project's complexity.

[8] Nobes, p. 86.

[9] Center for Audit Quality, pp. 3, 7.

[10] Ibid, p. 7.

[11] Ibid, p. 3.

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What is it like to work on an audit project?

A career in audit can be extremely dynamic, especially in an increasingly global economy. To serve a multibillion-dollar company, a typical audit team could include multiple audit partners working in different locations around the world. There may be managers, senior associates and associates working together. There may also be specialists from other areas, such as tax services, offering their advice and counsel.

Senior members provide leadership and direction but there's a fair amount of autonomy, so each team member should be capable of self-management. To really excel at being an auditor, you need to be able to think critically to understand what business decisions drive the transactions you're auditing. Why did a particular transaction benefit the company and how does it fit in the company's overall strategy? Auditors who understand motivations for each transaction bring the right level of professional skepticism to the project.

Being an auditor can be challenging given the always-changing nature of a company's business. It's a practice that provides an intimate view of how business works. As an auditor, you see why companies make the decisions they make and the financial impact those decisions have across the organization. You can also see what companies gain from the services an accounting firm offers.

Auditors are expected to give an unbiased and honest professional opinion on the financial statements to shareholders, sometimes described as a skeptical approach.

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What are the differences in audit reports?

Five possible types of judgments and reports can result from an audit:

Unqualified
The most common report from an audit is an unqualified (or "clean") audit opinion. That means the auditing firm has examined the client's financial statements and concluded that the statements were prepared in accordance with GAAP and are free of material misstatements.

Unqualified with explanation
In some cases, an auditor will issue an unqualified opinion that is nevertheless accompanied by additional explanatory information. The auditor might wish to highlight a change in an accounting principle from the previous year or might even express reservations about the ongoing viability of the business.[12]

Qualified
A third type of opinion is a "qualified" one. This means that the financial statements are in accord with GAAP but with one or more exceptions. For example, one accounting principle is that historical cost should be used to report certain assets; if replacement cost accounting was used instead, this would be noted within a qualified opinion.[13] Such an opinion would not be acceptable to the SEC, however, and the company would need to take corrective measures.[14]

Adverse
Fourth, if the auditor concludes that the client's financial statements do not conform to GAAP or are materially misstated, the result is an "adverse" opinion.

Disclaimer
Finally, a "disclaimer" opinion may be issued if the auditor concludes that it did not have access to sufficient information to form a conclusion or if the audit was restricted in some way by the client.

As with the "qualified" opinion, adverse and disclaimer opinions would require the company to take steps to remediate its reporting situation in order to file the report with the SEC.

[12] Ibid., p. 10.[6] Label, p. 154.

[13] Label, p. 158.

[14] Center for Audit Quality, p. 10.

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Are financial statements free from fraud?

Auditors follow procedures that help detect fraud, but an audit's goal is "reasonable assurance" that statements are in accord with GAAP. Audits typically involve testing a *sampling* of data and exercising judgment about audit evidence.

Because auditors do not examine every transaction and event, they cannot guarantee the dollar accuracy of every statement nor detect all misstatements, whether caused by error or fraud.[15]

[15] Ibid., p. 9.

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Who audits the auditors?

A standard audit opinion can only be issued if the auditor has followed generally accepted auditing standards (GAAS), established by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA), for private companies or the PCAOB standards for public companies. In addition, the PCAOB, established by the U.S. Congress, is responsible for making sure auditor performance meets public expectations through its inspections of registered accounting firms.[16]

Auditors are also required to demonstrate **independence** from the client company so that the audit opinion will not be influenced by any relationship between the two entities. The auditors are expected to give an unbiased and honest professional opinion on the financial statements to the shareholders. Such an approach is sometimes described as a "skeptical" one; that is, a good auditor makes no presumptions but approaches all information with the idea that it could be accurate or it could be inaccurate.

That independence can be compromised in a number of ways. The auditing firm or its employees might have a financial interest in the client or might become advocates defending or promoting the client's interests. In addition, certain auditing firm services are prohibited. This is described in the next section.

[16] Label, pp. 152–154.Label, pp. 152–154.

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Are any restrictions placed on an auditor who is also conducting tax or advisory services for a client?

The answer to this question very much relates to the previous section on independence. In the United States, independence rules—set forth by the SEC, PCAOB, and the AICPA—limit the scope and type of services that an auditing firm can perform for its audit clients. For example, under AICPA and SEC rules, an auditing firm may not have any type of management responsibilities for the audited company nor make management decisions.[17] Nor can auditing firms provide nonaudit services that are significant or material to the subject matter of the audits.[18]

In the European Union, audit reforms were passed in April 2014 to take effect in June 2016. These will require mandatory rotation of audit firms after 10 years for all public interest entities (which include publicly traded firms as well as credit and insurance firms).

[17] Citation. http://bit.ly/1OhG8hE.

[18] GAO Auditor Independence Standard: Fact Sheet.

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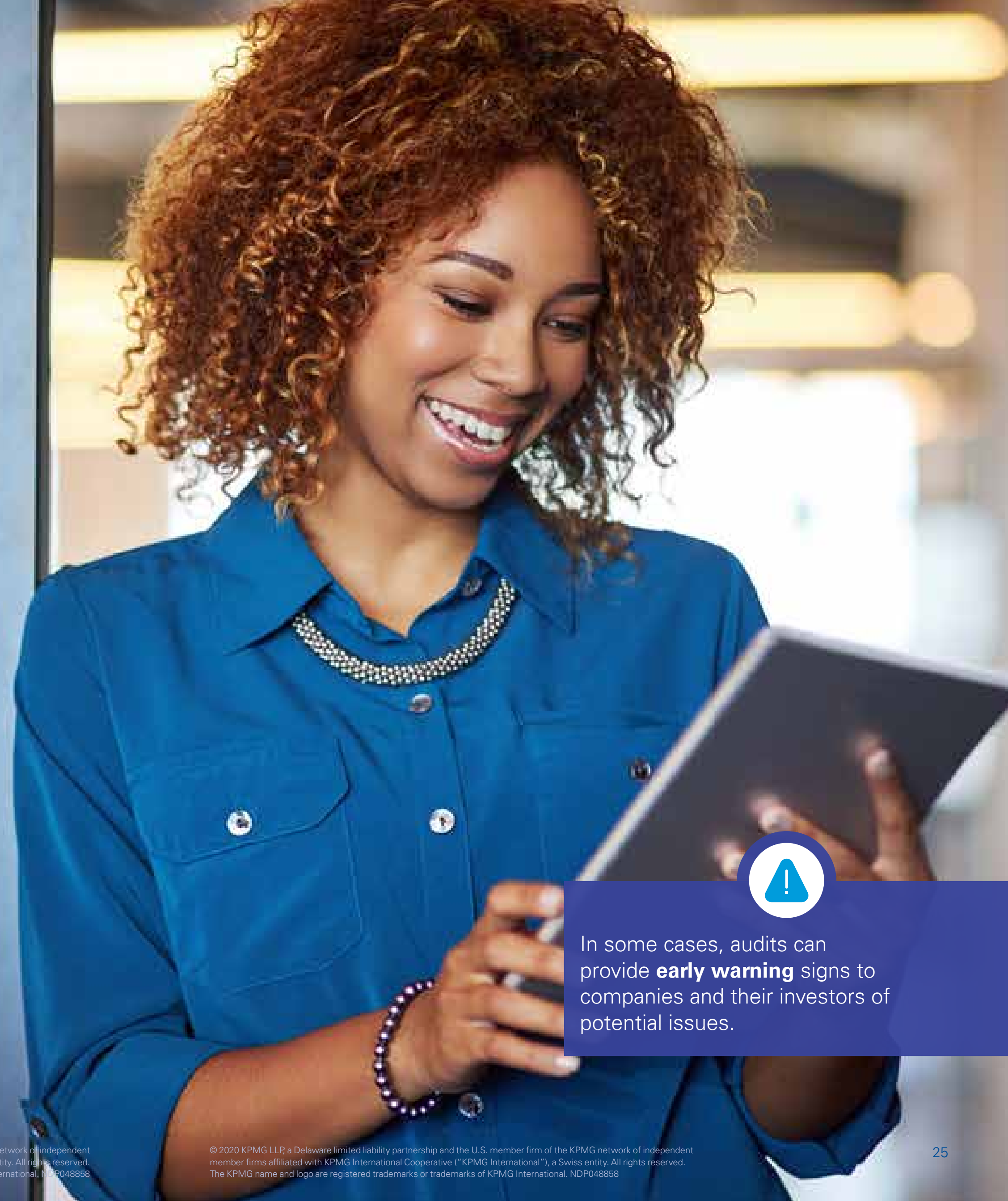
Why should I care about audits of companies?

Recent global economic events have demonstrated the tight linkage between the health of companies—especially larger companies—and the overall health of economies. In some cases, audits can provide early warning signs to companies and their investors of potential issues that affects all of our lives.

Audits are also important to you if you are an investor of any kind. Financial information has become exceedingly complex, so an audit opinion can provide you with reasonable assurance that the company you're investing in is preparing its financial statements in accord with GAAP.



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What are permissible services?

SEC/PCAOB guiding principles
SEC independence rules and PCAOB and AICPA standards explicitly prohibit certain services for audit clients. In general, independence may be impaired if, in providing nonaudit services, an auditor:

- Acts as management or an employee of the audit client
- Performs a service that places us in a position of auditing our own work
- Has conflicts of interest with our audit client (in relation to investments and relationships, known as independence)
- Is placed in a position of advocating our client's position.
- Under SEC rules, the following nonaudit services are explicitly prohibited services to an SEC registered audit client:
- Bookkeeping or other services related to the audit client's accounting records or financial systems
- Financial information systems design and implementation services—Appraisal or valuation services, fairness opinions, or contribution in-kind reports
- Management functions (acting as management or employee)
- Entering into a contingent fee arrangement
- Performing services relating to tax transactions under conditions of confidentiality
- Recommending aggressive tax position transactions
- Providing any tax services to certain persons serving in financial reporting oversight roles
- Actuarial services
- Internal audit outsourcing
- Broker-dealer, investment adviser or investment banking services
- Legal services

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With a global approach to service delivery, KPMG member firms respond to clients’ complex business challenges with consistent methodologies and common tools across industry sectors and national boundaries.

We leverage our global presence by fostering collaboration and the sharing of resources among member firms all over the world. We back up our commitments with a set of shared values, a code of conduct, and common processes, policies and controls. Above all, we are committed to providing high-quality services in an ethical and independent way, regardless of location.

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