A424: Auditing

Learning objective:
Understanding the role of the auditor
YOU KNOW WHAT BUGS ME? INTENTIONALLY MISSPELLED WORDS.

YOU WOULDN'T TRY TO TAKE LIBERTIES WITH MATH, WOULD YOU?

DO YOU WANT TO TELL HIM ABOUT ACCOUNTING, OR SHALL I?
What is the independent auditor’s responsibility?

A. To assist management in the fair presentation of financial information.
B. To provide share holders with accurate information for decision making.
C. To protect the public interest.
D. All of the above.
Career Opportunities in Auditing

- Independent Auditor
- Internal Auditor
- Governmental Auditor
  - State Board of Accounts
  - Internal Revenue Agent
  - Special Services Agent
  - General Accounting Office
- FBI Agent
Who is this person?
Luca Pacioli

- Italian Renaissance Monk
- 1494 wrote *Summa de Arithmetica, Geometria, Proportioni et Proportionalita*
- One chapter summarizes the double-entry accounting process
Accounting History 1494 to 1790’s

- 300 years not much changed.
  - Sole proprietorships
  - Partnerships
- Then what happened?
The Industrial Revolution
Demand for Audits

- Economics of reducing information risk
  - Remoteness of information.
  - Biases and motives of the provider.
  - Voluminous data.
  - Complex exchange transactions.

- Regulatory requirements
  - SEC for publicly traded companies
  - State requires for state contracts.

- Lending requirements – part of loan contract.
CPA
The CPA. Never Underestimate The Value.
1896 New York Passes 1st CPA Law

- Four three hour tests
  - Theory of Accounts
  - Practical Accounting
  - Auditing
  - Commercial Law
- $25 fee
- High school graduate
April 2004: Computer Based Testing
CPA Exam Basics

- **AICPA**: Uniform exam, testing system, and grading
  - **Prometric**: Testing facility

- **State Board of Accountancy**, decides on:
  - qualifications for sitting for the exam
  - passing standards
  - fees
  - special appeals (for example, accreditation fiasco)
  - **NASBA**: facilitates review of candidates’ qualifications for the SBofAs
Indiana Qualification Requirements

150 credit hours with either:

- **Graduate degree**
  - 15 graduate hours in accounting
  - 24 hours in non-accounting business (law & computer science)

- **Undergraduate degree**
  - 24 hours *each* in accounting and other business courses

**Other:**

- One course each in auditing, tax, managerial, and financial
- Substantially equivalent courses only count once
  - Multi-internships count separately
Exam Basics – Grading

- Prometric → AICPA → NASBA → SBOA, meets and approves the release of grades.
- 2-5 weeks after window ends.
  - First month of window should get grades quicker.
  - 2011 goal to get results within 2 – 4 weeks of taking test
- Calibration but no curve.
Exam Basics - Opportunities

- Four times a year (two month windows)
- Six month window when register
- 18 month rolling window to pass all four parts
- Six months free access to research data bases after registering
Process (TWO stops)

- **NASBA**
  - Application for qualification (allow six weeks)
    - 1-800-CPA-EXAM
    - [www.nasba.org](http://www.nasba.org)
    - IN now has within **60 day completion rule**

- **Prometric**
  - Schedule the exam (at least 45 days in advance)
    - [www.prometric.com/cpa](http://www.prometric.com/cpa)
    - IPFW has a Prometric site
Candidates wishing to test in one of the following territories, Guam, Puerto Rico, or the U.S. Virgin Islands, please select from the list below:
It was $25

- Application fee (first time) $135.00
- Exam fee:
  - Auditing and attestation 230.55
  - Financial Accounting and Reporting 218.15
  - Regulation 193.35
  - Business Environment and Concepts 180.95

Grand total for first timers $958.00
Indiana Qualification Requirements

- Uniform Accountancy Act (UAA)
- Demonstrate good character
- Other requirements as set forth below:
  - Pass the exam
  - Meet experience requirements
  - Follow the code of conduct
  - Continuing professional education
2011 CPA EXAM CHANGES

- New calculator, spreadsheet
- Research task, FASB Codification
- IFRS
# 2011 CPA EXAM CHANGES

<table>
<thead>
<tr>
<th>Exam</th>
<th>Multiple Choice</th>
<th>Task-based Simulations</th>
<th>Communication</th>
<th>Hours</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUD</td>
<td>60% (3 with 30)</td>
<td>40% (1 with 7)</td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>FAR</td>
<td>60% (3 with 30)</td>
<td>40% (1 with 7)</td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>REG</td>
<td>60% (3 with 24)</td>
<td>40% (1 with 6)</td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>BEC</td>
<td>85% (3 with 24)</td>
<td>0%</td>
<td>15% (1 with 3)</td>
<td>3</td>
</tr>
</tbody>
</table>
What the next big event?

- Remember, we were originally at 1896 and the first CPA law.
But wait let’s fill in a few details
Define “Audit”

- Competent, independent person collects evidence comparing economic data against established standards and reports the findings.
Comparison Examples:

- Financial Statements
- Tax return
- Operational Report

Diagram:

- Economic Data
  - Comparison
  - Standards
  - Independent Report
Define “Audit”

- Competent, independent person collects evidence comparing economic data against established standards and reports the findings.
  - Evidence: Information used by the independent person to determine the degree of comparison between the report examined and the established criteria.
Evidence Example

Assume a client reports inventory on the balance sheet of $3,000,000. Looking at the financial records and through inquiries of the company controller you learn that this amount is composed of 2,000,000 gallons of peanut oil that the client valued at $1.45 per gallon. All of the peanut oil is stored in vats located at the company’s manufacturing plant in Louisiana. The peanut oil inventory serves as collateral for a bank loan and the company is required to have it verified by an independent auditor.
Audit of Inventory

What are the inventory standards?

- Economic Data
- Comparison
- Standards
- Independent Report
Evidence Example (cont’d)

- Inventory of $3,000,000 asserted.
  - 2,000,000 gallons of peanut oil
  - valued at $1.45 per gallon
  - stored in vat
  - Use FIFO with LCM

- What evidence would you gather?
Evidence Example (cont’d)
Define “Audit”

- Competent, independent person collects evidence comparing economic data against established standards and reports the findings.
  - Independent is defined by the AICPA code of conduct, the SEC and Sarbanes-Oxley.
Pre-Crash
Legal Liability: Common Law

- Breach of contract and torts
  - Most frequent, but least costly
  - Defense for contract:
    - Lacked duty to perform
    - Substantially performed the service
    - Not negligent (prudent person concept)
    - Contributory negligence
    - Absence of causal connection
    - Illegal purpose
Pre-Crash Common Law (cont’d)

- Defense for Negligence
  - Duty not owed
  - Duty not breached
    - Used reasonable care
    - Complied with standards
  - No loss suffered
  - Accountant’s behavior not cause of loss
  - Lack of privity
1929 Stock Market Crash

- New York Stock Exchange on Black Tuesday, October 29, 1929
- Sixteen million shares traded - a record - and $30 billion dollars vanished into thin air.
1930s

- Ultramares Corp (1931)
- McKesson and Robbins (1930)
- Securities Act of 1933 (statutory law)
- Securities Exchange Act of 1934
Terms

- **Business failure**: company fails due to economic, poor management, or other circumstances.
- **Audit risk**: Potential mistakes in conclusions due to sampling error or high level fraudulent financial reporting.
- **Audit failure**: CPA firm fails to follow standards, resulting in incorrect opinion.
Legal Liability Expands

● Third parties
  - Breach of contract to known third parties
  - Gross negligence or fraud – all foreseen users

● Civil Liability
  - Securities Acts of 1933 and 1934
  - Class action suits

● Criminal Liability

● Joint and severable liability
1947 Generally Accepted Auditing Standards (co-opted by PCAOB)

- Comprised of 10 broad guidelines in three categories:
  - General
  - Field Work
  - Reporting

- Supported by specific minimum rules:
  - SAS
  - SSARS
  - SSAE
  - PCAOB – supersede SASs (report, IC, documentation)
Generally Accepted Auditing Standards

**General qualifications and conduct**
- Adequate training and proficiency
- Independence in mental attitude
- Due professional care

**Field work** performance of the audit
- Proper planning and supervision
- Sufficient understanding of the entity, its environment, and its internal control
- Sufficient appropriate evidence

**Reporting results**
- Whether statements were prepared in accordance with GAAP
- Circumstances when GAAP not consistently followed
- Adequacy of informative disclosures
- Expression of opinion on financial statements
Review:

- Question 2-16 (p. 41)
- Assign Problem 2-21, 2-22
Legal Liability

- 1945 to 1966: Few major lawsuits
- 1967 to 1990: Extensive lawsuits
- 1973 Code of Conduct formalized
- 1988 ten new SASs issued
- 2002 SOX
- 2006 Fraud standards
Aug. 27, 2007 (Associated Press) — WASHINGTON - Auditing firm Deloitte & Touche will pay $167.5 million to a trust set up to pursue litigation on behalf of Adelphia Communications Corp. after a bankruptcy court approved a settlement between the auditor and the collapsed cable company.
1988 SASs

- New Standard Unqualified Audit Report
- Going Concern Evaluation

- Studies show most people don’t bother reading the audit report.
Standard Audit Report (p. 47)
Basic Format and Content

- Report Title
- Address
- Introductory Paragraph
- Scope Paragraph
- Opinion Paragraph
- Name of CPA Firm
- Audit Report Date
Preparation Questions

- Why would the accounting profession so rigidly rely on a standard format for it reports?
- What observations can you make when comparing the standard audit report to the GAAS reporting standards?
- Which paragraph in the standard unqualified report best reflects the field work standards?
PCAOB Standard Audit Report

- Two separate reports
  - Report on Internal Controls (p. 50)
  - Report on the Financial Statements
- One combined report
PCAOB Report on Internal Controls

- Introduction, scope, and opinion
- Framework for examination (COSO)
- Define Internal controls
- Inherent limitations
- As of end of most recent year
- Cross-reference to audit
Unqualified Report

1. All statements included
2. General standards followed
3. Sufficient evidence accumulated
4. GAAP, including disclosures
5. No circumstances requiring modification:
   - Immaterial condition
   - Take full responsibility for other auditors work
Unqualified with modification

- Explanatory 4th paragraph
  - Consistency exception
  - Substantial doubt about going concern
  - Auditor agrees with departure from GAAP
  - Emphasis of a matter

- Modified report – share responsibility with other auditors
Conditions That May Require Alternative Report

- Limitation of scope
- Departure from GAAP
- Lack of independence
Materiality Affects Report Type

- Immaterial – no effect on decisions
- Material – limited effect
- Highly material – overall fairness in question
- Percentage and nature
Adverse

- Know FSs not presented fairly
- Highly material departure from GAAP
- Add a third paragraph and change opinion paragraph
Disclaimer

- Don’t know if fairly presented
- Highly material limitation of scope
- Change introduction, omit scope, add new paragraph, change opinion paragraph

- Lack of independence
  - No report title, one paragraph report
Qualified

- Fairly stated “except for” certain items
- Material departure from GAAP or limitation of scope
- Other auditor – you take no responsibility or other auditor has material qualification
- Add paragraph, modify others as needed
Table 3-2 (p. 63)

- Great summary
Preparation Questions

- Is it appropriate to offer negative assurance in an audit report?

- If a client chooses to omit the Statement of Cash Flows what type of report should be issued?
Report examples

- Question 3-23, 3-24, 3-25 (p. 67)
- Start homework Problem 3-29

- Decisions:
  - Condition, if any
  - Materiality level
  - Appropriate report
  - Write
The 1990s

- Total audit fee revenues haven’t changed much in 10 years.
- Firms pursue other sources of revenue
- “Big 8” issue Position Paper threatening to stop auditing (1991)
- Private Securities Litigation Reform Act of 1995
  - In general, liability is proportionate to blame, unless deliberately violate securities laws.
Other Sources of Revenue

- Assurance and Attestation Services
  - Assurance – independent profession services that improve the quality of information for decision makers.
  - Attestation – A type of assurance where a CPA issues a report about the reliability of an assertion that is the responsibility of another party.
FIGURE 1-1  Relationships Among Assurance Services, Attestation Services, and Nonassurance Services

ASSURANCE SERVICES

ATTESTATION SERVICES
- Audits
- Reviews
- Other Attestation Services (e.g., WebTrust, SysTrust)
- Other Assurance Services (e.g., CPA ElderCare, CPA Performance View)

NONASSURANCE SERVICES
- Other Management Consulting
- Certain Management Consulting
- Accounting and Bookkeeping
- Tax Services
Preparation Question: What makes our profession different from other professions?
1, 4, LESS IS MORE

5, 2, IN OUR VIEW.

10, 8, WE VALIDATE

5, 9, THAT THIS LOOKS FINE.

7, 3, THE BIG FAT FEE!

MODERN ACCOUNTING

TOLÉ

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Who’s in Charge?

- Indiana State Board of Accountancy
  - Indiana regulations require CPAs to adhere to AICPA Code of Conduct (more or less)
- AICPA members must adhere to the AICPA Code of Conduct
- PCAOB (SEC)
  - CPA firms that audit publicly traded companies must register with the PCAOB and subject itself to the rules and regulations of that board.
AICPA Code of Conduct

- Applies to **members** of the AICPA.
- Many states have adapted the AICPA code
- Comprised of:
  - Principles
  - Rules of conduct
  - Interpretations of the rules of conduct
    - Disclosure of outsourcing to India
  - Ethical rulings
- Preparation Question: Which of the above four areas are enforceable?
AICPA Code of Conduct
AICPA Code of Conduct

- Ethical Principles:
  - Responsibilities
  - Public interest
  - Integrity
  - Objectivity and independence
  - Due care
  - Scope and nature of services

Independence and scope and nature of services only apply to public practice.
Code of conduct

- Independence
  - Defined: Taking an unbiased viewpoint in the conduct of the audit.
  - SEC/SOX more restrictive than code
  - Independence in fact
  - Independence in appearance
Rules of Conduct

● Rule 101 – Independence
  - Covered members prohibited from:
    ● Direct financial interest (immediate family including spouse, spousal equivalent, or dependent)
    ● Indirect material financial interest (such as parents or grandparents)
Covered Members include:

- Engagement team members
- Influential individuals in firm
- Nonattest providers who are partners or managers
- Partners out of same office as audit
- Firm and employee benefit plans
- Related entities controlled by covered member
Independence and Financial Interest Issues: Okay if:

- Former practitioners no longer associated with CPA firm.
- Normal lending procedures (car, fully collateralized, credit cards < $10,000, or grandfathered loans)
- No parent, spouse, sibling, nondependent children in key employment position with client
- Not a joint investor or investee relationship with client
- Honorary nonprofit director – cannot be a director, officer, management, or employee of a company
Other Issues with Independence

- Impairs: Lawsuit or intent to start a lawsuit related to audit
- Okay: Bookkeeping and auditing
  - Client accepts responsibility
  - CPA does no management functions
  - Audit conforms to GAAS
- Okay: Consulting and other nonaudit services
- Impairs: Unpaid fees over one year
Student handout

Directions: Assign a + or – sign to each arrow to depict how you perceive the below factors influence an auditors’ tendency to acquiesce to managements’ preferences.*

Rules of Conduct

- 102 – Integrity and objectivity
- 201 – General standards (p. 96)
- 202 – Compliance with standards (depends)
- 203 – Accounting principles (GAAP)
Code of Conduct

- *301- Confidential client information
  - Obligation related to standards
  - Subpoena or summons
  - Peer review (regulatory)
  - Response to ethics division

  - Indiana privilege laws include public accountants
- *302- Contingent fees
Rules of Conduct

- 501 – Acts discreditable
  - See list on page 99
- *502 – Advertising and other forms of solicitation
- *503- Commissions and referral fees
- *505- Form of organization and name
AICPA Code of Conduct

- Enforcement by AICPA Professional Ethics Division or state Board of Accountancy

- What are public accountants most often sanctioned for by enforcement boards?
  - 1.
  - 2.
Practice Makes Perfect

- Question 4-18 and 4-19
- Problem 4-21 and 4-22

- Use Table 4-1 (p. 103) as guide for selecting rules.
2002 Sarbanes-Oxley

- Public Company Accounting Oversight Board
  - Registration
  - Rule making
  - Inspections
  - Investigations
  - Enforcement
SOX/SEC

- Attest to effectiveness of Internal Controls over financial reporting
- SEC Requirements (see pages 30 – 31)
SEC/SOX – Public Companies that are audit clients

- Independence rules restrict:
  - Certain services (p. 88)
  - Employment of former audit firm employees (one year)
  - Partner continuation (limit 5 years)
  - Ownership interest (team members, influential persons, partners and managers of nonaudit service > 10 hours, office partners)

- Audit Committees (enhance independence)
  - Non-management, financial expert
  - Hire, approve work, & resolve disagreements with CPA firm
Peer Reviews
(CPA Firm Quality Checks)

- Publicly Traded – PCAOB
- Private Companies
  - AICPA (PCPS, Other)
  - Volunteer
  - IN Law → SBOA → INCPAS