Chapter 5

Professional Responsibilities and Ethical Obligations in Auditing
“We have to be able to convince the senior executives at companies that the world has changed and that under the new rules you are going to consistently lose if you are using accounting tricks…”

Howard Schilit
What is an Audit?

- Examination of company prepared financial statements in accordance with GAAP
- SEC requires all public companies to have an audit
  - Enhance the reliability
Exhibit 1: The Auditor’s Standard Report

Independent Auditor’s Report

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These statements are the responsibility of the Company’s management. Our responsibility is to express and opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that we plan and perform the audit to obtain reasonable assurance [italics added for emphasis] about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis [italics added for emphasis] for any opinion.

In our opinion, the financial statements referred to above present fairly [italics added for emphasis], in all material [italics added for emphasis] respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]
[Date]
Explaining the Audit Report

• Introductory Paragraph
  – Identifies the financial statements
  – Clarifies management’s responsibilities for the statements
  – States the auditor’s responsibilities to express an (independent) opinion on those statement
Scope Paragraph

• Defines the auditor’s responsibility in conducting an audit

1. Followed GAAS
2. Provides “reasonable assurance” that statements are free of “material” misstatement
3. Assessed principles, estimates, and overall presentation
4. Provides “reasonable” basis for opinion
Audit Opinions

- Unqualified (clean or standard opinion)
- Unqualified with explanatory paragraph
- Qualified
- Adverse
- Disclaimer
Unqualified

- Unqualified opinion when financial statements “present fairly”
  - Financial position
  - Results of operations
  - Cash flows
  - Stockholders’ Equity
  - Full and Complete Set of Notes
Explanatory Paragraph

- Going concern
- Consistent application of accounting principles
- Emphasis
- Report on internal control over financial reporting
Qualified Opinions

• Difference of opinion with management over application of GAAP that is material in amount
• Nature of the difference could be
  – Inability to determine amounts
  – Illegal acts
  – Foreign Corrupt Practices Act
Adverse Opinion

• Financial statements taken as a whole do not present fairly financial position or the results of operations or cash flows in conformity with GAAP

• Preceded by a separate paragraph that provides all the substantive reasons for the auditor’s conclusion and principal effects of the subject matter on financial position, results of operation and cash flows

Mar. 29--Oil, gas and gold company Tri-Valley Corp. expects auditors to issue an "adverse opinion" on its inside financial systems once its 2004 annual report is filed, the company reported Monday.

The Bakersfield company said its internal financial processes did not meet the requirements laid out by the 2002's Sarbanes-Oxley Act last year.

"That report is going to say we did not have the duties adequately segregated among enough people," Lynn Blystone, president and CEO of the company, said in a phone interview Monday.

Blystone stressed the problems with the company’s inside financial systems did not affect Tri-Valley’s cash flow or its ability to pay the bills.
Disclaimer

• Unable to gather sufficient evidence to warrant the expression of an opinion on the statements as a whole

FBI LAUNCHES PROBE OF FANNIE, FREDDIE
Former housing execs face grilling as SEC sues over risky mortgages
*By Andrew Strickler and Josh Bernstein Saturday, December 17, 2011*

Because of the limitation on the scope of our audit described in the second paragraph of this report, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on management’s assessment referred to above.

KPMG
Withdrawing from the Engagement

• Significant conflict exists with management
• Management cannot be trusted
Generally Accepted Auditing Standards (GAAS)

- Auditing Standards Board
  - Privately owned businesses
- Public Company Accounting Oversight Board (PCAOB)
  - Public companies
PCAOB

- GAAS incorporated into PCAOB
- Establishes auditing standards for public companies
- Required standards, not generally accepted
- Establishes independence rules
- Establishes quality control standards for registered CPA firms
- Conducts peer review for registered firms
GAAS
General Standards

1. Adequate technical training and proficiency
2. Independence in mental attitude
3. Due care in the performance of the audit and preparation of the report
1. Adequately plan the audit work and supervise assistants
2. Obtain a sufficient understanding of internal control to adequately plan the audit and determine the nature, timing, and extent of tests to be performed
3. Gather sufficient competent evidential matter to provide a basis for an opinion
GAAS Standards of Reporting

1. The statements have been in conformity with GAAP
2. Accounting principles have been consistently applied
3. Adequate informative disclosures have been made
4. Expression of an opinion on statements taken as a whole, or indication that an opinion cannot be expressed
Limitations of the Audit Report

1. Reasonable assurance
2. Materiality
3. Present fairly
Reasonable Assurance

- Due care
- Relation of independence and client relationships
- Not an absolute guarantee
- Followed GAAS, gathering sufficient competent evidential matter
Materiality

- Magnitude of an omission or misstatement of accounting information that the judgment of reasonable person relying on the information would have been changed or influenced by the omission or misstatement
Judging Materiality

• May not rely solely on a **quantitative threshold** as a “rule of thumb” to determine materiality
• **5%** is a common materiality test
• Unintended consequence of materiality is that it is subject to manipulation
• Full analysis of all relevant considerations
• Consideration of risk of fraud
Error versus Fraud

• Error
  – Innocent mistake in application of GAAP
  – Omission of information
  – Mathematical mistake

• Fraud
  – Deliberate decision made to deceive another party
Present Fairly

• Auditor’s assessment of fair presentation depends on whether
  1. Accounting principles used have general acceptance
  2. Accounting principles are appropriate
  3. Financial statements are informative
Present Fairly

4. Information presented is classified and summarized in a reasonable manner.

5. Financial statements reflect the underlying transactions and events in a manner that is consistent with materiality and reflects economic substance.
Expectations Gap

• Difference between
  – What the public and users of financial statements perceive as the responsibilities of accountants and auditors and
  – What accountants and auditors themselves see as their responsibilities
Expectations Gap

• Majority of investors expect an audit to provide **absolute assurance** that financial statements are free of all types of material misstatements
  – Confirming the gap

• Closing the gap, auditors should increase sensitivity to
  – Management honesty
  – Management integrity (or lack of)
SAS No. 55
Internal Control in an Audit

- Broadens the definition of internal control and the parties that affect it by linking sound controls to the actions of the BOD, management and other personnel
- Identifies five interrelated components of internal control
  - Control environment
  - Control activities
  - Monitoring of controls
  - Risk assessment
  - Information systems
SAS No. 54
Illegal Acts

• Violations of laws or governmental regulations

• Auditor’s responsibility to detect and report misstatements resulting from illegal acts that have a direct and material effect on financial statements amounts
Auditors Responsibilities for Fraud Prevention, Detection, and Reporting

• First line of defense against fraud
  – Effective system of internal controls
  – Independent internal audit function
Fraud Triangle

The Fraud Triangle
Three conditions are present when fraud occurs.

1. **Incentive/Pressure**
   - Management or other employees may have an incentive or be under pressure, which provides a motivation to commit fraud.

2. **Opportunity**
   - Circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an opportunity for fraud to be perpetrated.

3. **Rationalization/Attitude**
   - Those involved in a fraud are able to rationalize a fraudulent act as being consistent with their personal code of ethics. Some individuals possess an attitude, character or set of ethical values that allows them to knowingly and intentionally commit a dishonest act.
Incentives/Pressures to Commit Fraud

- Self-serving
- Pressures to meet financial numbers
- Financial distress
- Home Problems
Description and Characteristics of Fraud

• Misstatements arising from fraudulent financial reporting
• Misstatements arising from the misappropriation of assets
Techniques Used to Falsify Financial Information

- Lengthening estimated useful lives
- Special Purpose Entities (SPE)
- Bogus invoices to record revenue
- Backdated sales agreements
- Misapplication of GAAP
- Bill and Hold
- Channel Stuffing
- Others
Misappropriation of Assets

- Theft of company assets
- Understates cash or other assets
- Overstates expenses
- “Bury” the expenses in an innocuous account
- Lapping of accounts receivable
- Theft of inventory
- Other
Tool versus Target?
Opportunity to Commit Fraud

• Employees who have access to assets such as cash and inventory

• Internal controls to help safeguard assets
  – Segregation of duties

• Backdating stock options
Rationalization for Fraud

- Perpetrators are often in denial
- A good person may get caught up in the fraud
- Rationalization
  - Company had to make numbers
  - Fear losing job
  - I’m entitled since I’m underpaid
Fraud Considerations in the Audit

1. Description and characteristics of fraud
2. Importance of exercising **professional skepticism**
3. Discussion among engagement personnel regarding the **risks** of material misstatement due to fraud
4. Obtaining the information needed to identify risks of material misstatements due to fraud
Fraud Considerations in the Audit

5. Identifying risks that may result in a material misstatement due to fraud

6. Assessing the identified risks after taking into account an evaluation of the entity’s programs and controls

7. Responding to the results of the assessment
Fraud Considerations in the Audit

8. Evaluating audit evidence
9. Communicating about fraud to management, the audit commitment, and other
10. Documenting the auditor’s consideration of fraud
Fraud Risk Factors

- Red Flags
  1. Overstating revenues and assets
  2. Understating expenses and liabilities
  3. Giving disclosures that are misleading or omit important information
Revisiting the Expectation Gap

- Eight risk assessment statements for non-public companies issued in March 2006

1. More in-depth understanding of
   - Entity and its environment,
   - Including its internal control
   - Identify the risks of material misstatement
   - What entity is doing to mitigate risks
Revisiting the Expectation Gap

1. More rigorous assessment of the risk of material misstatement of the financial statements based on that understanding

2. Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks
Internal Control Assessment

- SAS No. 55 identifies five interrelated components of internal control
  1. Control Environment sets the tone of an organization
  2. Risk assessment is the identification and evaluation of how risk might affect achievement of objectives
Internal Control Assessment

3. Control activities are strategic actions established to ensure directives are carried out

4. Information and communication systems provide information in a form and at a time that enables people to carry out responsibilities

5. Monitoring is a process that assesses efficiency and effectiveness of internal control over time
Enterprise Risk Management – Integrated Framework

Internal control enhanced with corporate governance and risk management

• Aligning risk appetite and strategy
• Enhancing risk response decisions
• Reducing operational surprises and losses
• Identifying and managing multiple and cross-enterprise risks
• Seizing opportunities
• Improving deployment of capital
PCAOB’s Integrated Audit Concept

- Integrated audit combines an audit of internal control over financial reporting with the audit of the financial statements.
- Objectives of the two audits are achieved simultaneously through a single coordinated process.
- Can help to improve the quality and integrity of both audits.