

WELCOME TO ECON 132- AUDIT

COURSE INTRO & CHAPTER 1



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INTRO & CHAPTER 1-1

WHO AM I?

BOB ANDERSON

- UCSB Graduate of 1992
- Senior Manager, KPMG, LLP- 1993-2004
- RAFS, Inc.
- Interests

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Intro & Chapter 1-2

Why are we here?

Learn foundation in AUDITING- which is useful for?

- Doing your JOB!
- CPA Exam
 - Unfortunately lots of theory!

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OVERVIEW OF THE COURSE

- What is auditing and other services offered by CPA's
- The current environment
- Regulation and rules governing audit
 - Sarbanes-Oxley Act
- Audit Evidence
- Planning an Audit (7 P's)
- Internal control
- A/R and Revenue
- Operations and completing the audit
- Auditor's reports

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Course Approach

- Mutually well prepared;
- Lectures to be an expansion of what is in the book
 - Real World
 - Interesting and Layman's terms
- IAS: Covered via convergence!!!



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Administrative Matters

NOTE: All of the following is in syllabus

- Web-Page address is econ.ucsb.edu/~anderson
- Student preparation for classes
 - Class presentations on the web for review/ printing before class
 - Quizzes and Homework will combine for 10% of your course grade
 - One drop allowed
- My office: NH 3039. Hours Posted on Syllabus



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PROTECTED CONTENT

USERNAME: anderson

PASSWORD: xxxxxx



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POINTS

EXAMS MAKE UP 83% OF YOUR COURSE GRADE

- Combination of multiple choice, short answer and problem solving;
- Grade allocation (1,000 points):
 - Exams 83%
 - Homework & Quiz 12%
 - Simulations 5%



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HONORS

VARIES BY QUARTER- CHECK SYLLABUS



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LANDSCAPE/ HISTORY

ENRON, GLOBAL CROSSING, ETC...= PRESSURE ON:

- Financial reporters (management)- certifications
- Auditors- SOX 404, fraud responsibilities
- SEC, FASB. Rushing to release.

Sarbanes-Oxley Act of 2002 Created new rules for public company's and their auditors. The Public Company Accounting Oversight Board (PCAOB) is under the SEC and oversees all firms registered to audit public companies.



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KEY NOTES

- 90% OF TRANSACTIONS ARE "ROUTINE" AND CAN BE ACCURATELY REPORTED BY A STRONG "SYSTEM"
 - Internal controls
- The other 10% is what you read about in the papers.
 - That 10% Does, did and always will require applying JUDGMENT.
- Accounting is NOT the stereotypical "bean counter".



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Financial statements

People work very hard for their money. They need to feel "assured" that information that they are looking at in making decisions about what to do with that hard earned money is reasonably accurate.



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GAAP

Because of the importance of quality financial statements, there are rules which should be adhered to, such that those statements be reliable, reasonable, comparable, etc.

THEREFORE we have generally accepted accounting principles (GAAP).



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GAAS

Because of the importance of the reliability of financial statements, they get audited. The auditing profession, similarly, is regulated by "Generally Accepted Auditing Standards". Which standards are applicable depend on the type of entity being audited (Public vs. Non-public entities)



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The Accounting Profession's Credibility Crisis

- 2000—The Panel on Audit Effectiveness made a variety of suggestions to improve audits.
- 2001—Enron Bankruptcy
- 2002—WorldCom Fraud
- 2002—Sarbanes-Oxley Act
- 2003—Public Company Accounting Oversight Board began operations
- Late 2003- Bob Anderson leaves public accounting!
- Auditors- SOX 404, fraud responsibilities and management certifications



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AICPA

Historically, and still for non-public companies, GAAS determined by the AICPA. The AICPA:

- Establishes auditing standards of non-public companies (Via its Auditing Standards Board)
- Administers the CPA exam (Each state licenses)
- Promotes continuing professional educ. (CPE)
- Contributes to self regulation
 - Yep, self-regulated! INTEGRITY!!



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INTRODUCING: PCAOB

Sarbanes-Oxley Act of 2002 granted extended powers to the SEC, creating the Public Company Accounting Oversight Board (PCAOB) *pronounced "peekaboo"*. Applies ONLY to firms auditing public companies and the audits of public companies. As you will see below, NO MORE SELF REGULATION (over public companies) Specifically the PCAOB:

- Registers accounting firms which plan to audit public companies.
- Inspects registered accounting firms
- Conducts investigations and disciplines
- Sanction registered firms



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What's an audit? Non-Public

We have audited the accompanying balance sheets of A Company, Inc. as of December 31, 20X2 and 20X1, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of A Company, Inc. as of December 31, 20X2 and 20X1(1), and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.



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What's an audit? Public

Report of Independent Registered Public Accounting Firm

We have audited the accompanying consolidated balance sheets of BOBS MONEY MAKER Corporation and subsidiaries (the Company) as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance 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 audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of BOBS MONEY MAKER Corporation and subsidiaries as of December 31, 2004 and 2003, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of BOBS MONEY MAKER internal control over financial reporting as of December 31, 2004 based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 10, 2005 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.



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Auditing: Overview

Whose responsibility is it to present materially accurate financial statements?

MANAGEMENT

Whose responsibility is it to "Opine" on the financial statements?

AUDITORS

What do we call the rules governing how to account for activity?

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

What do we call the rules governing performance of an audit?

GENERALLY ACCEPTED AUDITING STANDARDS (GAAS)

A public Company & Its auditors must conform to additional governance, prescribed by?

THE SECURITIES & EXCHANGE COMMISSION (SEC) & THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB) WHICH IS AN EXTENSION OF THE SEC



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What is an Audit?

Does an audit provide absolute assurance?

NO

Is an audit designed to detect Fraud?

NO

An audit is designed to provide assurance to the user, via an opinion from the auditor, that the financial statements are "free of MATERIAL misstatement from GAAP"

THINK HARD ABOUT WHAT AN AUDITORS OPINION ACTUALLY SAYS!



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AUDITING: WHAT IS IT?

Balance Sheet Approach:

If you test accounts receivable, what are you simultaneously testing?

SALES

We use a "dual-entry" system- which means that there is a consequence somewhere else to everything you post.

Fraudweis, Inc. is being audited. They have fraudulently inflated their sales by recording a false entry. If you create a false entry to sales, then the logical other place is a/r. If we are auditors and are auditing all material a/r, wouldn't we wonder why this receivable "ages" as we look at A/R. If they debit something obscure, it will look out-of-place when we are looking there too in our "balance sheet" approach.



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SOME TERMINOLOGY

General Ledger:

A "Ledger" of all of the activity for a specified period of time... very detailed

Trial Balance (or summary trial balance):

Takes the "activity" out of the general ledger and shows just the ending balances/ activity, as of a specified date and period.

Sub-Ledger/ Schedules:

Some detailed level of presenting an item of the general ledger (accounts receivable aging, or detailed accounts payable listing are examples)

Lead-Sheet:

Listing of items comprising a single line-item on a trial balance- much like a sub-ledger



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The Role of the Public Accountant in the American Economy



MORE TERMINOLOGY

Assurance: Providing some confidence or certainty.

Attestation: Provide assurance.

So an audit, which provides assurance, is therefore an attestation engagement.



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Attestation:

There are three broad categories of attestation:

1. Examination= audit where auditor renders an opinion (called "opining" or to "opine")
2. Review= Less in scope than an audit. Issues "negative assurance" which means, nothing came to the attention of the reviewer.
3. Agreed-upon procedures= No opinion or report, just a summary of findings based on applying procedures which were agreed upon at the beginning of the engagement.

- IMPORTANT NOTE: THESE MUST RESTRICT THE DISTRIBUTION!



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COMPILATION

- Does NOT provide any assurance!
 - Strictly putting client prepared data into financial statements without any procedures to verify the accuracy of the information.
- If a Compilation AND review DOES provide assurance:
 - The CPA DOES perform "review" procedures. Because the review component is an "assurance" service, a compilation and review IS an assurance service.



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ATTESTATION CONT'D

In order to "attest" there must be some suitable criteria to compare to. For instance an audit has suitable criteria called GAAP. A review also has GAAP to look to. Agreed upon procedures will state what the criteria and procedures are.

ALL OF THIS IS TO LEND CREDIBILITY-

The purpose of which is to reduce the amount of "Information Risk" to a user of the underlying data.

- Some degree of information risk is inherent
- Audit reduces information risk, but nothing can ELIMINATE information risk.



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FRAUD

What does the auditor's opinion say about fraud?
Not explicit

So what is the auditor's responsibility to detect fraud?
If it produces a material misstatement

BUT! There are rules called Generally Accepted Auditing Standards (GAAS) which actually increase the responsibility of an auditor beyond what their opinion states.



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Attestation Engagements

Type of Engagement	Level of Assurance	Nature of Report	Procedures
Examination	Highest	Expresses opinion	Sufficient to limit attestation risk to low level
Review	Moderate or Limited	Expresses negative assurance	Generally limited to inquiry & analytical procedures
Agreed-upon procedures	Varies with procedures	States findings	Procedures agreed-upon with the specified users



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What Creates the Demand for Audits?

- Credibility, as previously discussed.
- Financial statement misstatements arise due to--
 - Accidental errors
 - Lack of knowledge of accounting principles
 - Unintentional bias
 - Deliberate falsification or theft
- Audits do not directly address business risk, the risk that a company will not be able to meet its financial obligations due to economic conditions or poor management decisions



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Types of Audits

- Audits of Financial Statements
- Compliance Audits
- Operational Audits
- NEW: "INTEGRATED AUDIT"
 - Combines financial statement audit with compliance audit.



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Types of Auditors

- External Auditors
- Internal Auditors
- GAO Auditors
- Tax Auditors
- PCAOB



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AICPA's Traditional Role

- Establishes Standards
- Research and Publication
- Continuing Professional Education
- Self-Regulation
- CPA Examination

Note: The standards setting and regulation roles have been taken over by the SEC and the PCAOB with respect to auditors of public companies.



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OBTAINING AND MAINTAINING A CPA LICENSE

IMPORTANT NOTE: WE ARE IN A TRANSITION PHASE, THIS SLIDE SHOULD ONLY BE RELIED UPON IN CONNECTION WITH THE VERBAL EXPLANATIONS WHICH ACCOMPANY IT IN LECTURE

TO GET IT:

- Bachelors degree+ (225 quarter units if licensed > 1/1/14)
- Pass CPA exam: In order to take exam you need:
 - 36 quarter units of accounting courses
 - 36 quarter units of business related courses
 - You do NOT need the 225 units to sit for the exam!!!
- 2 years experience (1 if licensed after 1/1/14)
- Pass ethics course (additional ethics requirements coming)

TO KEEP IT:

- 120 Hours of continuing professional education every 3 years.
- Firm providing assurance services must have peer reviews.



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Types of Professional Services

- Attestation and Assurance
- Tax
- Consulting
- Accounting
- Personal Financial Planning
- Fraud Investigation

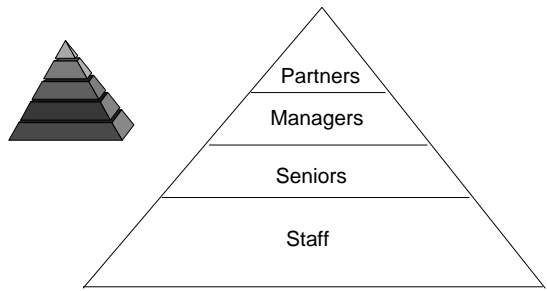
If performing attestation services, then the other forms of services may impair independence. In fact, did you know that a company's BOD must specifically approve if the firm performs both audit and tax services?



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Typical Structure of a National CPA Firm- Responsibility and headcount

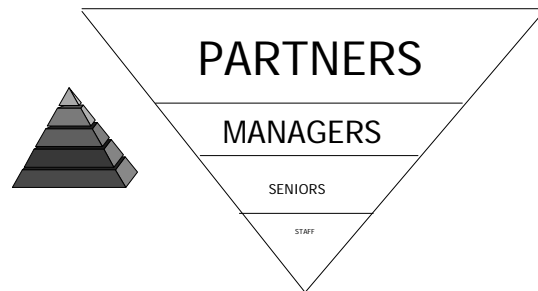


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Compensation Structure of a National CPA Firm- per individual



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