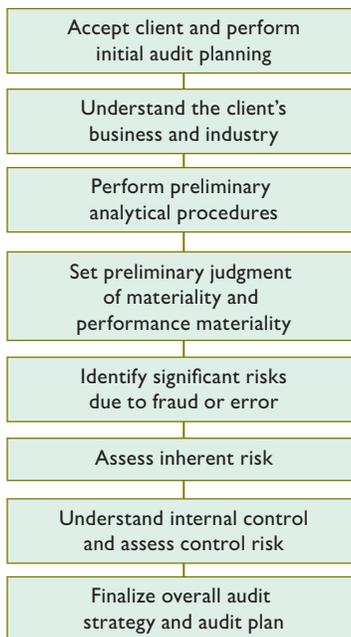


Summary of the Audit Process

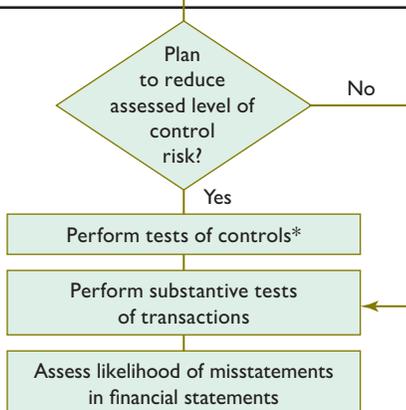
PHASE I

Plan and design an audit approach



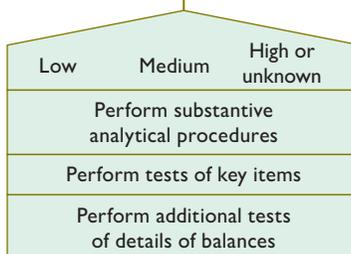
PHASE II

Perform tests of controls and substantive tests of transactions



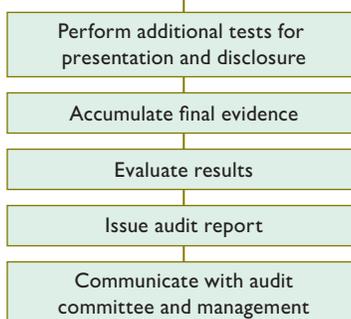
PHASE III

Perform substantive analytical procedures and tests of details of balances

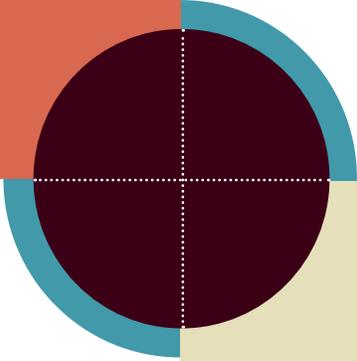


PHASE IV

Complete the audit and issue an audit report



*The extent of tests of controls is determined by planned reliance on controls. For public companies required to have an audit of internal control, testing must be sufficient to issue an opinion on internal control over financial reporting.



AUDITING AND ASSURANCE SERVICES

AN INTEGRATED APPROACH

SIXTEENTH EDITION

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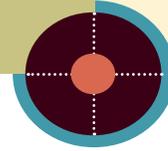
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CONTINUING THE LEGACY OF ALVIN A. ARENS



ALVIN A. ARENS: The author team of Randy Elder, Mark Beasley, and newest member of the author team, Chris Hogan, are pleased to continue the outstanding legacy of our book's founding author, Al Arens, in this 16th edition of *Auditing and Assurance Services: An Integrated Approach*. As was done for the 15th edition, we again dedicate this new edition to Al's memory.

Randy and Mark joined Al as coauthors on this textbook in the 8th edition, and have been honored to continue Al's leadership in helping shape classroom instruction and student learning about auditing concepts and their practical implementation around the world. Since the first edition was published, this textbook has impacted audit education for over 30 years in the U.S. and globally, including seven different language translations. Al's leadership at national and international levels and his commitment to expanding knowledge through the development of educational materials, including this textbook, continue to inspire us as we strive to advance his legacy for future generations of auditing professionals.

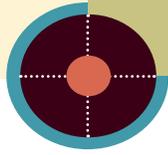


November 24, 1935 – December 6, 2010

Al was the PricewaterhouseCoopers Auditing Professor and member of the Accounting & Information Systems faculty in the Eli Broad College of Business at Michigan State University from 1968 through 2007. Thus, we are especially pleased to have Chris Hogan, Professor at Michigan State University, join the author team on this edition, continuing the Michigan State connection started by Al.

Among his many honors, Al was selected as one of five national auditing educators to hold a Price Waterhouse Auditing professorship, was honored as AICPA Educator of the Year, served on the AICPA Auditing Standards Board, and was President of the American Accounting Association. Al taught accounting, mainly auditing, with a passion that is legendary. He had a heart for sharing his knowledge of auditing with students throughout his career.

This 16th edition continues his outstanding legacy in audit education.



ABOUT THE AUTHORS

ALVIN A. ARENS

Al Arens, founding author of this textbook, was the PricewaterhouseCoopers Professor of Accounting Emeritus at Michigan State University. In addition to writing books on auditing, he was a coauthor of computerized accounting supplements and he was actively involved in the continuing education of practitioners with local and regional CPA firms. Al was a past president of the American Accounting Association and a former member of the AICPA Auditing Standards Board. He practiced public accounting with both a local CPA firm and the predecessor firm to Ernst & Young. He received many awards including the AAA Auditing Section Outstanding Educator award, the AICPA Outstanding Educator award, the national Beta Alpha Psi Professor of the Year award, and many teaching and other awards at Michigan State.

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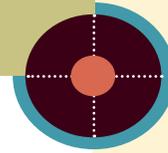
MARK S. BEASLEY

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We are pleased to have **Chris Hogan** join us as a coauthor for this 16th edition. Chris is a Professor of Accounting in the Eli Broad College of Business at Michigan State University. We are thrilled to continue the Michigan State connection started by Al Arens. Chris teaches graduate auditing and her research focuses on internal controls and integrated audits, audit firm client portfolios, and the impact of regulation on audit markets. Chris has auditing experience with Price Waterhouse, one of the predecessor firms to PricewaterhouseCoopers, LLP. She has served in multiple leadership roles within the American Accounting Association, including serving as President of the Auditing Section and on the Audit Committee of the AAA.

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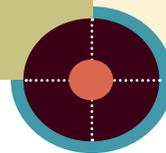
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PREFACE



INTEGRATED APPROACH FOR RISK ASSESSMENT AND AUDIT DECISION MAKING

Auditing and Assurance Services: An Integrated Approach is an introduction to auditing and other assurance services. It is intended for either a one-quarter or one-semester course at the undergraduate or graduate level. This book is also appropriate for introductory professional development courses for CPA firms, internal auditors, and government auditors.

The primary emphasis in this text is on the auditor's decision-making process in a financial statement audit, as well as an integrated audit of both financial statements and internal control over financial reporting required for accelerated filer public companies. We believe that the most fundamental concepts in auditing concern determining the nature and amount of evidence the auditor should gather after considering the unique circumstances of each engagement. If students of auditing understand the objectives to be accomplished in a given audit area, the risks related to the engagement, and the decisions to be made, they should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained.

Our objective is to provide up-to-date coverage of globally recognized auditing concepts with practical examples of the implementation of those concepts in real-world settings. The collective experience of the author team in the practice of auditing is extensive. We have all worked in the auditing profession involving both large international audit firms and regional firms. Members of our author team have taught extensively in continuing education for either large international or small CPA firms and have been involved in standards setting activities of the Auditing Standards Board and the PCAOB. One author served over seven years as one of the board members of the Committee of Sponsoring Organizations of the Treadway Commission (COSO). These experiences provide unique perspectives about the integration of auditing concepts in real-world settings.

As the title of this book reflects, our purpose is to integrate the most important internationally recognized concepts of auditing in a logical manner to assist students in understanding audit decision making and evidence accumulation in today's complex, global auditing environment. For example, developments related to issues affecting auditing in a global and economically volatile environment are described throughout the book and are emphasized in selected mid-chapter vignettes and homework problems. Key concepts related to risk assessment as emphasized in standards issued by the Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB), including emphasis on significant risks, are integrated into all of the planning chapters, as well as each chapter dealing with a particular transaction cycle and related accounts. Our coverage of internal control is related to tests of controls and substantive tests of transactions that are performed in a financial statement audit and an integrated audit of financial statements and internal control over financial reporting, with an emphasis on the requirements of PCAOB Auditing Standards. Tests of controls and substantive tests of transactions are, in turn, related to the tests of details of financial statement balances for the area. Audit sampling is applied to the evaluation of audit evidence rather than treated as a separate topic. Risk assessment, technology, fraud, and auditing of internal control issues are integrated throughout the chapters.

WHAT'S NEW IN THIS EDITION

Current Coverage

New auditing standards are released without regard to textbook revision cycles. As auditing instructors, we appreciate how critical it is to have the most current content available. This edition includes complete coverage of the AICPA Clarity Project, including guidance in the recently issued SAS No. 130 *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* and new PCAOB standards including Standard No. 18, *Related Parties*. We are committed to continually providing you with up-to-date content in this dynamic global auditing environment and will keep you updated with highlights posted on our Web site of major changes in new standards as they are issued.

AICPA Clarity Projects

As part of the effort to converge U.S. auditing standards with international standards, the AICPA Auditing Standards Board (ASB) recently completed its Clarity Project to redraft most of the existing GAAS standards to not only align them with the ISAs, but to also make them easier to read, understand, and apply. Chapter 2 provides an overview of the major implications of the clarified standards, including the new principles that provide the framework to help auditors fulfill the objectives of the audit of financial statements in accordance with AICPA auditing standards and the new Codification of Statements on Auditing Standards. Chapter 3 contains examples of the new standard auditor's report format updated by the Clarified SASs. All remaining chapters of the textbook reflect the various revisions resulting from the issuance of the Clarity standards.

The AICPA's Accounting and Review Services Committee (ARSC) has largely completed a similar Clarity Project affecting compilation and review standards with the issuance of SSARS No. 21, *Statement on Standards for Accounting and Review Services: Clarification and Recodification*. In redrafting SSARS, the ARSC used similar redrafting standards as those used by the Auditing Standards Board. Changes resulting from the redrafting of SSARS are addressed in Chapter 25. Additionally, that chapter also highlights forthcoming changes in Statements on Standards for Attestation Engagements (SSAEs) resulting from the AICPA's Clarity Project affecting attestation standards, which was recently voted for final issuance by the ASB.

Coverage of Revised AICPA Code of Professional Conduct

The AICPA recently restructured its *Code of Professional Conduct* to align it with international standards. The organization of the *Code* now presents the Principles as part of the Preface and then includes Rules for members in public practice separately from Rules for members in business and others. Chapter 4 has been substantially revised to provide an overview of the key elements of the revised *Code* based on this new structure.

Expanded Coverage of Professional Skepticism and Auditor Judgment

With the profession's continued focus on the importance of applying appropriate levels of professional skepticism, we have expanded coverage of this topic in Chapter 6, along with integrated coverage in later chapters, including Chapter 10, which addresses the auditor's responsibilities for detecting fraud. We discuss the importance of a questioning mindset and the need to critically evaluate audit evidence to strengthen student awareness of the elements of effective professional skepticism.

To assist auditors with maintaining an appropriate level of professional skepticism when making professional judgments during an audit, this edition features the Center for Audit Quality's *Professional Judgment Resource*, which outlines key elements of a process that auditors apply when making professional judgments. Chapter 6 illustrates an effective decision-making process that guides auditors' thinking to help them be aware of their own judgment tendencies, traps, and biases. We have added homework problems that expose students to this judgment framework and a number of the common traps and biases.

The requirements of the Sarbanes–Oxley Act of 2002 and the PCAOB Auditing Standard 5 (AS 5) that impact accelerated filer public companies, and the risk assessment standards issued by the Auditing Standards Board are integrated throughout the text. Chapter 2 emphasizes the importance of understanding the client’s business and its environment, including internal control. Chapter 3 highlights reporting on internal controls over financial reporting for auditors of accelerated filer public companies.

We have always emphasized understanding the client’s business and industry in planning. For the 16th edition we reorganized Chapters 8–12 to include expanded coverage of the auditor’s performance of risk assessment procedures, including the identification of significant risks. Chapter 9 addresses the performance of risk assessment procedures to address the risk of material misstatement, followed in Chapter 10 with discussion of assessing and responding to the risk of fraud.

Our coverage in Chapters 11 and 12 of internal controls, including coverage of IT general and application controls, has been restructured to reflect key elements of COSO’s 2013 revision of its *Internal Control—Integrated Framework* and to better integrate the auditor’s consideration of both manual and automated controls. Chapter 11 introduces students to important elements of effective internal controls, including those related to IT, while Chapter 12 outlines the auditor’s responsibilities to understand the design and operating effectiveness of internal control, and also highlights auditor reports on internal control over financial reporting. Subsequent chapters that focus on the transaction cycles include extensive coverage of internal controls to help students understand how the auditor’s consideration of internal controls is integrated for audits of the financial statements and internal controls over financial reporting.

Chapter 1 introduces the importance of considering international auditing standards developments, followed by discussion in Chapter 2 about the role of the International Auditing and Assurance Standards Board (IAASB) in the issuance of international standards on auditing (ISAs) and the Auditing Standards Board’s efforts to converge U.S. standards to international standards. Chapter 3 highlights implications for auditor reports on companies reporting under International Financial Reporting Standards (IFRS). Several chapters throughout the book include text or mid-chapter vignette coverage of international issues, and international issues are also addressed in homework problems.

With the increasing volume and complexity of various types of financial instruments and challenges associated with fair value accounting, Chapter 23 addresses issues associated with auditing financial instruments and obtaining sufficient appropriate audit evidence for fair value account estimates. We believe this guidance will help strengthen student understanding of the challenges associated with auditing financial instruments.

With more organizations taking advantage of cloud computing options and third party IT service providers, there is a greater need for information about the design and operating effectiveness of internal controls provided by these external service providers. This 16th edition contains expanded coverage of service organization control (SOC) reports issued by service center auditors. Both Chapters 12 and 25 reflect the new guidance for service auditors reporting on internal controls at service organizations, including coverage of the different types of reports provided in SOC 1, SOC 2, and SOC 3 engagements.

**Expanded Coverage
on Risk Assessment
Procedures and
Understanding Internal
Control**

**Emphasis on
International Issues**

**Coverage of Financial
Instruments**

**Service Organization
Controls (SOC) Reports**

New Coverage of Preparation Service Engagements

The issuance of SSARS No. 21 introduced a new type of nonattest engagement service that allows nonissuers to engage a CPA to help management prepare monthly, quarterly, or annual financial statements without providing any assurance on the financial statements or issuing a report, even if the financial statements are expected to be used by, or provided to, a third party. Chapter 25 describes this new type of service and distinguishes it from compilation and review engagement requirements.

New Concept Checks

A new feature in the 16th edition is the inclusion of Concept Checks periodically within each chapter that highlight short-answer questions to help students recap content covered within different sections of the chapter. These short in-chapter review questions are intended to help call student attention to key concepts as they read the material in the chapter.

Expanded Homework Material

We are excited about the inclusion of a number of changes to the end-of-chapter homework material for all chapters. For the 16th edition, we have partnered with Becker CPA Review to include new multiple choice problems from their CPA exam preparation materials. These problems, which are included in all 26 chapters, are labeled with the Becker logo. Additionally, each chapter identifies new or revised Discussion Questions and Problems that instructors can use in class to generate discussion about important topics addressed in each chapter. These problems are highlighted by an “in-class” discussion icon in the margin next to the related homework problem. Each chapter also identifies homework problems that require students to research standards and other material using the Internet. While many of these research problems expose students to standards, such as those on the PCAOB Web site, other problems require students to examine recently issued financial statements or other corporate filings, or they expose students to best practices thought papers as part of the assignment. Sample problems, assignable in MyAccountingLab, provide an introduction to the CPA Exam format and an opportunity for early practice with CPA exam-style questions.

Data Analysis Problems

CPA firms expect auditors to analyze data using spreadsheets and audit software. A number of the problems in the text can be completed using Excel templates available on the text Web site. These problems are indicated by a spreadsheet icon in the margin next to the problem. CPA firms increasingly emphasize data analytics and increasingly use audit software to perform audit testing including tests for fraud. We have included selected problems using ACL in several chapters in the text. These problems are related to the topic of the chapter so that students can see how audit software is used to perform specific types of audit tests. Guidance for students on the use of ACL is included on the text Web site.

Hillsburg Hardware Annual Report

The annual report for the Hillsburg Hardware Company is included as an insert to the text. Financial statements and other information included in the annual report are used in examples throughout the text to illustrate chapter concepts. The annual report also includes management’s report on internal control required by Section 404a and the auditor’s report required by Section 404b, consistent with PCAOB Auditing Standard No. 5.

Pinnacle Manufacturing Integrated Case

The Pinnacle Manufacturing integrated case is based on a large, multi-division company. The case has been revised and expanded to now consist of seven parts included at the end of the chapter to which that part relates. Each part of the case is designed to give students hands-on experience, and the parts of the case are connected so that students will gain a better understanding of how the parts of the audit are integrated by the audit process.

The text is divided into six parts. The chapters are relatively brief and designed to be easily read and comprehended by students.

Part 1, The Auditing Profession (Chapters 1–5) The book begins with an opening vignette featuring a Big 4 public accounting firm’s assurance report contained in the Corporate Sustainability Report issued by United Parcel Service (UPS), to help students see the increasingly important role of auditors in providing assurance on a broad range of information important to key stakeholders. Chapter 1 introduces key provisions of the Sarbanes–Oxley Act, including the creation of the PCAOB and Section 404 internal control reporting requirements. Chapter 2 covers the CPA profession, with particular emphasis on the standards setting responsibilities of the International Auditing and Assurance Standards Board (IAASB) and the PCAOB and how those responsibilities differ from those of the AICPA Auditing Standards Board (ASB). Chapter 2 provides in-depth coverage of the AICPA Clarity Project and resulting changes to AICPA auditing standards. Chapter 3 provides a detailed discussion of audit reports issued under AICPA and PCAOB standards, including a separate section on the report on internal control over financial reporting for an accelerated filer public company. The chapter also emphasizes conditions affecting the type of report the auditor must issue and the type of audit report applicable to each condition under varying levels of materiality. Chapter 4 explains ethical dilemmas, professional ethics, and independence, and it features the newly revised AICPA *Code of Professional Conduct*. Chapter 5 ends this part with an investigation of auditors’ legal liability.

Part 2, The Audit Process (Chapters 6–13) The first two of these chapters deal with auditor and management responsibilities, professional skepticism, a professional judgment framework for auditor decision making, audit objectives, general concepts of evidence accumulation, and audit documentation, including the management assertions and evidence concepts in the risk assessment standards. Chapter 8 deals with planning the engagement, including understanding the company’s business and its industry as part of the auditor’s risk assessment procedures, using analytical procedures as an audit tool, and making preliminary judgments about materiality. Chapter 9 provides expanded coverage of the auditor’s performance of risk assessment procedures used to assess the risk of material misstatement due to fraud or error and how the auditor responds to risks of significant misstatement with further audit procedures. Fraud auditing is the focus of Chapter 10, which builds upon risk assessment concepts covered in the previous chapter to illustrate how risk assessment includes the assessment of fraud risk. The chapter also includes specific examples of fraud and discusses warning signs and procedures performed in response to heightened fraud risk. Chapter 11 outlines the key components of an effective system of internal controls over financial reporting, consistent with the 2013 revision of COSO’s *Internal Control—Integrated Framework*. Because most internal control systems are heavily dependent on information technologies, this chapter integrates coverage of IT general controls and application controls. Chapter 12 shows how effective internal controls can reduce planned audit evidence in the audit of financial statements, and it outlines procedures auditors perform as tests of those controls to support a low control risk assessment. The chapter also describes how auditors of accelerated filer public companies integrate evidence to provide a basis for their report on the effectiveness of internal control over financial reporting with the assessment of control risk in the financial statement audit. Chapter 13 summarizes Chapters 6 through 12 and integrates them with the remainder of the text.

Part 3, Application of the Audit Process to the Sales and Collection Cycle (Chapters 14–17) These chapters apply the concepts from Part 2 to the audit of sales, cash receipts, and the related income statement and balance sheet accounts. The appropriate audit procedures for accounts in the sales and collection cycle are related to internal control and audit objectives for tests of controls, substantive tests of transactions, and tests of details of balances in the context of both the audit of financial statements and the audit of internal control over financial reporting.

Students also learn to apply audit sampling to the audit of sales, cash receipts, and accounts receivable. Chapter 15 begins with a general discussion of audit sampling for tests of controls and substantive tests of transactions. Similarly, Chapter 17 begins with general sampling concepts for tests of details of balances. The next topic in each chapter is extensive coverage of nonstatistical sampling. The last part of each chapter covers statistical sampling techniques.

Part 4, Application of the Audit Process to Other Cycles (Chapters 18–23) Each of these chapters deals with a specific transaction cycle or part of a transaction cycle in much the same manner as Chapters 14 through 17 cover the sales and collection cycle. Each chapter in Part 4 demonstrates the relationship of internal controls, tests of controls, and substantive tests of transactions for each broad category of transactions to the related balance sheet and income statement accounts. We integrate discussion of implications related to the audit of internal control throughout all these transaction cycle chapters. Cash and financial instruments are studied late in the text to demonstrate how the audit of cash and financial instrument balances is related to most other audit areas.

Part 5, Completing the Audit (Chapter 24) This part includes only one chapter, which deals with performing additional tests to address presentation and disclosure objectives, summarizing all audit tests, reviewing audit documentation, obtaining management representations in an integrated audit of financial statements and internal control, communicating with those charged with governance, and all other aspects of completing an audit.

Part 6, Other Assurance and Nonassurance Services (Chapters 25 and 26) The last two chapters deal with various types of engagements and reports, other than the audit of financial statements using generally accepted accounting principles. Topics covered include assurance services; review, compilation, and preparation services; agreed-upon procedures engagements; attestation engagements; other audit engagements; internal financial auditing; governmental financial auditing; and operational auditing. This edition also includes expanded coverage of service organization control (SOC) reports on internal controls at external service providers.

SUPPLEMENTS

Instructor's Resource Center www.pearsonhighered.com/arens This password-protected site is accessible from the catalog page for *Auditing and Assurance Services, 16th ed.*, and hosts the following resources:

Image Library The Image Library allows access to most of the images and illustrations featured in the text.

Instructor’s Resource Manual Suggestions for each chapter include: Homework problems, how learning objectives correlate with chapter problem material, and visual aids that can be added to PowerPoint slides or used on document cameras or overhead projectors. Chapters have been designed so that their arrangement and selection provide maximum flexibility in course design. Sample syllabi and suggested term projects are provided.

Solutions Manual Included are detailed solutions to all the end-of-chapter exercises, problems, and cases. Guidelines for responses to review questions and discussion questions are offered.

Test Item File & TestGen The **Test Item File** includes multiple choice exercises, true/false responses, essay questions, and questions related to the chapter vignettes. To assist the instructor in selecting questions for use in examinations and quizzes, each question has been assigned one of three difficulty ratings—easy, medium, or challenging. In addition, questions that uniquely relate to the integrated audits of large public companies or to the provisions of the Sarbanes–Oxley Act and Section 404 have been separately labeled for easy identification by the professor. TestGen testing software is an easy-to-use computerized testing program. It can create exams as well as evaluate and track student results. All Test Item File questions are available in the TestGen format.

PowerPoint Slides PowerPoint presentations are available for each chapter of the text. Instructors have the flexibility to add slides and/or modify the existing slides to meet course needs.

Enhanced Companion Web Site Pearson’s Learning on the Internet Partnership offers the most expansive Internet-based support available. Our Web site provides a wealth of resources for students and faculty. Periodically, faculty will be able to access electronic summaries and PowerPoint slides of the most recent changes to professional standards and summaries of major issues affecting the auditing profession. This will help instructors to stay informed of emerging issues.

Auditing Cases, 6th ed., by Beasley/Buckless/Glover/Prawitt This collection of 49 auditing cases addresses most major activities performed during the conduct of an audit, from client acceptance to issuance of an audit report. Several cases ask students to work with realistic audit evidence to prepare and evaluate audit schedules. The cases are available as part of Pearson Collections. For details, go to collections.pearsoned.com.

MyAccountingLab® MyAccountingLab is an online homework, tutorial, and assessment program designed to work with this text to engage students and improve results. Within its structured environment, students practice what they learn, test their understanding, and receive immediate feedback to help them better absorb course material and understand difficult concepts.

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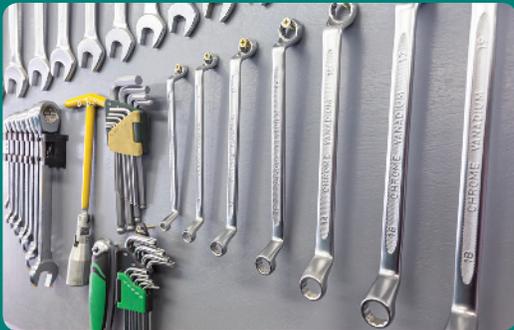
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2016 Annual Report





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Rick Chulick, President and Chief Operating Officer

DEAR SHAREHOLDERS

March 29, 2017

We are proud to announce another year of noticeable improvement.

In last year's letter we stated, "We are committed to increasing the efficiency and effectiveness of operations through cost savings and productivity improvements, in light of current economic conditions. In addition, we intend to maintain and further develop our customer base through recently implemented post-sale service programs." The operating results in this report demonstrate that our objectives have been achieved, resulting in a net income increase of \$740,000 from 2015 to 2016. This amounts to 15 cents per share, a 23.2% increase from last year. Our goal in the current year is to further improve the results of operations and create value for shareholders. In doing so, we will focus primarily on the following three strategic components of our business plan:

1. Post-sale service arrangements designed to further develop and maintain our customer base.
2. Aggressive advertising campaigns that allow us to penetrate markets dominated by national wholesale hardware store chains.
3. Implementation of new warehouse technology designed to increase productivity and reduce stocking and distribution costs.

We will report our progress throughout the year.

Christopher J. Kurran
Chief Executive Officer

Rick Chulick
President and Chief Operating Officer