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AUDITING &  
ASSURANCE  
SERVICES *6e*



# Auditing & Assurance Services

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# Auditing & Assurance Services

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Some people come into our lives and quickly go. Some stay awhile and leave footprints on our hearts and we are never quite the same.

*Anonymous*

We dedicate this book to the following educators whose footprints we try to follow:

**Professor Homer Bates**

(University of North Florida)

**Professor Stanley Biggs**

(University of Connecticut)

**Professor Lewis C. Buller**

(Indiana State University)

**Professor Patrick Delaney**

(Northern Illinois University)

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### Index II

# Look Beneath the Surface . . .

As auditors, we are trained to investigate beyond appearances to determine the underlying facts—in other words, to *look beneath the surface*. The recent financial crisis has made this skill even more crucial to the business community. As a result of this recent crisis and of the financial statement accounting scandals that occurred at the turn of the century, understanding the auditor's responsibility related to fraud, maintaining a clear perspective, probing for details, and understanding the big picture are indispensable to effective auditing. The author team of Louwers, Ramsay, Sinason, Strawser, and Thibodeau has dedicated years of experience in the auditing field to this new edition of *Auditing & Assurance Services*, supplying the necessary investigative tools for future auditors.

## Cutting-Edge Coverage

The sixth edition of *Auditing & Assurance Services* is the most up-to-date auditing text on the market. The book has fully integrated the Clarified Statements on Auditing Standards. In addition, all chapters and modules in the sixth edition have been revised to incorporate the eight standards (*AS 8–AS 16*) adopted by the PCAOB that relate to the auditor's assessment of and response to risk in a financial statement audit and that include guidance related to audit planning, supervision, materiality, and communication with audit committees. **All chapters and modules have also been revised to incorporate the latest updates from the international standards of auditing (ISAs) and the Auditing Standards Board (ASB).** In fact, each chapter now begins with a list of the AU/ISA sections that are covered from the Codification of Statements on Auditing Standards published by the AICPA. Fraud awareness, a thorough understanding of internal controls, and the ability to use technology effectively are the hallmarks of a successful auditor in the post-Sarbanes-Oxley auditing environment. With *Auditing & Assurance Services*, sixth edition, students are prepared to take on auditing's latest challenges.

## Engage Your Students

An effective accounting textbook integrates real-world scenarios with theoretical discussion. *Auditing & Assurance Services* places the student in the role of decision maker, using situations from companies such as General Motors, General Electric, Time Warner, Disney, Hewlett-Packard, and Walmart to illustrate the application of auditing concepts. Importantly, the author team employs a rigorous monthly process by which they scrutinize leading business and academic publications (e.g., *The Wall Street Journal*) for relevant real-world auditing headlines. The result is that *each* chapter features relevant and recent examples, including infamous accounting scandals that occurred at Satyam, Enron, Siemens, HealthSouth, Adelphia Communications Corporation, and WorldCom. The Louwers author team uses a conversational, yet professional, tone—hailed by reviewers as a key strength of the book.

*“The tone of the textbook is in a conversational manner that allows for more student-friendly reading material.”*  
—Aretha Hill, Florida A&M University



## Market-Leading Technology

Auditing in modern business utilizes the latest technology. The author team of *Auditing & Assurance Services* has again included the educational version of **ACL software** in the

# KAPLAN CPA REVIEW

sixth edition at no extra cost so students can benefit from the kind of cutting-edge

software they'll use the first day on the job. Exercises to accompany ACL are included on the book's website, [www.mhhe.com/louwers6e](http://www.mhhe.com/louwers6e). In addition, the selection of **Kaplan CPA Review audit simulations** allows students to go online and complete simulations similar to those on the CPA exam—seamlessly integrating technology with the textbook.

**CHAPTER 4**

**Management Fraud and Audit Risk**

*Profit is the result of risks wisely selected.*  
Frederick Barnard Hawley, American economist (1843–1929)

*Risk comes from not knowing what you're doing.*  
Warren Buffett, widely regarded as one of the most successful investors in the world

Professional Standards References		
Topic	AU/ISA Section	PCAOB Reference <sup>a</sup>
Overall Objectives of the Independent Auditor	200	AU 110, AU 150, AU 201, AU 220, AU 230

## Fraud Awareness

The fraud coverage in *Auditing & Assurance Services* is the most extensive available and is complemented by real-world examples chosen to engage students. The authors use short “**Auditing Insight**” boxes to provide real-life (and often humorous!) examples of fraud as well as examples of how auditors contributed to solving the case. Extended discussions of fraud cases at Satyam, Parmalat, HealthSouth, KPMG, Andersen, General Motors, and the PTL Club, just to name a few, give students an inside view of fraud detection. Chapters 4 and 6 cover management and employee fraud, respectively, and Module D focuses on the Certified

Fraud Examiner Exam. With the **Apollo Shoes Case**, the only stand-alone fraud audit case on the market (available online), *Auditing & Assurance Services* is truly the leading auditing textbook for fraud coverage.

## Comprehensive Cases

Eight comprehensive cases are included: Arthur Andersen, PTL Club, General Motors, HealthSouth Corporation, KPMG, Parmalat, General Electric, and Satyam Computer Services Ltd.

*“The format allows you to integrate the modules into the chapter material in any way you would find useful.”*

—Frank J. Beil, University of Minnesota

## Flexible Organization

*Auditing & Assurance Services* teaches students auditing concepts by emphasizing real-life contexts when describing the auditing process. The authors use chapters and modules to achieve this goal. Although the chapters follow a logical sequence that we recommend professors consider for their classes, **the modules have been written to be used on a stand-alone basis**. In essence, the modules have been deliberately prepared for entirely flexible

implementation of these topics without excessive reliance on chapter sequencing. We encourage you to integrate these modules into your syllabi in a manner that best suits your approach to the auditing course.

Chapters	Modules
<p>The 12 chapters cover the auditing process extensively with a multitude of cases designed to give students a better understanding of how a best-practice concept developed from real-world situations.</p>	<p>Modules A–H provide instructors additional material that can be used throughout the course. Topics such as fraud, ethics, sampling, and technology are covered in the modules, which are designed to be taught whenever instructors want to introduce the topic in their course.</p>

## Highlights of Auditing & Assurance Services, 6e

- Once again, this book features **Connect<sup>®</sup> Accounting!** See pages xxiv–xxv for details.
- This edition has fully integrated the **Clarified Statements on Auditing Standards**. Each chapter begins with a list of the AU/ISA sections from the PCAOB, the international standard of auditing (ISAs), and the Auditing Standards Board (ASB) covered in that chapter.
- **Auditing Insight boxes** have been added and updated throughout the textbook.
- New multiple-choice questions have been added to each chapter’s test bank, including a significant number of questions that appeared on the **CPA exam** from 2010–2013.
- This edition includes substantial coverage of **sustainability assurance and reporting**. The topic is now featured in Chapter 1, Module A, and Module D and includes example sustainability reports for UPS and Starbucks.
- Chapter 1 has been revised to incorporate more extensive coverage of professional skepticism and the auditor’s professional judgment process.
- The book has expanded its coverage of the importance of auditing the completeness and accuracy of data produced by the entity’s information system in both Chapter 5 and Module H.
- Chapters 6 and 7 have been revised to increase coverage of electronic confirmations. An end-of-chapter problem that asks students to complete a tutorial of a leading electronic confirmation platform (i.e., Confirmation.com) has been added to Chapter 6.
- Recent pronouncements and the new format for written representations (Chapter 11) are incorporated.
- Chapter 12 has been extensively revised to focus on the auditors’ report and modification to the auditors’ report for nonpublic entities.
- Module B (Professional Ethics) now begins with a discussion of the Scott London insider trading scandal. The module also now includes a discussion of virtue ethics.
- Module H has been revised to more clearly focus on how the use of automated transaction processing affects the audit team’s study and assessment of internal control.
- **All chapters and modules have been revised to incorporate professional standards adopted through December 2013.**

### **Association to Advance Collegiate Schools of Business (AACSB) Statement**

The McGraw-Hill Companies is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Auditing and Assurance Services*, 6e, recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the text and test bank to the six general knowledge and skill guidelines in the AACSB standards. The statements contained in *Auditing and Assurance Services*, 6e, are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, their mission, and their faculty. Although *Auditing and Assurance Services*, 6e, and the teaching package make no claim of any specific AACSB qualification or evaluation, we have within *Auditing and Assurance Services*, 6e, labeled selected questions according to the six general knowledge and skills areas.

# New to the Sixth Edition of

## Part I: The Contemporary Auditing Environment

### CHAPTER 1: Auditing and Assurance Services

- Added a discussion about how more companies than ever are seeking to quantify their sustainability and social responsibility efforts with measurable outputs. This movement is increasing the demand for CPAs to complete attestation engagements on these measurable outputs. We also added a new exhibit that provides an example of the 2011 Sustainability Report for United Parcel Service (UPS).
- Improved and clarified the section on management's financial statement assertions, with an added emphasis on the importance of understanding the relationship between a company's internal control activities and the relevant financial statement assertions.
- Added more discussion about the importance of professional skepticism and an auditor's professional judgment in today's auditing environment. In addition, we included a new Auditing Insight to highlight how one firm, KPMG, is helping its professionals overcome judgment biases with a new monograph that focuses on an auditor's professional judgment process.

### CHAPTER 2: Professional Standards

- Added an introductory vignette that details the recent deficiencies noted in audits conducted by Deloitte.
- Provided a summary of the recent Staff Audit Practice Alert issued by the PCAOB on professional skepticism.
- Included McDonald's 2013 audit report to demonstrate the contents of an actual audit report and how this report reflects the guidance in the reporting principle.
- Provided a summary of findings from PCAOB inspections of audits conducted by Big Four firms from 2009 through 2011.
- Provided a summary of academic research investigating the relationship between PCAOB inspection reports and auditor dismissals, client reporting, and firm reporting decisions.
- Added an Auditing Insight discussing controversies over the inspection of audits conducted by Chinese firms.
- Added an appendix on how to use and reference professional literature issued by the PCAOB and Auditing Standards Board (Clarified Standards).

## Part II: The Financial Statement Audit

### CHAPTER 3: Engagement Planning

- Added a discussion to emphasize the importance of processes designed to ensure that professionals in CPA firms are independent of any relationships that might impact their professionals when making professional judgments on an audit engagement.
- Added an Auditing Insight to describe how KPMG handled the situation involving its rogue partner, Scott London, who provided confidential client information to a friend about two of his audit clients. KPMG resigned from both audits.
- Updated and clarified the section on the effect of a client's computer processing on audit planning with an overall emphasis on the importance of gaining audit comfort on the data produced by an entity's information system that is used in the internal control system.

### CHAPTER 4: Management Fraud and Audit Risk

- Improved and clarified the section on enterprise risk management with a particular emphasis on how understanding an entity's risk management process

can help when an auditor assesses risk on an audit engagement.

- Added an Auditing Insight to illustrate how Enron's change in strategic direction impacted its accounting choices and ultimately its financial statements. The example is used to emphasize the importance of gaining an understanding of a client's strategy during the risk assessment process.
- Added an Auditing Insight to highlight the dispute between Hewlett-Packard (HP) and Autonomy regarding the price HP paid to acquire Autonomy in 2011. The dispute illustrates the importance of gaining an understanding of the client, its industry, and any companies being acquired during the risk assessment process.
- Added recent fraud statistics from *The Network* and *BDO Consulting*.

### CHAPTER 5: Risk Assessment: Internal Control Evaluation

- Improved and clarified the section on the components of an internal control system under COSO. In

# Auditing & Assurance Services

addition, added a discussion of how auditors evaluate the separation of duties in an information technology environment.

- Added a discussion to highlight the importance of auditors' verification of the completeness and accuracy of information produced by the entity when completing tests of controls. The discussion is illustrated with a new Auditing Insight that discusses how the PCAOB is emphasizing this area in its inspections.
- Added an Auditing Insight to describe the particulars of the COSO 2013 update to its internal control framework. The update provides more implementation guidance that will help organizations adapt their internal control systems to meet the needs of the current business environment. Specifically, the COSO 2013 framework adds 17 explicit principles that are associated with the five components of internal control (i.e., control environment, risk assessment, control activities, information and communication, and monitoring).

## **CHAPTER 6: Employee Fraud and the Audit of Cash**

- Updated the Auditing Insight with a new example of a recent embezzlement by a trusted employee and updated the discussion of evidential matter in a fraud investigation to include computer forensic investigations.
- Improved and clarified the section on electronic cash confirmations. An end-of-chapter problem has also been added that asks students to complete a tutorial of a leading electronic confirmation platform, Confirmation.com.
- Added an Auditing Insight describing the fraud perpetrated by Peregrine Financial Group (PFG). The fraud was detected because the regulators switched to an electronic platform to confirm PFG's cash balances. The fraud went undetected for many years because the CEO had rented a post office box to intercept bank confirmation requests and forged the documents to conceal the missing money.

## **CHAPTER 7: Revenue and Collection Cycle**

- Updated the confirmation discussion for e-mail, fax, and verbal responses.
- Updated PCAOB inspections.

## **CHAPTER 8: Acquisition and Expenditure Cycle**

- Conformed the risk assessment discussion to new standards.

- Added discussion of the bidding process for purchasing.
- Updated PCAOB inspections.

## **CHAPTER 9: Production Cycle**

- Added analysis of presentation and disclosure of inventory in Boeing Corporation's 2010 annual report.
- Updated for new auditing standards.
- Updated PCAOB inspections.

## **CHAPTER 10: Finance and Investment Cycle**

- Updated for new auditing standards.
- Updated PCAOB inspections.

## **CHAPTER 11: Completing the Audit**

- Included revised discussions of roll-forward work and attorneys' letters.
- Added discussion of *AS 16*'s increased responsibilities to communicate with those charged with governance.

## **CHAPTER 12: Reports on Audited Financial Statements**

- Moved the chapter's focus from the audit report for public entities under *Auditing Standard 5* to the report for nonpublic entities.
- Updated reporting examples throughout the chapter to provide more current examples of report modifications.
- Updated academic research on the impact of auditors' reports on user decisions and perceptions.
- Provided an extensive summary of factors that influence the decision to issue going-concern reports and the impact of these reports on users' decisions. to provide assurance on information outside the financial statements, and the clarification of various language and concepts used in the auditors' report.
- Added an Appendix to discuss the new wording and format adopted by the AICPA for reports used for the audits of nonpublic entities in AU 700.
- Added additional end-of-chapter material that requires students to identify the type of opinions issued in various reporting scenarios and how the auditors' report would be modified.
- Added additional end-of-chapter material that addresses reporting options for departures from GAAP and scope limitations assuming various scenarios regarding the pervasiveness and materiality of these issues.

## Part III: Stand-Alone Modules

### **MODULE A: Other Public Accounting Services**

- Updated the coverage of assurance services to include reports on sustainability. A recent example of a sustainability report for Starbucks is included.
- Included a new table describing the differences between prospective and pro forma engagements.
- Included examples of revised reports (review reports, reports on elements, reports on special purpose frameworks).

### **MODULE B: Professional Ethics**

- Opened the module with the story of disgraced former KPMG partner Scott London who sacrificed his career to share confidential client information with a friend.
- Added a discussion of Aristotelian virtue ethics to already existing discussions of Kantian categorical imperatives and utilitarianism.
- Added a discussion of the role of the PCAOB's Division of Enforcement and Investigations.

### **MODULE C: Legal Liability**

- Updated the introductory vignette on litigation involving BDO Seidman for its audits of E.S. Bank-est to include the ultimate resolution of this litigation.
- Updated the summary of major settlements involving Big Four accounting firms to include settlements occurring since 2008.
- Expanded the discussion of academic research examining auditor litigation to include recent studies that investigated the factors affecting the litigation risk faced by audit firms.

### **MODULE D: Internal Audits, Governmental Audits, and Fraud Examinations**

- Updated the coverage of the reliance of Congress on the GAO.
- Added internal audits for sustainability.

### **MODULE E: Overview of Sampling**

- Greatly simplified content to focus on key sampling terminology and basics of sampling for instructors wishing to provide a broad overview to students.

### **MODULE F: Attributes Sampling**

- Discussed PCAOB inspection findings related to attributes sampling.
- Moved sampling tables to the appendix and revised the chapter to illustrate the use of these tables on a step-by-step basis.
- Used graphics throughout the chapter to illustrate progress in the sampling process from the planning stages to the evaluation stage.

### **MODULE G: Variables Sampling**

- Discussed PCAOB inspection findings related to variables sampling.

### **MODULE H: Auditing and Information Technology**

- Significantly revised (and simplified) the chapter throughout to reinforce how the client's use of automated transaction processing systems affects the major stages of the audit team's study and evaluation of internal control.
- Provided an example of how students encounter IT general and app controls when using a smartphone.
- Added additional end-of-chapter material that requires students to identify tests of controls that would be used to evaluate the operating effectiveness of general and automated application controls.



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In addition to Blackboard integration, course cartridges for whichever online course management system you use (e.g., WebCT or eCollege) are available for Louwers,

sixth edition. McGraw-Hill Campus allows all McGraw-Hill Higher Education digital resources to converge in one place. Faculty members can then enter through the same online portal using their LMS (Learning Management System) login credentials to access instructor ancillaries, eBooks, or complete platforms, such as McGraw-Hill *Connect*, McGraw-Hill Create, and McGraw-Hill Tegrity.



Tegrity, available within *Connect Accounting* at no additional cost, provides a service that makes class time available 24/7 by automatically capturing every lecture in a searchable

format for students to review when they study and complete assignments. With a simple one-click start-and-stop process, you capture all computer screens and corresponding audio. Students can replay any part of any class with easy-to-use browser-based viewing on a PC, Mac, iPod or iPad, or any other mobile device.

Educators know that the more students can see, hear, and experience class resources, the better they learn. In fact, studies prove it. With Tegrity Campus, students quickly recall key moments by using its unique search feature. This search helps students efficiently find what they need, when they need it, across an entire semester of class recordings. Help turn all your students' study time into learning moments immediately supported by your lecture. To learn more about Tegrity, watch a 2-minute Flash demo at <http://tegritycampus.mhhe.com>.

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Instructors will find a wealth of material that complements *Auditing & Assurance Services*, including the Solutions Manual, solutions to the Apollo Shoes Case, **monthly updates from the authors**, and sample syllabi. A monthly update service, **the Updated Auditor**, provides references and brief summaries of accounting and business articles appearing in popular and business media. Publications excerpted include *The Wall Street Journal*, *Forbes*, *Fortune*, *Bloomberg Businessweek*, *CFO.com*, and various academic journals. Students and instructors also can access the **Kaplan CPA Review simulations** from the Online Learning Center—all of which are fully integrated into the end-of-chapter material in the textbook.

Additional resources include Access to EZ Test Online (McGraw-Hill's flexible electronic testing program), ACL solutions, instructor PowerPoints, and sample syllabi.

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The OLC for *Auditing & Assurance Services* provides students with the full Apollo Shoes Case, Kaplan CPA Review simulations, text updates, multiple-choice quizzes, student PowerPoint presentations, electronic working papers, web resources, and chapter summaries.

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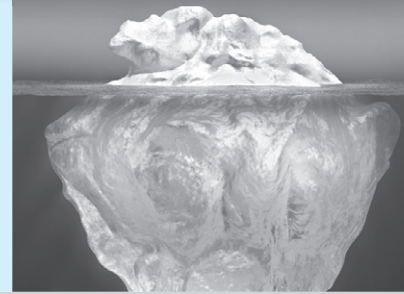
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*Jay Thibodeau*



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# Auditing and Assurance Services



*Our system of capital formation relies upon the confidence of millions of savers to invest in companies. The auditor's opinion is critical to that trust.*

*James R. Doty, Chairman, Public Company Accounting Oversight Board (PCAOB)*

## Professional Standards References

Topic	AU/ISA Section	PCAOB Reference*
Overall Objectives of the Independent Auditor and the Conduct of an Audit	200	AU 110, AU 150, AU 201, AU 220, AU 230
Consideration of Fraud in a Financial Statement Audit	240	AU 316
Audit Evidence	500	AS 15
Attestation Standards	AT 50	AT 50
Compliance Audits of Governmental Entities and Recipients of Governmental Assistance	935	AU 801

\*AU and AT references represent standards issued by the ASB prior to April 16, 2003, that have not been superseded or amended by the PCAOB.

## LEARNING OBJECTIVES

You are about to embark on a journey of understanding how auditors work to keep the capital markets safe and secure for the investing public. You should know that students demonstrate success in the auditing course quite differently than they do in other accounting courses. For example, when taking financial accounting, students typically demonstrate success by correctly identifying the proper journal entry for a given set of facts and circumstances. In auditing, success is typically demonstrated by completing multiple-choice and short-answer questions based on the professional standards that regulate the auditing

process. Overall, this book provides you with a comprehensive set of materials that will allow you to master these professional auditing standards. Chapter 1 provides an introduction to the auditing and assurance profession.

### Your objectives are to be able to:

- LO 1-1** Define *information risk* and explain how the financial statement auditing process helps to reduce this risk, thereby reducing the cost of capital for a company.
- LO 1-2** Define and contrast *financial statement auditing, attestation, and assurance services*.
- LO 1-3** Describe and define the assertions that management makes about the

- recognition, measurement, presentation, and disclosure of the financial statements and explain why auditors use them as the focal point of the audit.
- LO 1-4** Define professional skepticism and explain its key characteristics.
- LO 1-5** Describe the organization of public accounting firms and identify the various services that they offer.
- LO 1-6** Describe the audits and auditors in governmental, internal, and operational auditing.
- LO 1-7** List and explain the requirements for becoming a certified public accountant (CPA) and other certifications available to an accounting professional.

## USER DEMAND FOR RELIABLE INFORMATION

### LO 1-1

Define *information risk* and explain how the financial statement auditing process helps to reduce this risk, thereby reducing the cost of capital for a company.

**Enron, WorldCom, HealthSouth, Bernard Madoff Investments, Parmalat, Satyam, Tyco, Fannie Mae**—the list of financial accounting frauds that have been uncovered in recent years has been shocking to the business community. Investor confidence was understandably shaken because investors depend on reliable financial statement information to make their investment decisions about a company. So, where were the auditors? How could they have missed such high-profile frauds? These questions are not easy to answer. Before we attempt to address these, we must first explain the vital role that information assurance providers (such as financial statement auditors) play in supplying key decision makers (management, investors, and creditors) with useful, understandable, and timely information. When you have a better understanding of why auditing has been so critical in establishing America's capital markets as the strongest in the world, we will explore the issues surrounding the financial accounting frauds identified here. Because many of you are likely planning to enter the public accounting profession, we hope that you will equip yourself with this knowledge so that you may help avoid similar problems in the future and play a key role in maintaining public confidence in both the auditing profession and the capital markets.

### Information and Information Risk

All businesses make a countless number of decisions each and every day. Decisions to purchase or sell goods or services, lend money, enter into employment agreements, or buy or sell investments depend in large part on the quality of useful information. These decisions affect *business risk*, the chance a company takes that customers will buy from competitors, that product lines will become obsolete, that taxes will increase, that government contracts will be lost, or that employees will go on strike. In other words, **business risk** is *the risk that an entity will fail to meet its objectives*. If the company fails to meet its objectives enough times, the company may ultimately fail. To minimize these risks and take advantage of other opportunities presented in today's competitive business environment, decision makers such as chief executive officers (CEOs) demand *timely, relevant, and reliable* information. Similarly, investors and creditors demand high-quality information to make educated financial decisions. Information professionals (such as accountants, auditors, and other information assurance providers) help satisfy this demand.

Four environmental conditions increase user demand for relevant, reliable information:

1. **Complexity.** Events and transactions in today's global business environment are numerous and often very complicated. You may have studied derivative securities and hedging activities in other accounting courses, but investors and other decision makers may not have your level of expertise when dealing with these complex transactions. Furthermore, they are not trained to collect, compile, and summarize the key operating information themselves. They need the services provided by information professionals to help make the information more understandable for their decision processes.
2. **Remoteness.** Decision makers are usually separated from current and potential business partners not only by a lack of expertise but also by distance and time. Investors may not

be able to visit distant locations to check up on their investments. They need to employ full-time information professionals to do the work they cannot do for themselves.

3. *Time-sensitivity.* Today's economic environment requires businesses, investors, and other financial information users to make decisions more rapidly than ever before. The ability to promptly obtain high-quality information is essential to businesses that want to remain competitive in our global business environment.
4. *Consequences.* Decisions can involve significant investment of resources. The consequences are so important that reliable information, obtained and verified by information professionals, is an absolute necessity. Enron's aftermath provides a graphic example of how decisions affect individuals' (as well as companies') financial security and well-being. Enron's stock dropped from \$90 to \$0.90 in little more than a year, leaving employees who had invested their life savings in the company virtually penniless. To put this drop in perspective, an investor's \$5 million investment in Enron stock in 2000 (enough for an enjoyable retirement) was worth only \$50,000 a year later.



## AUDITING INSIGHT

### The Consequences of Fraudulent Financial Information

Bernard Madoff, a former chairman of the NASDAQ stock market and a respected Wall Street adviser and broker for 50 years, was arrested after his sons turned him in for running "a giant Ponzi scheme," bilking investors out of billions of dollars. Many investors, including actors, investment bankers, politicians, and sports personalities, lost their life savings. Some who had already retired, now in their 70s and 80s, were forced to go back to work. Others lost their retirement homes. Charities and pensions that had invested heavily were wiped out.

Although some of the world's most knowledgeable investors fell prey to the scam, numerous red flags were present for all who were wise enough to see them. First, Madoff's fund

returned 13–16% per year, every year, no matter how the markets performed. Second, his stated strategy of buying stocks and related options to hedge downside risk could not have occurred because the number of options necessary for such a strategy did not exist. Third, although his firm claimed to manage billions of dollars, its auditing firm had only three employees, including a secretary and a 78-year-old accountant who lived in Florida.

**Sources:** "Fund Fraud Hits Big Names," *The Wall Street Journal*, December 13, 2008, pp. A1, A7; "Fees, Even Returns and Auditor All Raised Flags," *The Wall Street Journal*, December 13, 2008, p. A7; "Top Broker Accused of \$50 Billion Fraud," *The Wall Street Journal*, December 12, 2008, pp. A1, A14; "Probe Eyes Audit Files, Role of Aide to Madoff," *The Wall Street Journal*, December 23, 2008, A1, A14.

A further complication in effective decision making is the presence of information risk. **Information risk** is the probability that the information circulated by a company will be false or misleading. Decision makers usually obtain their information from companies or organizations with which they want to conduct business, to provide loans, or to buy or sell stock. Because the primary source of information is the target company itself, an incentive exists for that company's management to make their business or service appear to be better than it actually is, to put their best foot forward. As a result, preparers and issuers of financial information (directors, managers, accountants, and other people employed in a business) might benefit by giving false, misleading, or overly optimistic information. This potential *conflict of interest* between information providers and users, along with financial statement frauds such as those of Enron and WorldCom, leads to a natural skepticism on the part of users. Thus, they depend on information professionals to serve as independent and objective intermediaries who will lend credibility to the information. This *lending of credibility* to information is known as providing **assurance**. When the assurance is provided for specific assertions made by management, we refer to the assurance provided as **attestation**. When the assertions are embodied in a company's financial statements, we refer to the attestation as **auditing**. More specifically, when their work is completed, the auditors supply an opinion as to whether the financial statements and related footnotes are presented fairly in all material respects. The actual compilation and creation of the financial statements is completed by the company's accountants.

## ✓ REVIEW CHECKPOINTS

- 1.1 What is a business risk?
- 1.2 What conditions increase the demand for reliable information?
- 1.3 What risk creates a demand for independent and objective outsiders to provide assurance to decision makers?

## AUDITING, ATTESTATION, AND ASSURANCE SERVICES

### LO 1-2

Define and contrast *financial statement auditing, attestation, and assurance services*.

Now that you understand why decision makers need independent information professionals to provide assurance on key information, we further define auditing and expand the discussion of attestation and assurance services in this section and explain their roles in today's information economy.

### Definition of Financial Statement Auditing

The focus of this book is on the financial statement auditing process, by far and away the most common type of auditing and assurance service provided in today's market. Many years ago, the American Accounting Association (AAA) Committee on Basic Auditing Concepts provided a very useful general definition of *auditing* as follows:

*Auditing* is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established criteria and communicating the results to interested users.<sup>1</sup>

A closer look at the definition reveals several ideas that are important to any type of auditing engagement. Auditing is a *systematic process*. It is a purposeful and logical process and is based on the discipline of a structured approach to reaching final decisions. It has a logical starting point, proceeds along established guidelines, and has a logical conclusion. It is not haphazard, unplanned, or unstructured.

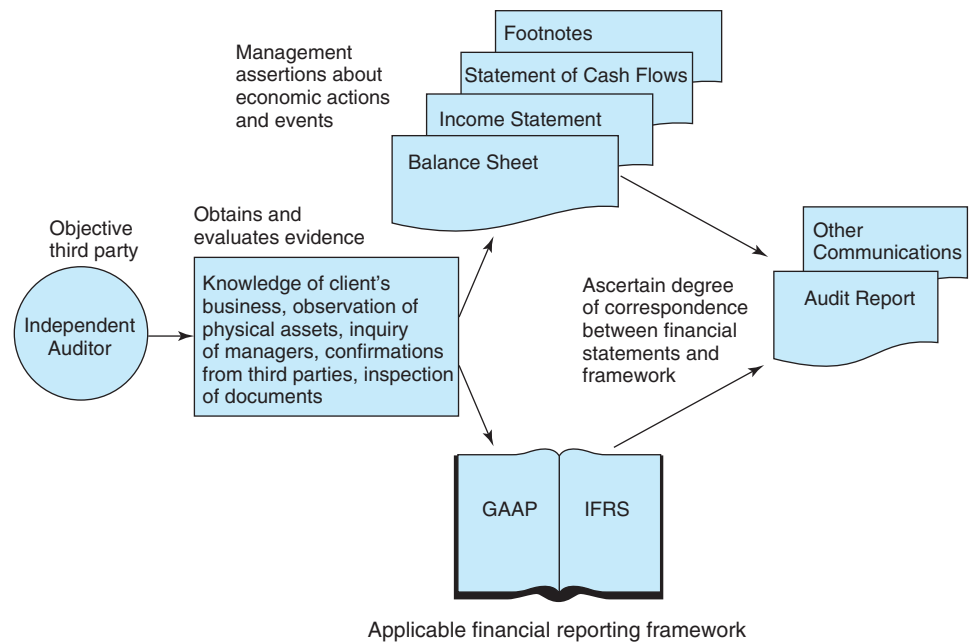
The process involves obtaining and evaluating *evidence*. Evidence consists of all types of influences that ultimately guide auditors' decisions and relates to *assertions made by management about economic actions and events*. When beginning a financial statement audit engagement, an independent auditor is provided with financial statements and other disclosures by management. In doing so, management essentially makes assertions about the financial statement balances (that the inventory on the balance sheet really does exist, that revenue recorded on the income statement really did occur, that the list of liabilities on the balance sheet is complete, etc.) as well as assertions that the financial statement disclosures are fairly presented.

External auditors generally begin their work with a focus on these assertions (explicit representations) made by management about the financial statement amounts and information disclosed in footnotes, and then set out to obtain and evaluate evidence to prove or disprove these assertions or representations. Other auditors, however, often are not provided with explicit representations. An internal auditor may be assigned to evaluate the cost effectiveness of the company's policy to lease, rather than to purchase, heavy equipment. A governmental auditor may be assigned to determine whether goals of providing equal educational opportunities have been achieved with federal grant funds. Oftentimes, these latter two types of auditors must develop the explicit performance criteria or benchmarks for themselves.

The purpose of obtaining and evaluating evidence is to ascertain the degree of correspondence between the assertions made by the information provider and established

<sup>1</sup>American Accounting Association Committee on Basic Auditing Concepts, *A Statement of Basic Auditing Concepts* (Sarasota, FL: American Accounting Association, 1973).

### EXHIBIT 1.1 Overview of Financial Statement Auditing



criteria. Auditors will ultimately communicate their findings to interested users. To communicate in an efficient and understandable manner, auditors and users must have a common basis for measuring and describing financial information. This basis is the established criteria essential for effective communication.

Established criteria may be found in a variety of sources. For independent auditors, the criterion is whatever the applicable financial reporting framework is, whether it is generally accepted accounting principles (GAAP) in the United States or international financial reporting standards (IFRS). Internal Revenue Service (IRS) auditors rely heavily on criteria specified in the Internal Revenue Code. Governmental auditors may rely on criteria established in legislation or regulatory agency rules. Bank examiners and state insurance board auditors look to definitions, regulations, and rules of law. Internal and governmental auditors rely a great deal on financial and managerial models of efficiency and effectiveness. All auditors rely to some extent on the sometimes elusive criteria of general truth and fairness. Exhibit 1.1 depicts an overview of financial statement auditing.

The AAA definition already presented is broad and general enough to encompass external, internal, and governmental auditing. The more specific viewpoint of external auditors in public accounting practice is reflected in the following statement about the financial statement audit made by the American Institute of Certified Public Accountants (AICPA), the public accounting community's professional association:

The purpose of an audit is to enhance the degree of confidence that intended users can place in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, in accordance with the framework. An audit conducted in accordance with generally accepted auditing standards and relevant ethical requirements enables the auditor to form that opinion. (AU 200.11).<sup>2</sup>

<sup>2</sup>The *Statements on Auditing Standards (SASs)* and *Statements on Standards for Attestation Engagements (SSAEs)* are authoritative AICPA pronouncements on auditing and attestation theory and practice. *Statements on Auditing Procedure (SAPs)* numbers 1–54 were codified into *SAS 1* in 1972. Statements on Auditing Standards are issued periodically by the Auditing Standards Board (ASB). Taken together, the SASs form the basis for U.S. generally accepted auditing standards (GAAS). You can find the number of the most recent SAS or SSAE by referring to the AICPA website ([www.aicpa.org](http://www.aicpa.org)). Throughout this text, SAS references are followed by parenthetical section numbers (e.g., AU 200), which refer to the Codification of Statements on Auditing Standards published by the AICPA. SSAE references are followed by parenthetical section numbers (e.g., AT 101), which refer to the Attestation Standards published by the AICPA.

As your study of external auditing continues, you will find that auditors perform many tasks designed to reduce the risk of giving an inappropriate opinion on financial statements. Auditors are careful to work for trustworthy clients, to gather and analyze evidence about the assertions in financial statements, and to take steps to ensure that audit personnel report properly on the financial statements when adverse information is known.



## AUDITING INSIGHT

Although most of the largest public accounting firms (collectively referred to as the “Big Four”) trace their roots to the turn of the 19th century, auditing in the United States has a rich history. When the Pilgrims had a financial dispute with the English investors who financed their trip, an “auditor” was sent to resolve the difference. George Washington sent his financial records to the Comptroller of the Treasury to be audited before he could be reimbursed for expenditures he made during the Revolutionary

War. One of the first Congress’s actions in 1789 was to set up an auditor to review and certify public accounts. Even the “modern” concept of an audit committee is not so modern; the bylaws of the Potomac Company, formed in 1784 to construct locks on the Potomac River to increase commerce, required that three shareholders annually examine the company’s records.

**Source:** D. Flesher, G. Previts, and W. Samson, “Auditing in the United States: A Historical Perspective,” *Abacus* 41 (2005), pp. 21–39.

## Attestation Engagements

Many people appreciate the value of auditors’ attestations on historical financial statements, and, as a result, they have found other types of information to which certified public accountants (CPAs) can *attest*. The all-inclusive definition of an **attestation engagement** is

An engagement in which a practitioner is engaged to issue a report on subject matter, or an assertion about subject matter that is the responsibility of another party. (AT 101.01)

By comparing the AAA’s earlier definition of auditing with the definition of attestation, you can see that the auditing definition is a specific type of attestation engagement. According to the earlier definition, in an audit engagement, an auditor (more specific than a *practitioner*) issues a report on assertions (financial statements) that are the responsibility of management. For example, as more and more companies and organizations seek to demonstrate their efforts related to corporate social responsibility, demand is growing for attestation services related to sustainability reporting. The following Auditing Insight indicates the significance of this emerging market for public accounting firms.

In today’s global business environment, activist shareholders are increasingly pressuring board of director members and upper management teams regarding issues of social responsibility, the environment, and other matters related to sustainability. As a direct



## AUDITING INSIGHT

### Sustainability Reporting—An Emerging Market for CPAs

The Global Reporting Initiative (GRI) is a nonprofit organization that was established to promote environmental sustainability to organizations throughout the world. Perhaps most importantly, the GRI has established a reporting framework that leading companies use to report key information about their efforts to promote sustainability in their business practices. The GRI last issued its Sustainability Reporting Guidelines in March 2011 (G3.1) and the next generation

of Guidelines (G4) are currently in process. KPMG LLP reported that as of the end of 2011, 95 percent of the 250 largest global companies issue some type of corporate responsibility report.

**Sources:** <https://www.globalreporting.org/resource/library/GRI-Annual-Report-2011-2012.pdf>; [www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/corporate-responsibility/Documents/2011-survey.pdf](http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/corporate-responsibility/Documents/2011-survey.pdf)

## EXHIBIT 1.2

Corporate Sustainability Report 2011 Logistics at the Core : Profile

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## Independent Accountants' Report

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Profile | Page 19

**Deloitte & Touche LLP**

Board of Directors, Shareowners, and Stakeholders  
United Parcel Service, Inc.  
Atlanta, Georgia

We have reviewed the accompanying Corporate Sustainability Report of United Parcel Service, Inc. (the "Company") for the year ended December 31, 2011. The Company's management is responsible for the Corporate Sustainability Report.

We conducted our review in accordance with attestation standards established by the American Institute of Certified Public Accountants, which includes AT Section 101, Attest Engagements. A review consists principally of applying analytical procedures, considering management assumptions, methods, and findings, and making inquiries of and evaluating responses from persons responsible for corporate social and operational matters. It is substantially less in scope than an examination, the objective of which is the expression of an opinion on the Corporate Sustainability Report. Accordingly, we do not express such an opinion. A review of the Corporate Sustainability Report is not intended to provide assurance on the entity's compliance with laws or regulations.

The preparation of the Corporate Sustainability Report requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Different entities may make different but acceptable interpretations and determinations. The Corporate Sustainability Report includes information regarding the Company's corporate social responsibility initiatives and targets, the estimated future impact of events that have occurred or are expected to occur, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

Based on our review, nothing came to our attention that caused us to believe that the Corporate Sustainability Report does not include, in all material respects, the required elements of the Global Reporting Initiative G3.1 Sustainability Reporting Framework for Application Level A; that the 2011, 2010, and 2009 data, and the 2007 Transportation Index baseline included therein have not been accurately derived, in all material respects, from the Company's records, or that the underlying information, determinations, estimates, and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

The comparative disclosures for periods prior to 2009, other than the 2007 Transportation Index baseline information, were not reviewed by us and, accordingly, we do not express any form of assurance on them.

June 26, 2012

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*Deloitte & Touche LLP*

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result, more companies than ever are directly integrating their sustainability initiatives into their overall business strategy and then seeking to quantify their sustainability and social responsibility efforts with measurable outputs. These measurements might help to quantify the company's performance in areas such as the environment, labor, and human rights. Exhibit 1.2 provides an example of the 2011 Sustainability Report for UPS. Although sustainability is a prominent example of an attestation engagement, other examples of attestation engagements completed by CPAs (discussed more in Module A) appear in the following box.

## Examples of Attestation Engagements

- **Agreed Upon Procedures Engagements** (AT 201), such as verifying inventory quantities and locations.
- **Financial Forecasts and Projections** (AT 301), such as analysis of prospective or hypothetical "what-if" financial statements for some time period *in the future*.
- **Reporting on Pro Forma Financial Information** (AT 401), such as retroactively analyzing the effect of a proposed or consummated transaction on the *historical* financial statements "as if" that transaction had already occurred.
- **An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated with an Audit of Its Financial Statements** (AT 501), focused on the design and operating effectiveness of an entity's internal control over financial reporting.
- **Compliance Attestation** (AT 601), such as ascertaining a client's compliance with debt covenants.
- **Examination of Management's Discussion and Analysis** (AT 701), prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).
- **Reporting on Controls at a Service Organization** (AT 801), such as organizations that provide outsourced processes that are likely to be relevant to the user entities' internal control over financial reporting.



## Assurance Services

Although *auditing* refers specifically to expressing an opinion on financial statements and *attestation* refers more generally to expressing an opinion on any type of information or subject matter that is the responsibility of another party (such as sustainability measures), *assurance services* includes an even broader set of information, including nonfinancial information. The following Auditing Insight indicates how the quality of information can assist both buyers and sellers in today's market.



### AUDITING INSIGHT

Exhibit 1.3 shows two 1976 **Topps** Mike Schmidt baseball cards. The card on the right was offered on eBay with the seller's representation that the card was in Near Mint/Mint condition. This representation is a standard description and is the equivalent of a grade 8 on a standard 10-point scale used in grading the quality of a trading card. The card was purchased on **eBay** for \$11.55.

Within a week, a second 1976 Topps Mike Schmidt baseball card was sold on eBay. Again, this card was offered with the seller's representation that the card was in Near Mint/Mint condition (card on the left). The only difference was that this card had been sent to **Professional Sports Authenticator** (PSA), a company that verifies the authenticity and quality of sports

items. Note that PSA does not buy or sell sports merchandise; it acts only as an independent third party expressing a professional opinion regarding the merchandise in question. This card sold for \$22.53.

The only difference between the two transactions was that the buyers of the card on the right had more information concerning the risk inherent in the transaction. Why was the first transaction riskier? What were the buyers' concerns? Were the concerns only from intentional misstatements? How did the grading of the card by PSA reduce these concerns? What are the incentives for PSA to grade the card accurately? How does the business of PSA relate to the profession of auditing?

### EXHIBIT 1.3

#### Professional Sports Authenticator as Third-Party Assuror



Although the primary focus of our earlier discussion of information risk was in the context of economic decisions, information risk is present whenever someone must make a decision without having complete knowledge. The AICPA expanded the profession's traditional focus on accounting information to include all types of information, both financial and nonfinancial. The expanded services are collectively referred to as **assurance services**, which the AICPA defines as independent professional services that

improve the quality of information, or its context, for decision makers. The major elements, and boundaries, of the definition are

- *Independence.* CPAs want to preserve their attestation and audit reputations and competitive advantages by preserving integrity and objectivity when performing assurance services.<sup>3</sup>
- *Professional services.* Virtually all work performed by CPAs (accounting, auditing, data management, taxation, management, marketing, finance) is defined as a professional service as long as it involves some element of judgment based on education and experience.
- *Improving the quality of information, or its context.* The emphasis is on information, CPAs' traditional stock in trade. CPAs can enhance quality by assuring users about the reliability and relevance of information, and these two features are closely related to the familiar credibility-lending products of attestation and auditing services. *Context* is relevance in a different light. For assurance services, improving the context of information refers not to the information itself but to how the information is used in a decision-making context. An example would be providing key information in a database that management could use to make important decisions.
- *For decision makers.* They are the consumers of assurance services, and they personify the consumer focus of different types of professional work. The decision makers are the beneficiaries of the assurance services. Depending upon the assignment, decision makers may be a very small, targeted group (e.g., managers of a database) or a large targeted group (e.g., potential investors interested in a mutual fund manager's performance).

### Examples of Assurance Services

Although they are subsets of assurance services, attestation and auditing services are highly structured and intended to be useful for large groups of decision makers (e.g., investors, lenders). On the other hand, assurance services other than audit and attestation services tend to be more customized for use by smaller, targeted groups of decision makers. For example, many companies and organizations have used public accounting firms to conduct a comprehensive assessment of the risks the enterprise faces. This type of enterprise risk assessment can then be used to show stakeholders that the management team understands and is properly managing the risks the enterprise faces. We also present a few more examples of assurance services to illustrate the variety of services that fall under the assurance service umbrella. Some will look familiar and others may defy imagination. Be aware, however, that public accounting firms must pick and choose the services that they wish to provide to the market based on the expertise that lies within the firm. Nobody maintains that all public accounting firms will want or be able to provide all types of assurance services.

- XBRL (eXtensible Business Reporting Language) reporting.
- Information risk assessment and assurance.
- Third-party reimbursement maximization.
- Rental property operations review.
- Customer satisfaction surveys.
- Evaluation of investment management policies.

<sup>3</sup>A survey commissioned by the AICPA found that CPAs are viewed more positively than any other business professional by both business decision makers and investors. Sixty-nine percent of investors and 74 percent of business decision makers feel that "CPAs have a unique perspective that is valuable when making business and financial decisions, even when those decisions are not directly related to accounting." In terms of attributes ascribed to CPAs, they are most associated with integrity, competence, and objectivity ("Brand Research Shows CPAs Viewed Positively in Marketplace," *AICPA News Update*, October 20, 2008).