NINTH EDITION

AUDITING

A RISK-BASED APPROACH TO CONDUCTING A QUALITY AUDIT

JOHNSTONE / GRAMLING / RITTENBERG

This is an electronic version of the print textbook. Due to electronic rights restrictions, some third party content may be suppressed. Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. The publisher reserves the right to remove content from this title at any time if subsequent rights restrictions require it. For valuable information on pricing, previous editions, changes to current editions, and alternate formats, please visit www.cengage.com/highered to search by ISBN#, author, title, or keyword for materials in your areas of interest.

NINTH EDITION

AUDITING

A RISK-BASED APPROACH TO CONDUCTING A QUALITY AUDIT

Karla M. Johnstone
University of Wisconsin—Madison

Audrey A. Gramling
Bellarmine University

Larry E. Rittenberg
University of Wisconsin—Madison

SOUTH-WESTERN
CENGAGE Learning

Australia • Brazil • Japan • Korea • Mexico • Singapore • Spain • United Kingdom • United States

SOUTH-WESTERN
CENGAGE Learning

Auditing: A Risk-Based Approach to Conducting a Quality Audit, Ninth Edition
Karla M. Johnstone, Audrey A. Gramling, and Larry E. Rittenberg

Senior Vice President, LRS/Acquisitions & Solutions Planning: Jack W. Calhoun

Editorial Director, Business & Economics: Erin Joyner

Editor-in-Chief: Rob Dewey

Executive Editor: Sharon Oblinger

Senior Developmental Editor: Craig Avery

Editorial Assistant: Ann Loch

Market Development Manager: Natalie Livingston

Brand Manager: Kristen Hurd

Marketing Communications Manager: Jason LaChapelle

Marketing Coordinator: Eileen Corcoran

Art and Cover Direction, Production Management, and Composition: PreMediaGlobal

Media Editor: Bryan England

Rights Acquisition Director: Audrey Pettengill

Rights Acquisition Specialist, Text and Image: Anne Sheroff

Manufacturing Planner: Doug Wilke

Cover Images:
© Tim Mainiero/Shutterstock/
© Samot/Shutterstock/
© upthebanner/Shutterstock/
© Ian D Walker/Shutterstock

© 2014, 2012 South-Western, Cengage Learning

ALL RIGHTS RESERVED. No part of this work covered by the copyright herein may be reproduced, transmitted, stored, or used in any form or by any means graphic, electronic, or mechanical, including but not limited to photocopying, recording, scanning, digitizing, taping, web distribution, information networks, or information storage and retrieval systems, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without the prior written permission of the publisher.

For product information and technology assistance, contact us at
Cengage Learning Customer & Sales Support, 1-800-354-9706
For permission to use material from this text or product,
submit all requests online at **www.cengage.com/permissions**
Further permissions questions can be emailed to
permissionrequest@cengage.com

Library of Congress Control Number: 2013931325

Package Edition ISBN-13: 978-1-133-93915-3

Package Edition ISBN-10: 1-133-93915-5

Student Edition ISBN-13: 978-1-133-93916-0

Student Edition ISBN-10: 1-133-93916-3

South-Western
5191 Natorp Boulevard
Mason, OH 45040
USA

Cengage Learning is a leading provider of customized learning solutions with office locations around the globe, including Singapore, the United Kingdom, Australia, Mexico, Brazil, and Japan. Locate your local office at: **www.cengage.com/global**

Cengage Learning products are represented in Canada by Nelson Education, Ltd.

For your course and learning solutions, visit **www.cengage.com**

Purchase any of our products at your local college store or at our preferred online store **www.cengagebrain.com**

Printed in the United States of America
1 2 3 4 5 6 7 17 16 15 14 13

Dedication

We dedicate this book to our families who encourage and support us through many hours of development, to our students who inspire us to always improve, to our mentors who guide us, to our professional friends who continue to educate us, and to our colleagues who challenge us.

Karla M. Johnstone
Audrey A. Gramling
Larry E. Rittenberg

BRIEF CONTENTS

CONTENTS

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

PREFACE

The auditing environment continues to change in dramatic ways, and university graduates entering the profession must be prepared for a high standard of responsibility. Here are only three examples of these changes:

- The American Institute of Certified Public Accountants (AICPA) and the International Auditing and Assurance Standards Board (IAASB) have issued clarifications that harmonize auditing standards in the United States (for nonpublic entities) and internationally.
- The Committee of Sponsoring Organizations (COSO) of the Treadway Commission has issued an updated ***Internal Control–Integrated Framework***.
- The AICPA recently issued new audit sampling guidance.

The ninth edition of ***Auditing: A Risk-Based Approach to Conducting a Quality Audit*** represents the most up-to-date professional guidance available, and reflects the clarified auditing standards and the newest PCAOB standards. It discusses COSO's updated *Internal Control–Integrated Framework* and integrates discussions of fraud risk throughout the textbook. In short, the ninth edition helps students understand the full range of auditing issues in the evolving global environment.

Just as significantly, the ninth edition features entirely new and significantly revised end-of-chapter materials that have been developed to help students prepare for exams and understand real-life auditing scenarios. This material is updated, streamlined, and user friendly, with each problem linked to a specific learning objective. In addition, students will gain valuable experience by using the professional ACL auditing software that is packaged with each new textbook.

Revision Themes of the Ninth Edition

1. **Enhance and integrate discussion of audit quality and the importance of fraud detection throughout all chapters.** Many instructors indicate that they support an increased focus of the ninth edition on audit quality. And fraud detection is a recurring theme of importance among auditing instructors. Accordingly, the authors **thoroughly revised Chapter 2** to focus on audit quality and the importance of fraud detection. Significant fraud-related

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

material from the eighth edition's Chapter 9 was moved to Chapter 2, which enables the early introduction of this topic and allows for integration of the topic of fraud throughout the chapters dealing with audit risk, audit evidence, and auditing specific cycles. Moreover, the authors introduced the Financial Reporting Council's ***Audit Quality Framework*** in Chapter 1. Elements of this framework are applied throughout subsequent chapters of the textbook, with particular focus continuing in the chapter on completing the audit (Chapter 14). Finally, a section of each relevant chapter includes a new fraud-related discussion with both U.S. and international examples and applications.

2. **Implement a unifying framework for the chapters containing transaction cycles to provide users with a big picture perspective (Chapters 9–13).** Each chapter covering one of the primary transaction cycles has been restructured and contains a unifying framework to address key audit activities. This unifying framework is initially introduced in Chapter 5. The activities comprising the framework include identifying significant accounts, disclosures, and relevant assertions; identifying and assessing inherent risks, fraud risks, and control risks; using preliminary analytical procedures to identify possible material misstatement; determining appropriate responses to identified risks of material misstatement; determining appropriate tests of controls and considering results of tests of controls; and determining and applying sufficient appropriate substantive audit procedures.
3. **Restructure and streamline end-of-chapter materials.** The end-of-chapter materials have been thoroughly updated and streamlined to be much more user friendly. They are organized into the following categories: True-False Questions, Multiple-Choice Questions, Review and Short Case Questions, Contemporary and Historical Cases, Application Activities, Academic Research Cases, Ford and Toyota Case, and ACL Cases. Further, each end-of-chapter item is linked to a specific learning objective identified at the beginning of the chapter.
4. **Develop an entirely *new* chapter on non-external audit services.** The first 16 chapters of the textbook include the discussion of the audit opinion formulation process and cover topics relevant to a financial statement audit. The ***new*** Chapter 17 covers other services, including nonaudit attestation services, review engagements, compilation engagements, assurance on interim financial information, special considerations for reporting, agreed-upon procedures, financial forecasts and projections, pro forma financial information, forensic accounting, and sustainability reporting.
5. **Appropriately balance increased international focus.** A significant number of auditing instructors plan to increase coverage of international auditing standards and practices as U.S. and international standards converge. However, an equally large number of instructors counsel caution, saying that until the standards converge they will continue to moderate their international coverage. In response to these diverse opinions, the authors include more cases, examples, and descriptions of frauds containing international coverage, and they have updated coverage of international auditing standards. All the while, the revised textbook continues with extensive coverage of U.S. trends in standards and practices.

New, Revised, and Enhanced Ninth Edition

The ninth edition reflects the evolving nature of the auditing profession and the environment in which it operates.

***New*: Incorporates all AICPA and IAASB clarified auditing standards.** Users of the ninth edition can be sure that they will be fully up-to-date in all

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

auditing rules and practices. The textbook has been significantly revised to reflect the clarified standards. A ***new*** feature (found in the Appendix to Chapter 5) articulates the relationship between AICPA, IAASB, and PCAOB standards. Where relevant, the textbook compares and contrasts key differences between standards. Selected end-of-chapter materials require students to review the Appendix to Chapter 5, obtain relevant standards, and answer related questions.

New: **Audit sampling guidance.** The AICPA issued ***new*** audit sampling guidance in 2012. A newly revised Chapter 8 incorporates all relevant changes in terminology and sampling procedures.

Revised: **Advanced topics in Chapter 16 concerning complex audit judgments.** This revised Chapter 16 covers a variety of important, complex audit judgments, including determining materiality; resolving detected financial statement misstatements; distinguishing between material weaknesses and significant deficiencies in internal control; assessing the quality of a client's internal audit function; identifying and describing concepts of fair value and impairment, including goodwill impairment; and considering approaches to auditing significant management estimates.

Revised: **Emphasis on internal control.** A newly revised Chapter 3 discusses the importance of internal control to quality reporting and auditing and provides complete coverage of the *Committee of Sponsoring Organizations* of the *Treadway Commission's* updated *Internal Control–Integrated Framework* issued in 2013.

Enhanced: **Emphasis on fraud.** A newly revised Chapter 2 introduces the topic of fraud very early in the textbook, and this important topic is emphasized in relevant chapters and their end-of-chapter materials throughout the textbook. Chapter 2 covers the risk of fraud and mechanisms to address fraud, including regulation, corporate governance, and audit quality.

Enhanced: **Emphasis on audit quality**. As reflected in the new subtitle, the ninth edition focuses on ***audit quality***, including the determinants of audit quality that are introduced through the Financial Reporting Council's ***Audit Quality Framework*** in Chapter 1. This edition applies elements of this framework throughout selected chapters, with a particular focus in Chapter 14 on completing the audit.

Enhanced: **Research analysis problems.** Because academic research yields insights on auditor decisions, the end-of-chapter materials in the ninth edition provide at least one problem related to an academic research paper addressing a relevant topic. Each research analysis problem requires the student to obtain an identified research paper, read it, and answer a set of uniform questions tied to the chapter's topics. These activities help students link the topical theory of the chapter with relevant contemporary academic research. The new research analysis problems are ideal for instructors who wish to extend students' theoretical understanding of the chapter concepts, particularly for graduate-level classes. Academic research articles have been selected that are approachable to students and yet highlight the complexities in the real practice of auditing. These research analysis problems address the recommendation of the recent report from the Pathways Commission to embed academic research into learning experiences for all accounting students.

Hallmark Pedagogical Features

Continued emphasis on professional skepticism. This emphasis provides students with the tools to learn how to apply the concept of professional skepticism. This textbook contains an introduction to this topic in Chapter 1 as well as in end-of-chapter materials throughout the textbook. This emphasis helps students see the practical application of this concept.

Continued emphasis on professional judgment. In addition to the focus on professional judgment in this textbook, numerous exercises emphasize this key

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

auditing skill, including analyses of Ford and Toyota's SEC filings and proxy statements. Further, this textbook contains end-of-chapter materials to help ensure that students understand the link between mandatory financial reporting and auditing, risk assessment, transaction cycles, and analytical procedures.

Professional Judgment in Context feature. Each chapter opens with a real-life example from practice that illustrates the judgments involved in auditing. The examples tie to the learning objectives in the chapter and address important topics such as fraud, regulation, audit quality, and internal control. The following provides an example from Chapter 1.

PROFESSIONAL JUDGMENT IN CONTEXT

The Importance of Conducting a Quality Audit and Complying with Professional Standards

On December 20, 2011, the Public Company Accounting Oversight Board (PCAOB) revoked the ability of Bentleys Brisbane Partnership (an external audit firm) to audit public company audits, and the Board imposed a monetary penalty of $10,000 on Robert Forbes, the audit partner in charge of the audit of Alloy Steel International. These penalties were imposed because the PCAOB concluded that Bentleys and Forbes failed to exercise **due professional care** (a standard of care expected to be demonstrated by a competent auditing professional), failed to exercise **professional skepticism** (an attitude that includes a questioning mind and critical assessment of audit evidence), and failed to obtain sufficient evidence necessary to issue an audit opinion on the financial statements of Alloy Steel's 2006 fiscal year end financial statements. The PCAOB also concluded that Bentleys violated PCAOB quality control standards because the firm did not develop policies to ensure that the work performed by its personnel met PCAOB auditing standards and the Board said that the firm did not undertake audits that the firm could reasonably expect to be completed with professional competence.

Alloy Steel International is an American company headquartered in Malaga, Australia. Alloy's stock was traded on the Over the Counter (OTC) Bulletin Board and as such was subject to Securities and Exchange Commission (SEC) rules and requirements. Its auditors were subject to PCAOB rules and requirements. On the audit of Alloy, Bentleys and Forbes made a number of critical quality control mistakes. Bentleys and Forbes used an unregistered audit firm in Australia to actually perform the audit work, rather than performing the audit work themselves. Bentleys' and Forbes' involvement on the engagement was limited to reviewing the unregistered audit firm's workpapers. The unregistered audit firm's personnel had no training or experience in conducting audits that complied with PCAOB standards. Despite these factors, Bentleys and Forbes issued and signed an unqualified audit report on Alloy's 2006 financial statements. For further information about this scenario, see PCAOB disciplinary proceedings in Release No. 105-2011-007.

As you read through this chapter, consider the following questions:

- What is the objective of auditing, and what process should auditors follow to accomplish this objective? (LO 1)
- Why do companies obtain audited financial statements? (LO 1)
- Who are the users of audited financial statements? (LO 1)
- What skills and knowledge are needed to be a competent audit professional? (LO 3)
- Why is it vital to perform an audit in a quality manner? (LO 5)
- Why are low quality audits, like those performed in this case, harmful? (LO 5)

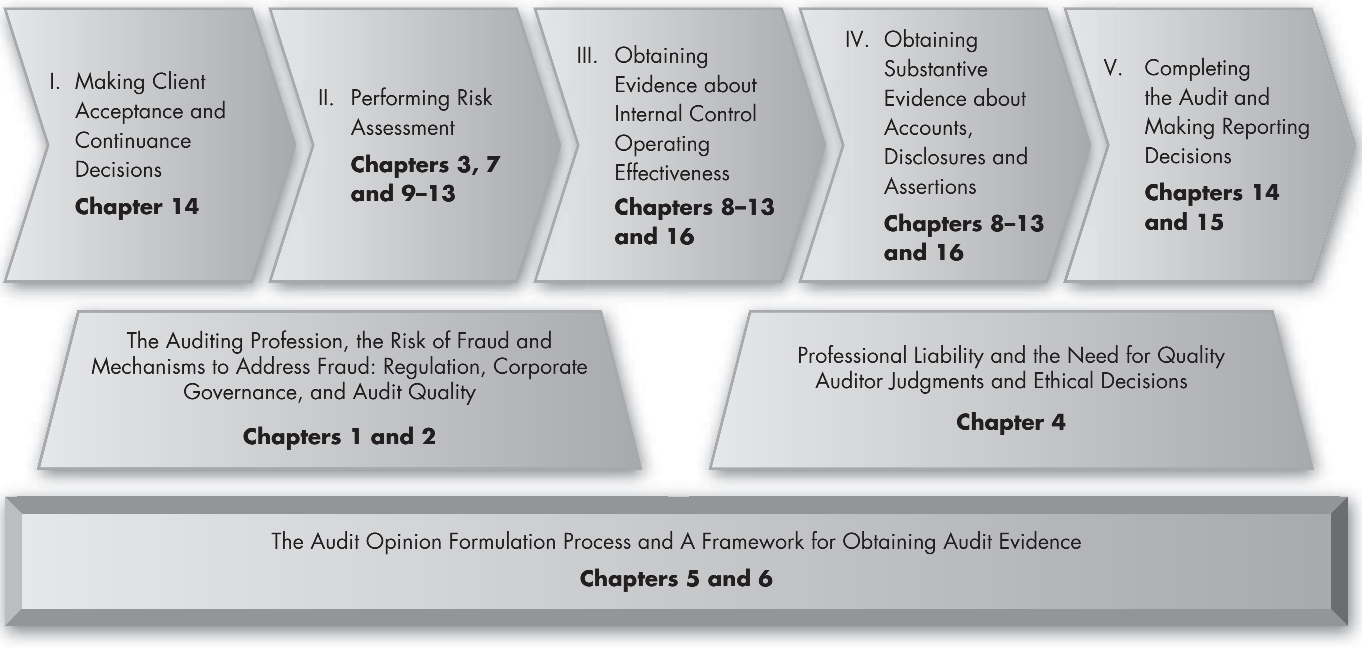
Professional decision-making and ethical decision-making frameworks. Decision-making frameworks, complete with a chapter-opening Professional Judgment in Context feature, require students to think about real-life professional and ethical decisions associated with that chapter. End-of-chapter materials continue the use of these professional and ethical decision-making frameworks to help students address contemporary issues.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Continued emphasis on the audit opinion formulation process to help organize study. A chapter-opening ***Audit Opinion Formulation Process*** figure helps students identify the major phases in the audit process and see how those steps within that process relate to specific chapters.

This textbook describes how auditors go through a structured judgment process to issue an audit opinion. This process is referred to as the ***Audit Opinion Formulation Process***, and it serves as the foundation for this textbook. The process consists of five phases. **Phase I** concerns client acceptance and continuance. Once a client is accepted (or the audit firm decides to continue to provide services to a client), the auditor needs to perform risk assessment procedures to thoroughly understand the client's business (or update prior knowledge in the case of a continuing client), its industry, its competition, and its management and governance processes (including internal controls) to determine the likelihood that financial accounts might be materially misstated (**Phase II**). In some audits, the auditor also obtains evidence about internal control operating effectiveness through testing those controls (**Phase III**). Much of what most people think of as auditing, the obtaining of substantive evidence about accounts, disclosures, and assertions occurs in **Phase IV**. The information gathered in Phases I through III greatly influences the amount of testing to be performed in Phase IV. Finally, in **Phase V**, the auditor completes the audit and makes a decision about what type of audit report to issue.

Also fundamental to students' understanding is the framework's inclusion of the auditing profession, fraud, regulation, corporate governance, and audit quality. Further fundamentals highlighted in the ***Audit Opinion Formulation Process*** include discussion of professional liability and the need for quality audit judgments and ethical decisions, as depicted below.



Auditing in Practice **features and chapter exhibits.** Each chapter contains multiple ***Auditing in Practice*** features and exhibits that highlight important, relevant, and practical examples and information related to chapter topics. Selected end-of-chapter materials require students to review these features and exhibits to

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

answer related questions. Below is an example of an *Auditing in Practice* feature from Chapter 1.

AUDITING IN PRACTICE

Why Is Owning Stock in an Audit Client Unacceptable?

In 2005, Susan Birkert was an audit senior working for KPMG on the audit engagement of Comtech Corporation. One of Susan's friends asked her whether she thought that Comtech stock was a good investment. She responded that, indeed, it was a good investment. At that point, her friend asked if she would like him to purchase Comtech stock on her behalf. She agreed, and gave her friend $5,000 to make the purchase under his name rather than hers. She did so because she was aware that owning stock in one's audit client is not allowed because of independence concerns. If auditors own stock in their audit clients, they are not independent of their clients because they are part owners. Therefore, rather than acting in an unbiased manner during the conduct of the audit, they might make judgments that favor the client company rather than external users of the financial statements. Even if the auditor does not actually behave in a biased manner and is independent in fact, external users may *perceive* an independence conflict—the auditor would not be independent in appearance.

Susan continued working on the Comtech engagement well into 2006, and she lied when she responded to KPMG's yearly written requirements to comply with the firm's independence policies. Prompted by an anonymous tip later in 2006, KPMG launched an internal investigation into the matter and terminated her employment. The PCAOB barred her from serving as an external auditor for a period of at least one year. For further details on this case, see PCAOB Release No. 105-2007-003.

Real-life corporate disclosures to provide practical applications. The Ford and Toyota end-of-chapter case uses the actual SEC filings and proxy materials from Ford Motor Company and Toyota Motor Corporation. These exercises use real-life corporate disclosures to help students extract the practical applications from the chapter concepts. Starting in Chapter 2, the authors introduce the case, and discuss how they have conducted this case in their own classes. Using this case enables students to see the practical application of theoretical concepts using companies that are familiar, are high profile (in the news), and vary in terms of their financial condition and U.S. versus international domicile.

ACL generalized audit software with updated cases. Version 9 of the ACL Desktop Education Edition, the most popular generalized audit software, comes with each new copy of this textbook. The ninth edition integrates ACL software into end-of-chapter materials. A revised ACL Appendix and tutorial is located at the end of the textbook. The ACL Appendix contains an overview of the basic functions of ACL followed by a brief, illustrated tutorial to help students learn how to use the basic features of Version 9 of the ACL Desktop Education Edition.

ACL cases include the following:

1. *Pell Grants*, a fraud investigation case related to this student grant program. (Chapter 6)
2. *Husky Accounts Receivable*, which includes exercises in which students identify unpaid invoices and sales made over credit limits, perform cutoff analyses, conduct aging analyses, and identify procedures to be performed based upon their results. (Chapter 9)
3. *FloorMart Sales and Inventory*, which requires students to identify store locations in which data appear to indicate potential inaccuracies, and to identify procedures to gather additional evidence. (Chapter 9)
4. *Husky Inventory*, which includes exercises in which students identify potentially obsolete inventory, calculate inventory turnover, consider possible write-downs, and prepare a report based on their results. (Chapter 11)

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

5. *Benford's Law Case*, a fraud case dealing with employee expense reimbursements and the application of Benford's Law of numbers. (Chapter 16)

Organization of the Ninth Edition

The ninth edition is organized as follows:

Chapters 1 and 2: A Foundational Understanding of the Role of Auditing as Integral to the Economy; Implications of Fraud; *and* The Importance of Regulation, Corporate Governance, and Audit Quality. Chapters 1 and 2 provide the foundation for students to understand the economic context in which external auditing exists. **Chapter 1** defines the objective of external auditing and describes its role in meeting society's demands for reliable financial and internal control information. **Chapter 1** identifies parties involved in preparing and auditing financial statements, lists the types of audit service providers, identifies organizations that affect the external auditing profession, defines audit quality and introduces the Financial Reporting Council's ***Audit Quality Framework***, and identifies professional requirements that help to achieve high quality and minimize auditor exposure to lawsuits. **Chapter 2** defines the types of fraud and the fraud triangle, describes examples of recent financial reporting frauds, explains the findings of the third COSO report on fraud, discusses users' expectations of auditors' fraud-related responsibilities, explains how the requirements of the Sarbanes-Oxley Act of 2002 reflect frauds perpetrated in the late 1990s and early 2000s, and defines corporate governance and identifies parties involved in corporate governance.

Chapter 3: Internal Control over Financial Reporting: Management's Responsibilities and Importance to the External Auditors. Chapter 3 articulates the importance of internal control over financial reporting, defines management's responsibility related to internal control, defines internal control as presented in COSO's updated ***Internal Control–Integrated Framework***, identifies and describes the components and principles of internal control as presented in that framework, identifies management's responsibilities related to documenting internal control over financial reporting, and describes management's responsibility to evaluate and report on internal controls.

Chapter 4. Professional Liability and the Need for Quality Auditor Judgments and Ethical Decisions. Chapter 4 discusses the liability environment in which auditors operate and explores the effects of lawsuits on audit firms; lists laws from which auditor liability is derived; and describes possible causes of action, remedies or sanctions, and auditor defenses under both common and statutory law. **Chapter 4** also articulates frameworks for making quality professional and ethical decisions and illustrates how to apply these frameworks in selected audit settings. Finally, **Chapter 4** describes and applies the IESBA's Code of Ethics and the AICPA's Code of Professional Conduct.

Chapter 5. Professional Auditing Standards and the Audit Opinion Formulation Process. Chapter 5 identifies and compares the various auditing standards, discusses the foundational principles underlying the auditing standards, lists the phases and related activities in the audit opinion formulation process, explains the concept of accounting cycles, describes the assertions that are inherent to financial statements, defines audit evidence and the purpose and types of audit procedures used to obtain audit evidence, and discusses the importance of audit documentation.

Chapter 6. A Framework for Audit Evidence. Chapter 6 discusses the importance of the evidence concepts of sufficiency and appropriateness, identifies factors affecting the sufficiency and appropriateness of audit evidence, illustrates professional judgments about the type and timing of audit procedures, discusses the use and application of substantive analytical procedures, identifies issues relating to audit evidence needed for accounts involving management estimates, and discusses issues involving specialists and related-party transactions. **Chapter 6** also describes the characteristics of quality audit documentation and explains the nature, design, and purposes of audit programs.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Chapter 7. Planning the Audit: Identifying and Responding to the Risks of Material Misstatement. Chapter 7 defines the concept of *material misstatement* and discusses the importance of materiality judgments in the audit context. **Chapter 7** also identifies the risks of material misstatement and describes how they relate to audit risk and detection risk. **Chapter 7** illustrates the use of preliminary analytical procedures and brainstorming to identify areas of heightened risk of material misstatement, along with describing how auditors respond to assessed risks of material misstatement.

Chapter 8. Specialized Audit Tools: Sampling and Generalized Audit Software. Chapter 8 conveys all the new terminology and approaches recommended in the AICPA's 2012 sampling guidance. **Chapter 8** describes how auditors use sampling and generalized audit software, explains the objectives of sampling for testing controls and account balances, compares and contrasts nonstatistical and statistical sampling, describes attribute sampling, describes the sampling process used to gather evidence about misstatements in account balances and assertions, describes monetary unit sampling, and explains how to use generalized audit software to automate the audit process.

Chapters 9–13. Performing Audits Using the Transaction Cycle Approach: Revenue; Cash and Marketable Securities; Inventory, Goods and Services, and Accounts Payable; Long-Lived Assets; *and* Debt Obligations and Stockholders' Equity Transactions. Chapters 9–13 focus on the application of concepts developed earlier for assessing risk, identifying and testing controls designed to address those risks, and using substantive approaches to testing account balances. Each chapter contains topic-relevant discussion of identifying significant accounts, disclosures, and relevant assertions; identifying and assessing inherent risks, fraud risks, and control risks; using preliminary analytical procedures to identify possible material misstatement; determining appropriate responses to identified risks of material misstatement; determining appropriate tests of controls and considering results of tests of controls; and determining and applying sufficient appropriate substantive audit procedures.

Chapters 14–15. Activities Required in Completing a Quality Audit *and* Audit Reporting Decisions. Chapter 14 discusses numerous tasks that are conducted as part of completing the audit. These include reviewing activities relating to detected misstatements, loss contingencies, accounting estimates, disclosure adequacy, noncompliance with laws or regulations, going-concern considerations, analytical review, management representations, subsequent events, omitted audit procedures, and engagement quality review; audit committee and management communications; and issues relating to audit firm portfolio management (client acceptance and continuance decisions), audit partner rotation, and audit firm rotation. Once these activities are completed, the auditor makes a reporting decision, which is described in **Chapter 15**. This chapter identifies the principles underlying audit reporting on financial statements, describes the information that is included in a standard unqualified audit report, and describes financial statements requiring the following report modifications: unqualified audit report with explanatory language, qualified report, adverse report, and a disclaimer of opinion. **Chapter 15** also describes the information that is included in a standard unqualified audit report on internal control over financial reporting and identifies the appropriate audit report modifications for situations requiring other than an unqualified report on internal control over financial reporting.

Chapter 16. Advanced Topics Concerning Complex Auditing Judgments. Chapter 16 discusses the nature and types of complex judgments that permeate audit engagements and identifies complex audit judgments based on a review of a company's financial statements. **Chapter 16** describes a process for making judgments about materiality and assessing whether misstatements are material. It also describes audit considerations for long-term liabilities involving subjectivity, merger and acquisition activities, and assessing management's fair value estimates and related impairment judgments. It describes audit considerations for financial instruments, distinguishing between material weaknesses and significant deficiencies in internal control over financial reporting, and understanding and evaluating the client's internal audit function.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Chapter 17. Other Services Provided by Audit Firms. Chapter 17 describes other services provided by audit firms. This chapter explains review and compilation engagements, procedures and reporting requirements for providing assurance on interim financial information, special considerations for unique financial statement audit situations, and attestation engagements. **Chapter 17** also discusses forensic accounting and distinguishes between forensic accounting and auditing. Finally, **Chapter 17** describes sustainability reporting and articulates the auditor's role in providing assurance on management sustainability reports.

Supplements

CengageBrain. Instructors and students can find most of the textbook's support materials online at CengageBrain (www.cengagebrain.com), including the solutions manual, PowerPoint slides, ACL data spreadsheet files, and other resources.

Solutions Manual. The Solutions Manual contains the solutions to all end-of-chapter assignments. It is available on the instructor's page at www.cengagebrain.com and may be ordered in print form using this ISBN number.

ISBN-13: 9781133962281

PowerPoint Slides: Instructors can bring their lectures to life with engaging PowerPoint slides that are interesting, visually stimulating, and paced for student comprehension. These slides are ideal as lecture tools and provide a clear guide for student study and note-taking. PowerPoint slides are downloadable by chapter on the instructor's page at www.cengagebrain.com

ExamView Computerized Testing Software: This easy-to-use test-creation program contains all questions from the Test Bank, making it simple to customize tests to instructors' specific class needs as they edit or create questions and store customized exams. This is an ideal tool for online testing. This software is available only on the Instructor's Resource CD.

ISBN-13: 9781133962311

Test Bank in Word: A proven Test Bank features the questions instructors need to efficiently assess students' comprehension. These files are available along with the ExamView on the Instructor's Resource CD. These files are not accessible on the textbook Web site for security reasons.

ACL Desktop Education Edition, Version 9. Each new copy of the ninth edition comes with ACL's Desktop Education Edition, Version 9, at no additional cost. ACL is the most popular professional audit analytics software used in public accounting today. The software enhances the analysis of cases that are couched in significant account balances, such as inventory and accounts receivable.

Ford and Toyota Case Solution. To ensure that users have access to the most recent version of the Ford and Toyota case solutions as of the most recent fiscal year end, the authors will post an updated solution to all Ford and Toyota cases to the instructor's page at www.cengagebrain.com. This updated solution will appear on the instructor's page of the textbook's Web site approximately two months after the SEC filings become available.

Example Syllabi. The authors' syllabi for this edition of the textbook are available at the instructor's page at www.cengagebrain.com. These may be helpful to instructors as they consider alternative ways to use the textbook and alternative presentation formats for the syllabi. Instructors should feel free to update these to individual uses.

ACKNOWLEDGMENTS

We are grateful to members of the staff at Cengage Learning for their help in developing the ninth edition: Sharon Oblinger, acquisitions editor; Craig Avery, senior developmental editor; Kristen Hurd, senior brand manager; and Natalie

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Livingston, senior market development manager; Joseph Malcolm, content project manager; Stacy Shirley, art director; and A.J. Smiley, editorial assistant.

We are appreciative of LuAnn Bean (Florida Institute of Technology), Jason McGregor (Baylor University), and Amy Sue Sexton (Morehead State University) for their work on the ExamView test bank. We thank Sean Dennis and Kara Obermire (both at the University of Wisconsin) for their assistance with revisions to the academic research cases and the ACL case. We are again grateful to our students and to the instructors who have used the previous editions and have given their thoughtful feedback. We appreciate the assistance of Monica Weaver in helping us integrate new examples, exhibits, and features into this edition.

The following instructors provided invaluable feedback to the publisher, and we wish to thank them for their insights:

George R. Aldhizer, III, Wake Forest University
Erick O. Bell, University of San Francisco
Katherine Boswell, University of Louisiana at Monroe
Barry Bryan, Southern Methodist University
Susan R. Cockrell, Austin Peay State University
Frank Daroca, Loyola Marymount University
Roger S. Debreceny, University of Hawai'i at Manoa
Todd DeZoort, The University of Alabama
Magdy Farag, California State Polytechnic University, Pomona
Bill Fowler, Abilene Christian University
Marvin Gordon, Northwestern University
Carl W. Hollingsworth, Clemson University
Mary Jepperson, College of Saint Benedict/Saint John's University
Mary Lewis Haley, Cumberland University
Ralph D. Licastro, The Pennsylvania State University
Jason MacGregor, Baylor University
Brian W. Mayhew, University of Wisconsin
Paul H. Mihalek, Central Connecticut State University
Michael J. Miller, Sullivan University
Andreas Nicolaou, Bowling Green State University
D. Robert Okopny, Eastern Michigan University
Denise M. Patterson, California State University, Fresno
Marshall K. Pitman, University of Texas at San Antonio
Lydia Radnik, University of North Texas
Michael A. Ridenour Jr., Pennsylvania State University–Fayette
Cindy Seipel, New Mexico State University
Amy Sexton, Morehead State University
Mike Shapeero, Bloomsburg University of Pennsylvania
Joel M. Strong, St. Cloud State University
Judy A. Thomas, Columbia College of Missouri
Jerry L. Turner, Texas Christian University
Michael Ulinski, Pace University
Kelly Ann Ulto, Fordham University
Donna L. Whitten, Purdue University North Central
Jeffrey Wong, University of Nevada, Reno
Laura M. Zellers, Wichita State University

We are very grateful to ACL Services, Ltd., for permission to distribute its software and tutorials and for permission to reprint related images.

Karla M. Johnstone
Audrey A. Gramling
Larry E. Rittenberg

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

ABOUT THE AUTHORS

KARLA M. JOHNSTONE

Karla M. Johnstone, PhD, CPA, is a Professor of Accounting and Information Systems at the University of Wisconsin Madison School of Business. She teaches auditing, and her research investigates auditor decision making, including auditors' client acceptance and continuance decisions, how fraud risk and fraud brainstorming affects audit planning and audit fees, client–auditor negotiation, and audit budget-setting processes. She has also published various articles on accounting curriculum effectiveness. Professor Johnstone serves on the editorial boards of several academic journals and is active in the Auditing Section of the American Accounting Association (AAA), currently serving on the Executive Committee in the role of Treasurer. She has worked as a corporate accountant and as a staff auditor, and she was a doctoral fellow in residence at Coopers & Lybrand.

AUDREY A. GRAMLING

Audrey A. Gramling, PhD, CPA, CIA, is the Fr. Raymond J. Treece Endowed Chair and Accounting Department Professor and Chair at Bellarmine University. Professor Gramling's research investigates both internal and external auditing issues, with a focus on decision behavior of auditors, external auditor independence, internal control reporting, and other factors affecting the market for audit and assurance services. Prior to earning her PhD at the University of Arizona, Professor Gramling worked as an external auditor at a predecessor firm of Deloitte and as an internal auditor at Georgia Institute of Technology. She has also served a one-year appointment as an Academic Accounting Fellow in the Office of the Chief Accountant at the U.S. Securities and Exchange Commission. She is the past President of the Auditing Section of the AAA and has served in an advisory role to the COSO.

LARRY E. RITTENBERG

Larry E. Rittenberg, PhD, CPA, CIA, is Professor Emeritus, Department of Accounting and Information Systems, at the University of Wisconsin, Madison, where he taught courses in auditing, risk management, and corporate governance. He is also Chair Emeritus of the COSO of the Treadway Commission, where he has provided oversight of the development of the COSO Enterprise Risk Management Framework as well as the COSO Guidance for Smaller Businesses. He has served as Vice-Chair of Professional Practices for the Institute of Internal Auditors

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

(IIA) and President of the IIA Research Foundation; and has been a member of the Auditing Standards Committee of the AAA Auditing Section, the AICPA's Computer Audit Subcommittee, the Information Technology Committee, and the NACD Blue Ribbon Commission on Audit Committees; and Vice-President and Treasurer of the AAA. He is a member of an audit committee, the board, and the governance committee of Woodward Governor, a publicly traded company, and has consulted on audit committee, risk, and control issues with the largest public company in China. More recently, he has been named as one of the seven members of the International Oversight Council for Professional Practice of the IIA. Professor Rittenberg served as Staff Auditor for Ernst & Young and has coauthored five books and monographs and numerous articles.

Recommendations from Instructors Who Have Used This Textbook

"I selected this textbook because I believe that it presents a realistic approach to the integrated audit. Having worked with several of the Global Seven firms, it is evident to me that the authors have been diligent in writing a book that mirrors the risk-based approach to the audit. In addition, my students have enjoyed outstanding success on the AUD Exam having used this text as their primary study resource."

Professor Barry J. Bryan
Southern Methodist University

"I have used [this] text for four years now and it has been an outstanding resource for teaching my students the fundamentals of contemporary auditing. Text discussions and end-of-chapter applications help me to develop students' critical analysis and judgment skills, sensitivity and responses to ethical dilemmas, and understanding and appreciation of the essential role of professional skepticism in auditing…. My impression based on use of successive editions of the text is that the authors have worked very hard to ensure it is up-to-date as auditing standards and related guidance evolve and audit-relevant events occur in the rapidly-changing business environment. Without reservation, I highly recommend this text."

Professor Tim Bell
University of North Florida

"As a former auditor and current audit professor, I find the book very easy to follow and well written. The content is organized in a similar fashion to the audit process itself, which I think is essential for students' understanding. The authors also include topics that I have not found in any other auditing textbook (e.g., an entire chapter on corporate governance, sections on upcoming changes or changes soon to be integrated into the profession). This textbook simply *feels* more up to date about current events in auditing."

Professor Kim Westermann
Florida International University

"This textbook hits the sweet spot of the bat! As far as I am concerned it hits a home run! Not too complex yet not too simple, the right amount of standards presentation/explanation then a great example to illustrate the standard in the real world. This textbook is well organized and presents the materials and issues as an auditor would confront them in an actual audit. I like the inclusion of ACL on the disc that accompanies the book. The ACL materials are presented in such a manner that tech savvy students can do the assignments with a minimum of instruction."

Professor Douglas E. Ziegenfuss
Old Dominion University

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

AUDITING

A RISK-BASED APPROACH TO CONDUCTING A QUALITY AUDIT

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

CHAPTER 1

Auditing: Integral to the Economy

CHAPTER OVERVIEW AND LEARNING OBJECTIVES

Capital markets depend on reliable information about organizations. This information provides a basis for making many types of decisions, including investing and lending decisions. If the capital markets do not receive reliable information, investors and others lose confidence in the system, make poor decisions, and may lose a great deal of money. The external auditing profession helps enhance the reliability of information throughout the capital markets. Individual external auditors are asked to make professional and ethical judgments about the information provided by business organizations. Professional judgment and the processes used to make such judgments are critical to the usefulness of the external audit profession and to individual auditors as they conduct quality audits.

Through studying this chapter, you will be able to achieve these learning objectives:

1. Define the objective of external auditing and describe its role in meeting society's demands for reliable financial and internal control information.
2. Identify parties involved in preparing and auditing financial statements and briefly describe their roles.
3. List the types of audit service providers and the skills and knowledge needed by professionals entering the external auditing profession.
4. Identify organizations that affect the external auditing profession and the nature of their effects.
5. Define audit quality and identify drivers of audit quality as specified by the Financial Reporting Council's *Audit Quality Framework*.
6. Identify professional requirements that help to achieve audit quality and minimize auditor exposure to lawsuits.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

PROFESSIONAL JUDGMENT IN CONTEXT

The Importance of Conducting a Quality Audit and Complying with Professional Standards

On December 20, 2011, the Public Company Accounting Oversight Board (PCAOB) revoked the ability of Bentleys Brisbane Partnership (an external audit firm) to audit public company audits, and the Board imposed a monetary penalty of $10,000 on Robert Forbes, the audit partner in charge of the audit of Alloy Steel International. These penalties were imposed because the PCAOB concluded that Bentleys and Forbes failed to exercise **due professional care** (a standard of care expected to be demonstrated by a competent auditing professional), failed to exercise **professional skepticism** (an attitude that includes a questioning mind and critical assessment of audit evidence), and failed to obtain sufficient evidence necessary to issue an audit opinion on the financial statements of Alloy Steel's 2006 fiscal year end financial statements. The PCAOB also concluded that Bentleys violated PCAOB quality control standards because the firm did not develop policies to ensure that the work performed by its personnel met PCAOB auditing standards and the Board said that the firm did not undertake audits that the firm could reasonably expect to be completed with professional competence.

Alloy Steel International is an American company headquartered in Malaga, Australia. Alloy's stock was traded on the Over the Counter (OTC) Bulletin Board and as such was subject to Securities and Exchange Commission (SEC) rules and requirements. Its auditors were subject to PCAOB rules and requirements. On the audit of Alloy, Bentleys and Forbes made a number of critical quality control mistakes. Bentleys and Forbes used an unregistered audit firm in Australia to actually perform the audit work, rather than performing the audit work themselves. Bentleys' and Forbes' involvement on the engagement was limited to reviewing the unregistered audit firm's workpapers. The unregistered audit firm's personnel had no training or experience in conducting audits that complied with PCAOB standards. Despite these factors, Bentleys and Forbes issued and signed an unqualified audit report on Alloy's 2006 financial statements. For further information about this scenario, see PCAOB disciplinary proceedings in Release No. 105-2011-007.

As you read through this chapter, consider the following questions:

- What is the objective of auditing, and what process should auditors follow to accomplish this objective? (LO 1)
- Why do companies obtain audited financial statements? (LO 1)
- Who are the users of audited financial statements? (LO 1)
- What skills and knowledge are needed to be a competent audit professional? (LO 3)
- Why is it vital to perform an audit in a quality manner? (LO 5)
- Why are low quality audits, like those performed in this case, harmful? (LO 5)

Overview of the External Auditing Profession

LO 1 Define the objective of external auditing and describe its role in meeting society's demands for reliable financial and internal control information.

Introduction to the External Auditing Profession

A **financial statement audit** is a:

> systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria; and communicating the results to interested users.[1]

The external auditing profession performs a unique task. While managers create the financial statements and design internal control systems, the objective of external auditing is to provide opinions on the reliability of the financial statements and, as part of an **integrated audit**, provide opinions on internal control effectiveness. For external auditing to have value, the public

[1] Auditing Concepts Committee, "Report of the Committee on Basic Auditing Concepts," *The Accounting Review*, 47, Supp. (1972), 18.

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

needs to have confidence in the objectivity and accuracy of the opinions provided by external auditors.

A free-market economy can exist only if there is sharing of reliable information among parties that have an interest in the financial performance of an organization. The market is further strengthened if the information is transparent and unbiased—that is, the data is not presented in such a way that it favors one party over another. An organization's reported information must reflect the economics of its transactions and the current economic condition of both its assets and any obligations owed. The external audit is intended to enhance the confidence that users can place on management-prepared financial statements. When the auditor has no reservations about management's financial statements or internal controls, the report is referred to as an **unqualified audit report**. Such a report is shown in Exhibit 1.1. You will note in Exhibit 1.1 that the audit firm PricewaterhouseCoopers has provided two opinions. One opinion states that the audit firm believes that the financial statements of Ford are fairly stated. The other opinion states that PricewaterhouseCoopers believes that Ford's internal control over financial reporting was effective as of Ford's year end, December 31, 2011. PricewaterhouseCoopers was able to provide these opinions after going through a systematic process of objectively obtaining and evaluating sufficient appropriate evidence. If the auditor had reservations about the fair presentation of the financial statements, the audit report would be modified to explain the nature of the auditor's reservations (covered in Chapter 15). And if the auditor had reservations about the effectiveness of the client's internal controls, the auditor would issue an **adverse opinion** on internal controls.

External Auditing: A Special Function

External auditing is a "special function" as described by Chief Justice Warren Burger in a 1984 Supreme Court decision:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands ... complete fidelity to the public trust.[2]

Chief Justice Burger's statement captures the essence of the external auditing profession. Auditors serve a number of parties, but the most important is the public, as represented by investors, lenders, workers, and others who make decisions based on financial information about an organization. Auditing requires the highest level of technical competence, freedom from bias, and concern for the integrity of the financial reporting process. In essence, auditors should view themselves as guardians of the capital markets.

The public expects auditors to (a) find fraud, (b) require accounting principles that best portray the spirit of the concepts adopted by accounting standard setters, and (c) be independent of management. When it comes to being independent, auditors must not only be independent *in fact*, but they must act in a manner that ensures that they are independent *in appearance*. For example, if an audit partner's uncle was the CEO at the partner's client company, users could reasonably worry about a conflict of interest. It is entirely possible that the audit partner has, in fact, an independent mental attitude. However, the audit partner would not be independent in appearance in this scenario. Further complicating matters, consider that management and the audit committee expect cost-effective audits. Thus, the auditing profession faces many pressures—keeping fees down, making careful decisions regarding

[2] *United States v. Arthur Young & Co. et ah*, U.S. Supreme Court, No. 82-687 [52 U.S.L.W.4355 (U.S., Mar. 21, 1984)].

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

EXHIBIT 1.1 Integrated Audit Report

REPORT OF INDEPENDENT REGISTERED AUDIT FIRM

To the Board of Directors and Stockholders of Ford Motor Company

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of equity and of cash flows present fairly, in all material respects, the financial position of Ford Motor Company and its subsidiaries at December 31, 2011 and December 31, 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the accompanying financial statement schedule presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and the financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying sector balance sheets and the related sector statements of operations and of cash flows are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP
Detroit, Michigan
February 21, 2012

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

AUDITING IN PRACTICE

Why Is Owning Stock in an Audit Client Unacceptable?

In 2005, Susan Birkert was an audit senior working for KPMG on the audit engagement of Comtech Corporation. One of Susan's friends asked her whether she thought that Comtech stock was a good investment. She responded that, indeed, it was a good investment. At that point, her friend asked if she would like him to purchase Comtech stock on her behalf. She agreed, and gave her friend $5,000 to make the purchase under his name rather than hers. She did so because she was aware that owning stock in one's audit client is not allowed because of independence concerns. If auditors own stock in their audit clients, they are not independent of their clients because they are part owners. Therefore, rather than acting in an unbiased manner during the conduct of the audit, they might make judgments that favor the client company rather than external users of the financial statements. Even if the auditor does not actually behave in a biased manner and is independent in fact, external users may *perceive* an independence conflict—the auditor would not be independent in appearance.

Susan continued working on the Comtech engagement well into 2006, and she lied when she responded to KPMG's yearly written requirements to comply with the firm's independence policies. Prompted by an anonymous tip later in 2006, KPMG launched an internal investigation into the matter and terminated her employment. The PCAOB barred her from serving as an external auditor for a period of at least one year. For further details on this case, see PCAOB Release No. 105-2007-003.

independence, and conducting a quality audit. The *Auditing in Practice* feature "Why Is Owning Stock in an Audit Client Unacceptable?" is an example of a situation in which a young auditor violated independence rules, leading to her being sanctioned by the PCAOB and being fired by her audit firm employer.

The Need for Unbiased Reporting and Independent Assurance

Effective capital markets require quality financial reporting. An organization's financial statements should reflect a true and fair view of the organization's financial results. The statements should not favor one user over another. However, the interests of the various users can conflict. Current shareholders might want management to use accounting principles that result in higher levels of reported income, while lending institutions generally prefer a conservative approach to valuation and income recognition. Exhibit 1.2 presents an overview of potential financial statement users and the decisions they make based on the financial reports.

Why do financial statement users need independent assurance about information provided by management? Shouldn't the information provided by management be reliable? The need for independent assurance arises from several factors:

- *Potential bias*—Management has incentives to bias financial information in order to convey a better impression of the financial data than real circumstances might merit. For example, management's compensation may be tied to profitability or stock price, so managers may be tempted to "bend" GAAP to make the organization's performance look better.
- *Remoteness*—An organization and the users of its financial information are often remote from each other, both in terms of geographic distance and the extent of information available to the both parties. Most users cannot interview management, tour a company's plant, or review its financial records firsthand; instead, they must rely on financial statements to communicate the results of management's performance. This

Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

EXHIBIT **1.2** Users of Audited Financial Statements

User	Types of Decisions
Management	Review performance, make operational decisions, report results to capital markets
Stockholders	Buy or sell stock
Bondholders	Buy or sell bonds
Financial Institutions	Evaluate loan decisions, considering interest rates, terms, and risk
Taxing Authorities	Determine taxable income and tax due
Regulatory Agencies	Develop regulations and monitor compliance
Labor Unions	Make collective bargaining decisions
Court System	Assess the financial position of a company in litigation
Vendors	Assess credit risk
Retired Employees	Protect employees from surprises concerning pensions and other post-retirement benefits

can tempt management to keep information from users or bend GAAP so the organization looks better.

- *Complexity*—Transactions, information, and processing systems are often very complex, so it can be difficult to determine their proper presentation. This provides an opportunity for management to deceive users.
- *Consequences*—During the past decade, many financial statement users—pension funds, private investors, venture capitalists, and banks—lost billions of dollars because financial information had become unreliable. As an example, the factors leading up to, and the consequences of, unreliable information can be seen in the subprime mortgage crisis in the United States. Many borrowers did not provide correct information on their loan applications and lenders sometimes did not perform adequate due diligence in making lending decisions. Consequently, various financial statement users and others suffered significant losses. When financial information is not reliable, investors and other users lose a significant source of information that they need to make decisions that have important consequences.

These factors suggest a role for external auditors who are independent. Independence requires objectivity and freedom from bias, and is often referred to as the *cornerstone* of the auditing profession. Without independence, audits would lack value.

Overall Objectives in Conducting an Audit

The overall objective of an audit is to obtain reasonable assurance about whether the financial statements are free from material misstatement and to report on the financial statements based on the auditor's findings. In completing these objectives, the auditor:

- Complies with relevant ethical requirements
- Plans and performs an audit with professional skepticism
- Exercises professional judgment
- Obtains sufficient appropriate evidence on which to base the auditor's opinion
- Conducts the audit in accordance with professional auditing standards

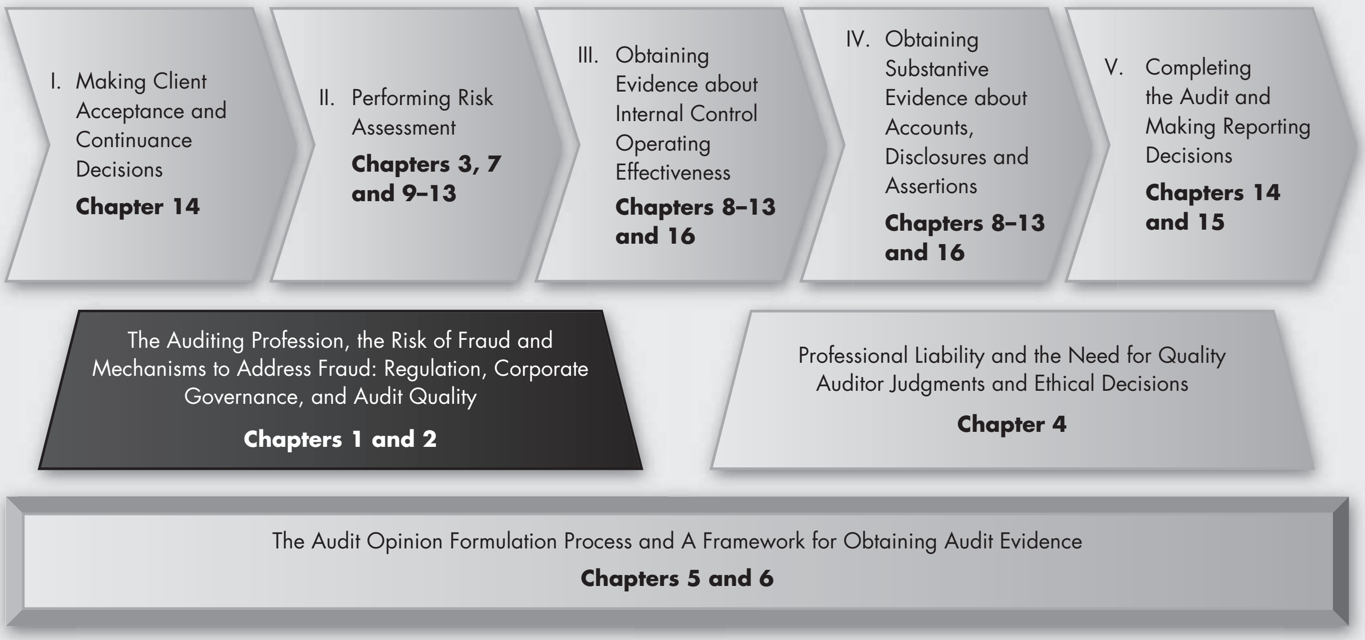
Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s).
Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Overview of the Audit Opinion Formulation Process

To be able to provide reasonable assurance, auditors go through a structured process, which we refer to as the Audit Opinion Formulation Process. That process is presented in Exhibit 1.3.

Phase I of the audit opinion formulation process concerns client acceptance and continuance. Auditors are not required to perform audits for any organization that asks; auditors choose whether or not to perform each individual audit. Audit firms have procedures to help them ensure that they are not associated with clients where management integrity is in question or where a company might otherwise present the audit firm with unnecessarily high risk (such as client financial failure or regulatory action against the client). Once a client is accepted (or the audit firm decides to continue to provide services to a client), the auditor needs to perform risk assessment procedures to thoroughly understand the client's business (or update prior knowledge in the case of a continuing client), its industry, its competition, and its management and governance processes (including internal controls) to determine the likelihood that financial accounts might be in error (Phase II). In some audits, the auditor will also obtain evidence about internal control operating effectiveness through testing those controls (Phase III). Much of what most people think of as auditing, the obtaining of substantive evidence about accounts, disclosures, and assertions, occurs in Phase IV. The information gathered in Phases I through III will greatly influence the amount of testing to be performed in Phase IV. Finally, in Phase V, the auditor will complete the audit and make a decision about what type of audit report to issue.

EXHIBIT 1.3 The Audit Opinion Formulation Process



Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

Parties Involved in Preparing and Auditing Financial Statements

LO 2 Identify parties involved in preparing audited financial statements and briefly describe their roles.

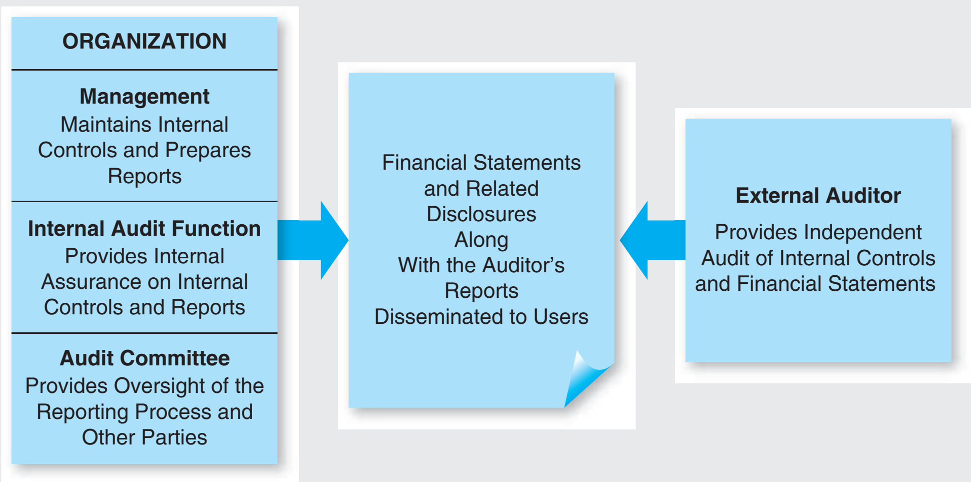
Various parties are involved in preparation and audit of financial statements and related disclosures; these parties are depicted in Exhibit 1.4. Management has responsibilities for (a) preparing and presenting financial statements in accordance with the applicable financial reporting framework; (b) designing, implementing, and maintaining internal control over financial reporting; and (c) providing the auditors with information relevant to the financial statements and internal controls. The internal audit function provides management and the audit committee with assurance on internal controls and reports. The audit committee, a subcommittee of the organization's board of directors, oversees both management and the internal auditors, and they also hire the external auditor. The external auditor's job is to obtain reasonable assurance about whether management's statements are materially accurate and to provide a publicly available report. External auditors conduct their procedures and make judgments in accordance with professional standards (described in Chapter 5). The audited financial statements are provided to users who have an interest in the organization.

Providers of External Auditing Services

LO 3 List the types of audit service providers and the skills and knowledge needed by professionals entering the external auditing profession.

The external auditing profession includes sole-practitioner firms, local and regional firms, and large multinational professional services firms such as the Big 4. The Big 4 firms are KPMG, Deloitte Touche Tohmatsu (Deloitte in the United States), PricewaterhouseCoopers (pwc), and Ernst & Young. The organizational structure of these firms is quite complex. For example, each of the Big 4 firms is actually a network of member firms. Each of the member firms enters into agreements to share a common name, brand, and quality standards. In most cases, member firms are organized as a partnership or limited liability corporation within each country. Some smaller firms also practice internationally through an affiliation with a network of firms. For example, a number of regional or local firms belong to an affiliation of such firms under the name of Moore Stephens, and another group operates under the name of Baker Tilly. Many public accounting firms have also organized their practices along industry lines to better serve clients in those industries. These often include categories such as financial services, retailing, not-for-profit, manufacturing, and government.

EXHIBIT 1.4 Parties Involved in Preparing and Auditing Financial Statements



Copyright 2013 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.