

William F. Messier | Steven M. Glover | Douglas F. Prawitt

# AUDITING & ASSURANCE SERVICES

A Systematic Approach

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Tenth Edition

# Auditing & Assurance Services

A SYSTEMATIC APPROACH





TENTH EDITION

# Auditing & Assurance Services

A SYSTEMATIC APPROACH



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AUDITING & ASSURANCE SERVICES: A SYSTEMATIC APPROACH, TENTH EDITION

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# About the Authors



**William F. Messier, Jr.** holds the Kenneth and Tracy Knauss Endowed Chair in Accounting at the Department of Accounting, University of Nevada, Las Vegas. He is also an Adjunct Professor at the Department of Accounting, Auditing and Law at the Norwegian School of Economics. Professor Messier holds a B.B.A. from Siena College, an M.S. from Clarkson University, and an M.B.A. and D.B.A. from Indiana University. He is a CPA in Florida and has held faculty positions at the University of Florida (Price Waterhouse Professor) and Georgia State University (Deloitte & Touche Professor). Professor Messier was a visiting faculty member at SDA Bocconi in Milan and the Universities of Luxembourg and Michigan. Professor Messier served as the Academic Member of the AICPA's Auditing Standards Board and as Chair of the AICPA's International Auditing Standards Subcommittee. He is a past editor of *Auditing: A Journal of Practice & Theory* and formerly President of the Auditing Section of the American Accounting Association. Professor Messier was the recipient of the American Accounting Association's Outstanding Accounting Educator Award (2015), AICPA's Distinguished Achievement in Accounting Education Award (2012), AAA Auditing Section's Outstanding Educator Award (2009) and the Distinguished Service in Auditing Award (2008). In 2011, Professor Messier was awarded an honorary doctorate from the Norwegian School of Economics and Business Administration. Professor Messier has also served as an expert witness in audit litigation cases.



**Professor Steven M. Glover** is the K. Fred Skousen Professor and Associate Dean of the Marriott School of Management, Brigham Young University. Professor Glover is a CPA in Utah and holds a PhD and BS from the University of Washington and an AA in Business from BYU – Idaho. He previously worked as an auditor for KPMG LLP and as a director in the national office of PwC LLP. Professor Glover is currently serving on the AICPA Auditing Standards Board and has served on the audit committee of a nonprofit organization. He has served on the board of advisors for technology companies and he actively consults with public companies and public accounting firms. He has also served as an expert witness. Professor Glover is a past President of the Auditing Section of the American Accounting Association and he has been on auditing-related task forces of the AICPA. Professor Glover is or has served on the editorial boards of *Auditing: A Journal of Practice & Theory*, *The Accounting Review*, *Current Issues in Auditing*, and the review board of the *AAA/CAQ Access to Audit Personnel Program*. He has authored or coauthored over 40 articles and books primarily focused in the areas of auditor decision making, audit education, and audit practice. Together with Professor Prawitt and KPMG, LLP, he co-authored an award-winning monograph designed to accelerate the professional judgment of auditors and auditing students, as well as a monograph on professional skepticism commissioned by the Standards Working Group of the GPPC, an international consortium of the six largest public accounting network firms.



**Professor Douglas F. Prawitt** is the Glen Ardis Professor of Accountancy at the Marriott School of Management, Brigham Young University. Professor Prawitt is a CPA in Utah. He holds a PhD from the University of Arizona, and BS and MAcc degrees from Brigham Young University. Professor Prawitt was awarded the Marriott School's Teaching Excellence and Outstanding Researcher awards in 1998 and 2000. He received the Merrill J. Bateman Student Choice Teaching Award in 2002, BYU's Wesley P. Lloyd Award for Distinction in Graduate Education in 2006, and the American Accounting Association's Deloitte/Wildman Award in 2013.

He consults actively with international, regional, and local public accounting firms. He worked extensively over a five-year period with the Committee of Sponsoring Organizations (COSO) on the *COSO Enterprise Risk Management Framework* and *Internal Control over Financial Reporting—Guidance for Smaller Public Companies* projects, and served a three-year appointment as a voting member of the AICPA Auditing Standards Board, from 2005–2008. In the fall of 2011, he was appointed to serve a three-year term as a member of the COSO Board and was appointed to serve a second three-year term beginning in 2014. Professor Prawitt also has served in several capacities with the American Accounting Association, including as a member of the editorial boards of *Auditing: A Journal of Practice & Theory*, *Behavioral Research in Accounting*, and as associate editor of *Accounting Horizons*. He has authored or co-authored over 40 articles and books, primarily in the areas of auditor judgment and decision making, and audit practice. Most recently, together with Professor Steve Glover and KPMG, LLP, he co-authored an award-winning monograph designed to accelerate the professional judgment of auditors and auditing students, as well as a monograph on professional skepticism commissioned by the Standards Working Group of the GPPC, an international consortium of the six largest public accounting firm networks.

## Dedications

The authors dedicate this book to the following individuals:

Teddie, Stacy, Brandon, Zachary, Mark, Lindsay,  
Olive, and Frederick

—William F. Messier, Jr.

Tina, Jessica, Andrew, Jennifer, Anna, Wayne,  
and Penny

—Steven M. Glover

Meryll, Nathan, Matthew, Natalie, Emily, AnnaLisa,  
Leah, George, and Diana

—Douglas F. Prawitt

# Why a New Edition?

## Dear Colleagues and Friends,

The pace of change in the financial statement auditing environment continues to accelerate, even as the need for reliable, high-quality assurance over financial reporting continues to intensify. The auditing environment is far more complex and dynamic today than it was even 10 years ago. Today, for example, financial statement auditors practice in a regulated environment and must deal with three sets of auditing standards: the standards of the PCAOB for audits of U.S. public companies, the standards of the AICPA's Auditing Standards Board for audits of essentially all other U.S. entities (e.g., private companies, government entities, universities), and the standards of the IFAC's International Auditing and Assurance Standards Board for audits of entities based outside of the United States. And those standards have undergone change at an unprecedented pace, with few signs of slowing. It is difficult enough for us as professors to stay abreast of the unprecedented change and complexity in the auditing environment; it is simply unrealistic to expect our students to be able to grasp all of this while they are working diligently just to learn the fundamentals of financial statement auditing.

That is why we have focused our efforts in this new edition to present the fundamentals of auditing in a crisp, clear, and understandable way, helping students navigate the inherent complexity while gaining a deep, intuitive grasp of fundamental auditing concepts. We do this by using simple yet compelling illustrations, examples, and analogies, such as relating the demand for an audit to the desire of a prospective home buyer to hire a house inspector. Our hope is that students will not only understand the important standards and concepts underlying auditing but that they will gain an intuitive grasp of why it is important and how the underlying logic can inform their judgments not only as auditors but as business people. In terms of the three sets of extant auditing standards, we simplify the complexities involved by adopting an approach similar to that taken by all of the major international accounting firms: we start with a base set of standards (in our case, the AICPA's new body of "clarity" standards, which are at this point very similar to the IAASB standards) and we build on that base by addressing any requirements in the PCAOB standards that require more from the auditor. The AICPA's clarity standards are newly converged with international auditing standards, which means that *by studying this book your students will learn the auditing concepts that underlie an audit performed under any of the three extant sets of standards*. All of the major firms have adopted a similar approach because it allows their professionals to practice effectively in any environment, domestic or international, using a single, merged set of auditing standards, rather than having to learn the specifics of three different sets. Your students will have that same advantage in learning auditing from this book.

Although the auditing environment has become even more complex and demanding, at the same time it is increasingly important that students gain a deep understanding and working knowledge of fundamental auditing concepts and how they are applied. From the beginning we have worked hard to make this book the most up-to-date, "student-friendly" introductory auditing book on the market, and this new edition continues that effort. Some of the ways this book encourages your students (and ours) to think more clearly and deeply about what they are studying are by

1. Expanding the use of "stop and think" phrases at key places throughout the chapters to encourage students to more fully internalize key concepts and facilitate deep learning by your students.
2. Clarifying explanations and adding easy-to-understand examples throughout the book.



3. Making several chapters more concise and enhancing the focus on key concepts by deleting noncentral detail.
4. Improving end-of-chapter and supplementary materials throughout the book and on the website.
5. Adding a “Professional Judgment” module to the print copy of the book to accelerate the development of professional judgment abilities in your students. This module is based on the 2013 AAA Wildman Award winning KPMG Professional Judgment monograph, authored by Steve Glover and Doug Prawitt, in collaboration with KPMG leaders and partners.
6. New discussion cases added to Chapters 3 and 6 relating to the misappropriations of assets at Koss Corporation and Dixon, Illinois.

This new edition also contains several important updates including the introduction of industry leader IDEA® software by CaseWare Analytics. IDEA is a powerful and user-friendly data analysis tool designed to help auditors perform data analysis, audit sampling, and other audit procedures efficiently and effectively. Students are introduced to IDEA in the text and through hands-on tutorials, exercises, and problems. This edition also has been updated to reflect changes in auditing standards, such as the PCAOB’s Risk Assessment standards and the AICPA’s newly revised body of “clarity” standards, including the “principles underlying an audit conducted in accordance with generally accepted auditing standards.” The book also reflects new developments in how auditors assess materiality, based on research into major firms’ materiality policies by Aasmund Eilifsen and Bill Messier, and includes insights into audit sampling in practice based on research co-authored by Steve Glover. This edition also includes coverage of the newly revised COSO *Internal Control-Integrated Framework*. Because of their increasing complexity and importance to the audit process, this edition also includes discussions of auditing the tax liability and auditing fair value measurements. The book also includes coverage of professionalism and ethics consistent with the AICPA’s newly reorganized Code of Professional Conduct. Finally, the authors took a hands-on role in improving this edition’s test bank, online quizzes, instructor PowerPoint slides, and the instructor’s manual.

While we are very much aware of the extra investment required when a book rolls to a new edition, we believe that we owe it to our colleagues and students to provide the most up-to-date materials possible so their hard work and energy in teaching and studying represents an investment in the latest, most current concepts, delivered in the most understandable way possible. We are confident that the changes made in this edition will make it easier for you to teach effectively and for your students to learn more efficiently and more deeply.

Thank you for your support of this text and the many compliments we have received regarding past editions. We are gratified by the enthusiastic response the text has received as we have done our best to create a clear, easy-reading, student-friendly auditing textbook. As always, we welcome your feedback and suggestions, and we hope you will be pleased with the updates we have made in this new edition.

With warm regards,

*William F. Messier, Jr.*

*Steven M. Glover*

*Douglas F. Prawitt*

# Give your students an intuitive, hands-on learning experience!

The 10th Edition includes the following important features and enhancements:

- A “professional judgment” module, designed to accelerate the development of the student’s professional judgment and based on the AAA Deloitte/Wildman Award-winning *KPMG Professional Judgment* monograph, is now included in the print version of the book. Additional resources relating to this module are available through KPMG’s *University Connection* website.
- Increased use of “Stop and Think” questions throughout the book to encourage students to more fully internalize key concepts.
- User-focused, user-friendly improvements.
- Chapter 2 has been updated for recent changes in the audit environment, Chapter 3 presents the latest information available on major firms’ audit guidance relating to materiality, Chapter 6 reflects COSO’s new internal control framework, and Chapter 19 includes coverage of professional conduct consistent with the AICPA’s newly reorganized Code of Professional Conduct.
- Increased use of Practice Insights that provide a link from the textbook material to the real world.
- The introduction of IDEA audit software. IDEA is a powerful and user-friendly data analysis tool designed to help auditors perform data analysis, audit sampling, and other audit procedures efficiently and effectively. IDEA is illustrated in Chapters 8 and 9 and there are end-of-chapter IDEA assignments and problems for hands-on application throughout the book.
- Improved descriptions of the hands-on EarthWear Mini-Cases that provide students with opportunities to apply audit professional judgment and practice audit procedures.
- Clarified explanations of technical business and accounting jargon.
- Improved linkage between chapter content and end-of-chapter material.
- References to auditing standards reflect the new codification of AICPA ASB clarity standards.

Here is a sampling of the improvements made in recent editions:

## **Chapter 1, *An Introduction to Assurance and Financial Statement Auditing***

- Discussion of fundamental concepts of auditing streamlined and clarified

## **Chapter 2, *The Financial Statement Auditing Environment***

- Updated to reflect changes in audit environment
- Includes AICPA’s “principles underlying an audit” in addition to PCAOB’s traditional set of “generally accepted auditing standards”

## **Chapter 3, *Audit Planning, Types of Audit Tests, and Materiality***

- Revised engagement letter for an integrated audit
- Discussion of the current practices of the major auditing firms based on a recent article by Aasmund Eilifsen and Bill Messier

## **Chapter 4, *Risk Assessment***

- Improved presentation of the risk assessment process
- Revised presentation of the fraud risk assessment process
- Addition of a new case based on the fraud at Koss Corporation

**Chapter 5, *Evidence and Documentation***

- Revised Advanced Module on the use of substantive analytical procedures

**Chapter 6, *Internal Control in a Financial Statement Audit***

- New discussion case about the fraud in Dixon, Illinois
- An extension of the Koss Corporation fraud that considers the control deficiencies

**Chapter 7, *Auditing Internal Control over Financial Reporting***

- Easier to understand explanations of the important steps in the audit of internal control over financial reporting

**Chapter 8, *Audit Sampling: An Overview and Application to Tests of Controls***

- Introduction of industry leading IDEA auditing software to this edition of the book with illustrations of how to use IDEA for attribute sampling within the chapter.
- Updated for academic research examining audit sampling in practice

**Chapter 9, *Audit Sampling: An Application to Substantive Tests of Account Balances***

- Introduction of industry leading IDEA auditing software to this edition of the book with illustrations of how to use IDEA for monetary unit sampling within the chapter.
- Updated for academic research examining audit sampling in practice

**Chapters 10–16, *Business Process Chapters***

- Revised for enhanced clarity and brevity
- Clarified illustrations linking assertions to possible misstatements to example controls and tests of controls
- Updated exhibits and practice insights for recent events

**Chapter 17, *Completing the Audit Engagement***

- Improved examples to illustrate the possible self-fulfilling prophecy effects of going concern opinions, and to explain the role and impact of commitments in completing an audit
- Clarified discussion of auditor's responsibility for subsequent events
- Enhanced discussion of evaluation of misstatements in light of qualitative materiality considerations
- New coverage of iron curtain versus roll-over methods of assessing materiality of misstatements

**Chapter 18, *Reports on Audited Financial Statements***

- Updated for recent developments including the new “clarified” form of the ASB audit report

**Chapter 19, *Professional Conduct, Independence, and Quality Control***

- Updated for changes in the newly reorganized AICPA Code of Professional Conduct
- Discussion of quality control and peer review/inspection updated for recent changes in relevant standards

**Chapter 20, *Legal Liability***

- Updated for important recent cases and statutory law

**Chapter 21, *Assurance, Attestation, and Internal Auditing Services***

- Updated standards relating to practitioner independence in compilation engagements
- Attestation reports updated for new AICPA standards
- Updated to reflect changes in IIA standards
- Updated to reflect changes to structure around Trust Services principles and practices

## Tenth Edition Supplements

### Connect instructor resources library offers:

- **Solutions Manual**, revised by William F. Messier, Jr., Steven M. Glover, and Douglas F. Prawitt
- **Instructor's Manual**
- **Test Bank with AACSB, AICPA, and Bloom's Taxonomy tags**
- **Instructor PowerPoint Presentations**
- **EarthWear Mini-Case Solutions**
- **Solutions to IDEA Solutions**

Additional resources include: Links to Professional Resources, Sample Syllabi, Text Updates, and Digital Image Library

### Connect student resources include:

- EarthWear Mini-Cases
- IDEA Assignments and Problems, by Messier, Glover, and Prawitt
- Student PowerPoint Presentations
- Relevant Accounting and Auditing Pronouncements by chapter
- Link to EarthWear Clothiers home page
- Link to Willis & Adams, CPAs home page

### Assurance of Learning Ready

Many educational institutions today are focused on the notion of *assurance of learning*, an important element of some accreditation standards. The Messier, Glover, and Prawitt *Auditing and Assurance Services: A Systematic Approach* book is designed specifically to support your assurance of learning initiatives with a simple, yet powerful, solution.

Each chapter in the book begins with a list of numbered learning objectives, which appear throughout the chapter as well as in the end-of-chapter assignments. Each test bank question for *Auditing and Assurance Services: A Systematic Approach* maps to a specific chapter learning outcome/objective listed in the text. Each test bank question also identifies topic area, level of difficulty, Bloom's Taxonomy level, AACSB and AICPA skill areas. You can use Connect to easily query for learning outcomes/objectives that directly relate to the learning objectives for your course.

# How does 10e prepare your students?

The continuing rapid pace of change in auditing standards and practices, together with the recent crises in the financial markets, has had a significant effect on the auditing profession. In this ever-changing environment, it is crucial that students learn from the most up-to-date, student-friendly resources. As always, the author team of *Auditing & Assurance Services: A Systematic Approach* is dedicated to providing the most current professional content and real-world application, as well as helping students develop professional judgment and prepare for the CPA exam.

In their 10th edition, authors Messier, Glover, and Prawitt continue to reinforce the fundamental values central to their past nine editions:

**Student Engagement.** The authors believe students are best served by acquiring a strong understanding of the basic concepts that underlie the audit process and how to apply those concepts to various audit and assurance services. The primary purpose for an auditing text is not to serve as a reference manual but to facilitate student learning, and this text is written accordingly. The text is accessible to students through straightforward writing and the use of engaging, relevant real-world examples, illustrations, and analogies. The text explicitly encourages students to think through fundamental concepts and to avoid trying to learn auditing through rote memorization. Students are prompted by the text to “stop and think” at important points in the text, in order to help them apply the principles covered. Consistent with this aim, the text’s early chapters avoid immersing students in unnecessary detail such as the minutia relating to all the complexities of audit reporting, focusing instead on students’ intuition relating to the fundamental audit concepts of materiality, audit risk, and audit evidence relating to management assertions. The first chapter provides a high-level introduction to what an audit report looks like while avoiding immersion in unnecessary detail. It also lays out a clear explanation and illustration of the demand for assurance and provides an understandable overview of the auditing process from start to finish. A case involving EarthWear Clothiers, a mail-order retailer, is integrated throughout the book and additional student resources and includes free student access to several useful hands-on mini-cases, with full solutions available to the instructor. Finally, “practice insights” throughout the book engage students and help them see the application of concepts in a practical setting.

**A Systematic Approach.** The text continues to take a systematic approach to the audit process by first introducing the three underlying concepts: audit risk, materiality, and evidence. This is followed by a discussion of audit planning, the assessment of control risk, and a discussion of the nature, timing, and extent of evidence necessary to reach the appropriate level of detection risk. These concepts are then applied to each major business process and related account balances using a risk-based approach. The text has been revised to include the risk assessment process included in the standards adopted by the Auditing Standards Board and the International Auditing and Assurance Standards Board, as well as the PCAOB’s newly adopted Risk Assessment Standards.

**Decision Making.** In covering these important concepts and their applications, the book focuses on critical judgments and decision-making processes followed by auditors. Much of auditing practice involves the application of auditor judgment. If a student understands these basic concepts and how to apply them to an audit engagement, he or she will be more effective in today’s dynamic audit environment. Two of the authors of this textbook recently worked with KPMG to develop a monograph designed to accelerate the development of professional judgment in students. We are very excited to include in this edition a “professional judgment” module as part of the printed material in the text. This module is based on the KPMG Professional Judgment monograph, which was awarded the 2013 AAA Deloitte/Wildman award for the work published within the most recent five-year period that has had the most significant impact on the practice of professional accountancy. Access to additional directly related resources, including videos, mini-cases, and problems, are available on KPMG’s *University Connection* website for integration into the auditing course, as instructors see fit.

# Practical applications for the modern student

## Real-World Integration and Hands-On Mini-Cases.



### Mini EarthWear cases

“Hands-on” mini-cases are integrated throughout the text. Enhanced case descriptions and a new mini-case on the search for unrecorded liabilities were added this edition. The mini-cases are also available in Connect, giving your students the opportunity to actually do some common auditing procedures.

### Practice Insights

Practice Insights in each chapter highlight important and interesting real-world trends and practices.



**IDEA**  
Data Analysis Software

### Free IDEA software

The educational version of IDEA software is available for free with each new book. IDEA is new to this edition and the authors wrote chapter-specific IDEA assignments and problems, all of which are found inside Connect. Exposing students to IDEA allows them the opportunity to work with *real* professional audit software.

## AACSB Statement

McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Auditing and Assurance Services* 10e 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* 10e 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, the mission of the school, and the faculty. While *Auditing and Assurance Services* 10e and the teaching package make no claim of any specific AACSB qualification or evaluation, we have within *Auditing and Assurance Services* 10e labeled selected questions according to the six general knowledge and as a helpful starting point.



### HANDS-ON CASES

EarthWear Online

#### EarthWear Introduction

In this activity you will become further acquainted with EarthWear Clothiers and their auditors Willis and Adams. This introductory activity also provides an opportunity to become familiar with the structure and format of the EarthWear Online cases.

Visit Connect's additional student resources to find a detailed description of the case and to download required materials.

Practice  
INSIGHT

At the heart of a capital-market economy is the flow of reliable information, which investors, creditors, and regulators use to make informed decisions. Chief Justice Warren Burger gave his view of the significance of the audit function 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.

More than 30 years later, the message is the same—users of financial statements rely on the external auditor to act with honor and integrity in protecting the public interest.



Additional Student  
Resources

Visit Connect for author-created problem material to be completed using IDEA software.



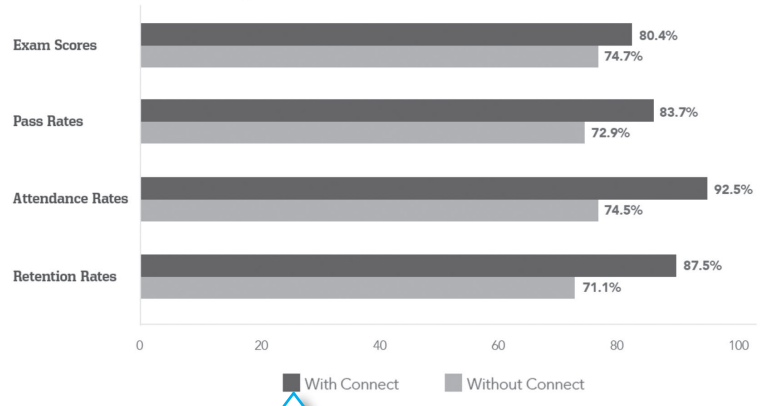
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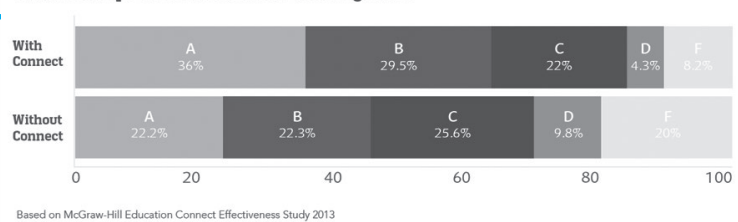
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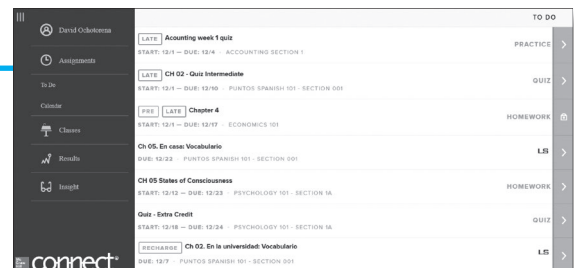
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\*Findings based on a 2015 focus group survey at Pellissippi State Community College administered by McGraw-Hill Education



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(Also visit KPMG's *University Connection* website for relevant resources, including videos, mini-cases, instructor notes, and problems, that were created to accompany the AAA Deloitte/Wildman award-winning KPMG Professional Judgment Framework monograph, on which this module is based.)

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# Introduction to Assurance and Financial Statement Auditing



**CHAPTER 1** An Introduction to Assurance and Financial Statement Auditing

**CHAPTER 2** The Financial Statement Auditing Environment



# CHAPTER

# 1



## LEARNING OBJECTIVES

Upon completion of this chapter you will

- 1-1** Understand why studying auditing can be valuable to you whether or not you plan to become an auditor, and why it is different from studying accounting.
- 1-2** Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.
- 1-3** Understand the relationships among auditing, attestation, and assurance services.
- 1-4** Know the basic definition of a financial statement audit.
- 1-5** Understand three fundamental concepts that underlie financial statement auditing.
- 1-6** Be able to explain why on most audit engagements an auditor tests only a sample of transactions that occurred.
- 1-7** Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.
- 1-8** Know what an audit report is and understand the nature of an unqualified report.
- 1-9** Understand why auditing demands logic, reasoning, and resourcefulness.

## RELEVANT ACCOUNTING AND AUDITING PRONOUNCEMENTS\*

**AU-C 200**, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with GAAS

**AU-C 210**, Terms of Engagement

**AU-C 450**, Evaluation of Misstatements Identified During an Audit

**AU-C 700**, Forming an Opinion and Reporting on Financial Statements

**AU-C 705**, Modifications to the Opinion in the Independent Auditor's Report

**AU-C 706**, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

**PCAOB Auditing Standard No. 1**, References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board

**PCAOB Auditing Standard No. 5**, An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements

**PCAOB Auditing Standard No. 8**, Audit Risk (AU-C 200)

**PCAOB Auditing Standard No. 9**, Audit Planning (AU-C 300)

**PCAOB Auditing Standard No. 10**, Supervision of the Audit Engagement

**PCAOB Auditing Standard No. 11**, Consideration of Materiality in Planning and Performing an Audit (AU-C 320)

**PCAOB Auditing Standard No. 12**, Identifying and Assessing Risks of Material Misstatement (AU-C 315)

**PCAOB Auditing Standard No. 13**, The Auditor's Responses to the Risks of Material Misstatement (AU-C 330)

**PCAOB Auditing Standard No. 15**, Audit Evidence (AU-C 500)

\*References to AU-C sections have been updated to reflect the new, *clarified* codification of ASB standards. Where the ASB has a standard that is similar to a PCAOB standard, the AU-C reference is included in parentheses after the PCAOB standard.

# An Introduction to Assurance and Financial Statement Auditing

You will learn in this chapter that auditing consists of a set of practical conceptual tools that help accounting professionals to find, organize, and evaluate evidence about the assertions of another party. The demand for capable accountants and auditors of high integrity has never been greater. Opportunities for auditors are plentiful and rewarding and can lead to attractive career opportunities in other areas. Those who practice as auditors often later go into financial management, becoming controllers, chief financial officers (CFOs), and even chief executive officers (CEOs). But even those who do not plan to become an auditor can benefit greatly from an understanding of financial statement auditing and its underlying concepts. Learning these tools is valuable to any business decision maker.

The past decade has been challenging for the auditing profession. In the early 2000s, a series of high-profile accounting frauds began to cause investors to doubt the integrity of the nation's financial reporting system, including the role of the external auditor. To restore investor confidence, Congress passed the *Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act* in July 2002—the most significant legislation related to financial statement audits of public companies since the Securities Acts of 1933 and 1934. The implications of the Sarbanes-Oxley Act are discussed throughout the text in appropriate places. While the public scrutiny, government reforms, and establishment of a regulated process for creating auditing standards for public companies have been challenging for accountants and auditors, the events of the last several years have also served as powerful reminders of just how critical the roles of accounting and auditing are in our society.

We live in a time when the amount of information available for decision makers via electronic databases, the Internet, and other sources is rapidly expanding, and there is a great need for the information to be reliable, credible, relevant, and timely. High-quality information is necessary if managers, investors, creditors, and regulatory agencies are to make informed decisions. Auditing and assurance services play an important role in ensuring the reliability, credibility, and relevance of business information.

The following examples present situations that illustrate how auditing increases the reliability and credibility of an entity's financial statements:

Sara Thompson, a local community activist, has been operating a not-for-profit center that provides assistance to abused women and their children. She has financed most of her operations from private contributions. Ms. Thompson applied to the State Health and Human Services Department requesting a large grant to expand her two shelters to accommodate more women. In completing the grant application, Ms. Thompson discovered that the state's laws for government grants require that recipients be audited to ensure that existing funds are being used appropriately. Ms. Thompson hired a CPA to audit the center's financial statements. Based on the center's activities, the intended use of the funds, and the auditor's clean report, the grant was approved.

Conway Computer Company is a wholesaler of computer products. The company was started by George and Jimmy Steinbucker five years ago. Two years ago, a venture capital

firm acquired 40 percent of the company and thus provided capital for expansion. Conway Computer's revenues and profits increased by 25 percent in each of the last two years, and the Steinbucker brothers and the venture capital firm decided to take the company public through a stock sale. However, they knew that the company's financial statements needed to be audited by a reputable public accounting firm before a registration statement could be filed with the Securities and Exchange Commission and in order for investors to trust the stock offering. The company hired a major public accounting firm to perform its audits and the company successfully sold stock to the public.

These situations show the importance of auditing to both private and public enterprise. By adding an audit to each situation, the users of the financial statements have additional assurance that the financial statements report honestly and accurately, and they will be more willing to rely on those statements. Auditors can also provide valuable assurance for operating information, information systems reliability and security, and the effectiveness of an entity's internal control. Consider the following example:



EarthWear Clothiers is a successful mail-order retailer of high-quality clothing for outdoor sports. Over the last few years the company has expanded sales through its Internet site. EarthWear's common stock is listed and traded on NASDAQ. Securities laws require company officials to certify that they have properly designed, implemented, and tested internal control over their accounting and reporting information systems. EarthWear's public accounting firm, Willis & Adams, examines the design and documentation of EarthWear's internal control on a yearly basis and conducts independent tests to verify that EarthWear's controls are operating effectively. Willis & Adams issues a report to the public expressing its opinion as to whether EarthWear's internal control is well designed and operating effectively. Thus, stockholders, creditors, and other stakeholders can have greater confidence in the financial reports issued by EarthWear's management.

Most readers of an introductory auditing text initially have little understanding of what auditing and assurance services entail. Thus, we start by helping you understand in general terms why there is a demand for auditing and assurance services. We then compare auditing to other well-known forms of assurance to provide an intuitive understanding of the economic role auditing plays. Finally, we define auditing, attestation, and assurance services and give you an overview of the financial statement auditing process.

## Tips for Learning Auditing



### LO 1-1

You will find that the study of auditing is different from any of the other accounting courses you have taken in college, and for good reason. Most accounting courses focus on learning the rules, techniques, and computations required to prepare and analyze financial information. Auditing, on the other hand, focuses on learning the analytical and logical skills necessary to evaluate the relevance and reliability of financial information as well as of the systems and processes responsible for recording and summarizing that information. As such, you will find the study of auditing to be much more conceptual in nature than your other accounting courses. This is simply due to the nature of auditing. Thus, we will periodically prompt you to "stop and think" about the concepts being discussed throughout the book. Seeking to thoroughly understand and apply principles as you read them will greatly improve your success in studying auditing.

Learning auditing essentially helps you understand how to gather and assess evidence so you can evaluate assertions (or claims) made by others. This text is filled with the tools and techniques used by financial statement auditors in practice. You'll find that the "tool kit" used by auditors consists of a coherent, logical framework, together with techniques useful for analyzing financial data and gathering evidence about others' assertions. Acquiring this conceptual tool kit can be valuable in a variety of settings, including practicing as an auditor, running a small business, providing consulting services, and even making executive business decisions. An important implication is that learning this framework makes the study of

auditing valuable to you as a future accountant or business decision maker, whether or not you plan to become a financial statement auditor.

While the concepts and techniques you will learn in this book will be useful to you regardless of your career path, our experience is that students frequently fall into the trap of defining auditing in terms of memorized lists of rules, tools, and techniques. The study of auditing and the related concepts and techniques will make a lot more sense if you build your intuition of why audits are needed, if you understand the necessary characteristics of audits and auditors, and if you focus on what an auditor does, and *why*. Don't fall into the trap of attempting to study auditing through rote memorization! Instead, pause frequently to be sure you understand both "what?" and "why?" as you study the concepts and techniques of auditing, as well as "how" auditing is carried out.

As you saw in the introduction to this chapter, reliable information is important for managers, investors, creditors, and regulatory agencies to make informed decisions. Auditing helps ensure that information is reliable, credible, and relevant. In fact, the assurance provided by auditing is vital to the proper functioning of our economic system!

## The Demand for Auditing and Assurance



### LO 1-2

In view of the fact that many of the largest companies spend millions of dollars each year for their annual audit, it is worth asking why an entity would decide to spend so much money on an audit?<sup>1</sup> Some might answer that audits are required by law. While true in certain circumstances, this answer is far too simplistic. Audits are often utilized in situations where they are not required by law, and audits were in demand long before securities laws required them. In fact, evidence shows that some forms of accounting and auditing existed in Greece as early as 500 BC.<sup>2</sup> However, the development of the corporate form of business and the expanding world economy over the last 200 years have given rise to an explosion in the demand for the assurance provided by auditors. In 1926, several years prior to the Securities Acts of 1933 and 1934, which required audits for publicly traded companies in the United States, 82 percent of the companies on the New York Stock Exchange were audited by independent auditors.<sup>3</sup>

### Principals and Agents

The demand for auditing can be understood as the need for accountability when business owners hire others to manage their businesses, as is typical in modern corporations. Until the late 18th and early 19th centuries, most organizations were relatively small and were owned and operated as sole proprietorships or partnerships. Because businesses were generally run by their owners and borrowing was limited, accountability to outside parties often was minimal. The birth of modern accounting and auditing occurred during the industrial revolution, when companies became larger and needed to raise capital to finance expansion.<sup>4</sup> Over time, capital markets developed, enabling companies to raise the investment capital necessary to expand to new markets, finance expensive research and development, and fund the buildings, technology, and equipment needed to deliver products to market. A capital market allows a public company to sell small pieces of ownership (i.e., stocks) or to borrow money in the form

<sup>1</sup>See G. L. Sundem, R. E. Dukes, and J. A. Elliott, *The Value of Information and Audits* (New York: Coopers & Lybrand, 1996), for a more detailed discussion of the demand for accounting information and auditing.

<sup>2</sup>G. J. Costouros, "Auditing in the Athenian State of the Golden Age (500–300 BC)," *The Accounting Historian Journal* (Spring 1978), pp. 41–50.

<sup>3</sup>G. J. Benston, "The Value of the SEC's Accounting Disclosure Requirements," *The Accounting Review* (July 1969), pp. 515–32.

<sup>4</sup>Also see M. Chatfield, *A History of Accounting Thought* (Hinsdale, IL: Dryden Press, 1974), for a discussion of the historical development of accounting and auditing. See D. L. Flesher, G. J. Previts, and W. D. Samson, "Auditing in the United States: A Historical Perspective," *ABACUS* (2005), pp. 21–39, for a discussion of the development of auditing in the United States.

of thousands of small loans (i.e., bonds) so that vast amounts of capital can be raised from a wide variety of investors and creditors. A *public company* is a company that sells its stocks or bonds to the public, giving the public a valid interest in the proper use of the company's resources. Thus, the growth of the modern corporation led to diverse groups of owners who are not directly involved in running the business (stockholders) and the use of professional managers hired by the owners to run the corporation on a day-to-day basis. In this setting, the managers serve as *agents* for the owners (who are sometimes referred to as *principals*) and fulfill a *stewardship* function by managing the corporation's assets.

Accounting and auditing play important roles in this principal-agent relationship. We first explain the roles of accounting and auditing from a conceptual perspective. Then we'll use an analogy involving a house inspector to illustrate the concepts. First, it is important to understand that the relationship between an owner and manager often results in information asymmetry between the two parties. *Information asymmetry* means that the manager generally has more information about the "true" financial position and results of operations of the entity than does the absentee owner.

---

**Stop and Think:** What negative consequences could information asymmetry have for the absentee owner? How do the perspectives and motives of the manager and absentee owner differ?

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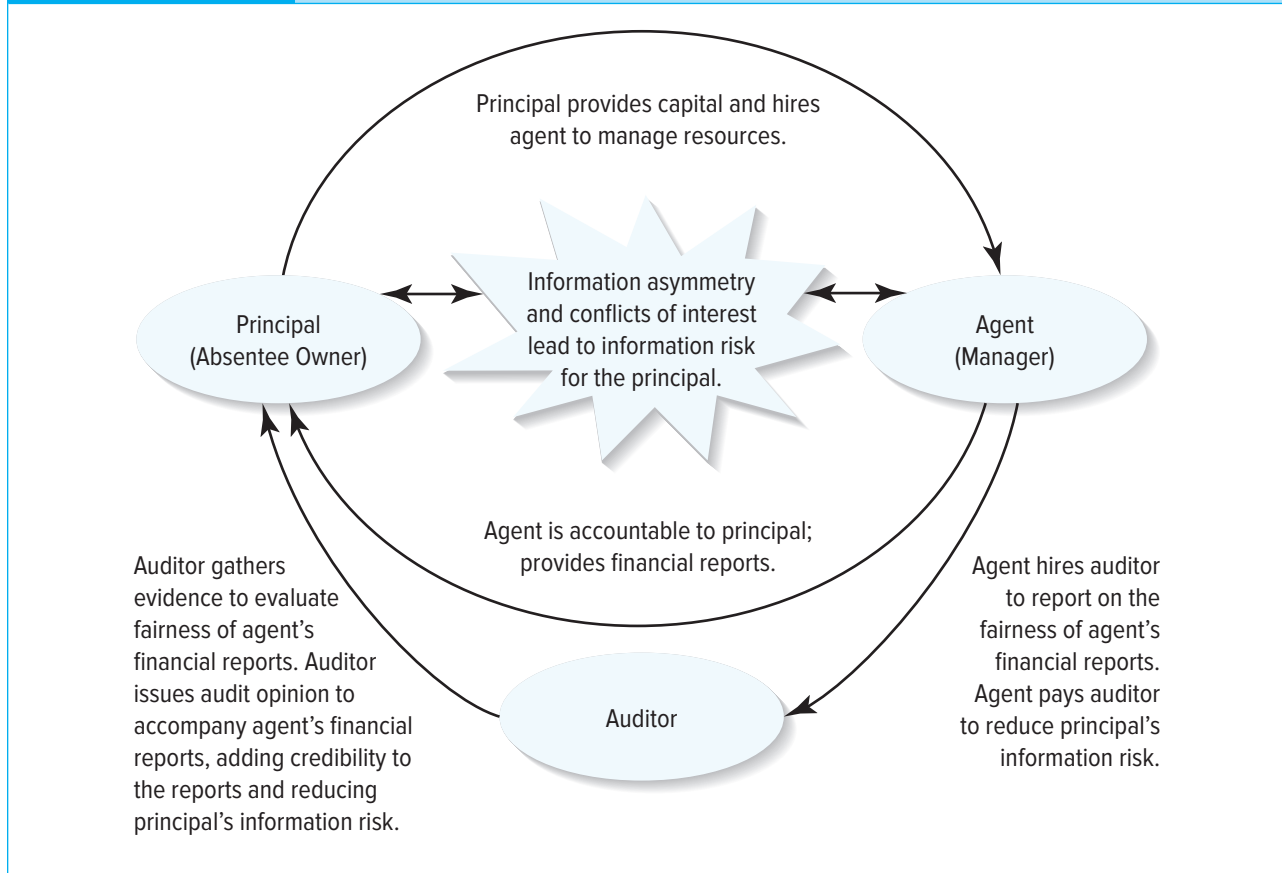
Because their goals may not coincide, there is a natural *conflict of interest* between the manager and the absentee owner. If both parties seek to maximize their self-interest, the manager may not always act in the best interests of the owner. For example, the risk exists that a manager may follow the example of Tyco Inc.'s former CEO Dennis Kozlowski, who spent Tyco funds on excessive personal benefits such as \$6,000 shower curtains, or Andrew Fastow, the former CFO of Enron, who pleaded guilty to manipulating the reported earnings of Enron in order to inflate the price of the company's stock so that he could earn larger bonuses and sell his stock holdings at artificially high prices. The owner can attempt to protect him or herself against the possibility of improper use of resources by reducing the manager's compensation by the amount of company resources that the owner expects the manager to consume. But rather than accept reduced compensation, the manager may agree to some type of monitoring provisions in his or her employment contract, providing assurance to the owner that he or she will not misuse resources. For example, the two parties may agree that the manager will periodically report on how well he or she has managed the owner's assets. Of course, a set of criteria is needed to govern the form and content of the manager's reports. In other words, the reporting of this financial information to the owner must follow some set of agreed-upon principles in holding the manager accountable. As you can see, one primary role of accounting information is to hold the manager accountable to the owner—hence the word *accounting*.

## The Role of Auditing

Of course, reporting in accordance with an agreed-upon set of accounting principles doesn't solve the problem by itself. Because the manager is responsible for reporting on the results of his or her own actions, which the absentee owner cannot directly observe, the manager is in a position to manipulate the reports. Again, the owner adjusts for this possibility by assuming that the manager *will* manipulate the reports to his or her benefit and by reducing the manager's compensation accordingly. It is at this point that the demand for auditing arises. If the manager is honest, it may very well be in the manager's self-interest to hire an auditor to monitor and report to the owner on his or her activities. The owner likely will be willing to invest more in the business and to pay the manager more if the manager can be held accountable for how he or she uses the owner's invested resources. As the amount of capital involved and the number of potential owners increase, the potential impact of accountability also increases. The auditor's role is to determine whether the reports prepared by the manager conform to the contract's provisions. Thus, the auditor's verification of the financial information

FIGURE 1-1

### Overview of the Principal–Agent Relationship Leading to the Demand for Auditing



adds credibility to the report and reduces *information risk*, or the risk that information circulated by a company's management will be false or misleading. Reducing information risk potentially benefits both the owner and the manager. Figure 1–1 provides an overview of this agency relationship.

While the setting we've outlined is very simple, understanding the basics of the owner–manager relationship is helpful in understanding the demand for auditing. The principal–agent model is a powerful conceptual tool that can be extrapolated to much more complex employment and other contractual arrangements. For example, how can a lender prevent management from taking the borrowed funds and using them inappropriately? One way is to place restrictive covenants in the debt agreement with which the entity and its management must comply. Again, this arrangement gives rise to a demand for the auditing of information reported by management to the lender.

#### Practice INSIGHT



At the heart of a capital-market economy is the flow of reliable information, which investors, creditors, and regulators use to make informed decisions. Chief Justice Warren Burger gave his view of the significance of the audit function 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.

More than 30 years later, the message is the same—users of financial statements rely on the external auditor to act with honor and integrity in protecting the public interest.

In summary, auditing is demanded because it plays a valuable role in monitoring the contractual relationships between the entity and its stockholders, managers, employees, and debt holders. Certified public accountants have been charged with providing audit services because of their traditional reputation of competence, independence, objectivity, and concern for the public interest. As a result, they are able to add credibility to information produced and reported by management to outside parties. The role of the Certified Public Accountant is discussed in more detail in Chapter 2.

## An Assurance Analogy: The Case of the House Inspector



### LO 1-2

Before we discuss financial statement auditors further, let's illustrate the concepts we've just covered using an analogy: buying a home. In the purchase of an existing house, *information asymmetry* usually is present because the seller typically has more information about the house than does the buyer. There is also a natural *conflict of interest* between the buyer and the seller. Sellers generally prefer a higher selling price and may be motivated to overstate the positive characteristics and understate or remain silent about the negative characteristics of the property they have for sale. In other words, there is *information risk* to the buyer.

### Seller Assertions, Information Asymmetry, and Inspector Characteristics

To support the asking price, sellers typically make *assertions* about their property. For instance, the seller of an older home might declare that the roof doesn't leak, that the foundation is sound, that there is no rot or pest damage, and that the plumbing and electrical systems are in good working order. Fortunately, many sellers are honest and forthcoming, but this is not always the case. The problem is that the buyer often does not know if she or he is dealing with an honest seller or if the seller has the necessary expertise to evaluate all the structural or mechanical aspects of the property. Lacking the necessary expertise to validate the seller's assertions, the buyer can logically reduce information risk by hiring a house inspector.

---

**Stop and Think:** Imagine for a moment that you are buying a house and are wisely considering hiring an inspector. Test your intuition—what characteristics would you like your inspector to possess?

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### Desired Characteristics of the House Inspection Service

Now that you have identified some of the characteristics of a good inspector, which likely included competence, honesty, and objectivity, consider the key characteristics of the service he or she will provide. Are some of the seller's assertions more important than others? For instance, you are probably not equally concerned with the assertions that there is no structural rot and that the lightbulbs in the master bathroom are working. Depending on what you are willing to pay, the inspection could theoretically range from the extremes of driving past the house to taking the home entirely apart, board by board. How thorough do you want the inspector to be? Do you want the inspector to issue a "pass-fail" grade based on a quick walk-through or would you like more details, such as careful examination of the furnace and air conditioner? As you can see, there are many factors to take into account in deciding on the nature and extent of the assurance service you want to buy. In Table 1-1 we have listed what we think are desirable characteristics of a house inspector and of the service provided by an inspector. Pause for a moment to compare your thinking with ours.

The concepts contained in Table 1-1 are in fact fundamental to most forms of inspection (including financial statement audits). Certainly home inspections and other assurance

TABLE 1-1

## Important Characteristics of House Inspectors and Inspections

**Desirable Characteristics of House Inspectors**

- Competent—they possess the required training, expertise, and experience to evaluate the property for sale.
- Objective—they have no reason to side with the seller; they are independent of the seller's influence.
- Honest—they will conduct themselves with integrity, and they will share all of their findings with the buyer.
- Skeptical—they will not simply take the seller's assertions at face value; they will conduct their own analysis and testing.
- Responsible and/or liable—they should stand behind their assessment with a guarantee and/or be subject to litigation if they fail to act with due care.

**Desirable Characteristics of a House Inspection Service**

- Timely—the results of the service are reported in time to benefit the decision maker.
- Reasonably priced—the costs of the services must not exceed the benefits. For this to occur the service provider will likely need to focus attention on the most important and risky assertions and likely can't provide absolute assurance, even with respect to important seller assertions.
- Complete—the service addresses all of the most important and risky assertions made by the seller.
- Effective—the service provides some degree of certainty that it will uncover significant risks or problems.
- Systematic and reliable—the service is based on a systematic process, and the conclusions are based on reliable evidence. In other words, another comparable inspector would likely find similar issues and come to similar conclusions.
- Informative—the service provides a sense for how likely mechanical or structural failure is in the near future and provides an estimate of the cost to repair known defects or failures.

services must focus on the assertions that are most important, and they must be conducted in a timely and cost-effective manner. Some assertions are more important than others because of their potential risk or cost. For example, a house inspector should recognize the signs that indicate an increased risk of a leaky roof. If those signs are present, he or she should investigate further, because damage caused by a leaky roof can be very expensive to repair. At the same time, just because the seller asserts that he or she recently lubricated all the door and window hinges doesn't mean it would be wise to pay the inspector to validate this assertion.

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**Stop and Think:** How might a house inspection be similar to a financial statement audit?

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### Relating the House Inspection Analogy to Financial Statement Auditing

Now that we have discussed some of the basic characteristics of house inspectors and their services, let's consider how these relate to financial statement auditors. As noted previously, the demand for the assurance provided by a house inspector comes from information asymmetry and conflicts of interest between the buyer and the seller. Information asymmetry and conflicts of interest also exist between managers of companies and potential investors. For example, if managers are overly optimistic or if they wish to inflate their bonus compensation, they may unintentionally or intentionally overstate the company's earnings and assets (e.g., by understating the allowance for doubtful accounts or by claiming to have more cash than they really have). One important difference between our house inspector example and financial statement auditing is that the buyer of a home typically hires the inspector. In other words, the buyer identifies and hires the inspector rather than hiring someone that the seller recommends—presumably because by hiring an inspector directly, they increase the likelihood that the inspector will be objective and independent.

However, as was discussed previously, the companies selling stocks or bonds to the public typically hire and pay the auditor, rather than the other way around. To raise capital in the marketplace, companies often sell many small parcels of stocks and bonds to a large number of investors. Suppose a financial statement audit of a given company would cost \$500,000. Under such circumstances, it obviously doesn't make sense for each individual investor to pay for an audit. Instead, the company hires and pays for the auditor because a reputable independent auditor's opinion can provide assurance to thousands of potential investors. In addition, recall from our previous discussion that the initial demand for auditing comes not from the principal but from the agent. By purchasing the assurance provided by an audit, the company can sell its stocks and bonds to prospective owners and creditors at more favorable prices,