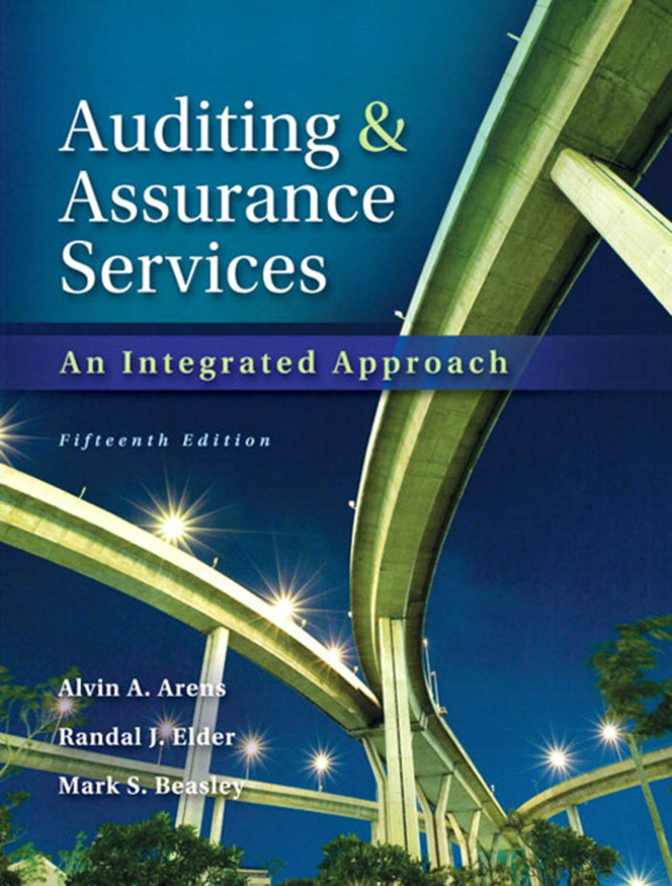

Auditing & Assurance Services

An Integrated Approach

Fifteenth Edition

Alvin A. Arens
Randal J. Elder
Mark S. Beasley

FIFTEENTH EDITION

AUDITING AND ASSURANCE SERVICES

AN INTEGRATED APPROACH

Includes coverage of international standards and global auditing issues, in addition to coverage of the AICPA Clarity Project, PCAOB Auditing Standards, the Sarbanes–Oxley Act, and Section 404 audits.

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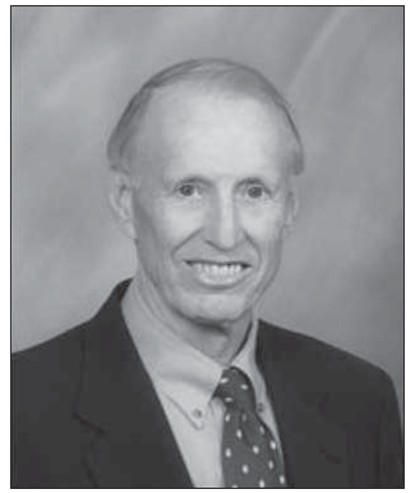
CONTINUING THE LEGACY OF ALVIN A. ARENS



November 24, 1935 – December 6, 2010

The author team of Randy Elder, Mark Beasley, and new contributing author Chris Hogan are pleased to continue the outstanding legacy of our book's founding author, Al Arens, in this 15th edition of *Auditing and Assurance Services: An Integrated Approach*. As was done for the 14th edition, we again dedicate this new edition to Al's memory.

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

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

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

This 15th edition continues his outstanding legacy in audit education.

ABOUT THE AUTHORS

ALVIN A. ARENS

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

RANDAL J. ELDER

Randy Elder, who has served as a coauthor of this textbook since the 8th edition, is Professor of Accounting and Senior Associate Dean at Syracuse University. He teaches undergraduate and graduate auditing courses, and has received several teaching awards. His research focuses on audit quality and current audit firm practices and he served as the team leader for American Accounting Association Auditing Section PCAOB research synthesis teams on audit confirmations and audit sampling. He has extensive public accounting experience with a large regional CPA firm, frequently teaches continuing education for a large international CPA firm, and is a member of the AICPA and Michigan Association of CPAs.

MARK S. BEASLEY

Mark Beasley, who has also served as a coauthor of this textbook since the 8th edition, is the Deloitte Professor of Enterprise Risk Management and Professor of Accounting at North Carolina State University. He teaches undergraduate and graduate auditing courses, and has received several teaching awards including membership in NC State's Academy of Outstanding Teachers. He has extensive professional audit experience with the predecessor firm to Ernst & Young and has extensive standards-setting experience working with the Auditing Standards Board as a Technical Manager in the Audit and Assurance Division of the AICPA. He served on the ASB Fraud Standard Task Force responsible for developing SAS 99, the ASB Antifraud Programs and Controls Task Force, and the Advisory Council overseeing the COSO Enterprise Risk Management Framework project. He recently completed over seven years of service as a member of the COSO Board, representing the AAA.

New Contributing Author

We are pleased to have **Chris Hogan** join us as contributing author for this 15th edition. Chris is an Associate Professor in the Eli Broad College of Business at Michigan State University. We are thrilled to continue the Michigan State connection started by Al Arens. Chris teaches a graduate auditing course and her research focuses on internal controls and integrated audits, audit firm client portfolios, and the impact of regulation on audit markets. Chris has auditing experience with Price Waterhouse, one of the predecessor firms to PricewaterhouseCoopers, LLP.

CONTENTS

CHAPTER 3

AUDIT REPORTS

CHAPTER 4

PROFESSIONAL ETHICS

CHAPTER 5

LEGAL LIABILITY

THE AUDIT PROCESS

PART 2

AUDIT RESPONSIBILITIES AND OBJECTIVES

CHAPTER 6

AUDIT EVIDENCE

CHAPTER 7

AUDIT PLANNING AND ANALYTICAL PROCEDURES

CHAPTER 8

FRAUD AUDITING

CHAPTER 11

THE IMPACT OF INFORMATION TECHNOLOGY ON THE AUDIT PROCESS

CHAPTER 12

OVERALL AUDIT STRATEGY AND AUDIT PROGRAM

CHAPTER 13

PART 3 APPLICATION OF THE AUDIT PROCESS TO THE SALES AND COLLECTION CYCLE

CHAPTER 14 AUDIT OF THE SALES AND COLLECTION CYCLE: TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS

CHAPTER 15 AUDIT SAMPLING FOR TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS

COMPLETING THE TESTS IN THE SALES AND COLLECTION CYCLE: ACCOUNTS RECEIVABLE

CHAPTER 16

AUDIT SAMPLING FOR TESTS OF DETAILS OF BALANCES

CHAPTER 17

APPLICATION OF THE AUDIT PROCESS TO OTHER CYCLES

PART 4

AUDIT OF THE ACQUISITION AND PAYMENT CYCLE: TESTS OF CONTROLS, SUBSTANTIVE TESTS OF TRANSACTIONS, AND ACCOUNTS PAYABLE

CHAPTER 18

PART 6 OTHER ASSURANCE AND NONASSURANCE SERVICES

CHAPTER 25 OTHER ASSURANCE SERVICES

CHAPTER 26 INTERNAL AND GOVERNMENTAL FINANCIAL AUDITING AND OPERATIONAL AUDITING

PREFACE

INTEGRATED APPROACH FOR RISK ASSESSMENT AND AUDIT DECISION-MAKING

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

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

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

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

WHAT'S NEW IN THIS EDITION

Current Coverage

New auditing standards are released without regard to textbook revision cycles. As auditing instructors, we appreciate how critical it is to have the most current content available. This edition includes coverage of the AICPA Clarity Project up through the issuance of SAS No. 126, *The Auditor's Consideration of the Entity's Ability to Continue as a Going Concern*, and new PCAOB standards including Standard No. 16, *Audit Evidence*. We are committed to continually providing you with up-to-date content in this dynamic global auditing environment and will keep you updated with highlights posted on our Web site of major changes in new standards as they are issued.

Emphasis on International Issues

Consistent with the convergence toward international accounting and auditing standards, this edition contains integrated coverage of developments related to international auditing standards and emphasizes issues affecting audits of multi-national entities. Chapter 1 introduces the importance of considering international auditing standards developments, followed by discussion in Chapter 2 about the role of the International Auditing and Assurance Standards Board (IAASB) in the issuance of international standards on auditing (ISAs) and the Auditing Standards Board's efforts to converge U.S. standards to international standards. Chapter 3 highlights implications for auditor reports on companies reporting under International Financial Reporting Standards (IFRS). Several chapters throughout the book include text or mid-chapter vignette coverage of international issues, and international issues are also addressed in homework problems, including research problems.

AICPA Clarity Project

As part of the effort to converge U.S. auditing standards with international standards, the AICPA Auditing Standards Board (ASB) embarked on its Clarity Project to redraft most of the existing GAAS standards to not only align them with the ISAs, but to also make them easier to read, understand, and apply. The ASB is in the final stages of completing this project. Chapter 2 provides an overview of the major implications of the clarified standards, including the new principles that provide the framework to help auditors fulfill the objectives of the audit of financial statements in accordance with AICPA auditing standards and the new Codification of Statements on Auditing Standards. That chapter also highlights the relationship between the new principles in the AICPA auditing standards with the PCAOB's 10 GAAS Standards. Chapter 3 contains examples of the new standard auditor's report format updated by the Clarified SASs. All remaining chapters of the textbook reflect the various revisions resulting from the issuance of the Clarity standards.

Expanded Coverage of Professional Skepticism

With the profession's continued focus on the importance of applying appropriate levels of professional skepticism, we have expanded coverage of this topic in Chapter 6. We discuss the importance of a questioning mindset and the need to critically evaluate audit evidence to strengthen student awareness of the elements of effective professional skepticism. A new homework problem has been added to help students think further about challenges and threats to applying professional skepticism in the context of an audit.

Coverage of AS 5 and the Risk Assessment Standards

The requirements of the Sarbanes–Oxley Act of 2002 and the PCAOB Auditing Standard 5 (AS 5) that impact accelerated filer public companies, and the risk assessment standards issued by the Auditing Standards Board are integrated throughout the text. Chapter 2 emphasizes the importance of understanding the client's business and its environment, including internal control. Chapter 3 highlights reporting on internal controls over financial reporting for auditors of accelerated filer public companies and describes the permanent exemption of that reporting requirement for non-accelerated filers that resulted from the passage of the 2010 federal financial reform legislation and the exemption for certain accelerated filers granted by the issuance of the 2012 JOBS Act. We have always emphasized understanding the client's business and industry in planning, and we incorporate the risk assessment procedures required by the risk assessment standards in our coverage of planning in Chapter 8 and throughout the text. Chapter 10 emphasizes the importance of considering internal control as part of the risk assessment process and for the audit of internal control over financial reporting for large public companies. Subsequent chapters that focus on the transaction cycles include extensive coverage of internal controls to help students understand how the auditor's consideration of internal controls is integrated for audits of the financial statements and internal controls over financial reporting.

Updated Sampling Guidance

In March 2012, the AICPA issued a new audit guide, *Audit Sampling*, to conform that guidance with the clarified SASs and to simplify some of the sampling procedures. Chapters 15 and 17 have been largely rewritten to reflect the guidance in the new audit guide and to simplify the application of sampling concepts. The chapter restructurings, especially coverage of Monetary Unit Sampling (MUS) in Chapter 17, should improve student understanding of core sampling concepts for both nonstatistical and statistical sampling applications.

New Coverage of Financial Instruments

With the increasing volume and complexity of various types of financial instruments and challenges associated with fair value accounting, Chapter 23 has been substantially revised to add important new coverage of issues associated with auditing financial instruments and obtaining sufficient appropriate audit evidence for fair value account estimates. We are excited about this new guidance and believe it will help strengthen student understanding of the challenges associated with auditing financial instruments.

Other Assurance Services

Our coverage of other assurance services in Chapter 25 highlights emerging opportunities for CPAs to provide assurance about corporate social responsibility and sustainability reports. Additionally, both Chapters 10 and 25 reflect the new guidance for service auditors who are reporting on internal controls at service organizations. Chapter 25 also reflects the updated standard compilation and review reports recently issued by the AICPA Accounting and Review Services Committee.

MyAccountingLab®

We are especially excited about our new MyAccountingLab® feature that will be available for the first time with the 15th edition. MyAccountingLab® is a Web-based tutorial and assessment software that not only gives students more "I Get It" moments, but gives instructors the flexibility to make technology an integral part of their course or a supplementary resource for students. MyAccountingLab's homework and practice questions are correlated to the textbook, and they regenerate algorithmically to give students unlimited opportunity for practice and mastery. Questions include guided solutions, DemoDoc Examples, and learning aids for extra help at point-of-use, and they offer helpful feedback when students enter incorrect answers.

ACL Problems

CPA firms continue to use audit software to perform audit testing including tests for fraud. We have included selected problems using ACL in several chapters in the text. These problems are related to the topic of the chapter so that students can see how audit software is used to perform specific types of audit tests. Additional guidance for students on the use of ACL is included both on the text Web site and as an appendix to the text. The educational version of ACL software is included with every new copy of this edition.

Hillsburg Hardware Annual Report

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

Pinnacle Manufacturing Integrated Case

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

New and Revised Homework Problems

All chapters include a research problem that requires students to use the Internet to research relevant auditing issues. All chapters include several new or revised problems.

ORGANIZATION

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

Part 1, The Auditing Profession (Chapters 1–5) The book begins with an opening vignette, featuring the WorldCom fraud, to help students begin to see the connection between recent frauds and the responsibilities for auditing internal control and other requirements of the Sarbanes–Oxley Act. Chapter 1 introduces key provisions of the Act, including the creation of the PCAOB and Section 404 internal control reporting requirements. Chapter 2 covers the CPA profession, with particular emphasis on the standards setting responsibilities of the International Auditing and Assurance Standards Board (IAASB) and the PCAOB and how those responsibilities differ from those of the AICPA Auditing Standards Board (ASB). Chapter 2 provides in-depth coverage of the AICPA Clarity Project and resulting changes to AICPA auditing standards. Chapter 3 provides a detailed discussion of audit reports, including a separate section on the report on internal control over financial reporting for an accelerated filer public company. The chapter also emphasizes conditions affecting the type of report the auditor must issue and the type of audit report applicable to each condition under varying levels of materiality. Chapter 4 explains ethical dilemmas, professional ethics, independence, and the AICPA *Code of Professional Conduct*. Chapter 5 ends this part with an investigation of auditors' legal liability.

Part 2, The Audit Process (Chapters 6–13) The first two of these chapters deal with auditor and management responsibilities, professional skepticism, audit objectives, general concepts of evidence accumulation, and audit documentation, including the management assertions and evidence concepts in the risk assessment standards. Chapter 8 deals with planning the engagement, including understanding the company's business and its industry as part of the auditor's risk assessment procedures, and using analytical procedures as an audit tool. Chapter 9 introduces materiality and risk and how the auditor responds to risks of significant misstatement with further audit procedures. Chapter 10 shows how effective internal controls can reduce planned audit evidence in the audit of financial statements. Most of the chapter describes how auditors of accelerated filer public companies integrate evidence to provide a basis for their report on the effectiveness of internal control over financial reporting with the assessment of control risk in the financial statement audit. Fraud auditing is the focus of Chapter 11, which describes the auditor's responsibility for assessing fraud risk and detecting fraud. The chapter also includes specific examples of fraud and discusses warning signs and procedures to detect fraud. Chapter 12 addresses the most important effects of information technology on internal controls in businesses, risks the auditor must consider, and audit evidence changes. Chapter 13 summarizes Chapters 6 through 12 and integrates them with the remainder of the text.

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

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

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

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

Part 6, Other Assurance and Nonassurance Services (Chapters 25 and 26) The last two chapters deal with various types of engagements and reports, other than the audit of financial statements using generally accepted accounting principles. Topics covered include assurance services, review and compilation services, agreed-upon procedures engagements, attestation engagements, other audit engagements, internal financial auditing, governmental financial auditing, and operational auditing.

SUPPLEMENTS

Instructor's Resource Center www.pearsonhighered.com/arens This password-protected site is accessible from the catalog page for *Auditing and Assurance Services, 15th ed.* and hosts the following resources:

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

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

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

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

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

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

***Auditing Cases, 5th ed.*, by Beasley/Buckless/Glover/Prawitt** This collection of 48 auditing cases addresses most major activities performed during the conduct of an audit, from client acceptance to issuance of an audit report. Several cases ask students to work with realistic audit evidence to prepare and evaluate audit schedules. The cases are available as a collection or as part of the Pearson Custom Publishing Resources Program. For details, go to **www.pearsoncustom.com**.

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We acknowledge the American Institute of Certified Public Accountants for permission to quote extensively from Statements on Auditing Standards, the *Code of Professional Conduct*, Uniform CPA Examinations, and other publications. The willingness of this major accounting organization to permit the use of its materials is a significant contribution to the book and audit education.

We gratefully acknowledge the contributions of the following reviewers for their suggestions and support in the 15th edition as well as previous publications:

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We especially thank the Pearson book team for their hard work and dedication, including Victoria Warneck, Acquisitions Editor; Christina Rumbaugh, Editorial Project Manager; Jane Avery, Editorial Assistant; Donna Battista, Editor in Chief; Maggie Moylan Leen, Director of Marketing; Kimberly Lovato, Marketing Assistant; Ashley Santora, Director of Editorial Services; Roberta Sherman, Senior Production Project Manager; and Jeff Holcomb, Managing Editor.

A. A. A.
R. J. E.
M. S. B.
C. E. H.

PART 1

THE AUDITING PROFESSION

CHAPTERS 1 – 5

These first five chapters in **Part I** provide background for performing financial audits, which is our primary focus. This background will help you understand why auditors perform audits the way they do.

- **Chapters 1 and 2** describe assurance services, including auditing and the role of certified public accounting (CPA) firms and other organizations in performing audits.
- **Chapter 3** provides a detailed discussion of audit reports, which are the final products of audits.
- **Chapters 4 and 5** emphasize the regulation and control of CPA firms through ethical standards and the legal responsibilities of auditors.

CHAPTER 1

THE DEMAND FOR AUDIT AND OTHER ASSURANCE SERVICES

Auditors Have A Great Responsibility

"Oh my!" Gene Morse was stunned. He stared at the computer screen in his cubicle, unable to believe that he had found an unsupported entry for $500 million in computer acquisitions. He immediately took his discovery to his supervisor, Cynthia Cooper, vice president for internal audit at WorldCom. "Keep going," directed Cooper. Her team of internal auditors kept digging. They worked late into the night to avoid detection, concerned that they would be fired if superiors found out what they were doing. They burned data onto CDs because they feared the data might be destroyed.

Major frauds often begin at the top, and such was the case at WorldCom. Bernie Ebbers, WorldCom's founder and CEO, had told Cooper not to use the term "internal controls," claiming that he did not understand it. However, Cooper fought for respect and more resources for the internal audit department. She told Ebbers that her division could save millions of dollars of wasteful operations with internal controls. In the years that followed, "we paid for ourselves many times over," said Cooper.

As she pursued the trail of fraud, Cooper was obstructed at every turn. In late May 2002, Cooper's team found a gaping hole in the accounting records. The company had recorded billions of dollars of regular fees paid to local telephone companies as capital assets. This accounting trick allowed the company to turn a $662 million loss into a $2.4 billion profit in 2001. The company's CFO, Scott Sullivan, called her to his office and asked her what they were up to. He then asked her to delay the investigation to the following quarter, but she refused. In June 2002, the company announced that it had inflated assets by $3.8 billion, the largest accounting fraud in history. When the investigation was complete, the total amount of the fraud had grown to an astonishing $11 billion.

Sources: Adapted from 1. Amanda Ripley, "The Night Detective," *Time* (December 30, 2002); 2. Susan Pulliam and Deborah Solomon, "Uncooking the Books: How Three Unlikely Sleuths Discovered Fraud at WorldCom," *The Wall Street Journal* (October 30, 2002) p. A1.

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- **1-1** Describe auditing.
- **1-2** Distinguish between auditing and accounting.
- **1-3** Explain the importance of auditing in reducing information risk.
- **1-4** List the causes of information risk, and explain how this risk can be reduced.
- **1-5** Describe assurance services and distinguish audit services from other assurance and nonassurance services provided by CPAs.
- **1-6** Differentiate the three main types of audits.
- **1-7** Identify the primary types of auditors.
- **1-8** Describe the requirements for becoming a CPA.

Each chapter's opening story illustrates important auditing principles based on realistic situations. Some of these stories are based on public information about the audits of real companies, whereas others are fictitious. Any resemblance in the latter stories to real firms, companies, or individuals is unintended and purely coincidental.

The opening story involving Cynthia Cooper and WorldCom illustrates the importance of company controls and the role of auditors in detecting fraud. In the aftermath of WorldCom and other major financial reporting frauds, Congress passed the **Sarbanes–Oxley Act**, called by many the most significant securities legislation since the 1933 and 1934 Securities Acts. The provisions of the Act apply to publicly held companies and their audit firms. Section 404 of the Act expanded the audit of public companies to include reporting on the effectiveness of the company's internal control over financial reporting.

This chapter introduces auditing and other assurance services provided by auditors, as well as auditors' role in society. These services provide value by offering assurance on financial statements, the effectiveness of internal control, and other information. There is also a discussion of the types of audits and auditors, including the requirements for becoming a certified public accountant (CPA).

NATURE OF AUDITING

OBJECTIVE 1-1

Describe auditing.

We have introduced the role of auditors in society and how auditors' responsibilities have increased to include reporting on the effectiveness of internal control over financial reporting for larger public companies. We now examine auditing more specifically using the following definition:

> **Auditing** is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent, independent person.

The definition includes several key words and phrases. For ease of understanding, we'll discuss the terms in a different order than they occur in the description.

Information and Established Criteria

To do an audit, there must be information in a *verifiable form* and some standards (*criteria*) by which the auditor can evaluate the information. Information can and does take many forms. Auditors routinely perform audits of quantifiable information, including companies' financial statements and individuals' federal income tax returns. Auditors also audit more subjective information, such as the effectiveness of computer systems and the efficiency of manufacturing operations.

The criteria for evaluating information also vary depending on the information being audited. In the audit of historical financial statements by CPA firms, the criteria may be U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS). This means that in an audit of Boeing's financial statements, the CPA firm will determine whether Boeing's financial statements have been prepared in accordance with GAAP. For an audit of internal control over financial reporting, the criteria will be a recognized framework for establishing internal control, such as *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (widely known as COSO).

For the audit of tax returns by the Internal Revenue Service (IRS), the criteria are found in the Internal Revenue Code. In an IRS audit of Boeing's corporate tax return, the internal revenue agent uses the Internal Revenue Code as the criteria for correctness, rather than GAAP.

For more subjective information, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts. For example, in an audit of the effectiveness of specific aspects of computer operations, the criteria might include the allowable level of input or output errors.

Accumulating and Evaluating Evidence

Evidence is any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including:

- Electronic and documentary data about transactions
- Written and electronic communication with outsiders
- Observations by the auditor
- Oral testimony of the auditee (client)

To satisfy the purpose of the audit, auditors must obtain a sufficient quality and volume of evidence. Auditors must determine the types and amount of evidence necessary and evaluate whether the information corresponds to the established criteria. This is a critical part of every audit and the primary subject of this book.

Competent, Independent Person

The auditor must be qualified to understand the criteria used and must be *competent* to know the types and amount of evidence to accumulate in order to reach the proper conclusion after examining the evidence. The auditor must also have an *independent mental attitude*. The competence of those performing the audit is of little value if they are biased in the accumulation and evaluation of evidence.

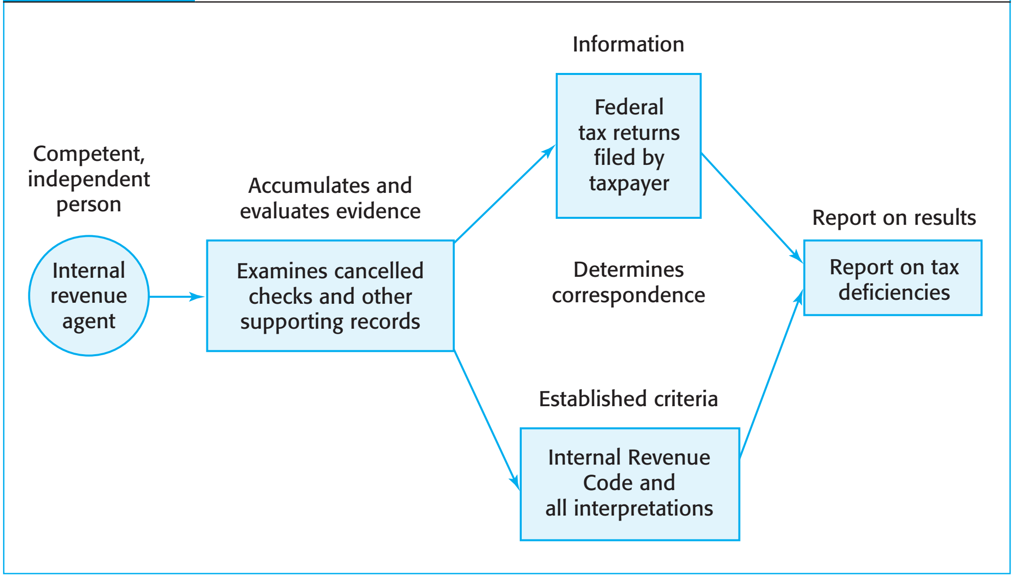
Auditors strive to maintain a high level of independence to keep the confidence of users relying on their reports. Auditors reporting on company financial statements are often called **independent auditors**. Even though such auditors are paid fees by the company, they are normally sufficiently independent to conduct audits that can be relied on by users. Even internal auditors—those employed by the companies they audit—usually report directly to top management and the board of directors, keeping the auditors independent of the operating units they audit.

Reporting

The final stage in the auditing process is preparing the **audit report**, which communicates the auditor's findings to users. Reports differ in nature, but all must inform readers of the degree of correspondence between the information audited and established criteria. Reports also differ in form and can vary from the highly technical type usually associated with financial statement audits to a simple oral report in the case of an operational audit of a small department's effectiveness.

The key parts in the description of auditing are illustrated in Figure 1-1 using an IRS agent's audit of an individual's tax return as an example. To determine whether the tax return was prepared in a manner consistent with the requirements of the federal Internal Revenue Code, the agent examines supporting records provided by the taxpayer and from other sources, such as the taxpayer's employer. After completing

FIGURE 1-1 **Audit of a Tax Return**



the audit, the internal revenue agent issues a report to the taxpayer assessing additional taxes, advising that a refund is due, or stating that there is no change in the status of the tax return.

DISTINCTION BETWEEN AUDITING AND ACCOUNTING

OBJECTIVE 1-2

Distinguish between auditing and accounting.

Many financial statement users and the general public confuse auditing with accounting. The confusion results because most auditing is usually concerned with accounting information, and many auditors have considerable expertise in accounting matters. The confusion is increased by giving the title "certified public accountant" to many individuals who perform audits.

Accounting is the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making. To provide relevant information, accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting information. In addition, accountants must develop a system to make sure that the entity's economic events are properly recorded on a timely basis and at a reasonable cost.

When auditing accounting data, auditors focus on determining whether recorded information properly reflects the economic events that occurred during the accounting period. Because U.S. or international accounting standards provide the criteria for evaluating whether the accounting information is properly recorded, auditors must thoroughly understand those accounting standards.

In addition to understanding accounting, the auditor must possess expertise in the accumulation and interpretation of audit evidence. It is this expertise that distinguishes auditors from accountants. Determining the proper audit procedures, deciding the number and types of items to test, and evaluating the results are unique to the auditor.

ECONOMIC DEMAND FOR AUDITING

OBJECTIVE 1-3

Explain the importance of auditing in reducing information risk.

To illustrate the need for auditing, consider the decision of a bank officer in making a loan to a business. This decision will be based on such factors as previous financial relationships with the business and the financial condition of the business as reflected by its financial statements. If the bank makes the loan, it will charge a rate of interest determined primarily by three factors:

1. *Risk-free interest rate.* This is approximately the rate the bank could earn by investing in U.S. treasury notes for the same length of time as the business loan.
2. *Business risk for the customer.* This risk reflects the possibility that the business will not be able to repay its loan because of economic or business conditions, such as a recession, poor management decisions, or unexpected competition in the industry.
3. *Information risk.* **Information risk** reflects the possibility that the information upon which the business risk decision was made was inaccurate. A likely cause of the information risk is the possibility of inaccurate financial statements.

Auditing has no effect on either the risk-free interest rate or business risk, but it can have a significant effect on information risk. If the bank officer is satisfied that there is minimal information risk because a borrower's financial statements are audited, the bank's risk is substantially reduced and the overall interest rate to the borrower can be reduced. The reduction of information risk can have a significant effect on the borrower's ability to obtain capital at a reasonable cost. For example, assume a large company has total interest-bearing debt of approximately $10 billion. If the interest rate on that debt is reduced by only 1 percent, the annual savings in interest is $100 million.

Causes of Information Risk

OBJECTIVE 1-4

List the causes of information risk, and explain how this risk can be reduced.

As society becomes more complex, decision makers are more likely to receive unreliable information. There are several reasons for this: remoteness of information, biases and motives of the provider, voluminous data, and the existence of complex exchange transactions.

Remoteness of Information In a global economy, it is nearly impossible for a decision maker to have much firsthand knowledge about the organization with which they do business. Information provided by others must be relied upon. When information is obtained from others, the likelihood of it being intentionally or unintentionally misstated increases.

Biases and Motives of the Provider If information is provided by someone whose goals are inconsistent with those of the decision maker, the information may be biased in favor of the provider. The reason can be honest optimism about future events or an intentional emphasis designed to influence users. In either case, the result is a misstatement of information. For example, when a borrower provides financial statements to a lender, there is considerable likelihood that the borrower will bias the statements to increase the chance of obtaining a loan. The misstatement could be incorrect dollar amounts or inadequate or incomplete disclosures of information.

Voluminous Data As organizations become larger, so does the volume of their exchange transactions. This increases the likelihood that improperly recorded information is included in the records—perhaps buried in a large amount of other information. For example, if a large government agency overpays a vendor's invoice by $2,000, it is unlikely to be uncovered unless the agency has instituted reasonably complex procedures to find this type of misstatement. If many minor misstatements remain undiscovered, the combined total can be significant.

Complex Exchange Transactions In the past few decades, exchange transactions between organizations have become increasingly complex and therefore more difficult to record properly. The increasing complexity in transactions has also resulted in increasingly complex accounting standards. For example, the correct accounting treatment of the acquisition of one entity by another poses relatively difficult accounting problems, especially as it relates to fair value estimations. Other examples include properly combining and disclosing the results of operations of subsidiaries in different industries and properly valuing and disclosing derivative financial instruments.

Reducing Information Risk

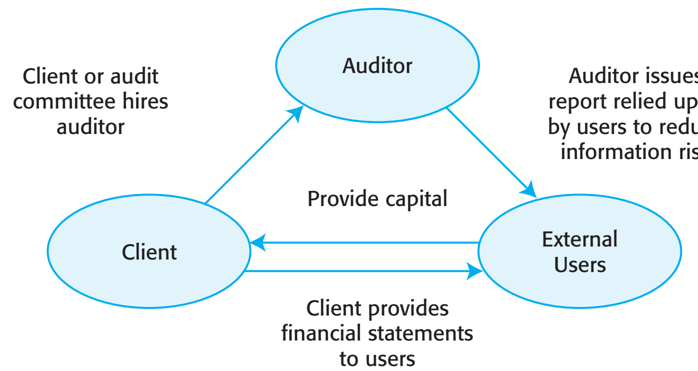
After comparing costs and benefits, business managers and financial statement users may conclude that the best way to deal with information risk is simply to have it remain reasonably high. A small company may find it less expensive to pay higher interest costs than to increase the costs of reducing information risk.

For larger businesses, it is usually practical to incur costs to reduce information risk. There are three main ways to do so.

User Verifies Information The user may go to the business premises to examine records and obtain information about the reliability of the statements. Normally, this is impractical because of cost. In addition, it is economically inefficient for all users to verify the information individually. Nevertheless, some users perform their own verification. For example, the IRS does considerable verification of business and individual tax returns to determine whether the tax returns filed reflect the actual tax due the federal government. Similarly, if a business intends to purchase another business, it is common for the purchaser to use a special audit team to independently verify and evaluate key information of the prospective business.

User Shares Information Risk with Management There is considerable legal precedent indicating that management is responsible for providing reliable information to users. If users rely on inaccurate financial statements and as a result

FIGURE 1-2 **Relationships Among Auditor, Client, and External Users**



incur a financial loss, they may have a basis for a lawsuit against management. A difficulty with sharing information risk with management is that users may not be able to collect on losses. If a company is unable to repay a loan because of bankruptcy, it is unlikely that management will have sufficient funds to repay users.

Audited Financial Statements Are Provided The most common way for users to obtain reliable information is to have an independent audit. Typically, management of a private company or the audit committee for a public company engages the auditor to provide assurances to users that the financial statements are reliable.

External users such as stockholders and lenders who rely on those financial statements to make business decisions look to the auditor's report as an indication of the statements' reliability. Decision makers can then use the audited information on the assumption that it is reasonably complete, accurate, and unbiased. They value the auditor's assurance because of the auditor's independence from the client and knowledge of financial statement reporting matters. Figure 1-2 illustrates the relationships among the auditor, client, and financial statement users.

ASSURANCE SERVICES

OBJECTIVE 1-5

Describe assurance services and distinguish audit services from other assurance and nonassurance services provided by CPAs.

An **assurance service** is an independent professional service that improves the quality of information for decision makers. Such services are valued because the assurance provider is independent and perceived as being unbiased with respect to the information examined. Individuals who are responsible for making business decisions seek assurance services to help improve the reliability and relevance of the information used as the basis for their decisions.

Assurance services can be done by CPAs or by a variety of other professionals. For example, Consumers Union, a nonprofit organization, tests a wide variety of products used by consumers and reports their evaluations of the quality of the products tested in *Consumer Reports*. The organization provides the information to help consumers make intelligent decisions about the products they buy. Many consumers consider the information in *Consumer Reports* more reliable than information provided by the product manufacturers because Consumers Union is independent of the manufacturers. Similarly, the Better Business Bureau (BBB) online reliability program, the BBB Accredited Business Seal, allows Web shoppers to check BBB information about a company and be assured the company will stand behind its service. Other assurance services provided by firms other than CPAs include the Nielsen television and Internet ratings and Arbitron radio ratings.

The need for assurance is not new. CPAs have provided many assurance services for years, particularly assurances about historical financial statement information. CPA firms have also performed assurance services related to lotteries and contests to provide assurance that winners were determined in an unbiased fashion in accordance with contest rules. More recently, CPAs have expanded the types of assurance services they perform to include forward-looking and other types of information, such as company financial forecasts and Web site controls. For example, businesses and consumers using the Internet to conduct business need independent assurances about the reliability and security of electronic information. The demand for assurance services continues to grow as the demand increases for real-time electronic information.

Attestation Services

One category of assurance services provided by CPAs is attestation services. An **attestation service** is a type of assurance service in which the CPA firm issues a report about a subject matter or assertion that is made by another party. Attestation services fall into five categories:

1. Audit of historical financial statements
2. Audit of internal control over financial reporting
3. Review of historical financial statements
4. Attestation services on information technology
5. Other attestation services that may be applied to a broad range of subject matter

Audit of Historical Financial Statements

In an **audit of historical financial statements**, management asserts that the statements are fairly stated in accordance with applicable U.S. or international accounting standards. An audit of these statements is a form of attestation service in which the auditor issues a written report expressing an opinion about whether the financial statements are fairly stated in accordance with the applicable accounting standards. These audits are the most common assurance service provided by CPA firms.

Publicly traded companies in the United States are required to have audits under the federal securities acts. Auditor reports can be found in all public companies' annual financial reports. Most public companies' audited financial statements can be accessed over the Internet from the Securities and Exchange Commission (SEC) EDGAR database or directly from each company's Web site. Many privately held companies also have their annual financial statements audited to obtain financing from banks and other financial institutions. Government and not-for-profit entities often have audits to meet the requirements of lenders or funding sources.

Audit of Internal Control over Financial Reporting

For an audit of **internal control over financial reporting**, management asserts that internal controls have been developed and implemented following well established criteria. Section 404 of the Sarbanes–Oxley Act requires public companies to report management's assessment of the effectiveness of internal control. The Act also requires auditors for larger public companies to attest to the effectiveness of internal control over financial reporting. This evaluation, which is integrated with the audit of the financial statements, increases user confidence about future financial reporting, because effective internal controls reduce the likelihood of future misstatements in the financial statements.

"AND THE OSCAR GOES TO . . ."

"THERE SHE IS, MISS AMERICA . . ."

"WELCOME TO THE NEW YORK STATE LOTTERY . . ."

You probably recognize these statements from the Academy Awards, the Miss America Pageant, and the New York State Lottery drawing. What you may not recognize is what these well-known events have to do with assurance services. Each event is observed by CPAs from a major accounting firm to assure viewers that the contests were fairly conducted. So when you become a member of a CPA firm, you might not win an Oscar—but you could be on the Oscars!