



11TH EDITION

# AUDITING

A RISK-BASED APPROACH

JOHNSTONE | GRAMLING | RITTENBERG





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The auditing environment continues to change in significant ways. University graduates entering the auditing profession today should be prepared for a high standard of responsibility, should be ready to serve the public interest, and should recognize the emerging issues and continuing points of focus facing auditors. Examples of today's emerging issues and continuing points of focus facing the profession include:

- New accounting guidance from the Financial Accounting Standards Board on *leases* and *revenue recognition*.
- Increased need for *critical thinking* and *professional skepticism*.
- Increased and growing use of *data analytics tools*.
- Continued and increasing importance of *ethical and professional decision making*.
- Continued efforts toward *international convergence of auditing standards* of the American Institute of Certified Public Accountants (AICPA) and the International Auditing and Assurance Standards Board (IAASB).
- *Reorganization of the Public Company Accounting Oversight Board (PCAOB) auditing standards* to provide auditors and others with a logical framework and easy access to the standards governing the conduct of audits of public companies.
- The *IAASB's issuance of new and revised auditor reporting standards*, which require auditors to provide more transparent and informative reports on the companies they audit, including the disclosure of *key audit matters*.
- The *PCAOB's adoption of a new auditing standard on the auditor's report*, including the disclosure of *critical audit matters*.

The eleventh edition of *Financial Statement Auditing: A Risk-Based Approach* represents the most up-to-date professional auditing guidance available and reflects the many emerging issues and continuing points of focus in the profession. This text provides students with the tools they need to understand the full range of issues associated with conducting a quality financial statement audit in an evolving national and global context.

## Revision Themes and New Enhancements in the Eleventh Edition

**Coverage of Emerging Data Analytics Tools.** Data analytics tools include qualitative and quantitative techniques and processes that auditors use to enhance their productivity and effectiveness in terms of extracting, categorizing, identifying, and analyzing patterns in their client's data. Emerging data analytics tools facilitate testing 100% of a population, enabling the auditor to focus on potentially erroneous transactions or risky areas of the audit. These emerging tools also include sophisticated data visualization tools, for example, Tableau. Data analytics tools also include familiar platforms such as Excel, ACL, and IDEA; the landscape is changing dramatically and quickly in this space, so instructors and students must be adaptive to fast-paced change. We introduce

key terms and explain data analytics tools in an expanded *Chapter 8*, with an entirely new section, “Using Data Analytics Tools to Obtain and Evaluate Evidence.” We also include end-of-chapter problems to reinforce opportunities to employ data analytics tools within *Chapter 8* and the following cycle chapters (e.g., data analytics in the revenue cycle in *Chapter 9*).

*Auditing Standards Exhibit—PCAOB, AICPA, and IAASB—appears inside the front cover of this textbook.* This exhibit allows for easy access to relevant standards, and provides a platform for relative comparisons across each of the standards-setting bodies. End-of-chapter problems require students to review and apply the material in the *Auditing Standards Exhibit*. These problems provide students with practice completing task-based simulations similar to what they will see on the CPA exam; we highlight these problems with an identifying icon.

*Three New Learning Engagement Features.* Students today demand more than case facts and standard lectures. They require opportunities to engage with the instructor and classmates on important topics facing the profession.

- *“Why It Matters” feature.* This feature helps students see beyond the factual insights provided in the chapters. Elements include for example, extensions based on in-the-news examples that illustrate fundamental features and applications of text facts, professional standards in foreign jurisdictions, and interesting points that may be tangential to the text facts, but that should facilitate students’ deep engagement with the chapter. Certain of these features are noted as relating to an International Focus.
- *“Prompt for Critical Thinking—It’s Your Turn!” feature.* This feature encourages students to engage in critical thinking as they acquire knowledge relevant to each chapter. This feature is intentionally creative in form and substance, and varies widely in structure based upon the learning objective to which it is related. As an example of one such prompt, students are asked to consider auditors’ responsibilities with respect to internal controls around the Foreign Corrupt Practices Act.
- *“What Do You Think?—For Classroom Discussion” feature.* This feature provides an avenue by which instructors can facilitate preparation for class, cognitive engagement, and critical thinking through discussions with other students. Like the *Prompt for Critical Thinking* feature, *What Do You Think?* is creative in form and substance and varies in unexpected ways to spark students’ interest in engagement with the chapter topic. This feature is an ideal way for instructors to facilitate an interesting class discussion using a flipped-classroom approach (either involving the entire class or within small teams).

Below we provide examples of each of these three new learning engagement features that appear in *Chapter 14* (“Completing a Quality Audit”) with respect to the learning objective “Obtaining Remaining Audit Evidence on Noncompliance with Laws and Regulations.”

- The *Why It Matters* feature articulates the motivation for and provisions of the Foreign Corrupt Practices Act (FCPA).
- The *Prompt for Critical Thinking* feature extends this discussion by prompting students to think about corruption, how to measure it, and its variation across different jurisdictions.
- The *What Do You Think?* feature encourages students to consider the applicability of the FCPA in today’s business and auditing environment.

## Compliance with the Foreign Corrupt Practices Act (FCPA) of 1977

*Why It Matters*

*This feature highlights an important law that many companies have failed to comply with.*

The FCPA was written to respond to SEC investigations in the 1970s revealing that over 400 companies had made questionable or illegal payments of over \$300 million to foreign officials, politicians, and political parties. The payments involved bribery of foreign officials to facilitate business operations in their respective foreign countries. The main provisions of the FCPA include:

- No U.S. person or company that has securities listed on U.S. markets may make a payment to a foreign official for the

purpose of obtaining or retaining business. This provision is commonly called the anti-bribery provision of the FCPA.

- Companies that have securities listed on U.S. markets must make and keep financial records that accurately and fairly reflect the transactions of the company and must design and maintain an adequate system of internal accounting controls.
- Certain payments to foreign officials are acceptable. These include grease payments, which are payments made to an official to expedite the performance of the duties that the official would already be bound to perform.

## Prompt for Critical Thinking

Before reading this text, had you heard of the Transparency International corruption perception index? Think critically about what you know about the political and economic structure of the following countries. In the spaces below, (1) rank the six countries

from most corrupt to least corrupt just from what you know, and (2) guess what their ranking is on a scale from 0–100 on the corruption perception index from 0 (highly corrupt) to 100 (very clean):

Country (in alphabetical order)	Rank (1 = most to 6 = least corrupt among this list)	Estimated corruption perception index (0 – 100)
Belgium		
Brazil		
New Zealand		
Somalia		
South Korea		
United States of America		

After ranking the countries, visit Transparency International and compare your answers and estimates against theirs:

[https://www.transparency.org/news/feature/corruption\\_perceptions\\_index\\_2016#table](https://www.transparency.org/news/feature/corruption_perceptions_index_2016#table)

What are your reactions to what you have learned? What rankings surprised you? How accurate were your rankings?



## What Do You Think?

### For Classroom Discussion

The FCPA of 1977 was enacted a LONG time ago!

1. Do you think it is still relevant today? Why or why not?
2. Review the following SEC website:

<https://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml> What are your impressions? What surprises you? What companies on this

list are well-known? Focus on one of the enforcement actions (perhaps at the discretion of your instructor) and explain how the company violated the FCPA.

*Updates to “Focus on Fraud” Feature.* The authors continue their use of this learning engagement feature, which provides compelling examples of recent frauds, and the role of the auditor in preventing, detecting, or (sometimes) *not* detecting those frauds. Below we provide an example of this learning feature that appears in *Chapter 14* (“Completing a Quality Audit”) with respect to the learning objective “Obtaining Remaining Audit Evidence on Noncompliance with Laws and Regulations.”

## Focus on Fraud

### Triton Energy and Noncompliance with Laws and Regulations

*This feature describes a historically important case involving noncompliance with the Foreign Corrupt Practices Act (FCPA) of 1977.*

Triton Energy engages in the exploration and production of crude oil and natural gas in many areas around the world. Triton has traditionally operated in relatively high-risk, politically unstable areas where larger and better-known producers do not operate. Top Triton Indonesia officials (President, CFO, Commercial Manager, and Controller) were investigated by the SEC for violations of the Foreign Corrupt Practices Act. These violations included:

- Improper payments were made to a middleman who used the funds to reduce Triton Indonesia’s tax liability.
- Improper payments were made to a middleman who used the funds to ensure a favorable governmental audit.
- Improper payments were made to a middleman who used the funds to obtain corporate tax refunds from government officials.

- The recording of false journal entries by Triton Indonesia’s Commercial Manager and Controller were made to cover up the improper payments.

These improper payments and false journal entries were facilitated because Triton’s CEO, Bill Lee, was an aggressive top manager who provided weak tone at the top in terms of his failure to encourage compliance with applicable laws and regulations, failure to discourage improper payments, and failure to implement internal controls to deter improper payments. Triton was ultimately fined \$300,000 related to the scandal.

*For further details, see the SEC’s Securities Exchange Act of 1934 Release No. 38343 and Accounting and Auditing Enforcement Release No. 889, February 27, 1997.*

- To help students prepare for the CPA exam, MindTap for Auditing includes two pre- and post-tests using author-selected multiple-choice questions from Becker Professional Education, all tailored to this edition’s critical learning objectives.
- “*Check Your Basic Knowledge*” feature. To enhance and expand on the *Becker CPA Exam Questions* feature, each chapter includes additional true-false and multiple-choice questions *within the chapter text itself*.

Following the discussion of each learning objective within the chapters, we challenge students to answer four questions (two true-false and two multiple-choice) to alert students to their effective learning, or alternatively, to their lack of understanding (which should encourage students to more carefully acquire the concepts relating to each particular learning objective). Taken collectively, the Becker CPA Exam Questions and Check Your Basic Knowledge questions ensure that students have the opportunity to challenge themselves during reading the chapter, thereby tracking their learning, and after reading the chapter.

- *Updated and Expanded Chapter Examples and End-of-Chapter* problems, including “*Review Questions and Short Cases*,” “*Application Activities*,” along with more extensive longer cases: “*Fraud Focus: Contemporary and Historical Cases*.” To help instructors identify these problems, the text includes the following icons that highlight overall themes: *Ethics, Fraud, Professional Skepticism, International Issues, and Auditing Standards Application Activities*. We also rely extensively on using facts from SEC Accounting, Auditing, and Enforcement Releases (AAERs) and PCAOB Enforcement Actions in the cases to illustrate the regulatory implications of auditors’ judgments and decisions. For most chapters, we have updated the *Academic Research Cases*, providing instructors with an opportunity to introduce students to the relevance of academic research to the auditing profession.

*Examples of Selected Cases by Chapter include:*

Longtop Financial Technologies (Ch. 1), Bentley’s Brisbane Partnership (Ch. 1), Wells Fargo (Ch. 2), Weatherford International (Ch. 2), Lime Energy (Ch. 2), U.S. Department of Defense (Ch. 3), Diamond Foods (Ch. 3), Chesapeake Petroleum and Supply (Ch. 3), Florida Department of Financial Services (Ch. 4), Toshiba (Ch. 4), Boeing (Ch. 5), ContinuityXSolutions, Inc. (Ch. 7), Ag Feed Industries (Ch. 9), China Media Express Holdings (Ch. 9), Monsanto Corporation (Ch. 9), Agricultural Bank of China (Ch. 10), MagnaChip (Ch. 11), Miller Energy Resources (Ch. 12), Soyo Group (Ch. 13), Logitech (Ch. 13), 2GO (Ch. 14), Chelsea Logistics Holding Corp. (Ch. 14), Swiss Finance (Ch. 14), ImmunoGen, Inc. (Ch. 15), Rolls Royce (Ch. 15), and Westmoreland Coal Company (Ch. 15).

*Expanded View of “Users.”* In prior versions, our user-emphasis was on shareholders, bondholders, regulators, and standards-setters as primary actors. While of course critical, we now incorporate discussion of the role that analysts play (e.g., in incentivizing managers, and therefore affecting the judgments and decisions of users), along with stock market reactions to both financial accounting and auditing information disclosures. As an illustration of one such view, we include the following discussion in *Chapter 9* (the revenue cycle), embedded in a *Why It Matters* feature.

# Why It Matters

## The Incentive for Managers to Commit Fraud in the Revenue Cycle: The Role of Stock Analysts and Consensus Earnings Calculations

This feature provides insight into the role that stock analyst following and consensus analyst earnings per share calculations play in affecting managements' incentives to commit fraud.

To understand this concept better, see the analysts' forecast report for Ford Motor Company as of June 2017, which we reproduce below.

Stock analysts follow companies and issue earnings per share and revenue forecasts they anticipate for the companies they follow.



This report shows that 16 analysts together, that is, by consensus predict Q1 2017 earnings per share of \$0.35 per share, and that the actual results were better than that at \$0.39 per share. It also shows that the annual earnings per share for 2016 was \$1.76; analysts

make predictions about both quarterly and annual earnings per share. Managers do not want to "disappoint" the market by having their earnings results come in "under forecast," which creates the incentive for earnings manipulation.



This report shows that 15 analysts together, that is, by consensus predict Q1 2017 revenues at \$34.59 billion, while the actual revenue that Ford reported exceeded that estimate, coming in at \$36.48 billion. Managers do not want to “disappoint” the market by having their revenue results come in “under forecast,” which creates the incentive for fraudulently overstated revenue amounts.

**What does the term “analyst consensus forecast” mean?**

It means the average earnings per share or revenue based on all the analysts that are following the company. If a company is at or near its consensus forecast and the auditor proposes a material, income decreasing audit adjustment, client management may

resist because they do not want to report a negative earnings surprise.

**What is a negative earnings surprise or a negative revenue surprise?**

It is a negative departure from the consensus analyst earnings forecast or the revenue forecast, for example, lower actual earnings per share amount compared to the consensus or lower revenue compared to the consensus expectation.

For further details, see

<https://markets.ft.com/data/equities/tearsheet/forecasts?s=F:NYQ>

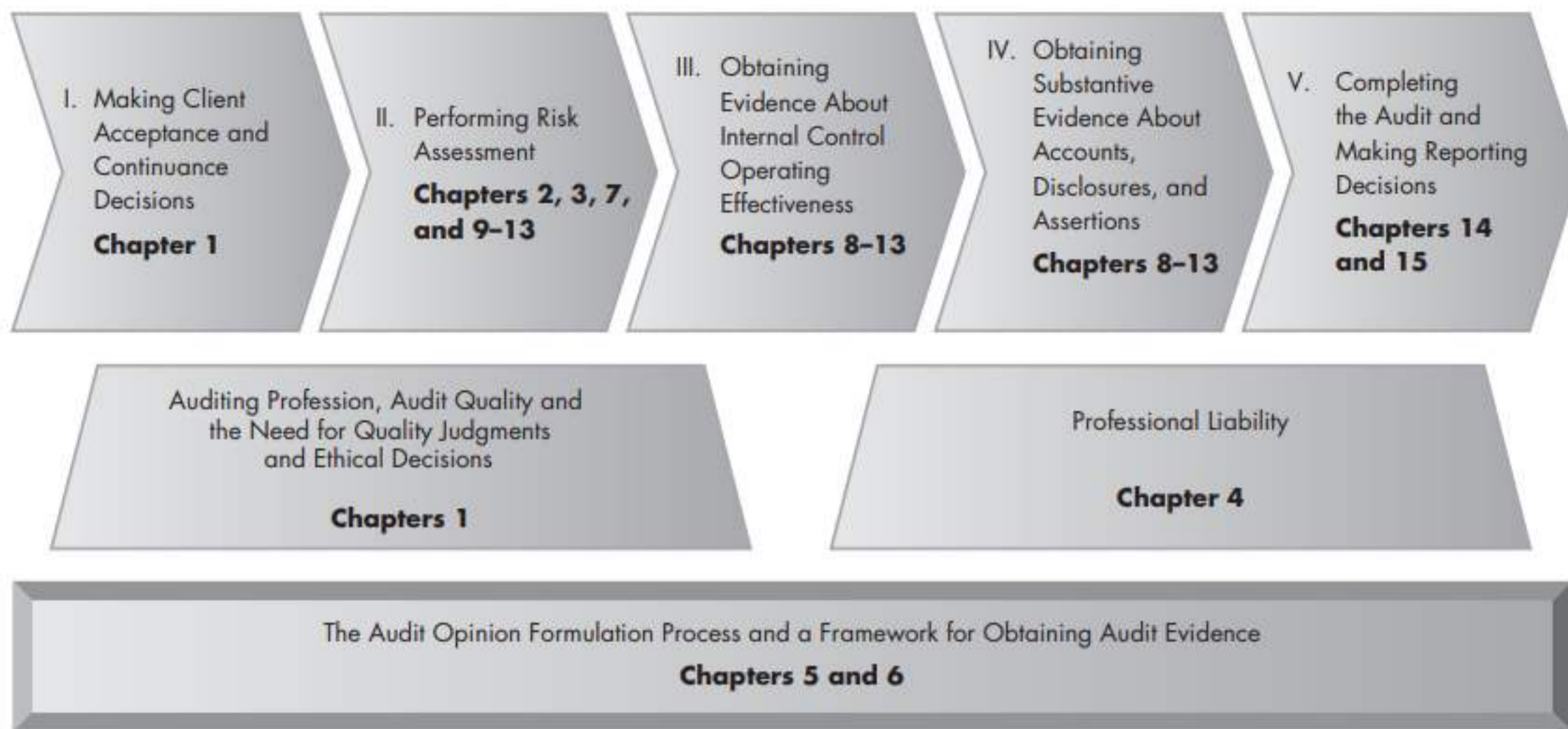
## Hallmark Pedagogical Features

*Articulating an audit opinion formulation process to help organize students’ acquisition of the technical material in each chapter.* A chapter-opening figure helps students identify the major phases in the audit process and see how the steps within that process relate to specific chapters. The textbook describes how auditors go through a structured judgment process to issue an audit opinion. We refer to this process as the *Audit Opinion Formulation Process*, and it serves as the foundation for this textbook.

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

Also fundamental to students’ understanding is the framework’s inclusion of the auditing profession, audit quality, quality judgments, ethical decisions, and professional liability. Further fundamentals highlighted in the *Audit Opinion Formulation Process* include discussion of a framework for obtaining audit evidence, as depicted below.

*Recognizing that professional judgment, sufficient appropriate evidence, and quality decisions are critical to conducting a quality financial statement audit.* In addition to the focus on professional judgment throughout the text, numerous exercises emphasize this key auditing skill, including examples and end-of-chapter materials based on the business press, PCAOB enforcement actions, SEC filings, and company proxy statements. Further, the end-of-chapter materials help ensure that students understand the link between mandatory financial reporting and auditing, risk assessment, transaction cycles, and analytical procedures.



*Emphasizing that professional skepticism, which can be challenging to maintain, is at the heart of auditor judgments.* This emphasis provides students with the tools to learn how to apply the concept of professional skepticism. We include conceptual discussion of this topic in *Chapter 1*, with substantial reinforcement through the remaining chapters in the text, as well as in end-of-chapter materials (highlighted with an identifying icon for ease of identification). This emphasis helps students see the practical application of professional skepticism, as well as provides practical insights as to downside risks when auditors fail to maintain appropriate levels of skepticism.

*Using data analytics tools and analytical procedures to improve the effectiveness and efficiency of the audit.* The text contains a new focus on data analytics around “big data” that will become an evolving hallmark pedagogical feature over subsequent editions. The text covers planning, substantive, and review-related analytical procedures, and provides ways in which auditors can use data analytics tools to perform these procedures. *Chapter 6* and *Chapter 7* outline the theory of analytical procedures, and discuss appropriate processes and best practices. Various end-of-chapter problems provide examples of using analytical procedures. *Chapters 9, 11, and 13* contain an extensive practice case (set in the pharmaceutical industry, complete with data based on three real companies) that would be ideal for a semester team project to enforce concepts around analytical procedures.

*Employing specific learning objectives, which we introduce at the outset of each chapter in a “What You Will Learn” feature and summarize at the end of each Chapter with a “Let’s Review” feature.* We reinforce these objectives throughout the chapter materials, along with linking the objectives to specific end-of-chapter materials, including links to academic research cases to enhance students’ appreciation for the theoretical underpinnings of the learning objectives. These learning objectives help to shape students’ cognitive architecture as they integrate their preliminary understanding of chapter topics with the theory, examples, and accompanying discussion that follow.

*Providing and applying professional decision-making and ethical decision-making frameworks.* Decision-making frameworks, introduced in *Chapter 1*, require students to think about real-life professional and ethical decisions associated in each chapter. End-of-chapter materials continue the use of these professional and ethical decision-making frameworks to help students

address contemporary issues. Further, we identify these problems as part of the last learning objective in each chapter.

*Acquiring hands-on experience through a practice-oriented audit case.* On the CengageNOW website, you will find a tool that allows students to engage in a practice-oriented audit case. Brony's Bikes is an auditing case that encompasses a complete auditing scenario spanning from Performing Risk Assessment (Phase II of the Audit Opinion Formulation Process) to making reporting decisions (Phase V of the Audit Opinion Formulation Process). The case includes 13 modules that address specific activities included in the Audit Opinion Formulation Process. The authors have structured these 13 modules so that each can be undertaken independently of the other modules. For example, Module I, *Assessment of Inherent Risk*, takes the students through the audit planning process based on AU-C 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, AU-C 300 *Planning an Audit*, and AU 315-C *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Module I can be assigned on a stand-alone basis or along with any or all of the other modules at the instructor's discretion.

Students gain experience with auditing documentation including many working papers. Analytical procedures are performed in Excel worksheets requiring conclusions and recommendations.

## Other Resources

### **MindTap: Empower Your Students**

MindTap is a platform that propels students from memorization to mastery. It gives you complete control of your course, so you can provide engaging content, challenge every learner, and build student confidence. Customize interactive syllabi to emphasize priority topics, then add your own material or notes to the eBook as desired. This outcomes-driven application gives you the tools needed to empower students and boost both understanding and performance.

### **Access Everything You Need in One Place**

Cut down on prep with the preloaded and organized MindTap course materials. Teach more efficiently with interactive multimedia, assignments, quizzes, and more. Give your students the power to read, listen, and study on their phones, so they can learn on their terms.

### **Empower Students to Reach their Potential**

Twelve distinct metrics give you actionable insights into student engagement. Identify topics troubling your entire class and instantly communicate with those struggling. Students can track their scores to stay motivated toward their goals. Together, you can be unstoppable.

### **Control Your Course—and Your Content**

Get the flexibility to reorder textbook chapters, add your own notes, and embed a variety of content including Open Educational Resources (OER). Personalize course content to your students' needs. Students can even read your notes, add their own notes, and highlight key text to aid their learning.

### **Get a Dedicated Team, Whenever You Need Them**

MindTap isn't just a tool; it's backed by a personalized team eager to support you. We can help set up your course and tailor it to your specific objectives, so you'll be ready to make an impact from day one. Know we'll be standing by to help you and your students until the final day of the term.

*Becker CPA Exam Questions*

To help students prepare for taking the CPA exam, for each chapter, students have access to four or five representative multiple-choice questions from the Becker test bank, tailored to each chapter's most critical learning objectives.

*ACL analytics and audit software with updated cases.*

This edition integrates ACL software into end-of-chapter materials. An ACL Appendix and tutorial is located at the end of the text. The ACL Appendix contains an overview of the basic functions of ACL followed by a brief, illustrated tutorial to help students learn how to use the basic features of the ACL Analytics. Access to the software can be provided by Instructors who are enrolled in the ACL Academic Network program.

ACL cases include the following:

1. *Pell Grants*, a fraud investigation case related to this student grant program. (*Chapter 6*)
2. *Husky Accounts Receivable*, which includes exercises in which students identify unpaid invoices and sales made over credit limits, perform cutoff analyses, conduct aging analyses, and identify procedures to be performed based upon their results. (*Chapter 9*)
3. *FloorMart Sales and Inventory*, which requires students to identify store locations in which data appear to indicate potential inaccuracies, and to identify procedures to gather additional evidence. (*Chapter 9*)
4. *Husky Inventory*, which includes exercises in which students identify potentially obsolete inventory, calculate inventory turnover, consider possible write-downs, and prepare a report based on their results. (*Chapter 11*)
5. *Benford's Law Case*, a fraud case dealing with employee expense reimbursements and the application of Benford's Law of numbers. (*Chapter 14*)

## Organization of the Eleventh Edition

### **The demand for quality auditing: Chapter 1.**

*Chapter 1* provides the foundation for students to understand the economic context in which financial statement auditing exists. The chapter defines the objective of financial statement auditing and describes its role in meeting society's demands for reliable financial and internal control information. *Chapter 1* introduces the Financial Reporting Council's *Audit Quality Framework*, and identifies professional conduct requirements that help auditors achieve high quality. This chapter also provides frameworks for professional and ethical decision making. *Chapter 1* also describes the process by which audit firms make client acceptance and continuance decisions, and recognizes that this process is important to achieving audit quality.

### **Risk assessment with a focus on fraud and internal controls over financial reporting: Chapters 2 and 3.**

*Chapter 2* defines fraud, describes the fraud triangle, and provides examples of recent financial reporting frauds. The chapter discusses users' expectations of auditors' fraud-related responsibilities, explains how various requirements of the Sarbanes-Oxley Act of 2002 help prevent fraud, and discusses the importance of corporate governance in relation to quality auditing.

*Chapter 3* articulates the importance of internal control over financial reporting, defines internal control, identifies and describes the components

and principles of internal control, and describes management's responsibility related to internal control. *Chapter 3* also explains how to distinguish between material weaknesses, significant deficiencies, and control deficiencies in internal control over financial reporting.

**Important elements of the professional environment and the audit opinion formulation process: Chapters 4, 5, and 6.**

*Chapter 4* discusses the liability environment in which auditors operate, explores the effects of lawsuits on audit firms, identifies laws from which auditor liability is derived, and describes possible remedies, sanctions, and auditor defenses.

*Chapter 5* identifies and compares auditing standards that provide audit guidance on the audit opinion formulation process, and discusses the foundational principles underlying these standards. The chapter lists the phases and related activities in the audit opinion formulation process, explains the concept of accounting cycles, describes the assertions that are inherent to financial statements, defines audit evidence and the purpose and types of audit procedures used to obtain audit evidence, and discusses the importance of audit documentation.

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

**Planning the audit and employing appropriate audit tools: Chapters 7 and 8.**

*Chapter 7* defines the concept of material misstatement and discusses the importance of materiality judgments in the audit context. The chapter also identifies the risks of material misstatement and describes how they relate to audit risk and detection risk. *Chapter 7* illustrates how auditors respond to assessed risks of material misstatement.

In planning how to respond to assessed risk of material misstatements, auditors need to determine which of the available specialized tools they will use. *Chapter 8* describes how auditors can use sampling techniques and data analytics tools to gather and evaluate sufficient appropriate audit evidence. The chapter explains the objectives of sampling for testing controls and account balances, compares and contrasts nonstatistical and statistical sampling, describes attributes sampling, describes the sampling process used to gather evidence about misstatements in account balances and assertions, describes monetary unit sampling, and explains how to use data analytics tools to obtain and evaluate audit evidence.

**Performing Audits Using the Transaction Cycle Approach: Chapters 9, 10, 11, 12, and 13.**

These five chapters focus on the application of concepts developed earlier for assessing risk, identifying and testing controls designed to address those risks, and using substantive approaches to testing account balances. Each chapter:

- identifies significant accounts, disclosures, and relevant assertions
- explains the process of identifying and assessing inherent risks, fraud risks, and control risks



- describes planning analytical procedures that the auditor can use to identify potential material misstatement
- articulates appropriate responses to identified risks of material misstatement, including appropriate tests of controls and considering results of tests of controls
- and identifies how to apply substantive audit procedures.

### **Completing a quality audit and issuing the audit report: Chapters 14 and 15.**

*Chapter 14* discusses the procedures that auditors conduct while completing the audit. These procedures include reviewing activities relating to detected misstatements, loss contingencies, disclosure adequacy, non-compliance with laws or regulations, review analytical procedures, going-concern matters, and subsequent events. The chapter also distinguishes between a management representation letter and a management letter, identifies procedures that are part of an engagement quality review, and identifies issues the auditor should communicate to the audit committee and management.

Once these activities are completed, the auditor makes a reporting decision, which is described in *Chapter 15*. This chapter identifies the principles underlying audit reporting on financial statements, describes the information that is included in an unqualified/unmodified audit report, and describes financial statement audits resulting in an unqualified/unmodified audit opinion with report modifications. The chapter describes financial statement audits resulting in a qualified opinion, an adverse opinion, or a disclaimer of opinion. *Chapter 15* describes the emerging critical audit matters (PCAOB) and key audit matters (IAASB) disclosures that auditors will, or already are, including in the auditor's report. The chapter also describes the information that is included in a standard unqualified audit report on internal control over financial reporting and identifies the appropriate audit report modifications for situations requiring other than an unqualified report on internal control over financial reporting. *Chapter 15* concludes with a discussion of how auditors should respond to situations in which omitted procedures come to light after the audit report has been issued.

## Supplements

**Companion Site:** Instructors and students can find most of the textbook's support materials online at [login.cengage.com](http://login.cengage.com)., including the solutions manual, PowerPoint slides, ACL data spreadsheet files, and other resources.

**Solutions Manual:** The solutions manual contains the solutions to all end-of-chapter assignments. It is available on the instructor's page at [www.cengagebrain.com](http://www.cengagebrain.com).

**PowerPoint Slides:** Instructors can bring their lectures to life with engaging PowerPoint slides that are interesting, visually stimulating, and paced for student comprehension. These slides are ideal as lecture tools and provide a clear guide for student study and note-taking. We have purposely provided *more* slides rather than *less*! We encourage instructors to tailor down the slides to meet their own, individual instructional preferences.

**Test Bank:** Cengage Learning Testing Powered by Cognero is a flexible, online system that allows you to:

- author, edit, and manage test bank content from multiple Cengage Learning solutions,
- create multiple test versions in an instant,
- deliver tests from your LMS, your classroom, or wherever you want. The test bank is also available in Microsoft Word.

The eleventh edition integrates the use of ACL software into both homework and cases. An appendix and tutorial located at the end of the textbook provide guidance for students unfamiliar with the software. Access to the software can be provided by instructors who are enrolled in the ACL Academic Network program.

Access to the software for qualified instructors and their students can be arranged with ACL through the Academic Network program: <http://info.acl.com/Academic-Network-for-Professors.html> and [http://info.acl.com/Academic-Network-Program\\_Professor-Sign-up.html](http://info.acl.com/Academic-Network-Program_Professor-Sign-up.html). The signup process may take a few weeks to process so first-time instructors should sign-up for the program in advance of their teaching semester.

Once instructors join the Academic Network, they will have access to:

- ACL GRC - a cloud-based platform for audit management (including electronic workpapers)
- ACL Analytics
- ACL Launchpad - the single access point for ACL GRC, ACL Analytics, as well as support, ScriptHub, and ACL Academy
- Analytical Procedures: A Case in the Context of the Pharmaceutical Industry (*Chapters 9, 11, and 13*): The case contains online Excel files that students download and analyze. The case enables students to practice developing and conducting planning and substantive analytical procedures. We developed the case using the published financial statements of three prominent companies in this industry, with adaptations to make the case suitable for classroom use. Students will access an Excel file on the companion site at [login.cengage.com](http://login.cengage.com). The Excel file contains financial data and information from footnote disclosures. We view these exercises as one type of data analytic technique – one that individual instructors may be more comfortable using than emerging data analytics such as Tableau or other similar platforms.

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Karla M. Johnstone, Ph.D., CPA, is the Ernst & Young (EY) Professor of Accounting and Information Systems at the University of Wisconsin–Madison, School of Business. She teaches auditing, and her research investigates a broad range of auditing topics, including: curriculum enhancements in auditing, along with auditor decision making; client acceptance and continuance decisions; how fraud risk and fraud brainstorming affect audit planning and audit fees; client–auditor negotiation; competitive bidding; audit budget-setting processes; and governance responses to various negative corporate events such as fraud or internal control material weakness disclosures. Professor Johnstone serves on the editorial boards of numerous academic journals and is active in the Auditing Section of the American Accounting Association (AAA). She recently completed a term as the President of the Auditing Section. Before beginning her coursework for her Ph.D., Karla worked as a corporate accountant and as a staff auditor and was a doctoral fellow in residence at Coopers & Lybrand. Importantly, Karla’s research and interactions with practice—both in the U.S., and abroad (e.g., the Foundation for Audit Research in the Netherlands)—demonstrate a significant commitment to the theory and practice of auditing, along with associated regulatory and standards-setting activities.

## **Audrey A. Gramling**

Audrey A. Gramling, Ph.D., CPA, CIA is the Accounting Department Chair and Professor at Colorado State University. Previously, she held the Treece Endowed Chair and was Accounting Department Professor and Chair at Bellarmine University. She has been on the accounting faculty at Kennesaw State University, Georgia State University, Wake Forest University, and University of Illinois at Urbana-Champaign. Audrey’s research investigates both internal and external auditing issues, with a focus on decision behavior of auditors, external auditor independence, internal control reporting, and other factors affecting the market for audit and assurance services. Prior to earning her Ph.D. at the University of Arizona, Audrey worked as an external auditor at a predecessor firm of Deloitte and as an internal auditor at Georgia Institute of Technology. She has also served a one-year appointment as an Academic Accounting Fellow in the Office of the Chief Accountant at the U.S. Securities and Exchange Commission. She is a past-President of the Auditing Section of the American Accounting Association and has served in an advisory role to the Committee of Sponsoring Organizations (COSO). In February 2018 she began serving as a member of the AICPA’s Auditing Standards Board. For over three decades, in recognition of the valuable role of auditing as a key component of corporate governance, Audrey has been committed to both the practice and theory of quality auditing.

## Larry E. Rittenberg

Larry E. Rittenberg, Ph.D., CPA, CIA, is Professor Emeritus, Department of Accounting and Information Systems, at the University of Wisconsin–Madison, where he taught courses in auditing, risk management, and corporate governance. He is also Chair Emeritus of the COSO of the Treadway Commission, where he provided oversight of the development of the COSO Enterprise Risk Management Framework, the COSO Guidance for Smaller Businesses, and was instrumental in developing the Framework for COSO 2013. He has served as Vice-Chair of Professional Practices for the Institute of Internal Auditors (IIA) and President of the IIA Research Foundation, and has been a member of the Auditing Standards Committee of the AAA Auditing Section, the NACD Blue Ribbon Commission on Audit Committees, the IIA's Professional Practices Committee, and Vice-President and Treasurer of the AAA. He recently retired as audit committee chair and board member of Woodward Governor, a publicly traded company, and has consulted on audit committee, risk, and control issues with Petro China – the largest public company in China. Professor Rittenberg served as a staff auditor for Ernst & Young and has co-authored five books and monographs and numerous research articles.

## Recommendations from Instructors Who Have Used Our Textbook Previously

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

*Professor Veena L. Brown, University of Wisconsin-Milwaukee.* This textbook is ideal for my students as it presents a good mix of theory and practice using the integrated audit approach. The authors do a great job portraying the auditing concepts in a deceptively simple manner. The Exhibits and the Professional Judgment in Context presented in each chapter helps students better grasp the sometimes-elusive auditing concepts. I have successfully used this textbook for the past six years and look forward to exploring the next edition with my students.

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

*Professor Sean Dennis, University of Kentucky.* I use this book because it has it all... detailed (yet intuitive!) explanations, challenging review questions for students, and detailed cases that are both timely and relevant. The authors have organized the material in a way that helps students build an understanding of risk and the audit process from the ground up. The questions and cases at the end of the chapters also help create engaging discussions among students that

lead to productive critical thinking. In fact, my favorite thing about this book is that the authors continually update the cases at the end of the chapters. This has really helped my students relate to the course material – and I use these cases in class as much as I can!

*Professor Denise Hanes Downey, Villanova University.* The beauty of this textbook is that it facilitates an appreciation for the many nuances and complexities of auditing without overwhelming students. The authors appropriately balance necessary details with illustrations and *recent* examples to guide students' understanding. As a result, students come into class ready to engage in higher level discussions – having mastered the fundamentals on their own. From a course design perspective, I appreciate how the chapters stand-alone allowing professors to select chapters they find to be of particular importance without requiring additional chapters be added to the syllabus for clarity.

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

## How Can You Learn by Leveraging the Features of this Textbook?

*Follow these ten steps:*

1. Before you even begin, go online to MindTap via [login.cengage.com](http://login.cengage.com) and complete the first **Becker CPA Exam Pre-test**, which the authors have personally tailored to the chapters and learning objectives in this textbook. There is a 25-question Pre-test relating to Chapters 1–8, and another 25-question Pre-test relating to Chapters 9–15. In addition, these same tests are available online as **Becker CPA Exam Post-tests**, so that you can track your knowledge progress both within this course, as well as relating to the upcoming CPA exam.
2. For each chapter, start by viewing the **Audit Opinion Formulation Process** diagram at the outset of the chapter. Relevant chapter topics are highlighted for your reference so that you can track your progress through learning about all of the phases of conducting a quality audit.
3. Take a few minutes to read the **What's Covered** feature in the chapter, which briefly describes the main themes of the chapter. Then, review the **Learning Objectives**. Just as you begin to read the chapter, quickly read the **What You Will Learn** questions. Engaging in these simple and quick actions will help you know what to expect out of each chapter, which research shows will help you organize your knowledge and recall it later (during exams!).
4. To help set the practical application for each chapter, read the **Why It Matters** feature at the outset of each chapter. This feature will help you see beyond the factual insights provided in the chapters. Elements include for example, extensions based on in-the-news examples that illustrate fundamental features and applications of text facts, professional standards in foreign jurisdictions, and interesting points that may be tangential to the text facts, but that should facilitate your deep engagement with the chapter. In addition, we highlight some of these features as relating to an **International Focus**.

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