

Twenty-Second Edition

Principles of Auditing & OTHER ASSURANCE SERVICES



**Mc
Graw
Hill**

O. Ray Whittington | Kurt Pany

Principles of Auditing & Other Assurance Services

Principles of Auditing & Other Assurance Services

Twenty-second Edition

O. Ray Whittington

*CIA, CMA, CPA
DePaul University*

Kurt Pany

*CFE (RET), CPA (RET)
Arizona State University*

**Mc
Graw
Hill**



PRINCIPLES OF AUDITING & OTHER ASSURANCE SERVICES

Published by McGraw Hill LLC, 1325 Avenue of the Americas, New York, NY 10121. Copyright © 2022 by McGraw Hill LLC. All rights reserved. Printed in the United States of America. No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written consent of McGraw Hill LLC, including, but not limited to, in any network or other electronic storage or transmission, or broadcast for distance learning.

Some ancillaries, including electronic and print components, may not be available to customers outside the United States.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 LWI 24 23 22 21 20

ISBN 978-1-260-59808-7

MHID 1-260-59808-X

Cover Image: *littlewormy/Shutterstock*

All credits appearing on page or at the end of the book are considered to be an extension of the copyright page.

The Internet addresses listed in the text were accurate at the time of publication. The inclusion of a website does not indicate an endorsement by the authors or McGraw Hill LLC, and McGraw Hill LLC does not guarantee the accuracy of the information presented at these sites.

About the Authors

O. Ray Whittington

O. Ray Whittington, CIA, CMA, CPA, serves as the Director of the School Accountancy and MIS at DePaul University. He received his BBA, MS, and PhD degrees from Sam Houston State University, Texas Tech University, and the University of Houston, respectively. Professor Whittington is an active textbook author on the subjects of auditing and audit sampling. He also has published in a variety of journals, including *The Accounting Review*, *The Journal of Accounting Research*, *Behavioral Research in Accounting*, and *Auditing: A Journal of Practice and Theory*. He has served as a member of the Board of Regents of The Institute of Internal Auditors and has served as chair of the Auditing Standards Committee of the Auditing Section and the Bylaws Committee, both of the American Accounting Association. Professor Whittington has served as a member of the AICPA Auditing Standards Board and as the president of the Auditing Section of the American Accounting Association.

Kurt Pany

Kurt Pany, CFE and CPA (RET), is Professor Emeritus of Accounting at Arizona State University. He received his BS, MBA, and PhD degrees from the University of Arizona, the University of Minnesota, and the University of Illinois, respectively. He also has served as a staff accountant with Arthur Andersen and Touche Ross, as a member of the Auditing Standards Board, and as an academic fellow with the American Institute of Certified Public Accountants. Professor Pany has published articles on auditing in such journals as *The Journal of Accounting Research*, *The Accounting Review*, *Auditing: A Journal of Practice and Theory*, *The Journal of Accountancy*, and *The CPA Journal*. He is a member of and has served on various committees of the American Accounting Association and the American Institute of Certified Public Accountants.

Preface

The 22nd edition of *Principles of Auditing & Other Assurance Services* provides a carefully balanced presentation of auditing theory and practice. Written in a clear and understandable manner, it is particularly appropriate for students who have had limited or no audit experience. The approach is to integrate auditing material with that of previous accounting financial, managerial, and systems courses.

The text's first nine chapters emphasize the philosophy and environment of the auditing profession, with special attention paid to the nature and economic purpose of auditing, auditing standards, professional conduct, legal liability, audit evidence, audit planning, consideration of internal control, and audit sampling. Chapters 10 through 16 (the "procedural chapters") deal with internal control and obtaining evidence about the various financial statement accounts and classes of transactions, emphasizing a risk-based approach to selecting appropriate auditing procedures. Chapter 17 presents the auditors' reporting responsibilities when performing financial statement audits. Chapter 18 provides detailed guidance on integrated audits of public companies performed in accordance with PCAOB and SEC requirements under the Sarbanes-Oxley Act of 2002. Chapters 19 and 20 present the auditors' reporting responsibilities when performing other attestation and accounting services, such as reviews and compilations of financial statements and performing services on prospective financial statements. Chapter 21 presents coverage of internal, compliance, and operational auditing.

The text is well suited for an introductory one-semester or one-quarter auditing course. Alternatively, it is appropriate for a two-course auditing sequence that covers the material in greater detail. For example, an introductory course might emphasize Chapters 1 through 10, 16, and 17. A second course may include coverage of the other procedural chapters (Chapters 11 through 15); integrated audits (Chapter 18); other attestation and accounting services; and internal, operational, and compliance auditing (Chapters 19, 20, and 21). With two courses, the instructor might decide to divide coverage of the Chapter 9 modules between the first and second courses, with or without audit software. Overall, the text and supporting materials provide:

1. **A balanced presentation.** The text provides a carefully balanced presentation of auditing and assurance theory and practice. The concepts are written in a clear, concise, and understandable manner. Real company examples are integrated throughout the text to bring this material to life. Finally, Keystone Computers & Networks Inc., the text's illustrative audit case, is integrated into selected chapters, providing students with hands-on audit experience.
2. **Organization around balance sheet accounts emphasized in previous accounting courses.** Organizing the text around balance sheet accounts is a particularly straightforward and user-friendly way to address the risk assessment-based approach to auditing required by both U.S. and international auditing standards. These standards require an in-depth understanding of the audited company and its environment, a rigorous assessment of the risks of where and how the financial statements could be materially misstated, and an improved linkage between the auditors' assessed risks and the particulars of audit procedures performed in response to those risks. Chapters 5 through 7 of the text describe the risk assessment approach in detail. Chapters 10 through 16 are aligned with the risk assessment approach presented in the professional standards. Accordingly, the suggested audit approach and procedures of the professional standards flow smoothly from the approach suggested in earlier chapters of the text. In short, our organization of the book facilitates student learning of the risk assessment process in a very straightforward manner. Also, although the text chapters are structured around balance sheet accounts, they thoroughly cover the various transaction cycles. For example, Chapter 11 provides detailed coverage of the revenue cycle.

3. **A cohesive connection from learning to career: Data Analytics** is a rapidly expanding requirement in the field of auditing. To prepare students, data analytics is addressed throughout this text and incorporate exercises and problems that drive critical thinking and analysis. In conjunction, we incorporate software to drive these employability skills through the use of Tableau and IDEA software and with data analytics questions posed in Connect.
4. **CPA examination support.** The text's emphasis on current auditing standards, its many author-created objective questions (including document review simulations), and a partnership with Roger CPA Review are all aimed at helping students pass the CPA exam. As discussed in detail in the following section, this edition has significantly expanded the number of simulations like the ones included on the CPA exam, with several now included in *Connect*®.
5. **Strong student and instructor support.** McGraw Hill's *Connect*® and its vast array of instructor and student resources provide a wealth of material to help keep students up to date.

We are confident that the 22nd edition of *Principles of Auditing & Other Assurance Services* will provide students with a clear perspective of today's auditing environment.

O. Ray Whittington
Kurt Pany

Key Features of the Book

The first seven chapters of the text emphasize the philosophy and environment of the profession, with special attention paid to the nature and economic purpose of auditing and assurance services, professional standards, professional conduct, legal liability, audit evidence, audit planning, and consideration of internal control.

Chapter 1: Emphasizes the role of the public accountant, the structure of CPA firms, and the various types of audits and auditors. It also introduces the important concept of corporate governance and includes a brief history of the auditing profession, including up-to-date coverage of the Sarbanes-Oxley Act of 2002 and the Public Company Accounting Oversight Board.

Chapter 2: Includes detailed coverage of the various professional standards underlying audits and other attestation services. Also included are the recently revised nonpublic company audit report.

Chapter 3: Updated to reflect the most recent AICPA and PCAOB requirements. This includes detailed coverage of the AICPA Code of Professional Conduct and more research-oriented questions. Problems requiring an electronic search of the AICPA Code of Professional Conduct are included. New coverage includes (1) the effects of systems design on the independence of the auditors, and (2) audit firm responsibilities when a breach of independence has occurred.

Chapter 4: Clear, concise coverage of CPA legal liability reviewed by legal scholar Professor Marianne Jennings of Arizona State University.

Chapters 5, 6, and 7: Material from the risk assessment standards is thoroughly integrated throughout.

Chapter 5: A discussion of the nature of audit evidence. This chapter has been thoroughly revised to reflect new AICPA pronouncement on audit evidence and AICPA and PCAOB pronouncements on auditing estimates. Updated coverage of data analytics as applied to auditing is also included.

Chapter 6: The risk assessment approach to an audit is concisely summarized in a summary of the audit process. New guidance is provided on the AICPA revised definition of materiality, and the audit of significant unusual transactions and significant risks.

Chapter 7: Discusses internal control and how it is considered in an audit of financial statements. The chapter includes a brief overview of integrated audits (audits of internal control integrated with financial statement audits) required for certain public companies under PCAOB Auditing Standards, with more detailed coverage provided in Chapter 18. The chapter includes a section on the audit requirements for that increasingly frequent situation in which a client outsources its data processing to a service organization. Finally, it presents the auditors' internal control communication responsibilities.

Audit Standards Updates Students in auditing need familiarity with auditing standards promulgated by the **AICPA's Auditing Standards Board and the Public Company Accounting Oversight Board**. Also, for many, familiarity with standards of the **International Auditing and Assurance Standards Board** is needed. While similar in most respects, key differences exist among these sets of standards. The text integrates discussions of the various standards, focusing on the differences, in a very readable manner.

CPA Exam Prep and Simulations The end-of-chapter exercises include a number of simulations similar to those on the **CPA exam**. These simulations include five document review simulations which all relate to the text's integrated case, **Keystone Computers & Networks, Inc.** All simulations in the text are designed to help students both to learn the material presented and to prepare them to complete such questions on the **CPA Exam**. Many of the simulations are adapted from **CPA exam questions** released by the **AICPA**, and others were written by the authors to be similar to those released by the **AICPA**.

Data Analytics and Auditing Increasingly, collection of audit evidence is facilitated by the use of automated tools and techniques such as **Audit Data Analytics** that may enable auditors to aggregate and consider information obtained from multiple sources. Accordingly, the text has been revised to emphasize developments in this area.

- 1 The Role of the Public Accountant in the American Economy
- 2 Professional Standards
- 3 Audit Data Analytics
- 4 Professional Ethics
- 5 Legal Liability of CPAs
- 6 Audit Evidence and Documentation
- 7 Audit Planning, Understanding the Client, Assessing Risks, and Responding

Keystone Computers & Network, Inc.: Illustrative Audit Case

This feature has been updated in this edition and illustrates audit methods and provides realistic, thought-provoking case exercises. Although each portion of the case is designed to stand alone, if used in combination, the case will help the student develop problem-solving skills in planning (Chapter 6), in considering internal control and testing account balances (Chapters 11 and 14), and in completing the audit (Chapter 16). The case incorporates the use of computerized accounting applications (both IDEA and Tableau) and also integrates the fundamentals of audit sampling from Chapter 9. Also, Document Review Simulations relating to Keystone are included in the problem material for Chapters 10, 11, 12, 14, and 17.

- 8** Internal Control
- 9** Consideration of Internal Control in an Information Technology Environment
- 10** Audit Sampling
- 11** Cash and Financial Investments
- 12** Accounts Receivable, Notes Receivable, and Revenue
- 13** Inventories and Cost of Goods Sold
- 14** Property, Plant, and Equipment: Depreciation and Depletion
- 15** Accounts Payable and Other Liabilities
- 16** Debt and Equity Capital
- 17** Auditing Operations and Completing the Audit
- 18** Auditors' Reports
- 19** Integrated Audits of Public Companies
- 20** Additional Assurance Services: Historical Financial Information
- 21** Additional Assurance Services: Other Information
- 22** Internal, Operational, and Compliance Auditing

Chapter 8: Emphasizes the impact of IT on audits. This chapter has been updated and continues to emphasize the suggestions by George Easton, PhD, Emeritus Professor of MIS, San Diego State University.

Chapter 9: The format of this chapter has been thoroughly modified to allow adopters flexibility in audit sampling coverage. The body of the chapter now includes attributes sampling, and an introduction of audit sampling for substantive tests. Following are stand-alone modules on (1) monetary unit sampling, (2) classical variables sampling, and (3) nonstatistical variable sampling. Any, all, or none of these modules may be selected for inclusion. The chapter concludes with the long-standing appendix on the audit risk model. Many of the problems may be solved either manually or electronically using generalized audit software.

Chapters 10 through 16: These “procedural chapters” deal with internal control and obtaining audit evidence for the various financial statement amounts. The chapters emphasize the risk-based approach stressed in AICPA, PCAOB, and international standards. Updated in these chapters are discussions of data analytical evidence-gathering techniques, and increased coverage of management review controls, which is an area of concern from PCAOB inspections.

Chapter 17: Reflects the new AICPA Auditing Standards Board nonpublic company audit reporting standards. The chapter is heavily revised to allow a comparison of AICPA and PCAOB requirements (e.g., a comparison of key and critical audit matters).

Chapter 18: Reflects PCAOB auditing standards on the audit of internal control over financial reporting required for public companies.

Chapter 19: Includes up-to-date coverage of financial statement preparation, compilation and review engagements, auditor reporting on financial statements prepared using a special-purpose framework, and other changes due to the AICPA clarity standards.

Chapter 20: Discusses a variety of attestation and other assurance services. Coverage of Trust Services and system and organization control reports has been thoroughly updated. Other assurance services are included at both the conceptual and practical levels.

Chapter 21: Includes a discussion of compliance auditing based on the suggestions of Mr. Norwood J. Jackson, former Deputy Controller, Office of Federal Management, U.S. Office of Management and Budget. It is updated for the Compliance Supplement as revised in 2019. Also, the chapter is updated to include the revised International Standards for the Professional Practice of Internal Auditing issued in 2016.

New to This Edition

The 22nd edition has been revised to reflect the current nature of audits and the profession, and to update and improve presentations of various material, including:

- **Data Analytics & Generalized Audit Software:** Consistent with the text's increased coverage of **data analytics** in the various chapters, the data analytical procedures using generalized audit software have been updated and expanded. These materials are available in Connect and in the Instructor and Student Resources. Stand-alone modules for **IDEA software** are provided on (1) overall skills and (2) audit sampling. Similarly, detailed coverage of overall **Tableau** skills is included, allowing the instructor to include assignments from those that are very introductory in nature to those that are detailed and more advanced.
- **Audit Reports—Presentation of Key Audit Matters:** Auditors of nonpublic companies in the United States now have the option of including a section on key audit matters in their reports when the terms of the engagement call for it. In Chapter 17, the text integrates and compares this topic with requirements for reports of public companies.
- **Audit Reports—Form Changes:** The AICPA's Auditing Standards Board adopted major revisions to its audit report. Changed are both the report's form (e.g., like the public company report, it now begins with the opinion and basis for opinion sections) and its content (e.g., it includes a more detailed description of audits and auditor responsibilities and may include a section on key audit matters). The newly adopted Auditing Standards Board report is presented in Chapter 2, with detailed coverage of audit reporting requirements in Chapter 17.
- **Audit Data Analytics:** Paired together, the text's increasing coverage of **audit data analytics** and the inclusion of software including Tableau and IDEA continue to emphasize developments in this area. Chapter 5 presents an updated overview of audit data analytics and Chapter 6 includes a new appendix with detailed illustrations. Chapters 7 and 8 on internal control in general and in an information technology environment are updated to increase coverage of this rapidly evolving area. In addition, **data analytics** coverage has been updated and expanded in the "procedural chapters," Chapters 10 through 16. A number of new data analytic exercises and problems have been included in the text, and generalized audit software **data analytical** problems (see below) have been updated.
- **Audit Sampling:** Chapter 9 has been thoroughly revised to simplify decisions on the extent of coverage included in a course. The body of the chapter now includes attributes sampling and an introduction to variables sampling for substantive tests. Following that are stand-alone modules on (1) monetary unit sampling, (2) classical variables sampling, and (3) nonstatistical variables sampling. Any, all, or none of these modules may be selected for inclusion in your course. The chapter concludes with the long-standing appendix on the audit risk model.
- **Audit Evidence:** Chapter 5 has been thoroughly updated to include coverage of the AICPA's recent pronouncement on audit evidence and the AICPA and PCAOB pronouncements on accounting estimates. Coverage of the effects of both management and auditor potential biases is covered. In addition, coverage is updated on other topics including, data analytics, significant unusual transactions, and the use of specialists.
- **Audit Planning:** Chapter 6 is updated in a variety of ways to reflect recent changes in auditing standards. The new AICPA ASB definition of materiality is reflected. Increased coverage of significant unusual transactions, assessing the risks of material misstatement, and significant risks is also provided.
- **Management Review Controls:** PCAOB inspection reports continue to identify testing of these controls as a top audit deficiency. This edition of the text increases the emphasis through discussion and examples (Chapters 7, 10–16, 18) and two new illustrative cases (Chapters 7 and 18).
- **Automated Tools and Techniques:** Procedural chapters (10 through 16) are updated to reflect automated tools and techniques, including audit data analytics. Many more examples are provided on how **audit data analytics** are being used to increase the effectiveness and efficiency of audits.

Additional changes include:

- **Enhanced Coverage of the Public Accounting Profession:** Chapter 1's coverage of the impact of information technology on the profession is increased as is the discussion of positions within CPA firms.
- **Narrated PowerPoint Updates:** These slides and their narrations have been updated for changes made throughout the text. The slides are meant to be particularly helpful to the instructor developing either an online or a hybrid (online plus live) course. Also, these items may be made available for students in traditional courses as a supplement.
- **Conceptual Videos:** These videos, which are organized around the text's PowerPoint slides, highlight key information in each chapter and include questions that may be computer graded. The videos may be used in a variety of ways, including early in the discussion of a chapter or near the conclusion as an overall review.
- **Illustrations of PCAOB Required Critical Audit Matters:** Chapters 5, 11, and 17 include illustrations of critical audit matters. These illustrations highlight both the accounting complexities encountered on audits and auditor responses to obtain sufficient appropriate audit evidence.
- **Document Review Simulations:** These simulations have been updated and are designed to be similar to those that now appear on the CPA exam. They are included in Chapters 10, 11, 12, 14, and 17.
- **Revisions of agreed-upon procedures engagements:** Changes made to agreed-upon procedures engagements allowing general distribution of related reports are discussed in Chapter 19.
- **Updated Coverage of the Attestation Standards:** The AICPA now allows certain direct examinations in which the CPAs both (1) measure or evaluate the underlying subject matter against the criteria without requiring an assertion and (2) express an opinion on the results. Chapter 20 discusses this recent change.
- **Thoroughly Updated Coverage of Trust Services and System and Organization Controls (SOC) Engagements:** The profession is moving forward with services relating to various types of controls. For example, in addition to SOC reporting on service organization controls, standards have been developed for cybersecurity and supply chain services as discussed in Chapter 20.



McGraw-Hill has partnered with Roger CPA Review Powered by UWorld, a global leader in CPA exam preparation, to provide students a smooth transition from the accounting classroom to successful


completion of the CPA exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing the CPA exam. Accordingly, students using these McGraw-Hill materials will have access to sample CPA exam multiple-choice questions from Roger CPA UWorld, with expert-written explanations and solutions.

McGraw-Hill and Roger CPA UWorld are dedicated to supporting every accounting student along their journey, ultimately helping them achieve career success in the accounting profession. For more information about the full Roger CPA UWorld program, exam requirements, and exam content, visit www.rogercpareview.com.

Text Features

Illustrative Cases

Actual business and accounting examples are used to illustrate key chapter concepts. The cases are boxed and appear throughout the text. They are subtitled for easy reference.

	Illustrative Case	<i>Indirect Financial Interests</i>
<p>A covered member who owns shares in a mutual fund has a direct financial interest in the mutual fund, and an indirect financial interest in the mutual fund's investments. Thus, a covered member could not be involved in the audit of the mutual fund itself due to the direct financial interest. Concerning the mutual fund's investments in companies potentially audited by the covered member's firm, the following apply:</p>	<p>The following illustrates how to evaluate whether the underlying investment is material to a <i>covered member's</i> net worth. Assume:</p> <ul style="list-style-type: none">• Jano Mutual Fund, a diversified fund, has net assets of \$10 million, composed of an investment in shares of client Apple and a variety of other investments.• The <i>covered member</i> owns 6 percent of the outstanding shares of Jano Mutual Fund (a value of \$600,000).• Jano Mutual Fund has 2 percent of its assets invested in Apple (a \$200,000 investment).	

1. Ownership of 5% or less of the outstanding shares of a company in which the covered member has a financial interest.

Industry Focus Cases

These cases use examples from specific industries to provide students with a detailed, “real-world” illustration of points being emphasized in the text. These cases show the importance of having a thorough knowledge of the audit client's business and industry. Like the Illustrative Cases, these cases are boxed and appear throughout the text.

Focus on the Airline Industry
<p>Electronic ticketing has become basic to the airline industry. Under these systems, a passenger may book a flight electronically using any of a variety of devices and be assigned a reservation number rather than being issued a physical ticket. Because no ticket is created for the flight, the auditor is limited in the extent to which he or she can examine “paper” support for transactions. Accordingly, audit procedures should be developed relating to the associated revenues and receivables. Auditors often choose to include tests of the computer controls in such situations.</p>

Auditing Fair Value Information

As the accounting profession continues to value more assets and liabilities at their fair values, difficult audit issues often arise. The text includes integrated coverage of fair value accounting in Chapters 5, 10, 11, 13, and 16.

Audit Objectives

The use of Audit Objectives is a basic tool in audit plan design. These help the auditor focus on the *reason* a procedure is being done and provide a check to assure that all management assertions in the financial statements are audited.

Primary Audit Objectives:	
Valuation	<input checked="" type="checkbox"/>
Accuracy	<input checked="" type="checkbox"/>

2. Obtain Analyses of Notes Receivable and Related Interest and Reconcile to the General Ledger.

An analysis of notes receivable supporting the general ledger control account may be prepared for the auditors by the client's staff. The information to be included in the analysis normally will include the name of the maker, date, maturity, amount, and interest rate. In addition to verifying the accuracy of the analysis prepared by the client, the auditors should trace selected items to the accounting records and to the notes themselves.

Primary Audit Objectives:	
Existence	<input checked="" type="checkbox"/>

3. Inspect Notes on Hand and Confirm Those with Holders.

The inspection of notes receivable on hand should be performed concurrently with the count of cash and securities to prevent the concealment of a show substitution of

Fraud

Because fraud is such an important aspect of today's auditing environment, we have included a logo wherever we talk about its implications in the auditing process.

Errors and Fraud	<p>Auditing standards define errors as unintentional misstatements or omissions of amounts or disclosures in the financial statements. Errors may involve mistakes in gathering or processing data, unreasonable accounting estimates arising from overlooked or misinterpreted information, or mistakes in the application of applicable accounting principles.</p> <p>Fraud, as the term is used in financial statement auditing (AICPA AU-C 240; PCAOB AS 2401), relates to <i>intentional</i> acts that cause a misstatement of the financial statements. Misstatements due to fraud may occur due to either (1) fraudulent financial reporting or (2) misappropriation of assets.</p> <p>During the planning audit, the auditors are required to assess the risk of material</p>
-------------------------	---

END-OF-CHAPTER MATERIAL

The material at the end of each chapter includes a combination of Review Questions, Questions Requiring Analysis, Objective Questions, Problems, In-Class Team Cases, Research and Discussion Cases, and/or Ethics Cases. Appendixes to Chapters 6, 11, and 14 include the case material and exercises for the Keystone Computers & Networks Inc., the illustrative audit case. Many of these questions are included in Connect as well. New to Connect for this edition are the manually graded Questions Requiring Analysis, algorithmic versions of select Objective Questions, auto-graded simulations, and Completion Questions located within the Additional Study Questions.

Review Questions

The Review Questions are closely related to the material in the chapter and provide a convenient means of determining whether students have grasped the major concepts and details contained in that chapter.

Questions Requiring Analysis

The Questions Requiring Analysis require thoughtful consideration of a realistic auditing situation and the application of professional standards. A number of these questions are taken from CPA and CIA examinations, and others describe actual practice situations. These questions, which are generally shorter than the problems, tend to stress value judgments and conflicting opinions. They are now available for Connect assignment with manual grading.

Objective Questions

The Objective Questions are similar in format to those on the CPA exam. The first Objective Question in each chapter is composed of at least 12 multiple choice questions. Following that question are a number of task-based and document review simulations (discussed in the next section) and other objective questions. As indicated previously, the task-based simulations are from two sources—AICPA released questions (as adapted) and questions developed by the authors. All of the task-based simulations are meant to provide students with both a learning experience relating to the material in the chapter and a realistic example of CPA exam testing. The other objective questions address basic concepts and information covered by AICPA simulations but may be less complete or may address a more limited content area than is typically the subject of an AICPA simulation.

Document Review Simulations

A document review simulation presents a realistic document as well as related source materials requiring candidate review. These simulations ordinarily include highlighted words, phrases, or sentences in the document that may or may not be correct, requiring the candidate to select appropriate edits based on the relevant source documents. We have written a number of such simulations and included them in the text's integrated case, **Keystone Computers & Networks Inc.**, in Chapters 10, 11, 12, 14, and 17. These simulations are available for assignment within McGraw-Hill's online homework management system, *Connect*.

Problems

Many of the Problems are drawn from CPA and CIA examinations. These problems are retained because they require a relatively detailed analysis of audit situations. Problems are keyed to the chapter's Learning Objectives.

In-Class Team Cases

These cases are meant to be solved in class either by teams of students or, if the instructor prefers, by individuals. They help provide the student with an active learning environment in which to apply key concepts included in each chapter.

In-Class Team Case



LO 2-3

2-39.

Hide-It (HI), a family-owned business based in Tombstone, Arizona, builds custom homes with special features, such as hidden rooms and hidden wall safes. Hide-It has been an audit client for three years. You are about to sign off on a "clean" unmodified opinion on HI's current annual financial statements when Art Hyde, the VP-Finance, calls to tell you that the Arizona Department of Revenue has seized control of a Hide-It bank account that includes about \$450,000 of company funds; the account is not currently recorded in the accounting system and you had been unaware of it. In response to your questions about the origin of the funds, Art assures you that the funds, though not recorded as revenue, had been obtained legitimately. He explains that all of the money came from separately billed but unrecorded change orders to

Research and Discussion Cases

These cases involve controversial situations that do not lend themselves clear-cut answers. Students are required to research appropriate professional literature and then apply critical thinking skills to logically formulate and justify their personal positions on the issues involved in each case. The cases acquaint students with the professional literature, develop research and communication skills required on the new CPA exam, and demonstrate that several diverse, yet defensible, positions may be argued persuasively in a given situation.

relating to its maintenance. Otherwise, the two are self-supporting. Scott is a stockbroker, and recently she has started acquiring shares in one of the audit clients of this office of the public accounting firm. The shares are held in Scott's name. At present, the shares are not material in relation to her net worth.

Case 2: Mary Reed, a new staff auditor with the firm, has recently separated from her husband. Mary has filed for divorce, but the divorce cannot become final for at least five months. The property settlement is being bitterly contested. Mary's husband has always resented her professional career and has just used community property to acquire one share of common stock in each of the publicly owned companies audited by the office in which Mary works.

Ethics Cases

Ethics Cases allow the instructor to discuss ethical issues in an integrated manner throughout the course. The cases present a series of situations that result in ethical dilemmas of the type that beginning accountants may expect to encounter in practice. These cases are included in selected chapters.

Ethics Cases

LO 11-1, 2, 6



11-51. You are an assistant audit or with Zaird & Associates, CPAs. Universal Air (UA), your fifth audit client in your eight months with Zaird, is a national airline based in your hometown. UA has continued to grow while remaining healthy financially over the eight years of its existence. Indeed, as you start the audit, you notice that (unaudited) sales are up 30 percent this year (20X1), with earnings up 40 percent. Your firm, Zaird & Associates, has been UA's only auditor.

During the audit you noticed that UA records sales when tickets are sold—debit receivable (or cash), credit sales. In performing substantive procedures relating to receivables, you also found that some of the tickets are for 20X2 flights—generally in January and February.

Illustrative Audit Case Exercises

These exercises all pertain to the text's updated continuing integrated case, **Keystone Computers & Networks Inc.** While each exercise may "stand alone," when used in combination, these case exercises take the student from the original planning of an audit through the testing of controls, substantive testing, and accumulation and analysis of uncorrected misstatements. Exercises are included in Chapters 6, 11, 14, and 16. Also, the text's document review simulations relate to this integrated case—in Chapters 10, 11, 12, 14, and 17.

Appendix 6C

Illustrative Audit Case: Keystone Computers & Networks Inc.

Part I: Audit Planning

The Keystone Computers & Networks Inc. (KCN) case is used throughout the text to illustrate audit procedures and methodology. KCN is a company that sells and installs computer workstations and networking software to business customers. The CPA firm of Adams, Barnes & Co. audited the financial statements of KCN for the past three

Spreadsheet Templates

Spreadsheet templates are available on the text's website to be used in conjunction with selected audit case exercises. The exercises with templates are identified by a logo in the margin.



- LO 6-3, 4** 6C-4. The working paper for Keystone Computers & Networks' analytical review ratios is presented in this Appendix.
- Recalculate the 12/31/X5 ratios using Excel.
 - After completing part (a), review the ratios and identify financial statement accounts that should be investigated because the related ratios are not comparable to prior-year ratios, industry averages, or your knowledge of the company.
 - For each account identified in part (b), list potential reasons for the unexpected account balances and related ratios.

Internet Assignments

Internet assignments are included among the end-of-chapter problem material for selected chapters. These assignments require students to use the **Internet** to do audit research and are identified with a logo in the margin.

LO 6-3

Required:



6–38. Perform an Internet search to access the text of the Securities Exchange Act of 1934. Read and summarize the internal control requirements of Section 13(b)(2) of the act.

Audit Software Assignments

The text's generalized audit software materials using IDEA and Tableau are included in the Instructor and Student Resources from within Connect. The IDEA materials are composed of two stand-alone modules—(1) audit sampling and (2) overall analytics skills coverage—that integrate analytics into text and course coverage. Either or both of these modules may be incorporated into the course to supplement traditional coverage. The Tableau materials are included in one module that takes the user from the very basic essentials of Tableau through detailed exercises using textual materials. Also, Chapter 9 identifies problems for use with generalized audit software.

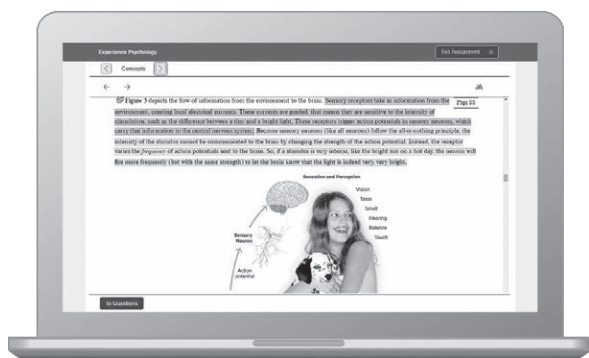
FOR INSTRUCTORS

You're in the driver's seat.

Want to build your own course? No problem. Prefer to use our turnkey, prebuilt course? Easy. Want to make changes throughout the semester? Sure. And you'll save time with Connect's auto-grading too.

65%

Less Time Grading



Laptop: McGraw-Hill; Woman/dog: George Doyle/Getty Images

They'll thank you for it.

Adaptive study resources like SmartBook® 2.0 help your students be better prepared in less time. You can transform your class time from dull definitions to dynamic debates. Find out more about the powerful personalized learning experience available in SmartBook 2.0 at www.mheducation.com/highered/connect/smartbook

Make it simple, make it affordable.



Connect makes it easy with seamless integration using any of the major Learning Management Systems—Blackboard®, Canvas, and D2L, among others—to let you organize your course in one convenient location. Give your students access to digital materials at a discount with our inclusive access program. Ask your McGraw-Hill representative for more information.

Padlock: Jobalou/Getty Images

Solutions for your challenges.



A product isn't a solution. Real solutions are affordable, reliable, and come with training and ongoing support when you need it and how you want it. Our Customer Experience Group can also help you troubleshoot tech problems—although Connect's 99% uptime means you might not need to call them. See for yourself at **status.mheducation.com**

Checkmark: Jobalou/Getty Images

SUPPORT ^{AT}
every step

FOR STUDENTS

Effective, efficient studying.

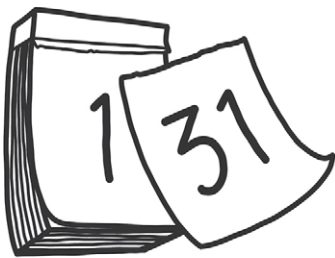
Connect helps you be more productive with your study time and get better grades using tools like SmartBook 2.0, which highlights key concepts and creates a personalized study plan. Connect sets you up for success, so you walk into class with confidence and walk out with better grades.

Study anytime, anywhere.

Download the free ReadAnywhere app and access your online eBook or SmartBook 2.0 assignments when it's convenient, even if you're offline. And since the app automatically syncs with your eBook and SmartBook 2.0 assignments in Connect, all of your work is available every time you open it. Find out more at www.mheducation.com/readanywhere

"I really liked this app—it made it easy to study when you don't have your textbook in front of you."

- Jordan Cunningham,
Eastern Washington University



Calendar: owattaphotos/Getty Images

No surprises.

The Connect Calendar and Reports tools keep you on track with the work you need to get done and your assignment scores. Life gets busy; Connect tools help you keep learning through it all.

Learning for everyone.

McGraw-Hill works directly with Accessibility Services Departments and faculty to meet the learning needs of all students. Please contact your Accessibility Services office and ask them to email accessibility@mheducation.com, or visit www.mheducation.com/about/accessibility for more information.

Top: Jenner Images/Getty Images, Left: Hero Images/Getty Images, Right: Hero Images/Getty Images



Instructor Supplements

Assurance of Learning Ready

Many educational institutions today are focused on the notion of assurance of learning, an important element of some accreditation standards. *Principles of Auditing & Other Assurance Services, 22e*, is designed specifically to support your assurance of learning initiatives with a simple, yet powerful solution.

Each test bank question for *Principles of Auditing & Other Assurance Services, 22e*, maps to a specific chapter learning outcome/objective listed in the text. The reporting features of **Connect** can aggregate students to make the collection and presentation of assurance of learning data simple and easy.

AACSB Statement

McGraw-Hill Education is a proud corporate member of AACSB International. Recognizing the importance and value of AACSB accreditation, we have sought to recognize the curricula guidelines detailed in AACSB standards for business accreditation by connecting selected questions in *Principles of Auditing & Other Assurance Services, 22e*, to the general knowledge and skill guidelines found in the AACSB standards. The statements contained in *Principles of Auditing & Other Assurance Services, 22e*, are provided only as a guide for the users of this text. The AACSB leaves content coverage and assessment clearly within the realm and control of individual schools, the mission of the school, and the faculty. The AACSB does also charge schools with the obligation of doing assessment against their own content and learning goals. While *Principles of Auditing & Other Assurance Services, 22e*, and its teaching package make no claim of any specific AACSB qualification or evaluation, we have, within *Principles of Auditing & Other Assurance Services, 22e*, tagged questions according to the six general knowledge and skills areas. The labels or tags within *Principles of Auditing & Other Assurance Services, 22e*, are as indicated. There are, of course, many more within the test bank, the text, and the teaching package that might be used as a “standard” for your course. However, the labeled questions are suggested for your consideration.

Instructor Resource Center (www.mhhe.com/whittington22e)

The password-protected instructor side of the book’s Online Learning Center houses all of the instructor resources you need to administer your course, including:

- Instructor’s Lecture Guide
- Solutions Manual
- Keystone Case and Solutions
- Test Bank
- End-of-Chapter Materials Conversion Guide—21e to 22e
- IDEA Software
- Tableau Software
- Text Updates
- Digital Image Library
- PowerPoint and Narrated PowerPoint Presentations.
- Conceptual Videos.

If you choose to use *Connect* with *Principles of Auditing & Other Assurance Services, 22e*, you will have access to these same resources via the Instructor Library.

Instructor’s Lecture Guide and Solutions Manual

Our Instructor’s Lecture Guide includes topical outlines of each chapter, the authors’ comments on each chapter, and numerous instructional aids. A Solutions Manual includes thorough and up-to-date solutions to the text’s questions, problems, and exercises. These are included on the Online Learning Center.

Test Builder in Connect


Available within Connect, Test Builder is a cloud-based tool that enables instructors to format tests that can be printed or administered within a LMS. Test Builder offers a modern, streamlined interface for easy content configuration that matches course needs, without requiring a download.

Test Builder allows you to:

- access all test bank content from a particular title.
- easily pinpoint the most relevant content through robust filtering options.
- manipulate the order of questions or scramble questions and/or answers.
- pin questions to a specific location within a test.
- determine your preferred treatment of algorithmic questions.
- choose the layout and spacing.
- add instructions and configure default settings.

Test Builder provides a secure interface for better protection of content and allows for just-in-time updates to flow directly into assessments.



connect[®] +  proctorio

New remote proctoring and browser-locking capabilities, hosted by Proctorio within Connect, provide control of the assessment environment by enabling security options and verifying the identity of the student.

Seamlessly integrated within Connect, these services allow instructors to control students' assessment experience by restricting browser activity, recording students' activity, and verifying students are doing their own work.

Instant and detailed reporting gives instructors an at-a-glance view of potential academic integrity concerns, thereby avoiding personal bias and supporting evidence-based claims.

Tegrity: Lectures 24/7

Tegrity in Connect is a tool that makes class time available 24/7 by automatically capturing every lecture. With a simple one-click start-and-stop process, you capture all computer screens and corresponding audio in a format that is easy to search, frame by frame. Students can replay any part of any class with easy-to-use, browser-based viewing on a PC, Mac, iPod, or other mobile device.

Educators know that the more students can see, hear, and experience class resources, the better they learn. In fact, studies prove it. Tegrity's unique search feature helps students efficiently find what they need, when they need it, across an entire semester of class recordings. Help turn your students' study time into learning moments immediately supported by your lecture. With Tegrity, you also increase intent listening and class participation by easing students' concerns about note-taking. Using Tegrity in Connect will make it more likely you will see students' faces, not the tops of their heads.

Remote Proctoring & Browser-Locking Capabilities

REFERENCES TO AUTHORITATIVE SOURCES

Numerous references are made to the pronouncements of the American Institute of Certified Public Accountants (AICPA), the Institute of Internal Auditors (IIA), the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), the Public Company Accounting Oversight Board (PCAOB), the Securities and Exchange Commission (SEC), and the International Federation of Accountants (IFAC). Special attention is given to the AICPA *Code of Professional Conduct*, *Statements on Standards for Accounting and Review Services*, *Statements on Standards for Attestation Engagements*, *Statements on Auditing Standards*, and guidelines developed for other types of assurance services. The cooperation of the AICPA and the IIA in permitting the use of their published materials and of questions from the CPA and CIA examinations brings to the text an element of authority not otherwise available.

Acknowledgments

The work of Donald A. Schwartz, JD, CPA, of National University, in developing the software supplement for the illustrative audit case exercises is especially appreciated. We thank Norwood Jackson (formerly of the U.S. Office of Management and Budget) for his guidance on compliance auditing.

We express our sincere thanks to the following professors who provided extensive reviews for the preceding editions:

John T. Ahern Jr. <i>DePaul University</i>	Fred Christensen <i>Boise State University</i>
Jeffrey J. Archambault <i>Marshall University</i>	Laurel Cobb <i>Saint Leo University</i>
Barbara Arel <i>University of Vermont</i>	John Corless <i>California State University at Sacramento</i>
Jack Armitage <i>University of Nebraska at Omaha</i>	Naman Desai <i>University of Central Florida</i>
Joseph Aubert <i>Bemidji State University</i>	Martha Doran <i>San Diego State University</i>
Dan Baglia <i>Grove City College</i>	Phil Drake <i>Arizona State University</i>
Anthony T. Barbera <i>SUNY College at Old Westbury</i>	Hans Dykxhoorn <i>Western Michigan University</i>
Katherine Barker <i>University of South Florida, St. Petersburg</i>	Thomas English <i>Boise State University</i>
D'Arcy Becker <i>University of Wisconsin, Eau Claire</i>	Ruth Epps <i>Virginia Commonwealth University</i>
David Blum <i>Moraine Park Technical College</i>	Magdy Farag <i>Cal Poly, Pomona</i>
Gary Bridges <i>University of Texas at San Antonio</i>	Gary Frank <i>University of Akron</i>
Rich Brody <i>University of New Mexico</i>	Diana Franz <i>University of Toledo</i>
Michael Broihahn <i>Barry University</i>	Lori R. Fuller <i>University of Delaware</i>
Ann Brooks <i>University of New Mexico</i>	Julie Ann Gardner-Treloar <i>UCLA</i>
Thane Butt <i>Champlain College</i>	Jacob Gatlin <i>Athens State University</i>
Douglas Carmichael <i>Baruch College</i>	Earl H. Godfrey Jr. <i>Gardner-Webb University</i>
Al Case <i>Southern Oregon University</i>	Mary Beth Goodrich <i>University of Texas at Dallas</i>
Ryan Casey <i>University of Illinois at Chicago</i>	Jongsoo Han <i>Rutgers University at Camden</i>
Paul Caster <i>Fairfield University</i>	James Hansen <i>University of Illinois at Chicago</i>
Joseph Chan <i>St. Joseph's College</i>	Aretha Hill <i>North Carolina A&T State University</i>

Theresa Hrnecir
Southeastern Oklahoma State University

William Huffman
Missouri Southern State University

Russell Jacques
Saint Leo University

David Jenkins
University of Delaware

Bonita Kramer
Montana State University

Terry Kubichan
Old Dominion University

Ellen Landgraf
Loyola University, Chicago

Pamela Legner
College of DuPage

Philip Levine
Berkeley College

Ralph Licastro
The Pennsylvania State University

D. Jordan Lowe
Arizona State University

Eldar Maksymov
Arizona State University

Heidi Meier
Cleveland State University

Michael Milliren
Milwaukee Area Technical College

Perry Moore
Lipscomb University

Roselyn Morris
Texas State University, San Marcos

Perseus Munshi
Arizona State University

Albert Nagy
John Carroll University

Bernard Newman
Pace University

Kathy O'Donnell
University at Buffalo

Peggy O'Kelly
Northeastern University

Vincent Owoso
Northern Kentucky University

Michael Pearson
Kent State University

Marshall Pitman
University of Texas at San Antonio

Margaret P. Pollard
American River College

Mattie Porter
University of Houston, Clear Lake

Bruce Prager
Hunter College

Theresa Presley
Kansas State University

Abe Qastin
Lakeland College

Alan Reinstein
Wayne State University

Raymond Reisig
Pace University

Shirley Rockel
Iowa Wesleyan College

Iris Stuart
California State University at Fullerton

Michael Trebesh
Alma College

Valerie Trott
Duquesne University

Daniel Tschopp
Daemen College

Jerry Turner
University of Memphis

Allan Unseth
Norfolk State University

Patricia Villafana
College of St. Catherine

Judith C. Walo
Central Connecticut State University

Thomas Weirich
Central Michigan University

Donna Whitten
Purdue University North Central

Jian Zhang
San Jose State University

O. Ray Whittington

Kurt Pany

Brief Contents

- 1** The Role of the Public Accountant in the American Economy 1
 - 2** Professional Standards 38
 - 3** Professional Ethics 74
 - 4** Legal Liability of CPAs 123
 - 5** Audit Evidence and Documentation 153
 - 6** Audit Planning, Understanding the Client, Assessing Risks, and Responding 209
 - 7** Internal Control 277
 - 8** Consideration of Internal Control in an Information Technology Environment 332
 - 9** Audit Sampling 367
 - 10** Cash and Financial Investments 427
 - 11** Accounts Receivable, Notes Receivable, and Revenue 485
 - 12** Inventories and Cost of Goods Sold 561
 - 13** Property, Plant, and Equipment: Depreciation and Depletion 607
 - 14** Accounts Payable and Other Liabilities 634
 - 15** Debt and Equity Capital 672
 - 16** Auditing Operations and Completing the Audit 697
 - 17** Auditors' Reports 741
 - 18** Integrated Audits of Public Companies 795
 - 19** Additional Assurance Services: Historical Financial Information 826
 - 20** Additional Assurance Services: Other Information 855
 - 21** Internal, Operational, and Compliance Auditing 881
- APPENDIX 927**
- INDEX 932**

Contents

Chapter 1

The Role of the Public Accountant in the American Economy 1

What Are Assurance Services?	1
Attest Engagements	1
<i>Assurance and Nonassurance Services</i>	3
Financial Statement Audits	4
<i>What Creates the Demand for Audits?</i>	5
<i>A Brief Summary of Major Auditing Developments</i>	8
<i>The Financial Crisis of 2008</i>	10
<i>Types of Audits</i>	11
<i>Types of Auditors</i>	12
The Public Accounting Profession	13
<i>American Institute of Certified Public Accountants</i>	13
<i>The CPA Examination</i>	16
<i>State Boards of Accountancy</i>	16
<i>Financial Accounting Standards Board</i>	16
<i>Governmental Accounting Standards Board</i>	16
<i>Federal Accounting Standards Advisory Board</i>	17
<i>The Public Company Accounting Oversight Board</i>	17
<i>Securities and Exchange Commission</i>	17
<i>The International Federation of Accountants</i>	18
<i>Other Types of Professional Services</i>	19
<i>Organization of the Public Accounting Profession</i>	20
<i>Industry Specialization</i>	22
<i>Responsibilities of the Professional Staff</i>	22
<i>Professional Development for Public Accounting Firm Personnel</i>	25
<i>Seasonal Fluctuations in Public Accounting Work</i>	25
<i>Relationships with Clients</i>	25
Chapter Summary	26
Key Terms Introduced or Emphasized in Chapter 1	27
Review Questions	29
Questions Requiring Analysis	30
Objective Questions	31
Problems	36
In-Class Team Case	36
Research and Discussion Case	37
Supplementary References	37

Chapter 2

Professional Standards 38

Auditing Standards	38
<i>AICPA Generally Accepted Auditing Standards</i>	40
<i>PCAOB Auditing Standards</i>	43
The Auditors' Responsibility for Detecting Misstatements	44
<i>Errors and Fraud</i>	44
<i>Compliance with Laws and Regulations</i>	45

Auditors' Reports	46
<i>Public Company Audit Reports—Unqualified Opinion</i>	46
<i>Nonpublic Company Audit Reports—Unmodified Opinion</i>	49
<i>Auditors' Reports with Modified Opinions</i>	53
The Attestation Standards	53
Quality Control in CPA Firms	54
Regulation of Accounting Firms	56
<i>Public Company Accounting Oversight Board</i>	56
<i>Peer Review and Inspections</i>	56
International Accounting and Auditing Standards	58
Chapter Summary	60
Key Terms Introduced or Emphasized in Chapter 2	61
Review Questions	63
Questions Requiring Analysis	64
Objective Questions	65
Problems	71
In-Class Team Case	72
Research and Discussion Case	72
Supplementary References	73

Chapter 3

Professional Ethics 74

The Nature of Ethics	74
<i>What Are Ethical Dilemmas?</i>	74
<i>A Framework for Ethical Decisions</i>	75
<i>Making Ethical Decisions—A Professional Example</i>	75
The Need for Professional Ethics	78
<i>Professional Ethics in Public Accounting</i>	79
The AICPA Code of Professional Conduct—Overall Structure	79
<i>Preface of Code of Professional Conduct</i>	80
<i>Rules and Conceptual Frameworks of Code of Professional Conduct</i>	81
Code of Professional Conduct: Applicability to Members in Public Practice	84
Independence	84
<i>Individual vs. Firm Impaired Independence and the Nature of Covered Members</i>	85
<i>Independence Requirements for All Partners and Staff</i>	87
<i>Additional Independence Requirements for Covered Members</i>	88
<i>Overall Firm Independence Requirements</i>	92
Additional Code of Professional Conduct Rules	97
<i>Integrity and Objectivity Rule</i>	97
<i>General Standards Rule</i>	98
<i>Compliance with Standards Rule</i>	99
<i>Accounting Principles Rule</i>	100

<i>Acts Discreditable Rule</i>	100
<i>Contingent Fees Rule</i>	101
<i>Commissions and Referral Fees Rule</i>	102
<i>Advertising and Other Forms of Solicitation Rule</i>	102
<i>Confidential Client Information Rule</i>	103
<i>Form of Organization and Name Rule</i>	104
Code of Professional Conduct: Applicability to Members in Business and Others	105
<i>Members in Business</i>	105
<i>Other Members (Retired and Unemployed)</i>	106
Enforcement of Professional Ethics	106
Ethics for Internal Auditors	107
Chapter Summary	109
Key Terms Introduced or Emphasized in Chapter 3	110
Review Questions	112
Questions Requiring Analysis	113
Objective Questions	114
Problems	119
AICPA Code of Professional Conduct Research Problems	120
In-Class Team Cases	121
Research and Discussion Case	121
Supplementary References	122
Chapter 4	
Legal Liability of CPAs	123
The Scope of CPA Liability	123
<i>Litigation Placed in Perspective</i>	123
<i>Sources of CPA Liability</i>	124
CPAs' Liability to Their Clients under Common Law	125
<i>The Elements of Duty and Breach of Duty</i>	126
<i>The Element of Losses (Damages)</i>	127
<i>The Element of Causation (Proximate Cause)</i>	127
Auditors' Common Law Liability to Third Parties	128
<i>Ultramares (Known User) Approach</i>	128
<i>Restatement of Torts (Foreseen User) Approach</i>	129
<i>Rosenblum (Foreseeable User) Approach</i>	129
<i>Summary of Third-Party Liability Approaches</i>	130
Liability to Third Parties under Statutory Law	130
<i>Securities Act of 1933</i>	131
<i>Securities Exchange Act of 1934</i>	132
<i>Comparison of the 1933 and 1934 Acts</i>	134
<i>Racketeer Influenced and Corrupt Organizations Act</i>	135
<i>Auditors' Criminal Liability under the Securities Acts</i>	135
<i>Criminal Liability under Other Statutes</i>	136
<i>SEC and Public Company Accounting Oversight Board Regulation</i>	136
<i>CPAs' Liability for Accounting and Review Services</i>	137
<i>CPAs' Posture in the Age of Litigation</i>	139

Chapter Summary	140
Key Terms Introduced or Emphasized in Chapter 4	140
Review Questions	142
Questions Requiring Analysis	143
Objective Questions	145
Problems	148
In-Class Team Case	151
Research and Discussion Case	152
Supplementary References	152

Chapter 5

Audit Evidence and Documentation 153

The Relationships among Audit Risk, Audit Evidence, and Financial Statement Assertions	153
<i>Financial Statement Assertions</i>	153
<i>Audit Risk at the Account Balance, Class of Transaction, or Disclosure Level</i>	155
<i>Audit Risk Illustrated</i>	156
<i>Measuring Audit Risk</i>	157
<i>Audit Evidence</i>	158
<i>Types of Audit Procedures</i>	160
Substantive Procedures	167
<i>Types of Substantive Procedures</i>	167
Analytical Procedures	169
<i>Nature of Analytical Procedures</i>	169
<i>Timing of Analytical Procedures</i>	173
<i>Extent of Analytical Procedures</i>	174
Data Analytics	174
<i>Application of Data Analytics to Auditing</i>	175
Audit Evidence for Subjective Areas	177
<i>Evidence Regarding Accounting Estimates</i>	177
<i>Evidence Regarding Fair Values</i>	180
<i>Evidence Regarding Related Party Transactions</i>	181
Audit Documentation	183
<i>Confidential Nature of Working Papers</i>	183
<i>Ownership of Audit Working Papers</i>	184
<i>Working Papers and Auditors' Liability</i>	184
<i>Types of Working Papers</i>	185
<i>Organization of Working Papers</i>	187
<i>Guidelines for Preparation of Working Papers</i>	189
<i>Computer-Generated Working Papers</i>	190
<i>Review of Audit Working Papers</i>	190
Chapter Summary	192
Key Terms Introduced or Emphasized in Chapter 5	193
Review Questions	196
Questions Requiring Analysis	197
Objective Questions	198
Problems	202
In-Class Team Case	207
Research and Discussion Case	207
Supplementary References	207
Appendix 5A	
Selected Internet Addresses	208

Chapter 6**Audit Planning, Understanding the Client, Assessing Risks, and Responding 209**

The Audit Process 209

Obtaining Clients 211

Submitting a Proposal 213*Communication with Predecessor Auditors* 214

Planning the Audit 216

Establish an Understanding with the Client 216*Develop an Overall Audit Strategy and Audit Plan* 218*Use of the Client's Staff* 219*Involvement of More Than One CPA Firm* 219*Use of Specialists* 219*Additional First-Year Considerations* 219

Obtaining an Understanding of the Client and Its Environment 220

Risk Assessment Procedures 220*Sources of Information* 222*Determining Materiality* 224

Assessing the Risks of Material Misstatement and Designing Further Audit Procedures 228

Assessing Risks of Material Misstatement 228*Addressing the Risks of Material Misstatement Due to Fraud* 231*Designing Further Audit Procedures in Response to Assessed Risks* 235*The Audit Trail and Directional Testing* 236*Transaction Cycles (Classes of Transactions)* 237

The Audit Plan's Systems and Substantive Portions 238

The Systems (Internal Control) Portion of the Plan 239*The Substantive Procedures Portion of the Plan* 239*Summary of the Relationship between Tests of Controls and Substantive Procedures* 241*Objectives of Audit Plans* 242*General Objectives of Audit Plans for Assets* 242

Substantiation of Account Balances 243

Existence of Assets 243*Rights to the Assets* 243*Establishing Completeness* 244*Verifying the Cutoff* 244*Valuation of Assets* 244*Financial Statement Presentation and Disclosure* 245

An Illustration of Audit Plan Design 245

Timing of Audit Work 246

Chapter Summary 247

Key Terms Introduced or Emphasized in Chapter 6 248

Review Questions 250

Questions Requiring Analysis 251

Objective Questions 253

Problems 258

Ethics Case 258

Appendix 6A**Audit Data Analytics 259**

Steps Involved in Performing Audit Data Analytics 259

ADAs in Risk Assessment and Forming an Overall Conclusion 260

ADAs in Tests of Controls 261

ADAs in Substantive Analytical Procedures 262

ADAs in Substantive Tests of Details 263

Appendix 6B**Examples of Fraud Risk Factors 264**

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting 264

Risk Factors Relating to Misstatements Arising from Misappropriation of Assets 266

Appendix 6C**Illustrative Audit Case: Keystone Computers & Networks Inc. 268**

Part I: Audit Planning 268

Appendix 6C Problems 276

Chapter 7**Internal Control 277**

The Meaning of Internal Control 277

The Foreign Corrupt Practices Act of 1977 279*Means of Achieving Internal Control* 279

The Control Environment 280

Commitment to Integrity and Ethical Values 280*Effective Board of Directors* 280*Effective Organizational Structure* 281*Attracting, Developing, and Retaining Competent Employees* 282*Individual Accountability* 283

Risk Assessment 283

Control Activities 284

Performance Reviews 284*Transaction Control Activities* 284*General Controls and Application Controls* 285*Physical Controls* 285*Segregation of Duties* 286*Controls over Accounting Estimates* 287*Fidelity Bonds* 287

The Accounting Information System 287

Monitoring of Controls 288

Management Review Controls 288*Internal Audit Function* 288

Limitations of Internal Control 289

Enterprise Risk Management 289

Corporate Governance and Its Relationship to Internal Control 290

Financial Statement Audits: The Role of Internal Control 291

Obtain an Understanding of the Client and Its Environment, Including Internal Control	292
<i>Required Auditor Understanding of Internal Control Components</i>	293
<i>Areas Difficult to Control</i>	295
<i>Risk Assessment Procedures for Internal Control</i>	296
<i>Documenting the Understanding of Internal Control</i>	296
Assess the Risks of Material Misstatement	301
<i>Assess Risks at the Financial Statement Level</i>	301
<i>Assess Risks at the Relevant Assertion Level</i>	302
Design and Perform Further Audit Procedures	302
<i>Tests of Controls</i>	303
<i>Revise the Risk of Material Misstatement Based on the Results of Tests of Controls</i>	305
<i>Design and Perform Substantive Procedures</i>	305
<i>Effects of Data Analytics</i>	305
<i>Documentation</i>	306
<i>Decision Aids for Audit Plan Modification</i>	307
<i>Using the Work of Internal Auditors</i>	307
<i>Consideration of Outsourced Computer Processing to Service Organizations</i>	309
<i>Communication of Control-Related Matters</i>	311
Internal Control Reporting by Public Companies and Their Auditors	312
<i>Overall Approach to an Audit of Internal Control</i>	314
Internal Control in the Small Company	315
Chapter Summary	316
Key Terms Introduced or Emphasized in Chapter 7	317
Review Questions	319
Questions Requiring Analysis	320
Objective Questions	322
Problems	326
In-Class Team Case	328
Appendix 7A	
Antifraud Programs and Control Measures	330

Chapter 8

Consideration of Internal Control in an Information Technology Environment 332

Nature of IT-Based Systems	333
<i>Characteristics of Various Types of IT-Based Systems</i>	334
<i>Impact of IT on the Audit Trail</i>	337
Internal Control in an IT Environment	338
<i>Segregation of Duties</i>	339
<i>Computer-Based Fraud</i>	340
<i>Internal Auditing in an IT Environment</i>	341
<i>Control Activities in an IT System</i>	341
<i>General Control Activities</i>	342
<i>Application Control Activities</i>	345
<i>User Control Activities</i>	346
<i>Controls When Using Cloud Computing</i>	346
<i>Control in Decentralized and Single Workstation Environments</i>	346
<i>Monitoring in an IT Environment</i>	347

The Auditors' Consideration of Internal Control in an IT Environment	347
<i>Obtaining an Understanding of IT-Based System Controls</i>	348
<i>Assessing the Risks of Material Misstatement</i>	350
<i>Tests of Controls</i>	351
<i>Evidence When Services Are Outsourced</i>	354
Designing Substantive Procedures with Computers	355
<i>Using Audit Software: An Illustration</i>	355
Chapter Summary	356
Key Terms Introduced or Emphasized in Chapter 8	357
Review Questions	359
Questions Requiring Analysis	360
Objective Questions	361
Problems	363
In-Class Team Case	365

Chapter 9

Audit Sampling 367

Comparison of Statistical and Nonstatistical Sampling	367
<i>Selecting a Random Sample</i>	368
<i>Other Methods of Sample Selection</i>	370
<i>Stratification</i>	371
<i>Types of Statistical Sampling Plans</i>	371
<i>Allowance for Sampling Risk (Precision)</i>	372
<i>Sample Size</i>	373
Audit Sampling for Tests of Controls	373
<i>Sampling Risk for Tests of Controls</i>	373
Attributes Sampling	374
<i>Determine the Objective of the Test</i>	375
<i>Define the Attributes and Deviation Conditions</i>	375
<i>Define the Population</i>	375
<i>Specify the Risk of Assessing Control Risk Too Low and the Tolerable Deviation Rate</i>	376
<i>Estimate the Expected Population Deviation Rate</i>	376
<i>Determine the Sample Size</i>	376
<i>Select the Sample</i>	378
<i>Test the Sample Items</i>	378
<i>Evaluate the Sample Results</i>	378
<i>Document the Sampling Procedure</i>	380
<i>Detailed Illustration of Attributes Sampling</i>	380
<i>Other Statistical Attributes Sampling Approaches</i>	382
<i>Nonstatistical Attributes Sampling</i>	384
Audit Sampling for Substantive Tests of Details	384
<i>Sampling Risk for Substantive Tests of Details</i>	385
<i>Sample Size for Substantive Tests of Details</i>	385
<i>Variables Sampling Approaches Included in Modules 9A, 9B, and 9C</i>	386
Chapter Summary	387
Key Terms Introduced or Emphasized in Chapter 9, Including Modules and Appendix	388
Review Questions	390
Questions Requiring Analysis	391

Objective Questions	391
Problems	394
In-Class Team Cases	395
Module 9A	
Monetary Unit Sampling (MUS)	396
Determination of Sample Size	396
Controlling Sampling Risk	397
Method of Sample Selection	397
Evaluation of Sample Results	397
Illustration of MUS	399
Considerations in Using Monetary Unit Sampling	401
Questions and Problems for Module A	402
Objective Questions	403
In-Class Team Case	405
Module 9B	
Classical Variables Sampling	406
Mean-Per-Unit	406
Determination of Sample Size	406
Evaluation of Sample Results	407
Illustration of Mean-per-Unit Estimation	409
Difference and Ratio Estimation	412
Illustration of Difference and Ratio Estimation	413
Questions and Problems for Module 9B	414
Review Questions	414
Questions Requiring Analysis	415
Objective Questions	415
Problems	417
Integrating Problem	418
Module 9C	
Nonstatistical Sampling for Substantive Procedures	419
Illustration of Nonstatistical Sampling	420
Questions and Problems for Module 9C	422
Questions Requiring Analysis	422
Objective Questions	422
Review Questions	422
Problems	423
Appendix	
Audit Risk	424
Appendix Questions	425
Chapter 10	
Cash and Financial Investments	427
Cash	427
<i>Sources and Nature of Cash</i>	427
<i>The Auditors' Objectives in the Audit of Cash</i>	427
<i>How Much Audit Time for Cash?</i>	428
<i>Internal Control over Cash Transactions</i>	428
<i>Internal Control over Cash Receipts</i>	429
<i>Internal Control over Cash Disbursements</i>	431
<i>Audit Documentation for Cash</i>	436
Audit of Cash	436
<i>Interim Audit Work on Cash</i>	451
Financial Investments	451
<i>The Need for Specialized Knowledge</i>	452
<i>The Auditors' Objectives in Auditing Financial Investments</i>	452
<i>Internal Control over Financial Investments</i>	453
<i>Internal Control Questionnaire</i>	454
Audit of Financial Investments	454
<i>Risks of Material Misstatement of Financial Investments</i>	455
<i>Substantive Procedures for Financial Investments</i>	455
Chapter Summary	461
Key Terms Introduced or Emphasized in Chapter 10	462
Review Questions	463
Questions Requiring Analysis	464
Objective Questions	467
Problems	480
In-Class Team Cases	481
Research and Discussion Case	483
Ethics Case	483
Chapter 11	
Accounts Receivable, Notes Receivable, and Revenue	485
Receivables and Revenue	485
<i>Sources and Nature of Accounts Receivable</i>	485
<i>Sources and Nature of Notes Receivable</i>	485
<i>The Auditors' Objectives in Auditing Receivables and Revenue</i>	486
<i>Internal Control of Accounts Receivable and Revenue</i>	486
<i>Control Environment</i>	486
<i>Risk Assessment</i>	487
<i>Revenue Cycle—Accounting System and Control Activities</i>	487
<i>Monitoring</i>	491
<i>Internal Control over Notes Receivable</i>	491
<i>Audit Documentation for Receivables and Revenue</i>	494
Audit of Receivables and Revenue	494
<i>Interim Audit Work on Receivables and Revenue</i>	520
Chapter Summary	520
Key Terms Introduced or Emphasized in Chapter 11	521
Review Questions	522
Questions Requiring Analysis	523
Objective Questions	526
Problems	536
In-Class Team Case	538
Ethics Cases	540
Appendix 11A	
Illustrative Audit Case: Keystone Computers & Networks Inc.	541
Part II: Consideration of Internal Control	541
Appendix 11A Problems	553
Appendix 11B	
Illustrative Audit Case: Keystone Computers & Networks Inc.	554
Part III: Substantive Tests—Accounts Receivable and Revenue	554
Appendix 11B Problems	560

Chapter 12**Inventories and Cost of Goods Sold 561**

- Inventories and Cost of Goods Sold 561
 - Sources and Nature of Inventories and Cost of Goods Sold* 561
 - The Auditors' Objectives in Auditing Inventories and Cost of Goods Sold* 561
 - Internal Control over Inventories and Cost of Goods Sold* 562
 - Control Environment* 563
 - Risk Assessment* 563
 - Monitoring* 564
 - Purchases and Production Cycles—Accounting Systems and Control Activities* 564
 - Audit Documentation for Inventories and Cost of Goods Sold* 569
- Audit of Inventories and Cost of Goods Sold 569
 - Problems Associated with Inventory of First-Year Audit Clients* 588
- Chapter Summary 588
- Key Terms Introduced or Emphasized in Chapter 12 589
- Review Questions 590
- Questions Requiring Analysis 590
- Objective Questions 592
- Problems 603
- In-Class Team Case 604
- Ethics Case 605
- Research and Discussion Case 605

Chapter 13**Property, Plant, and Equipment: Depreciation and Depletion 607**

- Property, Plant, and Equipment 607
 - The Auditors' Objectives in Auditing Property, Plant, and Equipment* 607
 - Contrast with Audit of Current Assets* 608
 - Internal Control over Plant and Equipment* 608
 - Audit Documentation* 609
 - Initial Audits and Repeat Engagements* 611
- Audit of Property, Plant, and Equipment 611
- Depreciation 620
 - The Auditors' Perspective toward Depreciation* 620
 - The Auditors' Objectives in Auditing Depreciation* 620
 - Audit Program—Depreciation Expense and Accumulated Depreciation* 621
 - Testing the Client's Provision for Depreciation* 621
 - Examination of Natural Resources* 622
- Audit of Intangible Assets 622
 - Audit of Plant, Equipment, and Intangibles in Advance of the Balance Sheet Date* 624
- Chapter Summary 624
- Key Terms Introduced or Emphasized in Chapter 13 625

- Review Questions 625
- Questions Requiring Analysis 626
- Objective Questions 627
- Problems 630
- In-Class Team Case 632

Chapter 14**Accounts Payable and Other Liabilities 634**

- Accounts Payable 634
 - Sources and Nature of Accounts Payable* 634
 - The Auditors' Objectives in Auditing Accounts Payable* 634
 - Internal Control over Accounts Payable* 635
 - Audit Documentation for Accounts Payable* 638
- Audit of Accounts Payable 638
- Other Liabilities 648
 - Amounts Withheld from Employees' Pay* 649
 - Sales Taxes Payable* 649
 - Unclaimed Wages* 649
 - Customers' Deposits* 649
 - Accrued Liabilities* 649
 - Balance Sheet Presentation* 653
 - Time of Examination* 653
- Chapter Summary 653
- Key Terms Introduced or Emphasized in Chapter 14 654
- Review Questions 654
- Questions Requiring Analysis 656
- Objective Questions 656
- Problems 665
- In-Class Team Case 667
- Appendix 14A**
- Illustrative Audit Case: Keystone Computers & Networks Inc. 668**
- Part IV: Consideration of Internal Control 668
- Appendix 14A Problems 671

Chapter 15**Debt and Equity Capital 672**

- Debt 672
 - Source and Nature of Debt* 672
 - The Auditors' Objectives in Auditing Debt* 672
 - Assessment of the Inherent Risks Related to Debt* 673
 - Internal Control over Debt* 673
 - Audit Documentation* 674
- Audit of Debt 674
 - Time of Examination—Debt* 680
- Equity Capital 680
 - Sources and Nature of Owners' Equity* 680
 - The Auditors' Objectives in Auditing Owners' Equity* 681
 - Internal Control over Owners' Equity* 681
 - Audit Documentation for Owners' Equity* 683
- Audit Plan—Capital Stock 683

Retained Earnings and Dividends	687
<i>Financial Statement Presentation of Stockholders' Equity</i>	687
<i>Time of Examination—Stockholders' Equity</i>	688
Audit of Partnerships and Sole Proprietorships	688
Chapter Summary	688
Key Terms Introduced or Emphasized in Chapter 15	689
Review Questions	689
Questions Requiring Analysis	691
Objective Questions	692
Problems	694

Chapter 16

Auditing Operations and Completing the Audit 697

Auditing Operations	697
<i>The Auditors' Approach to Auditing Operations</i>	697
<i>Internal Control over Revenues and Expenses</i>	698
Revenue	698
<i>Relationship of Revenue to Balance Sheet Accounts</i>	699
<i>Miscellaneous Revenue</i>	699
Expenses	699
<i>Relationship of Expenses to Balance Sheet Accounts</i>	700
<i>Substantive Procedures for Selling, General, and Administrative Expenses</i>	700
The Audit of Payroll	702
<i>Internal Control over Payroll</i>	702
<i>Outsourcing the Payroll Function</i>	705
<i>Documentation of Internal Control for Payroll</i>	705
<i>Audit Plan for Payroll</i>	705
<i>Audit of the Statement of Cash Flows</i>	707
Completing the Audit	707
<i>Search for Unrecorded Liabilities</i>	707
<i>Review the Minutes of Meetings</i>	708
<i>Perform Final Analytical Procedures</i>	708
<i>Perform Procedures to Identify Loss Contingencies</i>	708
<i>Perform the Review for Subsequent Events</i>	712
<i>Obtain Representation Letter</i>	715
<i>Communicate Misstatements to Management</i>	715
<i>Evaluate Audit Findings</i>	716
<i>Review the Engagement</i>	721
Responsibilities for Other Information	721
<i>Other Information Included in Annual Reports</i>	721
<i>Required Supplementary Information</i>	722
<i>Supplementary Information in Relation to the Financial Statements as a Whole</i>	723
<i>Opinion Formulation and Report Issuance</i>	723
<i>Additional Communications</i>	724
Post-Audit Responsibilities	725
<i>The Auditors' Subsequent Discovery of Facts Existing at the Date of Their Report</i>	725
<i>Subsequent Discovery of Omitted Audit Procedures</i>	725

Chapter Summary	726
Key Terms Introduced or Emphasized in Chapter 16	727
Review Questions	729
Questions Requiring Analysis	729
Objective Questions	731
Problems	737
In-Class Team Case	739
Research and Discussion Case	740
Supplementary References	740

Chapter 17

Auditors' Reports 741

Financial Statements and Audit Reports with Unmodified (Unqualified) Opinions	741
<i>Financial Statements</i>	741
<i>Financial Statement Disclosures</i>	742
<i>Comparative Financial Statements</i>	742
<i>Audit Reports with Unmodified Opinions—Nonpublic Clients</i>	742
<i>Audit Reports with Unqualified Opinions—Public Clients</i>	747
<i>Additional Information Disclosed under PCAOB Form AP</i>	751
Expression of an Opinion	753
Reports with an Unmodified Opinion and Additional Financial Statement–Related Information Included	754
<i>Substantial Doubt about a Company's Going-Concern Status</i>	755
<i>Generally Accepted Accounting Principles Not Consistently Applied</i>	758
<i>Additional Financial Statement–Related Information Added—Auditor Discretionary Circumstances</i>	760
<i>Group Financial Statements</i>	761
Modified Opinions	763
<i>Materially Misstated Financial Statements (“Departures from GAAP”)</i>	764
<i>Inability to Obtain Sufficient Appropriate Audit Evidence (Scope Limitation)</i>	767
<i>Effects of Opinion Modification on Reporting of Key (Critical) Audit Matters</i>	770
Additional Reporting Issues	770
<i>Two or More Report Modifications</i>	770
<i>Reporting on Comparative Financial Statements</i>	771
<i>Reports to the SEC</i>	771
Chapter Summary	772
Key Terms Introduced or Emphasized in Chapter 17	773
Review Questions	775
Questions Requiring Analysis	776
Objective Questions	777
Problems	789
In-Class Team Cases	792
Research and Discussion Case	794

Chapter 18 Integrated Audits of Public Companies 795

- Overview 795
- Management's Responsibility for Internal Control 796
 - Management's Evaluation Process and Assessment* 796
- The Auditors' Responsibility for Reporting on Internal Control in PCAOB Audits 799
 - Plan the Engagement* 800
 - Use a Top-Down Approach to Identify Controls to Test* 801
 - Test and Evaluate Design Effectiveness of Internal Control over Financial Reporting* 806
 - Test and Evaluate Operating Effectiveness of Internal Control over Financial Reporting* 806
 - Form an Opinion on the Effectiveness of Internal Control over Financial Reporting* 811
 - Audit Report Modifications* 813
 - Other Communication Requirements* 815
 - Reporting on Whether a Previously Reported Material Weakness Continues to Exist* 815
 - Integrated Audits for Nonpublic Companies* 817
- Chapter Summary 817
- Key Terms Introduced or Emphasized in Chapter 18 817
- Review Questions 818
- Questions Requiring Analysis 819
- Objective Questions 820
- Problems 824
- In-Class Team Cases 824

Chapter 19 Additional Assurance Services: Historical Financial Information 826

- Audit-Based Services: Assurance on Additional Information 826
 - Reporting on Compliance with Aspects of Contractual Agreements or Regulatory Requirements in Connection with Audited Financial Statements* 826
 - Letters for Underwriters* 827
 - Summary Financial Statements* 827
- Auditing Financial Statements That Use a Financial Reporting Framework Other Than GAAP 828
 - Audits of Financial Statements Prepared in Accordance with Special-Purpose Financial Reporting Frameworks* 828
 - Financial Statements Prepared Using a Financial Reporting Framework Generally Accepted in Another Country* 830
- Additional GAAS Audits and Other Types of Assurance Engagements 831

- Single Financial Statements and Specific Elements, Accounts, or Items of Financial Statements* 831
- Audits of Personal Financial Statements* 834
- Reviews of Historical Financial Statements 835
 - SSARS Reviews of Nonpublic Companies (Nonissuers)* 835
 - PCAOB and Auditing Standards Board Reviews of Interim Information* 840
- Compilation and Preparation of Historical Financial Statements 841
 - Compilation of Financial Statements* 842
 - Preparation of Financial Statements* 843
- Chapter Summary 845
- Key Terms Introduced or Emphasized in Chapter 19 846
- Review Questions 847
- Questions Requiring Analysis 848
- Objective Questions 849
- Problems 852
- In-Class Team Case 852
- Research and Discussion Case 853
- Supplementary References 854

Chapter 20 Additional Assurance Services: Other Information 855

- Assurance Services 855
 - The Demand for Assurance Services* 856
- Attestation Standards 857
 - The Criteria* 858
 - Direct Reporting Without the Assertion* 860
 - Attestation Risk and Materiality* 861
 - The Character of the Engagement* 861
- Assurance Service Examples 863
 - Trust Services* 863
 - System and Organization Controls (SOC) Engagements* 865
 - Assurance on Sustainability Information* 869
 - Assurance on Compliance* 869
 - XBRL Engagements* 869
 - Elder Care Services* 869
 - Assurance on Prospective Financial Statements* 870
 - Assurance on Management's Discussion and Analysis* 871
- Future Assurance Services 872
- Chapter Summary 872
- Key Terms Introduced or Emphasized in Chapter 20 873
- Review Questions 874
- Questions Requiring Analysis 875
- Objective Questions 876
- Problems 879
- In-Class Team Case 880
- Research and Discussion Case 880

Chapter 21**Internal, Operational, and Compliance Auditing 881**

Internal Auditing 881

What Is the Purpose of Internal Auditing? 881*Evolution of Internal Auditing* 881*The Internal Auditors' Role in Sarbanes-Oxley**Compliance* 883*Professional Standards of Internal Auditing* 883*Certification of Internal Auditors* 886

Operational Auditing 886

Objectives of Operational Audits 886*General Approach to Operational Audits* 887

Compliance Auditing 890

Attesting to Compliance with Laws and Regulations 890*Compliance Reporting by Broker-Dealers under PCAOB**Requirements* 892*Compliance Auditing of Government Entities and**Organizations Receiving Federal Financial Assistance* 893*Compliance Auditing—A Summary* 901

Chapter Summary 902

Key Terms Introduced or Emphasized in

Chapter 21 902

Review Questions 903

Questions Requiring Analysis 904

Objective Questions 906

Problems 908

In-Class Team Case 909

Appendix 21A**International Standards for the Practice of Internal Auditing 910**

Attribute Standards 910

Performance Standards 915

Glossary 924

Appendix 927**Index 932**

The Role of the Public Accountant in the American Economy

LO 1-1

Describe the nature of assurance services.

Dependable information is essential to the very existence of our society. The investor making a decision to buy or sell securities, the banker deciding whether to approve a loan, the government in obtaining revenue based on income tax returns—all are relying upon information provided by others. In many of these situations, the goals of the providers of information may run somewhat counter to those of the users of the information. Implicit in this line of reasoning is recognition of the social need for independent public accountants—individuals of professional competence and integrity who can tell us whether the information that we use constitutes a fair picture of what is really going on.

Our primary purpose in this chapter is to make clear the nature of independent audits and the accounting profession. We begin with a discussion of the broader concept of assurance services. Next, we describe those assurance services that involve attestation, of which audits of financial statements are an important type. Another purpose of this chapter is to summarize the influence exerted on the public accounting profession by the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), the Federal Accounting Standards Advisory Board (FASAB), the Public Company Accounting Oversight Board (PCAOB), the Securities and Exchange Commission (SEC), and the International Federation of Accountants (IFAC). We also will explore various types of audits and note the impact of The Institute of Internal Auditors (IIA) and the Government Accountability Office (GAO). Finally, we will examine other types of professional services and the nature and organization of public accounting firms.

What Are Assurance Services?

The name **assurance services** is used to describe the broad range of information enhancement services performed by a certified public accountant (CPA) that are designed to enhance the degree of confidence in the information. In general, assurance services consist of two types: those that increase the reliability of information and those that involve putting information in a form or context that facilitates decision making. In this chapter, we will focus on the first type—audit and assurance services that involve reliability enhancement.

Attest Engagements

LO 1-2

Identify assurance services that involve attestation.

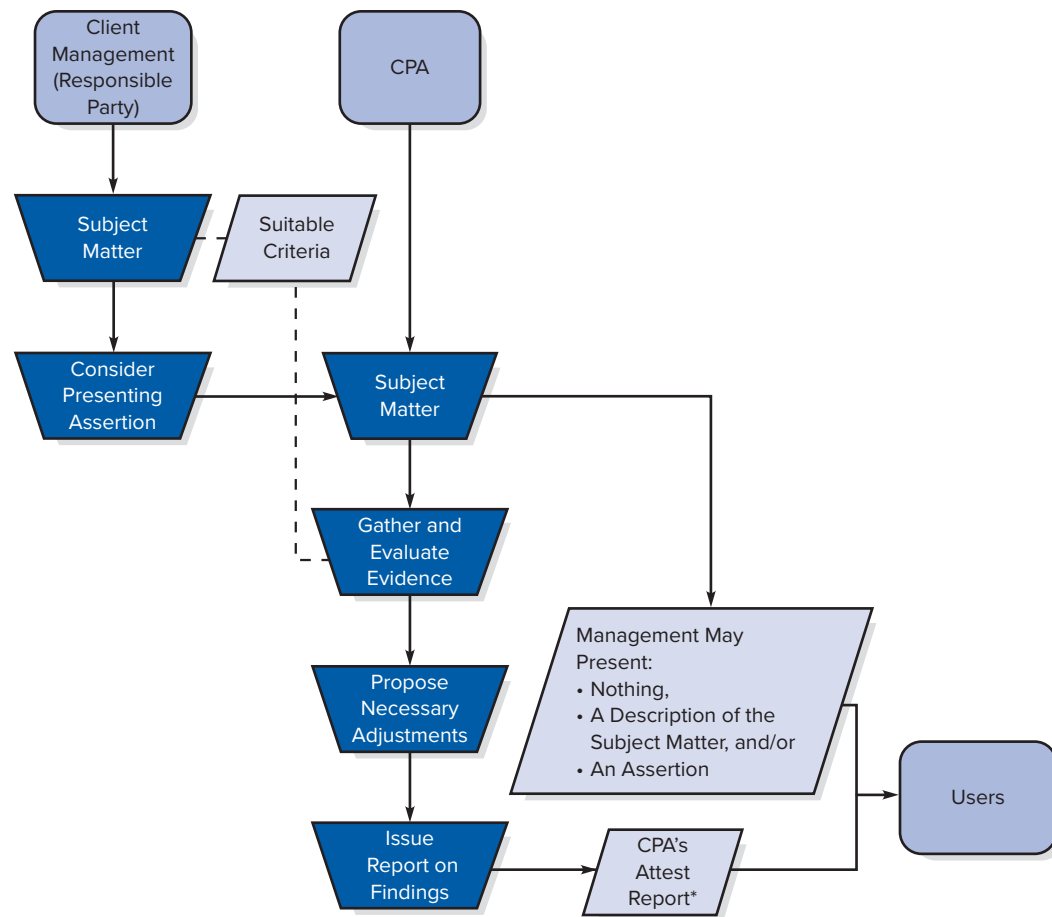
A significant portion of the assurance services provided by CPAs is referred to as *attestation services*. To attest to information means to provide assurance as to its reliability. In an **attestation engagement** (also referred to as an

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 1-1** Describe the nature of assurance services.
- LO 1-2** Identify assurance services that involve attestation.
- LO 1-3** Describe the nature of financial statement audits.
- LO 1-4** Explain why audits are demanded by society.
- LO 1-5** Describe how the credibility of the accounting profession was affected by the large number of companies reporting accounting irregularities in the beginning of this century.
- LO 1-6** Contrast the various types of audits and types of auditors.
- LO 1-7** Explain the regulatory process for auditors of public companies and auditors of nonpublic companies.
- LO 1-8** Describe how public accounting firms are typically organized and the responsibilities of auditors at the various levels in the organization.

FIGURE 1.1
The Attest Function



*If the criteria are not generally available to the users, they should be presented in the CPA's report or management's presentation.

attest engagement), CPAs provide a report on subject matter or an assertion about that subject matter.

CPAs attest to many types of subject matter (or assertions about subject matter), including financial forecasts, internal control, compliance with laws and regulations, and advertising claims.

Figure 1.1 describes the attest function, which begins with the subject matter that is the responsibility of another party, usually management. As an example, consider the situation in which the CPAs attest to a company's compliance with a state's laws and regulations on employee health requirements. The CPAs may be engaged to report directly on compliance with the specific requirements of the laws and regulations (the subject matter). Alternatively, they may report on an *assertion made by management* that the company's compliance. In this second case, the attestation report would include an opinion on whether management's **assertion** is accurate. This type of audit is discussed in Chapter 20.

What standards should the subject matter follow? The standards generally are those established or developed by groups composed of experts and are referred to as **suitable criteria**. In a compliance engagement such as the above, the criteria would address what is meant by substantial compliance with the law's specific requirements. In a financial statement audit, another term arises to describe suitable criteria—**financial reporting framework**. The suitable criteria in a financial statement audit are set forth in the financial reporting framework selected by management, often **generally accepted accounting principles (GAAP)**. The CPAs perform a financial statement audit to gather sufficient evidence to issue an audit report with their opinion on whether the financial statements



Illustrative Case

The Value of Attest Services

CPAs have attested that a supermarket chain in Phoenix has the lowest overall prices in that city. The CPAs selected a sample of approximately 1,000 items and compared the prices to those of the various

other major supermarkets. Representatives of the supermarket chain stated that the credibility added by the CPAs has helped to convince consumers that the chain's prices are indeed the lowest.

(the subject matter) follow the **applicable financial reporting framework** (i.e., the financial reporting framework chosen by management, usually GAAP).

The three forms of attest engagements are examinations, reviews, and the performance of agreed-upon (or selected) procedures. An **examination**, referred to as an *audit* when it involves historical financial statements, provides the highest form of assurance that CPAs can offer. In an examination, the CPAs select from all available evidence a combination that limits to an acceptably *low level* the risk of undetected material misstatement and obtains *reasonable assurance* that the subject matter (or assertion) is materially correct. A **review** is substantially less in scope of procedures than an examination and is designed to lend limited assurance that the information is materially correct. If an examination or review does not meet the client's needs, the CPAs and specified user or users of the information may mutually decide on specific agreed-upon procedures that the CPAs will perform. An **agreed-upon procedures engagement** results in a report by the CPAs that describes those procedures and their findings. Chapter 19 discusses the requirements of agreed-upon procedures engagements. Figure 1.2 summarizes the forms of attestation engagements.

Assurance and Nonassurance Services

It is important to understand the relationships among the range of services that are offered by CPAs because different professional standards apply to each type of service. Figure 1.3 illustrates the universe of services that may be offered by CPAs and the relationships among these services. As shown, CPAs provide both assurance and nonassurance services but a few, specifically of the management consulting type, overlap. Certain management consulting services have assurance aspects. Later in this chapter, we will provide a brief description of the prevalent types of nonassurance services offered by CPA firms.

FIGURE 1.2 Forms of Attestation

Type of Engagement	Level of Assurance Provided	Risk of Material Misstatement	Nature of Assurance in Report	Procedures
Examination*	High ("reasonable")	Low	"In our opinion . . ."	Select from all available procedures any combination that can limit attestation risk to a low level
Review	Limited	Moderate	"We are not aware of any material modifications that should be made . . ."	Generally limited to inquiry and analytical procedures
Agreed-Upon Procedures	Summary of findings	Varies by specific engagement	Includes a summary of procedures followed and findings	Procedures agreed upon with the engaging party

*Referred to as an audit when the subject matter is historical financial statements or internal control as a part of an integrated audit.

FIGURE 1.3
Relationships among
Assurance and Other
Services

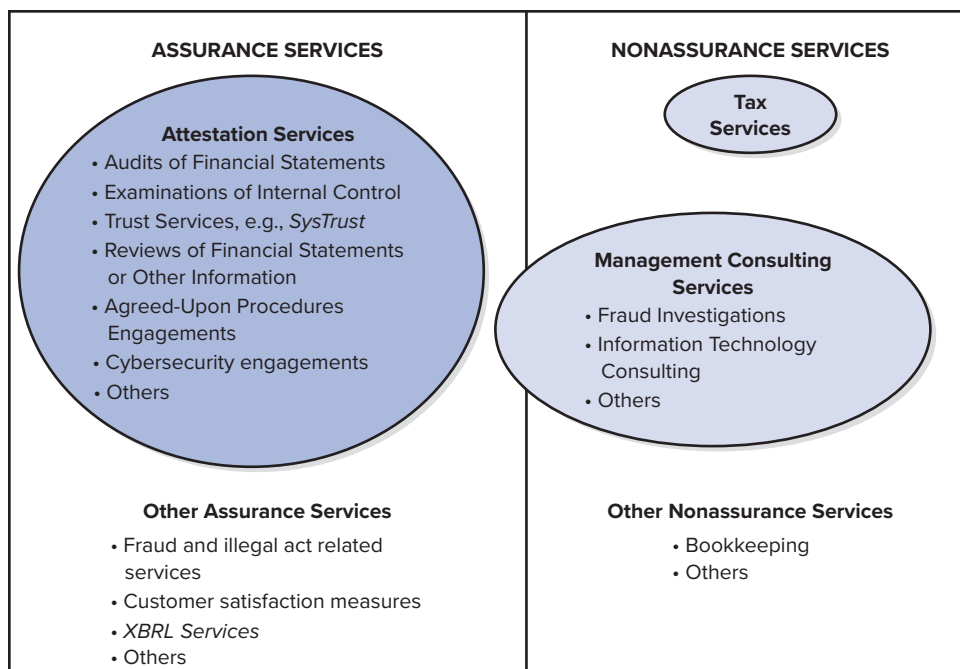


Figure 1.3 also illustrates that attestation services are only a portion of the assurance services that are offered by CPAs. Chapter 20 discusses number of these services in detail.

Throughout the first 17 chapters of this textbook, we will focus primarily on the attest function as it relates to the audit of financial statements. Other types of attestation and assurance services are discussed in Chapters 18 through 21.

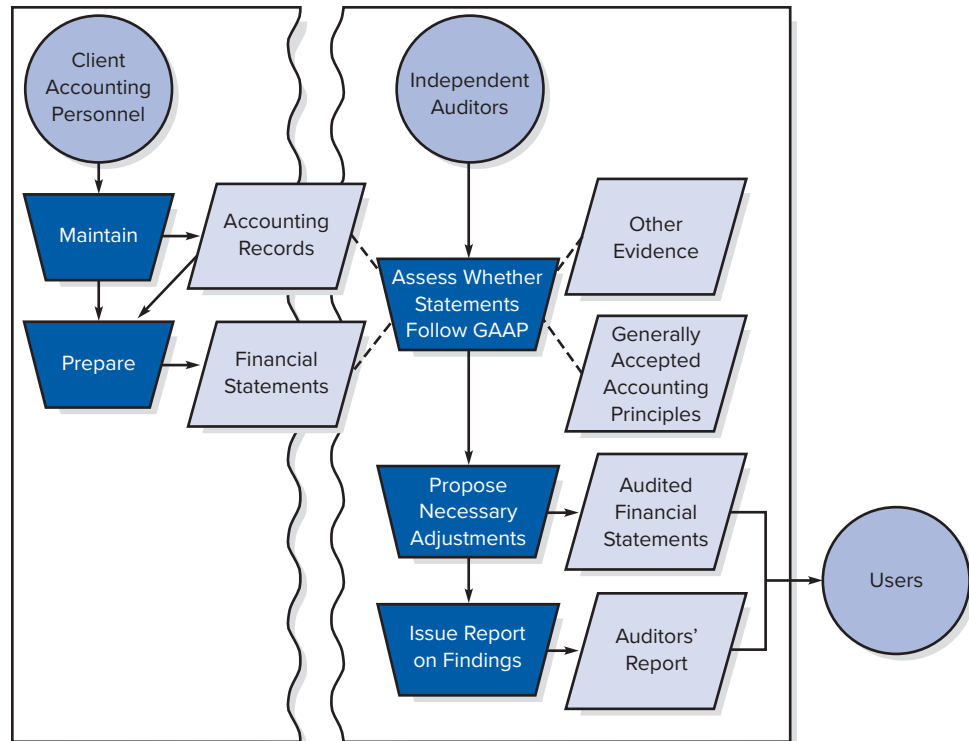
Financial Statement Audits

LO 1-3

Describe the nature of financial statement audits.

In a financial statement audit, the auditors undertake to gather evidence to obtain a high level of assurance (referred to as reasonable assurance) that the financial statements follow generally accepted accounting principles, or some other appropriate accounting framework. An audit involves searching and verifying the accounting records and examining other evidence supporting the financial statements. By gathering information about the company and its environment—including internal control, inspecting documents, observing assets, making inquiries within and outside the company, and performing other auditing procedures—the auditors will gather the evidence necessary to issue an audit report. That audit report states that it is the auditors' opinion that the financial statements follow generally accepted accounting principles. The flowchart in Figure 1.4 illustrates an audit of financial statements.

The evidence obtained and evaluated by the auditors focuses on whether the financial statements are presented in accordance with the applicable financial reporting framework, usually generally accepted accounting principles. More specifically, an audit addresses management's assertions that the assets listed in the balance sheet really exist, that the company has rights (by title or contract) to the assets, and that the valuations assigned to the assets have been established in conformity with generally accepted accounting principles. Evidence is gathered to show that the balance sheet contains *all the liabilities* of the company; otherwise the balance sheet might be grossly misleading because certain important liabilities have been accidentally or deliberately omitted. The auditors also obtain evidence that the recorded liabilities are actual obligations of the company and are properly valued. Similarly, the auditors gather evidence about the transactions recorded in the income statement. They demand evidence that the reported

FIGURE 1.4 Audit of Financial Statements

sales really occurred, that sales have been recorded at appropriate amounts, and that the recorded costs and expenses are applicable to the current period and all expenses have been recognized. Finally, the auditors consider whether the financial statement amounts are accurate, properly classified, and summarized and whether the notes are informative and complete. Only if sufficient evidence is gathered in support of all these significant assertions can the auditors provide an opinion on whether the financial statements are presented in accordance with generally accepted accounting principles.

The procedures included in an audit vary considerably from one engagement to the next. Many of the procedures appropriate to the audit of a small retail store would not be appropriate for the audit of a large corporation such as Apple Inc. Auditors perform audits of all types of businesses, and of governmental and nonprofit organizations as well. Banks and breweries, factories and stores, colleges and churches, school districts and labor unions—all are regularly visited by auditors. The selection of the procedures best suited to each audit requires the exercise of professional skill and judgment.

What Creates the Demand for Audits?

LO 1-4

Explain why audits are demanded by society.

Reliable accounting and financial reporting aid society in allocating resources in an efficient manner. A primary goal is to allocate limited capital resources to the production of those goods and services for which demand is great. Economic resources are attracted to the industries, the geographic areas, and the organizational entities that are shown by financial measurements to be capable of using the resources to the best advantage. Inadequate accounting and reporting, on the other hand, conceal waste and inefficiency, thereby preventing an efficient allocation of economic resources in the society.

The contribution of the independent auditor is to provide *credibility* to information. Credibility, in this usage, means that the information can be believed; that is, it can be relied upon by outsiders, such as stockholders, creditors, government regulators, customers, and other interested third parties. These third parties use the information to make various economic decisions, such as decisions about whether to invest in the organization.

Economic decisions are made under conditions of uncertainty; there is always a risk that the decision maker will select the wrong alternative and incur a significant loss.

The credibility added to the information by auditors actually reduces the decision maker's risk. To be more precise, the auditors reduce information risk, which is the risk that the financial information used to make a decision is materially misstated.

Audited financial statements are the accepted means by which business corporations report their operating results and financial position. The word *audited*, when applied to financial statements, means that the balance sheet and the statements of income, retained earnings, and cash flows are accompanied by an audit report prepared by independent public accountants, expressing their professional opinion as to the fairness of the company's financial statements.

Financial statements prepared by management and transmitted to outsiders without first being audited by independent accountants leave a credibility gap. In reporting on its own administration of the business, management can hardly be expected to be entirely impartial and unbiased, any more than a football coach could be expected to serve as both coach and referee in the same game. Independent auditors have no material personal or financial interest in the business; their reports can be expected to be impartial and free from bias.

Unaudited financial statements may have been honestly, but carelessly, prepared. Liabilities may have been overlooked and omitted from the balance sheet. Assets may have been overstated as a result of arithmetical errors or due to a lack of knowledge of generally accepted accounting principles. Net income may have been exaggerated because expenses were capitalized (i.e., misclassified as assets) or because sales transactions were recorded in advance of delivery dates.

Finally, there is the possibility that unaudited financial statements have been deliberately falsified in order to conceal theft and fraud or as a means of inducing the reader to invest in the business or to extend credit. Although deliberate falsification of financial statements is not common, it does occur and can cause devastating losses to persons who make decisions based upon such misleading statements.

For all these reasons (accidental errors, lack of knowledge of accounting principles, unintentional bias, and deliberate falsification), financial statements may depart from generally accepted accounting principles. Audits provide organizations with more credible financial statements to allow users to have more assurance that those statements do not materially depart from generally accepted accounting principles.

In *United States v. Arthur Young*, 465 U.S. 805 (1984), the Supreme Court described the auditor's role as being that of a public watchdog, requiring both total independence from the client at all times and a complete fidelity to the public trust. As such, the public accounting profession differs from other professions in that auditors do not directly interact with those for whom their service is provided—investors and other third parties. The connections with these individuals are the reports issued by the auditors and read by and relied upon by the third parties. The auditors' reports are meant to provide value because the auditors have no material personal or financial interest in the business being audited; their reports can be expected to be impartial and free from bias.

Illustrating the Demand for Auditing

A decision by a bank loan officer about whether to make a loan to a business can be used to illustrate the demand for auditing. Since the bank's objective in making the loan is to earn an appropriate rate of interest and to collect the principal of the loan at maturity, the loan officer is making two related decisions: (1) whether to make the loan at all and (2) what rate of interest adequately compensates the bank for the level of risk assumed. The loan officer will make these decisions based on a careful study of the company's financial statements along with other information. The risk assumed by the bank related to this customer has two aspects¹:

1. **Business risk**—the risk associated with a company's survival and profitability. This includes, for example, the risk that the company will not be able to make the

¹ For all loans, the banker also assumes *interest rate risk*, which varies depending on the terms of the loan. Interest rate risk reflects the risk due to potential changes in the "risk-free" interest rate.

interest payments and repay the principal of the loan because of economic conditions or poor management decisions. Business risk is assessed by considering factors such as the financial position of the company, the nature of its operations, the characteristics of the industry in which it operates, and the quality and integrity of its management.

2. **Information risk**—the risk that the information used to assess business risk is not accurate. Information risk includes the possibility that the financial statements might contain material departures from generally accepted accounting principles.

While auditing normally has only a limited effect on a company's business risk,² it can significantly affect the level of information risk. If the loan officer has assurance from the auditors that the company's financial statements are prepared in accordance with generally accepted accounting principles, he or she will have more confidence in his or her assessment of business risk. In addition, periodic audits performed after the loan has been made provide the loan officer with a way of monitoring management performance and compliance with the various loan provisions. By reducing information risk, the auditors reduce the overall risk to the bank; the loan officer is more likely to rely on the company's financial information, and if that information shows a healthy company, make the loan at a lower rate of interest. Therefore, management of the company has an incentive to provide audited financial statements to the loan officer to obtain the loan and to get the best possible interest rate.

The millions of individuals who have entrusted their savings to corporations by investing in securities rely upon annual and quarterly financial statements for investment decisions and for assurance that their invested funds are being used honestly and efficiently. An even greater number of people entrust their savings to banks, insurance companies, investment managers, and pension funds, which in turn invest the money in securities.

Various regulatory agencies also demand audit services. As an example, consider the income tax reporting system in the United States. The information provided on tax returns is provided by taxpayers and may be biased because of the self-interest of the providers. The government attempts to compensate for this inherent weakness through verification by audits carried out by agents of the Internal Revenue Service.

Corporate Governance and Auditing

The term **corporate governance** refers to the rules, processes, and laws by which businesses are operated, regulated, and controlled. Effective corporate governance requires that the interests of a company's management, shareholders, creditors, and other stakeholders be properly balanced. Shareholders elect **boards of directors** to oversee the corporation's activities. In the United States, public companies must establish **audit committees** of their board of directors, ordinarily composed of between three and six independent (nonmanagement) board members.³ Although details of responsibilities differ among companies, audit committees are charged with areas such as oversight of financial reporting, regulatory compliance, and risk management. Included in the audit committee's responsibilities is appointment, compensation, and oversight of the work of the company's external auditors. Chapter 7 provides more information on the relationship of corporate governance to internal control, including auditor responsibilities to communicate with audit committees.

² Possible effects of an audit on business risk include modifications of management's operating decisions either due to knowledge that an audit will be performed or due to operating recommendations made by auditors. Accordingly, an audit *may* reduce business risk.

³ Specifically, independent board members include those who are not employees of the company and do not receive consulting or other compensatory fees from the company (other than fees for serving on the board of directors and the audit committee). In addition, all members of the audit committee must be financially literate, while one member must be considered a "financial expert."

A Brief Summary of Major Auditing Developments

Audits of one type or another have been performed throughout the recorded history of commerce and government finance. The original meaning of the word *auditor* was “one who hears” and was appropriate to the era during which governmental accounting records were approved only after a public reading, in which the accounts were read aloud. From medieval times on through the Industrial Revolution, audits were performed to determine whether persons in positions of official responsibility in government and commerce were acting and reporting in an honest manner.

During the Industrial Revolution, as manufacturing concerns grew in size, their owners began to use the services of hired managers. With this separation of the ownership and management groups, the absentee owners turned increasingly to auditors to protect themselves against the danger of unintentional errors as well as fraud committed by managers and employees. Bankers were the primary outside users of financial reports (usually only balance sheets), and they also were concerned with whether the reports were distorted by errors or fraud. Before 1900, consistent with this primary objective to detect errors and fraud, audits often included a study of all, or almost all, recorded transactions.

Auditing Developments in the 20th Century

In the first half of the 20th century, the direction of audit work tended to move away from fraud detection toward a new goal of determining whether financial statements gave a full and fair picture of financial position, operating results, and changes in financial position. This shift in emphasis was a response to the increasing number of shareholders and the corresponding increased size of corporate entities. In addition to the new shareholders, auditors became more responsible to governmental agencies, the stock exchanges representing these new investors, and other parties who might rely upon the financial information. No longer were bankers the only important outside users of audited financial data. The fairness of reported earnings became of prime importance.

As large-scale corporate entities developed rapidly in both Great Britain and the United States, auditors began to sample selected transactions, rather than study all transactions. Auditors and business managers gradually came to accept the proposition that careful examination of relatively few selected transactions would give a cost-effective, reliable indication of the accuracy of other similar transactions.

In addition to sampling, auditors became aware of the importance of effective internal control. A company’s internal control consists of the policies and procedures established to provide reasonable assurance that the objectives of the company will be achieved, including the objective of preparing accurate financial statements. Auditors found that by studying the client’s internal control, they could identify areas of strength as well as of weakness. *The stronger the internal control, the less testing of financial statement account balances required by the auditors.* For any significant account or any phase of financial operations in which controls were weak, the auditors expanded the nature and extent of their tests of the account balance.

With the increased reliance upon sampling and internal control, professional standards began to emphasize limitations on auditors’ ability to detect **fraud**. The profession recognized that audits designed to discover fraud would be too costly. Good internal control and surety bonds were recognized as better fraud protection techniques than audits.

Beginning in the 1960s, the detection of large-scale fraud assumed a larger role in the audit process. Professional standards, which used the term *irregularities* in place of fraud, described fraudulent financial reporting and misappropriation of assets. This shift in emphasis to taking a greater responsibility for the detection of fraud resulted from (1) a dramatic increase in congressional pressure to assume more responsibility for large-scale frauds, (2) a number of successful lawsuits claiming that fraudulent financial reporting (management fraud) had improperly gone undetected by the independent auditors, and (3) a belief by public accountants that audits should have a reasonable probability of detecting *material* fraud.



As a result of a number of instances of fraudulent financial reporting, the major accounting organizations⁴ sponsored the *National Commission on Fraudulent Financial Reporting* (the Treadway Commission) to study the causes of fraudulent reporting and make recommendations to reduce its incidence. The commission's final report, which was issued in 1987, made a number of recommendations for auditors, public companies, regulators, and educators. Many of the recommendations for auditors were enacted by the AICPA in a group of *Statements on Auditing Standards* known as the *expectation gap* standards. The commission's recommendations about internal control led to the development of an internal control framework, titled *Internal Control—Integrated Framework*, to be used to evaluate the internal control of an organization. The development of these internal control criteria increased the demand for attestation by auditors to the effectiveness of internal control. As an example, the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 was passed requiring management of large financial institutions to engage CPAs to attest to the effectiveness of assertions by management about the effectiveness of the institution's controls over financial reporting.

In the late 1980s and early 1990s, the billions of dollars in federal funds that were required to "bail out" the savings and loan industry caused a movement toward increased regulation of federally insured financial institutions. Congress and regulatory agencies believed that the key to preventing such problems was enacting effective laws and regulations and requiring reports by auditors on compliance with provisions of these laws and regulations. An important example of this type of legislation is the FDIC Improvement Act of 1991. In addition to requiring reporting on internal control, the law also requires management of large financial institutions to engage its CPAs to attest to management's assertion about the institution's compliance with laws and regulations related to the safety and soundness of the institution.

In 1996, in response to a continuing expectation gap between user demands and auditor performance, the AICPA issued guidance to auditors requiring an explicit assessment of the risk of material misstatement in financial statements due to fraud on all audits. This auditing standard subsequently was updated to a more stringent standard that requires auditors to definitively design procedures to address the risk of fraudulent financial reporting.

The Accounting Profession's Credibility Crisis



In 2000, at the request of the Securities and Exchange Commission, the accounting profession established the Panel on Audit Effectiveness. The panel was charged with the responsibility of reviewing and evaluating how independent audits of financial statements are performed and assessing whether recent trends in audit practices serve the public interest. Recommendations from the panel resulted in changes in auditing standards related to the detection of fraud, documentation of audit evidence and judgments, risk assessments, and the linkage of audit procedures to audit risks. However, even before these changes in audit requirements could be implemented, a series of events in the capital markets produced a chain reaction that caused unprecedented reforms in the accounting profession.

In December 2001, Enron Corporation filed for bankruptcy shortly after acknowledging that accounting irregularities had been used to significantly inflate earnings in the current and preceding years. Shortly thereafter, it was disclosed that WorldCom had used accounting fraud to significantly overstate its reported income. In addition to these two very visible cases, a record number of public companies restated prior-period financial statements, and almost weekly the Securities and Exchange Commission announced a new investigation into another company's accounting practices. Investor uncertainty about the reliability of financial statements rocked an already weak financial market

LO 1-5

Describe how the credibility of the accounting profession was affected by the large number of companies reporting accounting irregularities in the beginning of this century.

⁴ The sponsoring organizations included the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute, The Institute of Internal Auditors, and the Institute of Management Accountants.