Louwers | Blay | Sinason | Strawser | Thibodeau

Auditing & Assurance Services 7e

Mc Graw Hill Education

Data and Analytics

IDEA Data Analysis Software

Auditing & Assurance Services

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Timothy J. Louwers, PhD, CPA, CISA, CFF
Director of the School of Accounting and
KPMG Eminent Professor in Accounting

Allen D. Blay, PhD, CPA
Associate Professor of Accounting
Florida State University

David H. Sinason, PhD, CPA, CIA, CFE, CFSA, CRMA
PwC Professor of Accountancy
Northern Illinois University

Jerry R. Strawser, PhD, CPA
KPMG Chair of Accounting
Texas A&M University

Jay C. Thibodeau, PhD, CPA
Rae D. Anderson Professor of Accounting
Bentley University

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Some people come into our lives and quickly go. Some stay awhile and leave footprints on our hearts and we are never quite the same.

Anonymous

We dedicate this book to the following educators whose footprints we try to follow:

Professor Homer Bates
(University of North Florida)

Professor Stanley Biggs
(University of Connecticut)

Professor Lewis C. Buller
(Indiana State University)

Professor Patrick Delaney
(Northern Illinois University)

Professor William Hillison
(Florida State University)

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(University of Texas at Austin)

Professor Robert Strawser
(Texas A&M University)

Professor Sally Webber
(Northern Illinois University)

Professor “IBM Jim” Whitney
(The Citadel)

Meet the Authors

Courtesy James Madison University

Timothy J. Louwers *is the Director of the School of Accounting and KPMG Eminent Professor in Accounting at James Madison University.*

Professor Louwers received his undergraduate and master's degrees from The Citadel and his PhD from Florida State University. Prior to beginning his academic career, he worked in public accounting with KPMG, specializing in financial, governmental, and information systems auditing. He is a certified public accountant (South Carolina and Virginia) and a certified information systems auditor. He is also certified in financial forensics.

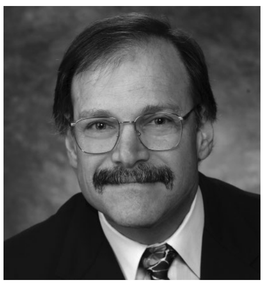
Professor Louwers's research interests include auditors' reporting decisions and ethical issues in the accounting profession. He has authored or coauthored more than 60 publications on a wide range of accounting, auditing, and technology-related topics, including articles in the *Journal of Accounting Research, Accounting Horizons,* the *Journal of Business Ethics, Behavioral Research in Accounting, Decision Sciences,* the *Journal of Forensic Accounting, Issues in Accounting Education,* the *Journal of Accountancy,* the *CPA Journal,* and *Today's CPA.* Some of his published work has been reprinted in Russian and Chinese. He is a respected lecturer on auditing and technology-related issues and has received teaching excellence awards from the University of Houston and Louisiana State University. He has appeared on both local and national television news broadcasts, including MSNBC and CNN news programs.

Courtesy Kallen M. Lunt

Allen D. Blay *is an Associate Professor of Accounting at Florida State University.*

Professor Blay completed his PhD at the University of Florida in 2000. He teaches auditing at all levels and teaches a seminar in auditing research in the doctoral program. His research interests relate to auditor judgment and decision making. Professor Blay has authored or coauthored publications on a wide range of accounting and auditing topics in journals such as *Contemporary Accounting Research, Auditing: A Journal of Practice and Theory, Organizational Behavior and Human Decision Processes,* the *Journal of Business Ethics, Behavioral Research in Accounting, Issues in Accounting Education,* the *International Journal of Auditing,* and the *Journal of Accounting, Auditing, and Finance.* He is currently Associate Editor for *Issues in Accounting Education* and serves on several editorial boards.

Professor Blay has been active in the American Accounting Association, serving on the auditing education committee and the annual meeting committee as Accounting, Behavior, and Organizations section chair, among other committees. He is also active in the American Institute of CPAs, serving in various volunteer roles relating to the Uniform CPA Exam. Prior to entering academics, Professor Blay worked in public accounting auditing financial institutions. He currently directs the accounting doctoral program at Florida State University.



Courtesy Northern Illinois University

David H. Sinason *is the PwC Professor of Accountancy at Northern Illinois University (NIU) and director of the NIU Internal Audit program.*

Professor Sinason received a BS in engineering from the University of Illinois, a BS in History from Northern Illinois University, a BBA and MAcc in accounting from the University of North Florida, and a PhD in accounting from Florida State University. He has certifications as a certified public accountant, a certified internal auditor, a certified financial services auditor, and a certified fraud examiner. He also has certification in risk management assurance. Professor Sinason has written more than 50 articles, mostly in the areas of assurance services, fraud prevention and detection, and auditor liability.

Professor Sinason has taught in the areas of accounting information systems, auditing and assurance services, and financial accounting. He has received teaching awards at each of the universities where he has taught including the 2002–2003 Department of Accountancy and Northern Illinois University Awards for Excellence in Undergraduate Teaching.

Courtesy Jerry R. Strawser

Jerry R. Strawser *is Executive Vice President and Chief Financial Officer at Texas A&M University and holds the KPMG Chair in Accounting.*

Prior to his current appointment, Professor Strawser served as dean of Mays Business School at Texas A&M University, interim executive vice president and provost at Texas A&M University, interim dean of the C. T. Bauer College of Business at the University of Houston, and Arthur Andersen & Co. Alumni Professor of Accounting.

Professor Strawser has coauthored three textbooks and more than 60 journal articles. In addition to his academic experience, he had prior public accounting experience at two Big Five accounting firms. He has also developed and delivered numerous executive development programs to organizations such as AT&T, Centerpoint Energy, Continental Airlines, ConocoPhillips, Halliburton, KBR, KPMG, Minute Maid, PricewaterhouseCoopers, McDermott International, Shell, Southwest Bank of Texas, and the Texas Society of Certified Public Accountants. Professor Strawser is a certified public accountant in the state of Texas and earned his BBA and PhD in Accounting from Texas A&M University.

Courtesy Bentley University

Jay C. Thibodeau *is the Rae D. Anderson Professor of Accounting at Bentley University.*

Professor Thibodeau is a certified public accountant and a former auditor. He received his bachelor's degree from the University of Connecticut in 1987 and his PhD from the University of Connecticut in 1996. He joined the faculty at Bentley in 1996 and has remained there. At Bentley, he serves as the coordinator for all audit and assurance curriculum matters. His off-campus commitments include consulting with the Audit Learning and Development group at KPMG.

Professor Thibodeau's scholarship focuses on audit judgment and decision making and audit education. He is a coauthor of two textbooks and has written more than 40 book chapters and articles for academics and practitioners in journals such as *Auditing: A Journal of Practice & Theory, Accounting Horizons,* and *Issues in Accounting Education.*

Professor Thibodeau served as the President of the Auditing Section of the American Accounting Association for the 2014/2015 academic year. He served on the Executive Committee for the Auditing Section from 2008 to 2010. He has received national recognition for his work five times. First, for his thesis, winning the 1996 Outstanding Doctoral Dissertation Award presented by the ABO section of the AAA. Three other times, for curriculum innovation, winning the 2001 Joint AICPA/AAA Collaboration Award, the 2003 Innovation in Assurance Education Award, and the 2016 Forensic Accounting Teaching Innovation Award. Finally, for outstanding service, receiving a Special Service Award from the Auditing Section for his work in helping to create the "Access to Auditors" program sponsored by the Center for Audit Quality.

Look Beneath the Surface . . .

As auditors, we are trained to investigate beyond appearances to determine the underlying facts—in other words, to *look beneath the surface.* From the Enron and WorldCom scandals of the early 2000s to the financial crisis of 2007–2008 to present-day issues and challenges related to significant estimation uncertainty, understanding the auditor's responsibility related to fraud, maintaining a clear perspective, probing for details, and understanding the big picture are indispensable to effective auditing. With the availability of greater levels of qualitative and quantitative information ("big data"), the need for technical skills and challenges facing today's auditor is greater than ever. The author team of Louwers, Blay, Sinason, Strawser, and Thibodeau has dedicated years of experience in the auditing field to this new edition of *Auditing & Assurance Services,* supplying the necessary investigative tools for future auditors.

Cutting-Edge Coverage

The seventh edition of *Auditing & Assurance Services* continues its tradition as the most up-to-date auditing text on the market. All chapters and modules have been revised to incorporate the latest professional standards, recodifications, and proposals from the International Auditing and Assurance Standards Board, Auditing Standards Board, and Public Company Accounting Oversight Board. To acquaint students with the professional standards, each chapter or module begins with a list of the relevant professional standards that are covered in that chapter. Importantly, this text incorporates the reorganized PCAOB standards effective December 31, 2016.

As a team, we use a variety of contacts and resources to stay informed of ongoing developments that affect learning objectives in the financial statement auditing course(s). In fact, changes to key learning goals and objectives are usually prompted by interactions with colleagues from practice.

In that spirit, since the publication of our sixth edition, we have been working hard to stay in touch with developments in practice so we can always respond to your needs in the financial statement auditing classroom. Among our many observations, one trend has emerged as a potential sea change in the financial statement auditing process, the "big data" challenge.

Indeed, based on our collective observations, we believe that students should be prepared to make the best use possible of relevant data using state-of-the art analytical tools. In fact, the terms *big data* and *data analytics* are frequently being used to describe a growing movement among audit professionals. Our collective view is that students must be prepared to meet the "big data" challenge.

To help students be prepared, the seventh edition of *Auditing & Assurance Services* has been revised deliberately to help students critically think about the use of increased data and analytical tools in the financial statement audit. In addition, we would like to help students learn how to effectively document their conclusions in the current "big data" environment.

In a recent white paper, PwC (2015)[1] lists five "new" skills that will be required of auditors moving forward. Although many of these skills require special statistical or programming knowledge, the first listed skill is one that is applicable to all auditors: "Research and identify anomalies and risk factors in underlying data." Although

[1]"Data Driven: What Students Need to Succeed in a Rapidly Changing Business World." Available at: http://www.pwc.com/us/en/faculty-resource/assets/PwC-Data-driven-paper-Feb2015.pdf.

extraction and analysis from client accounting data are critical skills for newly minted auditors, we are unaware of sufficient materials to assist professors in integrating data analytics into the auditing classroom. Thus, an important goal of the seventh edition is to provide a clear and implementable method to fully integrate a leading data analysis tool, the IDEA data analysis software, into the auditing class.

To start, McGraw-Hill Education is excited to announce a partnership with the developers of the IDEA software. We believe that IDEA provides an outstanding platform to illustrate the steps that auditors need to take related to data and data analysis while completing the financial statement audit. Leading auditing professionals have confirmed that using IDEA is an outstanding way for an entry-level auditing professional to begin the journey into the world of "big data" and "data analytics." Simply stated, big data is manifested in the financial statement auditing process through the use of tools like IDEA.

IDEA
Data Analysis Software

Overall, our revisions related to the big data challenge were designed to provide instructors a set of tools and mechanisms to bring data and analytics into the classroom in a meaningful way. Through the use of these tools, students can be sure they are prepared to enter practice with an appreciation for and knowledge of the increasing importance of data and analytics in the auditing profession. We hope that everyone enjoys our attempts to help students get ready for the big data challenge.

Of course, and perhaps most importantly, the seventh edition of *Auditing & Assurance Services* also continues to be the most up-to-date auditing text on the market. The book has fully integrated the reorganized PCAOB Auditing Standards. In addition, all chapters and modules in the seventh edition have been revised to incorporate the two new standards (AS 2701 and AS 2410) adopted by the PCAOB that relate to the auditor's work on supplementary information provided in the financial statements and related parties. In addition, all chapters and modules have been revised to incorporate the latest updates from the international standards of auditing (ISAs) and the Auditing Standards Board (ASB). With *Auditing & Assurance Services,* seventh edition, students are prepared to take on auditing's latest challenges.

The Louwers author team uses a conversational, yet professional tone—hailed by reviewers as a key strength of the book.

Flexible Organization

Auditing & Assurance Services teaches students auditing concepts by emphasizing real-life contexts when describing the auditing process. The authors use chapters and modules to

"The format allows you to integrate the modules into the chapter material in any way you would find useful."
—Frank J. Beil, *University of Minnesota*

Chapters	Modules
The 12 chapters cover the auditing process extensively with a multitude of cases designed to give students a better understanding of how a best-practice concept developed from real-world situations.	Modules A–H provide instructors additional material that can be used throughout the course. Topics such as fraud, ethics, sampling, and technology are covered in the modules, which are designed to be taught whenever instructors want to introduce the topic in their course.

achieve this goal. Although the chapters follow a logical sequence that we recommend professors consider for their classes, **the modules have been written to be used on a stand-alone basis.** In essence, the modules have been deliberately prepared for entirely flexible implementation of these topics without excessive reliance on chapter sequencing. We encourage you to integrate these modules into your syllabi in a manner that best suits your approach to the auditing course.

Engage Your Students with Real Examples

> ***"The tone of the textbook is in a conversational manner that allows for more student-friendly reading material."***
> —Aretha Hill, *Florida A&M University*

An effective accounting textbook integrates real-world scenarios with theoretical discussion. *Auditing & Assurance Services* places the student in the role of a decision maker, by illustrating the application of auditing concepts using actual situations experienced by accounting firms and companies such as:

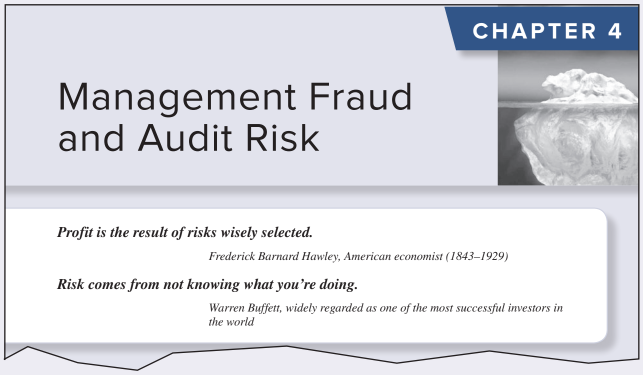
Each chapter or module opens with a "real-world" example that draws upon concepts discussed within that chapter or module. Finally, a series of mini-cases have been developed for use by instructors to further bring text material to life. These mini-cases feature real situations experienced by the following companies, individuals, or accounting firms [new cases to the seventh edition are noted with an asterisk (*)].

- Arthur Andersen (failure of auditors to detect fraud at Enron)
- Bernie Madoff Investment Securities (failure of auditors and regulators to detect fraud)*
- Crazy Eddie's (failure of auditors to detect fraud)*
- Daily Journal Corporation (auditor changes and reporting on internal control)*
- General Electric (audit fees and services provided by auditors)
- General Motors (going-concern report by auditors)
- HealthSouth Corporation (failure of auditors to detect fraud)
- KPMG (competition in the audit marketplace)
- Lehman Brothers (estimation uncertainties in the audit and disclosure concerns)*
- Parmalat (failure of auditors to detect fraud)
- Satyam Computer Services Ltd. (failure of auditors to detect fraud)
- Scott London, KPMG partner (failure of auditor to follow the AICPA Code of Conduct)*

Fraud Awareness

The fraud coverage in *Auditing & Assurance Services* is the most extensive available and is complemented by real-world examples chosen to engage students through the following tools:

- Auditing Insights integrated throughout the text.
- Mini-cases that may be assigned to supplement text chapters and modules that expose students to


CHAPTER 4

Management Fraud and Audit Risk

Profit is the result of risks wisely selected.

Frederick Barnard Hawley, American economist (1843–1929)

Risk comes from not knowing what you're doing.

Warren Buffett, widely regarded as one of the most successful investors in the world landmark fraud cases at Bernie Madoff Investment Securities, Enron, HealthSouth, Parmalat, PTL Club, and Satyam Computer Services.

- Specific discussion of management fraud (Chapter 4), employee fraud (Chapter 6), and the Certified Fraud Examiner Exam (Module D).
- **Apollo Shoes Case,** the only stand-alone fraud audit case on the market (available online).

Create a State-of-the-Art Learning Environment: Instructor Resources

The author team and McGraw-Hill are dedicated to providing instructors with the best teaching resources available. In addition to the solutions manual, test bank, and PowerPoint Presentations, and the Apollo Shoe Case, the following resources are also available.

The Updated Auditor

The author team scrutinizes leading business and academic publications for relevant issues and research that sheds light on auditing and the audit process. Recent findings from academic research and discussions from professional literature are drawn from the following publications:

- *Accounting Horizons*
- *Accounting Today*
- *Auditing: A Journal of Practice & Theory*
- *Behavioral Research in Accounting*
- *Bloomberg Businessweek*
- *CFO.com*
- *CPA Journal*
- *Journal of Accountancy*
- *Journal of Accounting and Economics*
- *The Accounting Review*
- *The Wall Street Journal*

These excerpts are highlighted throughout the text as Auditing Insights to allow for easy identification and review by instructors and students.

In addition to the use of Auditing Insights, on a monthly basis, the author team provides an *Updated Auditor* briefing, which summarizes the content of relevant business and academic publications on a chapter-by-chapter basis, to allow students to apply current developments in the profession with material discussed in class. The *Updated Auditor* briefing is available in Connect. With the *Updated Auditor,* instructors will always be at the cutting edge of auditing practice!

IDEA Software and Workbook

With the availability of unprecedented amounts of quantitative and qualitative information and tools available to access and process that information, it is imperative that students learn and utilize the latest technologies used by auditing professionals. As previously stated, McGraw-Hill Education has forged a partnership with Caseware Analytics for the use of the IDEA data analysis tool. Chapters 3 (audit planning), 4 (risk assessment), 5 (internal control), 7–9 (operating cycle chapters), Module F (attributes sampling), and Module G (variables sampling) have been revised to reference the use of IDEA within the chapter or module.

In addition, the seventh edition includes end-of-chapter exercises utilizing **author-developed databases** exclusively for use with *Auditing & Assurance Services* as well as supplemental materials available in Connect to complement the IDEA workbook and provide hands-on instructions on using the IDEA software. The authors also provide implementation guidance to instructors and detailed solutions and explanations on this new content. Overall, the author team has provided significant resources to prepare students for the auditing environment in 2017 and beyond.

Roger CPA Review

McGraw-Hill Education has partnered with Roger CPA Review, 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 and Task-based Simulations from Roger CPA Review, with expert-written explanations and solutions. All questions are either directly from the AICPA or are modeled on AICPA questions that appear in the exam. Task-based Simulations are delivered via the Roger CPA Review platform, which mirrors the look, feel and functionality of the actual exam. McGraw-Hill Education and Roger CPA Review 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 Review program, exam requirements and exam content, visit www.rogercpareview.com.

TestGen

TestGen is a complete, state-of-the-art test generator and editing application software that allows instructors to quickly and easily select test items from McGraw Hill's TestGen testbank content and to organize, edit and customize the questions and answers to rapidly generate paper tests. Questions can include stylized text, symbols, graphics, and equations that are inserted directly into questions using built-in mathematical templates. With both quick-and-simple test creation and flexible and robust editing tools, TestGen is a test generator system for today's educators.

Association to Advance Collegiate Schools of Business (AACSB) Statement

McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Auditing & Assurance Services*, 7e, recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the text and test bank to the eight general knowledge and skill guidelines in the AACSB standards. The statements contained in *Auditing & Assurance Services*, 7e, are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, their mission, and their faculty. Although *Auditing & Assurance Services*, 7e, and the teaching package make no claim of any specific AACSB qualification or evaluation, we have within *Auditing & Assurance Services*, 7e, labeled selected questions according to the eight general knowledge and skills areas.

MCGRAW-HILL CUSTOMER EXPERIENCE GROUP CONTACT INFORMATION

At McGraw-Hill Education, we understand that getting the most from new technology can be challenging. That's why our services don't stop after you purchase our products. You can contact our Product Specialists 24 hours a day to get product training online. Or you can search the knowledge bank of Frequently Asked Questions on our support website. For Customer Support, call 800-331-5094 or visit www.mhhe.com/support. One of our Technical Support Analysts will be able to assist you in a timely fashion.

New to the Seventh Edition of

In response to feedback and guidance from numerous auditing accounting faculty, the authors have made many important changes to the seventh edition of *Auditing & Assurance Services*, including the following:

Highlights of *Auditing & Assurance Services*, 7e

- The seventh edition of *Auditing & Assurance Services* features Connect and SmartBook.
- All chapter and modules have been revised to incorporate professional standards adopted through May 2016. In addition, the reorganized PCAOB framework (which becomes effective December 31, 2016) has been utilized throughout the text.
- **Auditing Insight boxes** have been added and updated throughout the textbook to place issues discussed within the text into a real-world context. These boxes incorporate numerous examples from business and academic publications as well as actual company annual reports and audit reports.
- Examples using the Caseware IDEA software have been added in Chapters 3, 4, 5, 7, 8, 9, Module F, and Module G. In addition, end-of-chapter exercises using **author-developed databases** exclusively for use with *Auditing & Assurance Services* as well as supplemental materials to complement the IDEA workbook are provided.
- Coverage in the cycle chapters has been standardized to focus on the risk assessment process for each relevant assertion. In addition, the chapters provide a consistent focus on how auditors respond to assessed risk of material misstatement, through the incorporation of easy-to-read tables throughout Chapters 6 through 10 to highlight the key issues and risks faced by auditors in the examination of different accounts. These tables take the students through the risk assessment process for each cycle on a step-by-step basis to mirror the methodology used in current audit practice.
- Five new Mini-cases have been added that feature Bernie Madoff Investment Securities (failure of auditors and regulators to detect fraud); Crazy Eddie's (failure of auditors to detect fraud); Daily Journal Corporation (auditor changes and internal control reporting); Lehman Brothers (estimation uncertainties in the audit and failure to make informative disclosures); and Scott London, KPMG Partner (failure of auditor to follow the AICPA Code of Conduct).

Part I: The Contemporary Auditing Environment

CHAPTER 1: Auditing and Assurance Services

- Our discussion about the CPA exam has been revised to fully reflect the substantial changes being made to the exam as of April 1, 2017. Due primarily to the outsourcing of routine tasks and significant advances in information technology, the job of a newly licensed CPA has changed. The AICPA responded with a revised exam that has an increased emphasis on higher-order skills like problem solving, critical thinking, and analytical ability. The changes are fully described in the text.
- Increased our emphasis about the importance of audit quality in the current environment and added an Auditing Insight that describes the audit quality indicators project recently completed by the PCAOB in 2015.
- Added a new exhibit that provides an example of the 2014/2015 Sustainability Report for the Coca-Cola Company. We also added a new exhibit that features Mickey Mantle's baseball card from 1961.
- Increased our emphasis on the emergence of big data in the auditing environment and added an Auditing Insight that describes what students need to succeed in a world characterized by big data.

CHAPTER 2: Professional Standards

- Summarized recent academic research related to the impact of PCAOB inspections and results of inspections on audit quality, client attraction and retention, and audit fee growth rates (including research specifically related to the Deloitte vignette in the introduction of this chapter).
- Summarized recent independence issues encountered by EY and KPMG.
- McDonald's 2016 audit report, which demonstrates the contents of an actual audit report and how this report reflects the guidance in the reporting principle.
- Included an Auditing Insight regarding controversy over PCAOB inspection of audits of Alibaba Group Holding Limited, which have been impacted by China's ban of PCAOB inspections.
- Summarized PCAOB inspections of 2012, 2013, and 2014 audits conducted by Big Four firms and expanded analysis to summarize the number of audits in which the client's report on internal control was revised as a result of the inspection.

Part II: The Financial Statement Audit

CHAPTER 3: Engagement Planning

- Added a discussion to emphasize the importance of identifying all of the significant accounts and each of the relevant financial statement assertions during the engagement planning process.
- Included a new table to help facilitate the understanding of significant accounts and relevant financial statement assertions and to show how this might be documented in the audit work papers.
- Added an Auditing Insight to describe the importance of audit quality and why planning is such an important aspect in helping to ensure that the engagement plan has been developed to achieve quality outcomes on the audit.
- Added a discussion about the availability of big data on the audit and included a demonstration problem of how to access a client's data using IDEA.

CHAPTER 4: Management Fraud and Audit Risk

- Increased focus on the importance of assessing the risk of material misstatement for each relevant financial statement assertion for each significant account and disclosure. This focus is entirely consistent with the audit approaches of each of the largest audit firms in the world. This focus will be very helpful in preparing students to enter the auditing environment in 2017 and beyond.
- Added a new easy-to-read table to highlight the importance of identifying "what can go wrong" for each relevant assertion identified in the planning process. This process is instrumental for assessing the risk of material misstatement for each relevant assertion.
- Moved our discussion of an audit client's risk management system to Chapter 5, where it is incorporated into our discussion of the risk assessment component of an effective internal control system as defined by COSO. By moving this section, students are able to better focus on inherent risk assessment in this chapter.
- Added an Auditing Insight to illustrate the potential dangers of analyst expectations at Bankrate and an Auditing Insight to illustrate the difficulty involved in auditing percentage of completion estimates at Toshiba. These examples are used to emphasize the importance of considering a client's business and operating environment during the risk assessment process.
- Incorporated newly released PCAOB Auditing Standard 2410 about Related Parties into the chapter.

CHAPTER 5: Risk Assessment: Internal Control Evaluation

- Fully integrated the specifics of the COSO 2013 update to its internal control framework. The update adds 17 explicit principles that are associated with the five components of internal control (i.e., control environment, risk assessment, control activities, information and communication, and monitoring). The chapter now includes five new exhibits to help clarify and make these principles salient to students.
- Added a new easy-to-read table to reinforce the importance of identifying "what can go wrong" to help assess the risk of material misstatement for each relevant assertion that provides a foundation to help identify control activities that might mitigate that risk. This is an important aspect of the audit process employed by each of the large audit firms, and the table is designed to help students better understand that process.
- Added a section on internal control testing alternatives with a focus on how auditors can use a tool such as IDEA to test the entire population of control instances in today's environment. We also added two new problems where students can complete exception tests using IDEA.

CHAPTER 6: Employee Fraud and the Audit of Cash

- Added two easy-to-read tables to allow for a focus on the risk assessment process for each relevant assertion related to cash. For each relevant assertion, students can see how the risk of material misstatement was assessed and how the auditors might respond to the assessed risks with tests of control and substantive tests. The step-by-step process mirrors the methodology used in current audit practice.
- Improved the flow and organization of the chapter by integrating the section on controls designed to mitigate the risk of employee fraud into the section on internal control testing for the cash account. In addition, the section on proof of cash has been moved to the extended fraud procedures section to better align the chapter with current audit practice.
- Added an Auditing Insight describing the fraud perpetrated by a controller at a Pepsi-Cola Bottler and how he escaped to the Appalachian trail for an extended period of time.

CHAPTER 7: Revenue and Collection Cycle

- Revised format tracking the audit process beginning with identification of significant accounts and relevant assertions.
- Added four new tables outlining risks and tracking them through the audit process, including tests of controls and substantive procedures.
- Updated discussion of revenue recognition restatements.
- Increased discussion of risks related to data breaches, including an Auditing Insight on the Target Corp. data breach.
- Added a discussion of the new revenue recognition standards, including examples from financial statements of Apple Inc.

- Updated PCAOB inspection findings through the latest inspection reports.
- Includes a focus on data and analytics that integrates several IDEA exercises, including new author-created content and end-of-chapter materials.

CHAPTER 8: Acquisition and Expenditure Cycle

- Revised format tracking the audit process beginning with identification of significant accounts and relevant assertions.
- Added five new tables outlining risks and tracking them through the audit process, including tests of controls and substantive procedures.
- Increased discussion of risks related to accounts payable.
- Updated PCAOB inspection findings through the latest inspection reports.
- Includes a focus on data and analytics that integrates several IDEA exercises, including new author-created content and end-of-chapter materials.

CHAPTER 9: Production Cycle

- Revised format tracking the audit process beginning with identification of significant accounts and relevant assertions.
- Added six new tables outlining risks and tracking them through the audit process, including tests of controls and substantive procedures.
- Extensive discussion of the production process and key reports of interest to the auditors.
- Updated PCAOB inspection findings through the latest inspection reports.
- Includes a focus on data and analytics that integrates several IDEA exercises, including new author-created content and end-of-chapter materials.

CHAPTER 10: Finance and Investment Cycle

- Revised format tracking the audit process beginning with identification of significant accounts and relevant assertions.
- Added five new tables outlining risks and tracking them through the audit process, including tests of controls and substantive procedures.
- Added a new Auditing Insight regarding Verizon's purchases, including the recent proposed purchase of Yahoo!
- Added a new Auditing Insight describing off-balance-sheet risk for Citigroup.
- Expanded discussion of auditing accounting estimates and fair values, with discussion of extreme estimation uncertainty and an Auditing Insight on the Lehman Brothers collapse.
- Added a discussion of blockchain technology and Bitcoin transactions.
- Updated PCAOB inspection findings through the latest inspection reports.

CHAPTER 11: Completing the Audit

- New introductory vignette discusses Valeant's year-end financial troubles and the effect on the auditors trying to complete the company's audit. Added discussion of AS 16's increased responsibilities to communicate with those charged with governance.

CHAPTER 12: Reports on Audited Financial Statements

- New introductory vignette discusses KPMG's report on the audit of Rolls-Royce and the identification of critical audit matters in this report.
- Discuss recently approved and proposed standards of audit report disclosures and practices related to critical audit matters, naming of the engagement partner, and audits of group financial statements.
- Summarize recent academic research related to the disclosure of critical audit matters, disclosure of engagement partner identity, receipt and issuance of going concern reports, and inclusion of explanatory paragraphs in otherwise unmodified audit opinions.
- Included examples from recent auditors' reports of Abbott Laboratories, Alaska Air, Best Buy Co. Inc., Caesars Entertainment Corporation, The Coca-Cola Company, General Electric, Harris Teeter Supermarkets Inc., The Kroger Co., Penske Automotive Group, and Softbank Corp. to illustrate how auditors modify their reports for situations encountered in practice.
- Include results of an Audit Analytics research report summarizing 15 years of data regarding going-concern reports.

Part III: Stand-Alone Modules

MODULE A: Other Public Accounting Services

- New section added on PCAOB broker–dealer standards, including an Auditing Insight describing compliance issues that led to the new standards.
- Updated for the revised standards on accounting and review services, including a section on preparation engagements.
- A new table clarifies the differences between preparation engagements and services that are not preparation engagements.

MODULE B: Professional Ethics

- Opened the module with the story of disgraced former KPMG partner Scott London who sacrificed his career to share confidential client information with a friend.
- Added a discussion of Aristotelian virtue ethics to already existing discussions of Kantian categorical imperatives and utilitarianism.
- Added a discussion of the role of the PCAOB's Division of Enforcement and Investigations.

MODULE C: Legal Liability

- Updated the introductory vignette on litigation involving BDO Seidman for its audits of E.S. Bankest to include the ultimate resolution of this litigation.
- Updated the summary of major settlements involving Big Four accounting firms to include settlements occurring since 2008.
- Expanded the discussion of academic research examining auditor litigation to include recent studies that investigated the factors affecting the litigation risk faced by audit firms.

MODULE D: Internal Audits, Governmental Audits, and Fraud Examinations

- Updated the coverage of the reliance of Congress on the GAO.
- Discussed the variety of services provided by internal auditors.
- Added Benford's law to the fraud investigation discussion.

MODULE E: Overview of Sampling

- New introductory vignette involve the recent U.S. Supreme Court ruling on use of sampling methods to determine monetary damages against Tyson Foods in an employment dispute.
- Revised walk-through example of the use of sampling to address a nonauditing issue.
- Auditing Insight addresse how sampling risk affected predictions in the 2015 United Kingdom general elections for David Cameron and the Conservative Party.
- Included a brief example of sampling in the evaluation of internal control to illustrate the major steps and decisions made in the sampling process.

MODULE F: Attributes Sampling

- Introductory section provide an overview of the audit engagement, the use of the audit risk model, and the role of attributes sampling in the audit engagement to place the attributes sampling process in context.
- IDEA is used in the determination of sample size, selection of sample items, and evaluation of sample results to supplement the use of AICPA sampling tables.
- Additional end-of-chapter items provide students with the opportunity to use IDEA in various stages of the attributes sampling process.
- Summarized a recent academic study that surveyed the sampling practices of six international accounting firms with respect to establishing parameters and selecting sample items.

MODULE G: Variables Sampling

- Introductory section provides an overview of the audit engagement, the use of the audit risk model, and the role of variables sampling in the audit engagement to place the variables sampling process in context.
- IDEA is used in the determination of sample size, selection of sample items, and evaluation of sample results to supplement the use of formulae in MUS.
- Additional end-of-chapter items to provide students with the opportunity to use IDEA in various stages of MUS applications.
- Auditing Insight summarize the results of a recent academic study that surveyed the sampling practices of six international accounting firms.
- Previous content on classical variables sampling and nonstatistical sampling has been expanded and relocated into appendixes to provide instructors with flexibility in addressing these topics.

MODULE H: Auditing and Information Technology

- Significantly revised (and simplified) the module throughout to reinforce how the client's use of automated transaction processing systems affects the major stages of the audit team's study and evaluation of internal control.
- Provided an example of how students encounter IT general and app controls when using a smartphone.
- Added additional end-of-chapter material that requires students to identify tests of controls that would be used to evaluate the operating effectiveness of general and automated application controls.

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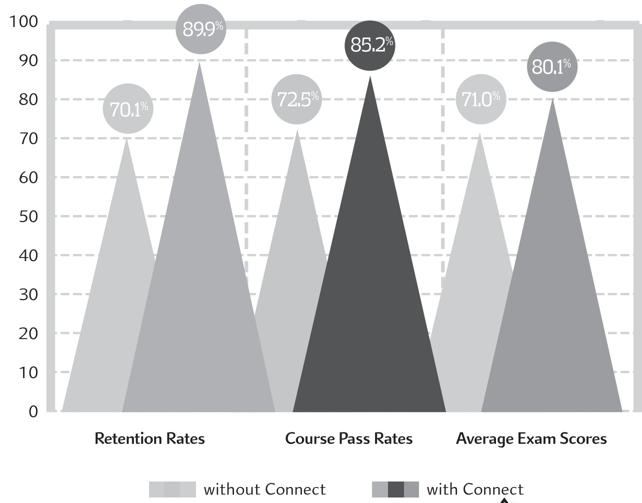

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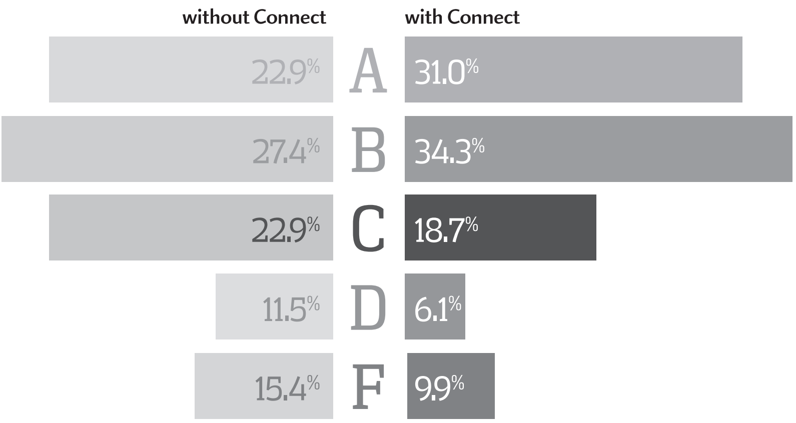

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Central New Mexico Community College

Michael D. Akers,
Marquette University

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California State University–Fullerton

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University of Maryland University College

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Marshall University

Jack Armitage,
University of Nebraska–Omaha

MaryAnne Atkinson,
Central Washington University

Dereck D. Barr,
The University of Mississippi

LuAnn Bean,
Florida Institute of Technology

Frank J. Beil,
University of Minnesota

Marie Blouin,
Penn State University–Harrisburg

David Blum,
Moraine Park Technical College

Russell F. Briner,
University of Texas at San Antonio

Alexander K. Buchholz,
Brooklyn College of the City University of New York

Suzanne M. Busch,
California State University–East Bay

Eric Carlsen,
Kean University

Meghann Cefaratti,
Northern Illinois University

John Critchett
Madonna University

Karl Dahlberg,
Rutgers University

John E. Delaney,
Southwestern Texas University

Marcus Mason Doxey,
University of Kentucky

Raymond Elson,
Valdosta State University

Tom English,
Boise State University

Patricia Feller,
Nashville State Community College

Marilyn Fisher,
Corinthian Colleges

Diana R. Franz,
University of Toledo

John Gabelman,
Columbus State Community College

Clyde Galbraith,
West Chester University

Andy Garcia,
Bowling Green State University

David Gelb,
Seton Hall University

Earl Godfrey,
Gardner-Webb University

Judith G. Grant,
Northern Virginia Community College at Annandale

Emily Elaine Griffith,
The University of Georgia

Richard Hale,
Midway College

James Hansen,
University of Illinois at Chicago

Aretha Hill,
Florida A&M University

Steven C. Hunt,
Western Illinois University

Venkataraman Iyer,
The University of North Carolina at Greensboro

Keith Jones,
George Mason University

Bonita K. Peterson Kramer,
Montana State University–Bozeman

Joseph M. Larkin,
St. Joseph's University

Rose Layton,
University of Southern California

Pamela Legner,
College of DuPage

Philip Levine,
Berkeley College

R. D. Licastro,
Penn State University–University Park

Maureen Mascha,
Marquette University

Dorothy McMullen,
Rider University

Heidi H. Meier,
Cleveland State University

Bharat Merchant,
Baruch College

Eddie Metrejean,
Georgia Southern University

Charles Miller,
California Polytech University

Perry Moore,
Lipscomb University

Fowler A. Murrell,
Lehman College

Ramesh Narasimhan,
Montclair State University

Vincent Owhoso,
Northern Kentucky University

Dwight M. Owsen
Long Island University Brooklyn

Gary Peters,
University of Arkansas

Byron Pike,
Minnesota State University–Mankato

Marshall Pitman,
University of Texas–San Antonio

Sharon Polansky,
Texas A&M University–Corpus Christi

Kathy Pollock,
Indiana University–Purdue University Fort Wayne

Duane Ponko,
Indiana University of Pennsylvania

Dwayne Powell,
Arkansas State University

Abdul Qastin,
North Carolina A&T State

Linda Quick,
University of South Carolina

Hema Rao,
SUNY–Oswego

Jason T. Rasso,
University of South Florida

Yigal Rechtman,
Pace University

Barbara Reider,
University of Montana

Raymond Reisig,
Pace University

John Rigsby,
Mississippi State University

Pamela Roush,
University of Central Florida

Maria Sanchez,
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Kristen Kelli Saunders,
University of South Carolina

Tammi Schaefer,
University of South Carolina

Bunney L. Schmidt,
Utah Valley State College

Timothy Andrew Seidel,
University of Arkansas

Carol Shaver,
Louisiana Tech University

Jaysinha Shinde,
Eastern Illinois University

Adrianne Slaymaker,
Metropolitan State University

Duane Smith,
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Beverly Strachan,
Troy University at Montgomery

Iris Stuart,
California State University

Christine N. Todd,
Colorado State University–Pueblo

John Trussel,
Penn State University–Harrisburg

Jerry L. Turner,
University of Memphis

Frank Venezia,
State University at Albany

Barbara Vinciguerra,
Moravian College

Bobby Waldrup,
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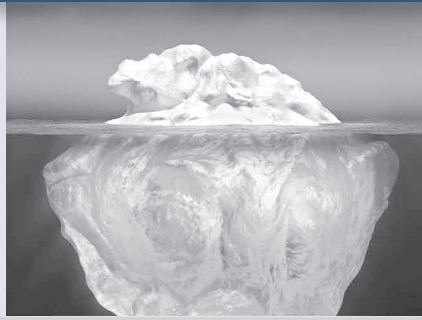
CHAPTER 1



Auditing and Assurance Services

Our system of capital formation relies upon the confidence of millions of savers to invest in companies. The auditor's opinion is critical to that trust.

James R. Doty, Chairman, Public Company Accounting Oversight Board (PCAOB)

Professional Standards References

Topic	AU-C/ISA Section	AS Section
Overall Objectives of the Independent Auditor	200	1001, 1005, 1010, 1015
Consideration of Fraud in a Financial Statement Audit	240	2401
Audit Evidence	500	1105
Attestation Standards	AT 101	AT 101
Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance	935	6110

LEARNING OBJECTIVES

You are about to embark on a journey of understanding how auditors work to keep the capital markets safe and secure for the investing public. You should know that students demonstrate success in the auditing course quite differently than they do in other accounting courses. For example, when taking financial accounting, students typically demonstrate success by correctly identifying the proper journal entry for a given set of facts and circumstances. In auditing, success is typically demonstrated by completing multiple-choice, short-answer, and simulation-type questions based on the professional standards that regulate the auditing process. Overall, this book provides you with a comprehensive set of materials that will allow you to master these professional auditing standards. Chapter 1 provides an introduction to the auditing and assurance profession.

Your objectives are to be able to:

LO 1-1 Define *information risk* and explain how the financial statement auditing process helps to reduce this risk, thereby reducing the cost of capital for a company.

LO 1-2 Define and contrast *financial statement auditing, attestation,* and *assurance services.*

LO 1-3 Describe and define the assertions that management makes about the recognition, measurement, presentation, and disclosure of the financial statements and explain why auditors use them as the focal point of the audit.

LO 1-4 Define *professional skepticism* and explain its key characteristics.

LO 1-5 Describe the organization of public accounting firms and identify the various services that they offer.

LO 1-6 Describe the audits and auditors in governmental, internal, and operational auditing.

LO 1-7 List and explain the requirements for becoming a certified public accountant (CPA) and other certifications available to an accounting professional.

USER DEMAND FOR RELIABLE INFORMATION

LO 1-1
Define *information risk* and explain how the financial statement auditing process helps to reduce this risk, thereby reducing the cost of capital for a company.

In 2002, the Sarbanes–Oxley Act was passed as a direct response to a wave of major financial statement frauds that had just occurred at companies like **Enron, WorldCom,** and **Tyco.** While the law was passed many years ago, the effect of this landmark legislation on financial statement auditing has been far reaching. Perhaps the most important change ushered in by the law is that financial statement auditing of public companies is regulated. Specifically, the Public Company Accounting Oversight Board (PCAOB) is now responsible for setting all audit standards to be followed on audits of public companies. In addition, the PCAOB is required to perform inspections of the audit work completed and the quality control processes employed by audit firms. As a direct result, accounting students should know that if they plan to work as financial statement auditors, they will be entering a world that is focused on audit quality. Consider the following Auditing Insight.

AUDITING INSIGHT — Audit Quality

In July 2015, the PCAOB released a concept statement that detailed 28 different indicators of audit quality. The indicators were categorized within three broad categories. The first category, audit professionals, focused on measures such as partner workload and industry expertise of professionals. The second category, audit process, focused on measures such as compliance with independence requirements and PCOAB inspection results. The third category, audit results, focused on measures such as number of client restatements and client frauds. The list is a clear indication to students that quality matters more than anything else in their future work as auditing professionals.

Source: PCAOB Concept Release on Audit Quality Indicators: Release No.2015-005, July 1, 2015. Available at http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf.

Why is audit quality so important? Well, both investors and creditors depend on reliable financial statement information to make their investment and lending decisions about a company. As a result, the confidence of investors and creditors is shaken each and every time that audit quality is compromised. In fact, before we think about audit quality any further, we must first explain the vital role that financial statement auditors play in supplying key decision makers with useful, understandable, and timely information. When you have a better understanding of why auditing is so critical to help ensure the liquidity of the world's capital markets, we will then explore in detail the process auditors take to help ensure that audit quality is achieved. Because many of you are likely planning to enter the public accounting profession and work as an auditor, we hope that you will work hard to acquire this knowledge so that you may do your part in playing a key role in maintaining the public's confidence in both the auditing profession and the capital markets.

Information Risk in a Big Data World

All businesses make a countless number of decisions each and every day. Decisions to purchase or sell goods or services, lend money, enter into employment agreements, or buy or sell investments depend in large part on the quality of useful information. These decisions affect business risk, which is *the risk that an entity will fail to meet its objectives*. For example, **business risk** includes the chance a company takes that customers will buy from competitors, that product lines will become obsolete, that taxes will increase, that government contracts will be lost, or that employees will go on strike. If the company fails to meet its objectives enough times, the company may ultimately fail. To minimize these risks and take advantage of other opportunities presented in today's competitive business environment, decision makers such as chief executive officers (CEOs) demand *timely, relevant,* and *reliable* information. Similarly, investors and creditors demand high-quality information to make educated financial decisions. Information professionals such as accountants and auditors help satisfy this demand.

In recent years, as a result of ever-increasing computing power, the decision-making environment is rapidly being transformed into one that is characterized by the availability of significant amounts of data and information. Let's face it, the amount of information that organizations are seeking to manage is larger than anyone could have possibly imagined just 10 years ago. You are entering a world where upper management teams are placing more emphasis than ever on how to make sense of this seemingly ever-increasing availability of data and information. To help you prepare for this "big data" challenge, we will be drawing upon this theme in multiple chapters throughout this book.

There are at least four environmental conditions in this "big data" world that increase user demand for relevant and reliable information:

1. *Complexity.* Events and transactions in today's global business environment are numerous and often very complicated. You may have studied derivative securities and hedging activities in other accounting courses, but investors and other decision makers may not have your level of expertise when dealing with these complex transactions. Furthermore, these decision makers are not trained to collect, compile, and summarize the key operating information themselves. They need the services provided by information professionals to help make the information more understandable for their decision processes.
2. *Remoteness.* Decision makers are usually separated from current and potential business partners not only by a lack of expertise but also by distance and time. Investors may not be able to visit distant locations to check up on their investments. They need to employ full-time information professionals to do the work they cannot do for themselves.
3. *Time sensitivity.* Today's economic environment requires businesses, investors, and other financial information users to make decisions more rapidly than ever before. The ability to promptly obtain high-quality information is essential to businesses that want to remain competitive in our global business environment.
4. *Consequences.* Decisions can involve a significant investment of resources. The consequences are so important that reliable information, obtained and verified by information professionals, is an absolute necessity. Enron's aftermath provides a graphic example of how decisions affect individuals' (as well as companies') financial security and well-being. Enron's stock dropped from $90 to $0.90 in little more than a year, leaving employees who had invested their life savings in the company virtually penniless. To put this drop in perspective, an investor's $5 million investment in Enron stock in 2000 (enough for an enjoyable retirement) was worth only $50,000 a year later.

A further complication in effective decision making is the presence of information risk. **Information risk** is *the probability that the information circulated by a company will be false or misleading.* Decision makers usually obtain their information from companies or organizations with which they want to conduct business, to provide

AUDITING INSIGHT — The Consequences of Fraudulent Financial Information

Bernard Madoff, a former chairman of the NASDAQ stock market and a respected Wall Street adviser and broker for 50 years, was arrested after his sons turned him in for running "a giant Ponzi scheme," bilking investors out of billions of dollars. Many investors, including actors, investment bankers, politicians, and sports personalities, lost their life savings. Some who had already retired, now in their 70s and 80s, were forced to go back to work. Others lost their retirement homes. Charities and pensions that had invested heavily were wiped out.

Although some of the world's most knowledgeable investors fell prey to the scam, numerous red flags were present for all who were wise enough to see them. First, Madoff's fund returned 13–16 percent per year, every year, no matter how the markets performed. Second, his stated strategy of buying stocks and related options to hedge downside risk could not have occurred because the number of options necessary for such a strategy did not exist. Third, although his firm claimed to manage billions of dollars, its auditing firm had only three employees, including a secretary and a 78-year-old accountant who lived in Florida.

Sources: "Fund Fraud Hits Big Names," *The Wall Street Journal,* December 13, 2008, pp. A1, A7; "Fees, Even Returns and Auditor All Raised Flags," *The Wall Street Journal,* December 13, 2008, p. A7; "Top Broker Accused of $50 Billion Fraud," *The Wall Street Journal,* December 12, 2008, pp. A1, A14; "Probe Eyes Audit Files, Role of Aide to Madoff," *The Wall Street Journal,* December 23, 2008, pp. A1, A14.

loans, or to buy or sell stock. Because the primary source of information is the target company itself, an incentive exists for that company's management to make its business or service appear to be better than it actually is, to put its best foot forward. As a result, preparers and issuers of financial information (directors, managers, accountants, and other people employed in a business) might benefit by giving false, misleading, or overly optimistic information. This potential *conflict of interest* between information providers and users, along with financial statement frauds such as those of Enron and WorldCom, leads to a natural skepticism on the part of users. Thus, they depend on information professionals to serve as independent and objective intermediaries who will lend credibility to the information. This *lending of credibility* to information is known as providing **assurance**. When the assurance is provided for specific assertions made by management, we refer to the assurance provided as **attestation**. When the assertions are embodied in a company's financial statements, we refer to the attestation as **auditing**. More specifically, when their work is completed, the auditors supply an opinion as to whether the financial statements and related footnotes are presented fairly in all material respects. The actual compilation and creation of the financial statements is completed by the company's accountants.

REVIEW CHECKPOINTS

1.1 What is a business risk?

1.2 What conditions increase the demand for reliable information?

1.3 What risk creates a demand for independent and objective outsiders to provide assurance to decision makers?

AUDITING, ATTESTATION, AND ASSURANCE SERVICES

LO 1-2
Define and contrast *financial statement auditing, attestation,* and *assurance services.*

Now that you understand why decision makers need independent information professionals to provide assurance on key information, we further define auditing and expand the discussion of attestation and assurance services in this section, and explain their roles in today's information economy.

Definition of Financial Statement Auditing

The focus of this book is on the financial statement auditing process, by far and away the most common type of auditing and assurance service provided in today's market. Many years ago, the American Accounting Association (AAA) Committee on Basic Auditing Concepts provided a very useful general definition of *auditing* as follows:

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

A closer look at the definition reveals several ideas that are important to any type of auditing engagement. Auditing is a *systematic process.* It is a purposeful and logical process and is based on the discipline of a structured approach to reaching final decisions. It has a logical starting point, proceeds along established guidelines, and has a logical conclusion. It is not haphazard, unplanned, or unstructured.

The process involves obtaining and evaluating *evidence.* Evidence consists of all types of information that ultimately guide auditors' decisions and relate to *assertions made by management about economic actions and events.* When beginning a financial statement audit engagement, an independent auditor is provided with financial statements and other disclosures by management. In doing so, management essentially makes assertions about the financial statement balances (that the inventory on the balance sheet really does exist, that revenue transactions recorded on the income statement really did occur, that the list of liabilities on the balance sheet is complete, etc.) as well as assertions that the financial statement disclosures are fairly presented.

AUDITING INSIGHT

Although most of the largest public accounting firms (collectively referred to as the "Big Four") trace their roots to the turn of the 19th century, auditing in the United States has a rich history. When the Pilgrims had a financial dispute with the English investors who financed their trip, an "auditor" was sent to resolve the difference. George Washington sent his financial records to the Comptroller of the Treasury to be audited before he could be reimbursed for expenditures he made during the Revolutionary War. One of the first Congress's actions in 1789 was to set up an auditor to review and certify public accounts. Even the "modern" concept of an audit committee is not so modern; the bylaws of the Potomac Company, formed in 1784 to construct locks on the Potomac River to increase commerce, required that three shareholders annually examine the company's records.

Source: D. Flesher, G. Previts, and W. Samson, "Auditing in the United States: A Historical Perspective," *Abacus* 41 (2005), pp. 21–39.

External auditors generally begin their work with a focus on these assertions (explicit representations) made by management about the financial statement amounts and information disclosed in footnotes, and then they set out to obtain and evaluate evidence to prove or disprove these assertions or representations. Other types of auditors, however, often are not provided with explicit representations. For example, an internal auditor may be assigned to evaluate the cost effectiveness of the company's policy to lease, rather than to purchase, heavy equipment. A governmental auditor may be assigned to determine whether goals of providing equal educational opportunities to all have been achieved with federal grant funds. Oftentimes, the latter two types of auditors must develop the explicit performance criteria or benchmarks for themselves.

The purpose of obtaining and evaluating evidence is to ascertain the degree of correspondence between the assertions made by the information provider and the established criteria. Auditors will ultimately communicate their findings to interested users.

[1]American Accounting Association Committee on Basic Auditing Concepts, *A Statement of Basic Auditing Concepts* (Sarasota, FL: American Accounting Association, 1973).

To communicate in an efficient and understandable manner, auditors and users must have a common basis for measuring and describing financial information. This basis is the established criteria essential for effective communication.

Established criteria may be found in a variety of sources. For independent auditors, the criterion is whatever the applicable financial reporting framework is, whether it is Generally Accepted Accounting Principles (GAAP) in the United States or International Financial Reporting Standards (IFRS) in other jurisdictions. Internal Revenue Service (IRS) auditors rely heavily on criteria specified in the Internal Revenue Code. Governmental auditors may rely on criteria established in legislation or regulatory agency rules. Bank examiners and state insurance board auditors look to definitions, regulations, and rules of law. Internal and governmental auditors rely a great deal on financial and managerial models of efficiency and effectiveness. Of course, all auditors rely to some extent on the sometimes elusive criteria of general truth and fairness. Exhibit 1.1 depicts an overview of financial statement auditing.

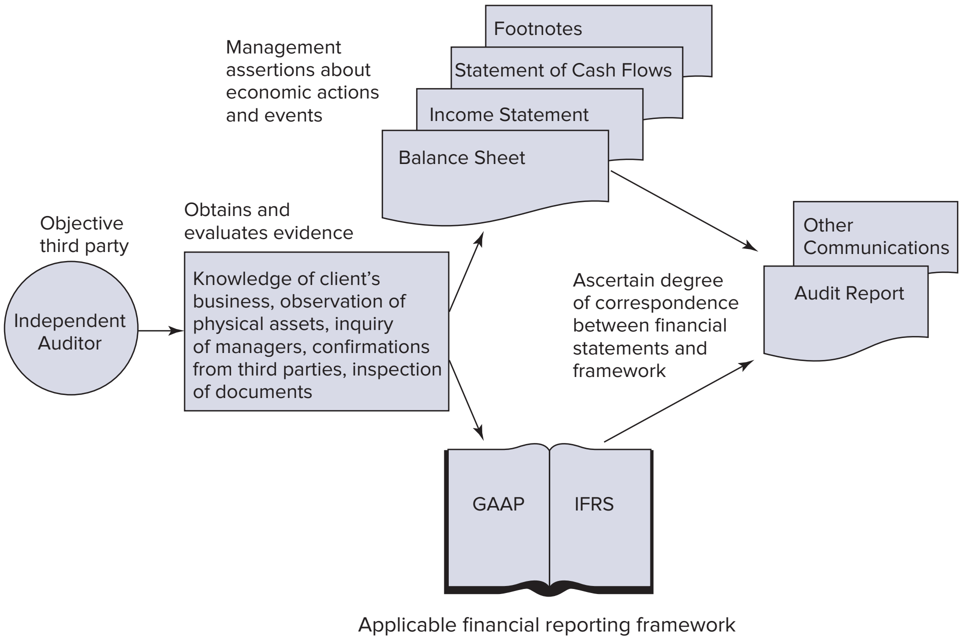
The AAA definition already presented is broad and general enough to encompass external, internal, and governmental auditing. The more specific viewpoint of external auditors in public accounting practice is reflected in the following statement about the financial statement audit made by the American Institute of Certified Public Accountants (AICPA), the public accounting community's professional association:

> The purpose of an audit is to enhance the degree of confidence that intended users can place in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, in accordance with the framework. An audit conducted in accordance with generally accepted auditing standards and relevant ethical requirements enables the auditor to form that opinion. (AU-C 200.11)

Auditing in a Big Data Environment

The auditing environment is rapidly being transformed into an environment characterized by the availability of significant amounts of data and cutting-edge analytical tools. As a direct result, entry-level professionals are being asked to join public accounting firms

EXHIBIT 1.1
Overview of Financial Statement Auditing



having completed coursework related to the use of data and analytical tools. The accompanying Auditing Insight provides some examples.

AUDITING INSIGHT — **What Students Need to Succeed in a "Big Data" World**

A recent report published by PwC, "Data Driven: What Students Need to Succeed in a Rapidly Changing Business World," clearly indicates that the skills needed by entry-level auditing professionals must include proficiency in data analytics and technology.

For example, insights from a CEO survey discussed in the PwC report reveal that "businesses are preparing for a future that's different from today. And they expect their talent to adapt. One implication of this rapidly changing business environment is clear—today's accounting curriculum should be updated to equip students with new skills, especially in technology and data analytics" (p. 4).

Overall, it seems clear that the world has changed and the set of skills acquired by students must also change to adapt to the new world. Most importantly, while the PwC report is published by only one firm, our conversations with professionals and observations indicate that the other Big Four firms (e.g., KPMG, Deloitte, and EY) are largely in agreement with this approach.

Source: "Data Driven—What Students Need to Succeed in a Rapidly Changing Business World," PwC, February 2015.

Among the critical issues for students is how to identify the right data to analyze given a set of facts and circumstances, and then how to present data analyses in a compelling format while documenting the results of their work. Frankly, these steps are important to learn even before completing analyses of data using the latest analytical tools. In addition, while analytical tools can rely on data sources that are both internal and external to the client, our current understanding is that staff audit professionals in today's environment need to first learn how to make the best use of data that is internal to the client in order to provide useful insights to the audit team. Throughout this book, we will be providing examples of how to make the best use of such internal client data.

In fact, as your study of external auditing continues, you will find that auditors perform many tasks designed to reduce the risk of giving an inappropriate opinion on financial statements. Auditors are careful to work for trustworthy clients, to gather and analyze evidence about the assertions in financial statements, and to take steps to ensure that audit personnel report properly on the financial statements when adverse information is known.

Attestation Engagements

Many people appreciate the value of auditors' attestations on historical financial statements, and as a result, they have found other types of information to which certified public accountants (CPAs) can attest. The all-inclusive definition of an **attestation engagement** is

> An engagement in which a practitioner is engaged to issue a report on subject matter, or an assertion about subject matter that is the responsibility of another party. (AT 101.01)

By comparing the AAA's earlier definition of auditing with the definition of attestation, you can see that the auditing definition is a specific type of attestation engagement. According to the earlier definition, in an audit engagement, an auditor (more specific than a *practitioner*) issues a report on assertions (financial statements) that are the responsibility of management. For example, as more and more companies and organizations seek to demonstrate their efforts related to corporate social responsibility, demand is growing for attestation services related to sustainability reporting. The following Auditing Insight indicates the significance of this emerging market for public accounting firms.

In today's global business environment, activist shareholders are increasingly pressuring board of director members and upper management teams regarding issues of social responsibility, the environment, and other matters related to sustainability. As a direct result, more companies than ever are directly integrating their sustainability initiatives

AUDITING INSIGHT — Sustainability Reporting—An Emerging Market for CPAs

The Global Reporting Initiative (GRI) is a nonprofit organization that was established to promote environmental sustainability to organizations throughout the world. Perhaps most importantly, the GRI has established a reporting framework that leading companies use to report key information about their efforts to promote sustainability in their business practices. The GRI last issued its Sustainability Reporting Guidelines in May 2013 and the current Guidelines are in transition to a set of GRI Sustainability Reporting Standards. The new GRI Standards will likely be finalized at some point in 2017. KPMG LLP reported that as of the end of 2015, 92 percent of the 250 largest global companies issue some type of corporate responsibility report.

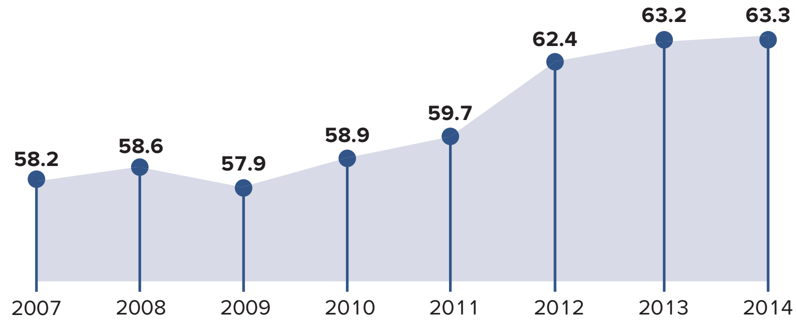
Sources: https://www.globalreporting.org/standards/transition-to-standards/Pages/default.aspx; http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/kpmg-survey-of-corporate-responsibility-reporting-2015-O-201511.pdf.

into their overall business strategy and then seeking to quantify their sustainability and social responsibility efforts with measurable outputs. These measurements might help to quantify the company's performance in areas such as the environment, labor, and human rights. For example, Coca-Cola reports in the 2014–2015 Sustainability Report about their goals and progress on improving energy efficiency. Exhibit 1.2 shows Coca-Cola's change in energy use and energy use ratio. Although sustainability is a prominent example of an attestation engagement, other examples of attestation engagements completed by CPAs (discussed more in Module A) appear in the following box.

EXHIBIT 1.2

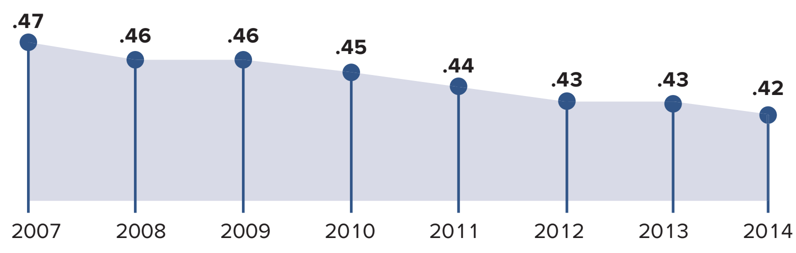
The Coca-Cola System Energy Use from 2007 to 2014

Systemwide total based on estimated total use (billion megajoules)



The Coca-Cola System Energy Use Ratio from 2007 to 2014

Average plant ratios based on collected data (megajoules/liter of product)



Examples of Attestation Engagements

- **Agreed Upon Procedures Engagements** (AT 201), such as verifying inventory quantities and locations.
- **Financial Forecasts and Projections** (AT 301), such as analysis of prospective or hypothetical "what-if" financial statements for some time period *in the future*.
- **Reporting on Pro Forma Financial Information** (AT 401), such as retroactively analyzing the effect of a proposed or consummated transaction on the *historical* financial statements "as if" that transaction had already occurred.
- **Compliance Attestation** (AT 601), such as ascertaining a client's compliance with debt covenants.
- **Examination of Management's Discussion and Analysis** (AT 701), prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).
- **Reporting on Controls at a Service Organization** (AT 801), such as organizations that provide outsourced processes that are likely to be relevant to the user entities' internal control over financial reporting.

Assurance Services

Although *auditing* refers specifically to expressing an opinion on financial statements and *attestation* refers more generally to expressing an opinion on any type of information or subject matter that is the responsibility of another party (such as sustainability measures), *assurance services* includes an even broader set of information, including nonfinancial information. The following Auditing Insight indicates how the quality of information can assist both buyers and sellers in today's market.

AUDITING INSIGHT

Exhibit 1.3 shows two 1961 **Topps** Mickey Mantle baseball cards. The card on the right was offered on eBay with the seller's representation that the card was in Near Mint/Mint condition. This representation is a standard description and is the equivalent of a grade 8 on a standard 10-point scale used in grading the quality of a trading card. The card was purchased on **eBay** for $205.50.

Within a week, a second 1961 Topps Mickey Mantle baseball card was sold on eBay. Again, this card was offered with the seller's representation that the card was in Near Mint/Mint condition (card on the left). The only difference was that this card had been sent to **Professional Sports Authenticator** (PSA), a company that verifies the authenticity and quality of sports items. Note that PSA does not buy or sell sports merchandise; it acts only as an independent third party expressing a professional opinion regarding the merchandise in question. This card sold for $585.

The only difference between the two transactions was that the buyers of the card on the left had more information concerning the risk inherent in the transaction. Why was the first transaction riskier? What were the buyers' concerns? Were the concerns only from intentional misstatements? How did the grading of the card by PSA reduce these concerns? What are the incentives for PSA to grade the card accurately? How does the business of PSA relate to the profession of auditing?

EXHIBIT 1.3 Professional Sports Authenticator as Third-Party Assuror

© Allen Blay

Although the primary focus of our earlier discussion of information risk was in the context of economic decisions, information risk is present whenever someone must make a decision without having complete knowledge. The AICPA expanded the profession's traditional focus on accounting information to include all types of information, both financial and nonfinancial. The expanded services are collectively referred to as **assurance services**, which the AICPA defines as independent professional services that improve the quality of information, or its context, for decision makers. The major elements, and boundaries, of the definition are

- *Independence.* CPAs want to preserve their attestation and audit reputations and competitive advantages by preserving integrity and objectivity when performing assurance services.[2]
- *Professional services.* Virtually all work performed by CPAs (accounting, auditing, data management, taxation, management, marketing, finance) is defined as a professional service as long as it involves some element of judgment based on education and experience.
- *Improving the quality of information or its context.* The emphasis is on information, CPAs' traditional stock in trade. CPAs can enhance quality by assuring users about the reliability and relevance of information, and these two features are closely related to the familiar credibility-lending products of attestation and auditing services. *Context* is relevance in a different light. For assurance services, improving the context of information refers not to the information itself but to how the information is used in a decision-making context. An example would be providing key information in a database that management could use to make important decisions.
- *For decision makers.* The decision makers are the consumers of assurance services, and they personify the consumer focus of different types of professional work. The decision makers are the beneficiaries of the assurance services. Depending upon the assignment, decision makers may be a very small, targeted group (e.g., managers of a database) or a large targeted group (e.g., potential investors interested in a mutual fund manager's performance).

Examples of Assurance Services

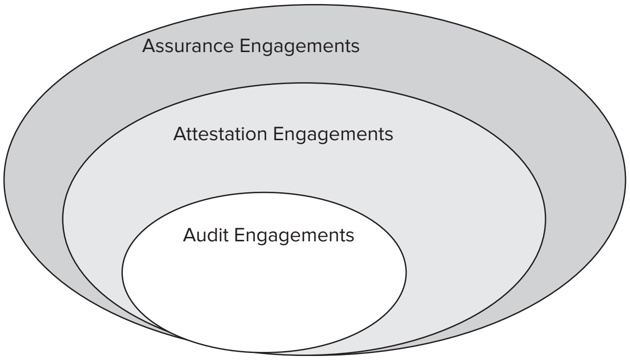
Although they are subsets of assurance services, attestation and auditing services are highly structured and intended to be useful for large groups of decision makers (e.g., investors, lenders). On the other hand, assurance services other than audit and attestation services tend to be more customized for use by smaller, targeted groups of decision makers. For example, many companies and organizations have used public accounting firms to conduct a comprehensive assessment of risks the enterprise faces. This type of enterprise risk assessment can then be used to show stakeholders that the management team understands and is properly managing risks the enterprise faces. We also present a few more examples of assurance services to illustrate the variety of services that fall under the assurance service umbrella. Some will look familiar and others may defy imagination. Be aware, however, that public accounting firms must pick and choose the services that they wish to provide to the market based on the expertise that resides within the firm. Nobody believes or maintains that all public accounting firms will want or be able to provide all types of assurance services.

- XBRL (eXtensible Business Reporting Language) reporting.
- Information risk assessment and assurance.
- Regulatory compliance.
- Third-party reimbursement maximization.
- Customer satisfaction surveys.
- Evaluation of investment management policies.
- Fraud and illegal acts prevention and deterrence.
- Cyber risk assessment and assurance.
- Internal audit outsourcing.

Attestation and financial statement auditing services are special types of assurance services, but consulting services are not. In providing consulting services, CPAs use their

[2]A survey commissioned by the AICPA found that CPAs are viewed more positively than any other business professional by both business decision makers and investors. Sixty-nine percent of investors and 74 percent of business decision makers feel that "CPAs have a unique perspective that is valuable when making business and financial decisions, even when those decisions are not directly related to accounting." In terms of attributes ascribed to CPAs, they are most associated with integrity, competence, and objectivity ("Brand Research Shows CPAs Viewed Positively in Marketplace," *AICPA News Update,* October 20, 2008).

EXHIBIT 1.4
The Relationships among Audit, Attestation, and Assurance Engagements



professional skills and experiences to provide recommendations to a client for outcomes such as information system design and operation; in assurance services, the focus is entirely on the information that decision makers use. However, like consulting services, assurance services do have a "customer focus," and CPAs develop assurance services that add value for customers (i.e., decision makers). Exhibit 1.4 depicts the relationships among assurance, attestation, and auditing services.

Although audits are specific types of assurance engagements and auditors can be described more generally as information assurors, hereafter we will use the term *auditor* instead of *information assuror* because of the specific responsibilities that auditors have under generally accepted accounting standards (GAAS) as well as under regulatory bodies such as the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB). However, many of the procedures that auditors perform as part of an audit engagement are similar to those performed as part of other information assurance engagements. Throughout this book, we will point out these shared procedures when appropriate.

AUDITING INSIGHT — XBRL Reporting

Advances in information technology have allowed for more efficient reporting platforms that better meet the needs of decision makers. In that spirit, the AICPA is currently focused on a number of initiatives to help auditors meet the needs of their clients. Among the initiatives, the need to help companies with XBRL implementations for SEC reporting has taken center stage. XBRL (also referred to by the SEC as interactive data) is an information format designed specifically for business reporting. Through the "tagging" of specific data items (cash, inventory, sales transactions, etc.), XBRL facilitates the collection, summarization, and reporting of financial information in a medium that users can easily transform for their own decision-making purposes.

The SEC now requires all U.S. public companies and foreign private issuers listed with the SEC to use XBRL for SEC filings. Recently, the AICPA helped to launch the XBRL U.S. Center for Data Quality in an attempt to improve the utility of XBRL financial data filed with the SEC even more.

Sources: *AICPA SOP 13-02,* "Performing Agreed-Upon Procedures Engagements That Address the Completeness, Mapping Consistency, or Structure of XBRL-Formatted Information"; *SEC 2009 Release No. 33-9002*, "Interactive Data to Improve Financial Reporting"; "XBRL US Center for Data Quality." All three are available through the AICPA's website (www.aicpa.org).

REVIEW CHECKPOINTS

1.4 Define and explain auditing. What would you answer if asked by a communications major, "What do *auditors* do?"

1.5 What is an *attestation engagement*?

1.6 What is an *assurance service engagement*?

1.7 In what ways are assurance services similar to attestation services (including audits of financial statements)?

1.8 What are the four major elements of the broad definition of assurance services?

MANAGEMENT'S FINANCIAL STATEMENT ASSERTIONS

LO 1-3
Describe and define the assertions that management make about the recognition, measurement, presentation, and disclosure of the financial statements and explain why auditors use them as the focal point of the audit.

From your earlier studies, you know that accounting is the process of recording, classifying, and summarizing a company's transactions into financial statements that will create assets, liabilities, equities, revenues, expenses, and related disclosures. It is the means of satisfying users' demands for financial information that arise from the forces of complexity, remoteness, time sensitivity, and consequences.

Auditing does not include the function of producing financial reports. The function of **financial reporting** is to provide statements of financial position (balance sheets), results of operations (income statements, statements of shareholders' equity, and statements of comprehensive income), changes in cash flows (statements of cash flows), and accompanying disclosures to outside decision makers who do not have access to management's internal sources of information. A company's accountants, under the direction of its management team, perform this function. In fact, auditing standards emphasize that the financial statements are the responsibility of a company's management. Thus, the financial statements contain management's assertions about the *transactions and events* that occurred during the period being audited (primarily the income statement, statement of shareholders' equity, statement of comprehensive income, and statement of cash flows), assertions about the *account balances* at the end of the period (primarily the balance sheet), and assertions about the financial statement *presentation and disclosure* (primarily the footnote disclosures).

AUDITING INSIGHT — Sarbanes–Oxley and Management's Responsibility for Financial Reporting

Congress passed the Sarbanes–Oxley Act in 2002 in an attempt to address a number of weaknesses found in corporate financial reporting as a result of the frauds at companies such as WorldCom and Enron. Although the preparation of the financial statements has always been the responsibility of management, Sarbanes–Oxley has enhanced the disclosure provisions to create a heightened sense of accountability. One of its most important provisions (Section 302) states that key company officials must certify the financial statements. Certification means that the company's chief executive officer and chief financial officer must sign a statement indicating

1. They have read the financial statements.
2. They are not aware of any false or misleading statements (or any key omitted disclosures).
3. They believe that the financial statements present an accurate picture of the company's financial condition.

Management must also make assertions regarding the effectiveness of the company's internal controls over financial reporting. In addition, the auditors are required to issue an attestation report (Section 404) on the system of internal controls to provide assurance that the system of internal controls over financial reporting has been designed and is operating effectively.

Source: U.S. Congress, *Sarbanes–Oxley Act of 2002,* Pub. L. No. 107-204, 116 Stat. 745 (2002).

As the Auditing Insight about Sarbanes–Oxley makes clear, the upper management team at public companies must certify the correctness of the financial statements and the effectiveness of the internal control system for financial reporting. Given the current focus on internal controls, first-year audit professionals are expected to understand the relationship between a company's internal control activities and the relevant financial statement assertions about the financial statement account balances. We suggest that as a new auditing professional, a detailed understanding of this relationship will provide you with the opportunity to immediately contribute to the audit team. As a result, we are hopeful that this book can provide a foundation of knowledge to help simplify the relationship, which is paramount in the post-Sarbanes–Oxley auditing environment.

When planning the audit engagement, auditors use management's assertions to assess external financial reporting risks by determining the different types of misstatements that could occur for each of the relevant management assertions identified and then develop auditing procedures that are appropriate in the circumstances. The auditing procedures are completed to provide the evidence necessary to persuade the auditor that there is no material misstatement related to each of the relevant assertions. Once the auditor is satisfied that the evidence has supported each of the relevant assertions, the auditor issues a report to provide assurance to financial statement users that the financial statements are free of material misstatement in accordance with generally accepted accounting principles. As an auditor, you must keep in mind the importance of understanding management's financial statement assertions and always remember that you are serving the entire public interest, including stakeholders such as bankers, investors, and employees when ultimately reporting that the financial statements are free of material misstatement.

When studying and learning about the assertions, a student of auditing must always remember that each assertion gives rise to a question that can be answered with audit evidence. In that spirit, Exhibit 1.5 provides a list of all of management's financial statement assertions and some of the key questions that the audit team must address, with evidence, about each assertion. Note that column 1 in Exhibit 1.5 denotes the assertions currently identified by the PCAOB for public company audits.[3] The PCAOB auditing standards do allow auditors to use different management assertions at their discretion, provided that the assertions cover the pertinent risks in each significant account. In that spirit, the Auditing Standards Board (ASB)[4] provides an additional set of management assertions (columns 2, 3, and 4 in Exhibit 1.5). You will note that the ASB set of assertions, while in direct alignment with the PCAOB assertions, does provide greater detail and clarity for students of auditing to conceptualize. As a result, largely all of the firms auditing public companies with international operations feature the ASB assertions as a starting point to guide their auditing processes. The key questions (column 5) indicate how each of these assertions must be thought about when evaluating specific aspects of management's financial statements and disclosures. Each of the assertions is defined and described in detail in the following sections, organized along the lines of the PCAOB assertions identified in column 1, with the aligned ASB assertion(s) following in parentheses.

Existence or Occurrence (Existence, Occurrence)

The numbers listed on the financial statements have no meaning to financial statement users unless the numbers *faithfully represent* the actual transactions, assets, and liabilities of the company. *Existence* asserts that each of the balance sheet and income statement balances actually exist. *Occurrence* asserts that each of the income statement events and transactions actually did occur. As a general rule, the *occurrence* assertion relates to events, transactions, presentations, and footnote disclosures (as indicated in columns 2 and 4 of Exhibit 1.5), and the *existence* assertion relates to account balances (as indicated in column 3). Therefore, auditors must test whether the balance sheet amounts reported as assets, liabilities, and equities actually *exist.* To test the existence assertion, auditors typically verify cash with banks and count the physical inventory, verify accounts receivables and insurance policies with customers, and perform other procedures to obtain evidence whether management's assertion is in fact supported. Similarly, management asserts that each of the revenue and expense transactions summarized on the income statement or disclosed in the financial statement footnotes really did occur during the period being audited. To test the occurrence assertion, auditors complete procedures to ensure that the reported sales transactions really did occur and were not created to fraudulently inflate the company's profits.

[3]The Public Company Accounting Oversight Board (PCAOB) is a nonprofit corporation established by Congress to oversee the audits of public companies. The PCAOB is discussed in more detail in Chapter 2.

[4]The ASB was established by the profession to issue auditing standards. Standards issued by the ASB apply to audits of private companies. The ASB is discussed in more detail in Chapter 2.

EXHIBIT 1.5 **Management Assertions**

	ASB Assertions			
(1)	**(2)**	**(3)**	**(4)**	**(5)**
PCAOB Assertions	**Assertions about Events and Transactions**	**Assertions about Account Balances**	**Assertions about Presentation and Footnote Disclosures**	**Key Questions**
Existence or **occurrence**	Occurrence	Existence	Occurrence	Do the assets listed really exist?
				Did the recorded sales transactions really occur?
Rights and obligations		Rights and obligations	Rights and obligations	Does the company really own the assets?
				Are all legal responsibilities to pay the liabilities identified?
Completeness	Completeness	Completeness	Completeness	Are the financial statements (including footnotes) complete?
				Were all transactions recorded?
	Cutoff			Are transactions included in the proper period?
Valuation or allocation	Accuracy	Valuation and allocation	Accuracy	Are the accounts valued correctly?
			Valuation and allocation	Are expenses allocated to the period(s) that were benefited?
Presentation and disclosure	Classification		Classification	Were all transactions recorded in the correct accounts?
			Understandability	Are the disclosures understandable to users?

AUDITING INSIGHT

Q: When Is a Sale of Computer Disk Drives Not a Sale? A: When They Are Bricks.

Miniscribe was a manufacturer of computer disk drives. When sales did not occur at a sufficient level to support the company's efforts to obtain outside financing, management generated fictitious sales to fraudulently boost the company's net income. After first sending obsolete inventory to customers who never ordered the goods, the company packaged bricks (about the same size and shape as the company's disk drives of that time) in disk drive boxes and shipped them to "customers" that were, in fact, company-owned warehouses.

Source: "A $128.1 Million Settlement Reached in Miniscribe Case," *The New York Times,* June 4, 1992, available at: http://www.nytimes.com/1992/06/04/business/company-news-a-128.1-million-settlement-reached-in-miniscribe-case.html.

Rights and Obligations (Rights and Obligations)

In the financial statements, management asserts that they have ownership rights for all amounts reported as assets on the company's balance sheet and that the amounts reported as liabilities represent the company's own obligations. In simpler terms, the objective for an auditor is to obtain evidence that the assets are really owned and that the liabilities are really owed by the company being audited. You should be careful about *ownership,* however, because the assertion extends to include assets for which a company may not actually hold title. For example, an auditor will have a specific objective of obtaining evidence about the amounts capitalized for leased property. Likewise, *owing* includes accounting liabilities a company may not yet be legally obligated to pay. For example, specific objectives would include obtaining evidence about the estimated liability for product warranties. The auditor also has an obligation to ensure that the details of the company's obligations are properly disclosed in the footnotes to the financial statements.

Completeness (Completeness, Cutoff)

In the financial statements, management asserts that all transactions, events, assets, liabilities, and equities that should have been recorded have been recorded. In addition, management asserts that all disclosures that should have been included in the footnotes have been presented. Thus, auditors' specific objectives include obtaining evidence to determine whether, for example, all inventory is included, all accounts payable are included, all notes payable are included, all expenses are recorded, and so forth. A verbal or written management representation saying that all transactions are included in the accounts is not considered a sufficient basis for deciding whether the completeness assertion is true. Auditors need to obtain persuasive evidence about completeness.

Cutoff is a more detailed expression of the completeness assertion. **Cutoff** refers to accounting for revenue, expense, and other transactions in the *proper period* (neither postponing some recordings to the next period nor accelerating next-period transactions into the current-year accounts). Simple cutoff errors can occur when (1) a company records late December sales invoices for goods not actually shipped until early January; (2) a company records cash receipts through the end of the week (e.g., Friday, January 4) when the last batch of receipts for the year should have been processed on December 31; (3) a company fails to record accruals for expenses incurred but not yet paid, thus understating both expenses and liabilities; (4) a company fails to record purchases of materials shipped free on board (FOB) shipping point but not yet received and, therefore, not included in the ending inventory, thus understating both inventory and accounts payable; and (5) a company fails to accrue unbilled revenue through the fiscal year-end for customers on a cycle billing system, thus understating both revenue and accounts receivable. In auditor's jargon, the *cutoff date* generally refers to the client's year-end balance sheet date.

Valuation and Allocation (Accuracy or Valuation)

In the financial statements, management asserts that the transactions and events have been recorded accurately and that the assets, liabilities, and equities listed on the balance sheet have been valued in accordance with GAAP (or IFRS). The audit objective related to valuation and allocation is to determine whether proper values have been assigned to assets, liabilities, and equities. *Allocation* refers to the appropriate percentage of an asset or liability balance being recorded on the income statement in accordance with GAAP (or IFRS). For example, has the proper depreciation expense been calculated for each fixed asset amount? *Accuracy* refers to the appropriate recording of the transactions involving these items. Auditors obtain evidence about specific valuations and mathematical accuracy by comparing vendors' invoices to inventory prices, obtaining lower-of-cost-or-market data, evaluating collectability of receivables, recalculating depreciation schedules, and so forth. Many valuation, accuracy, and allocation decisions amount to reaching conclusions about the proper application of GAAP (or IFRS). For example, due to the complexity in the accounting standards related to fair value (i.e., *ASC Topic 820*), there has been an increased focus on the valuation assertion.

Presentation and Disclosure (Classification, Understandability)

In the financial statements, management asserts that all transactions and events have been presented correctly in accordance with GAAP (or IFRS) and that all relevant information has been disclosed to financial statement users, usually in the footnotes to the financial statements. This assertion embodies several different components. First, disclosures must be relevant, reliable, and understandable or transparent to financial statement users. In addition, auditors will test to make sure that all have the proper disclosures made in accordance with GAAP (or IFRS). To complete this step, auditors will often use a disclosure checklist that highlights all the disclosures that should be made for a particular entity.

Second, transactions must be classified in the correct accounts (e.g., proper classification of transactions as assets or expenses). To test this assertion, auditors perform audit procedures such as analyzing repair and maintenance expenses to ensure that that they should in fact have been expensed rather than capitalized. Similarly, auditors will test from the opposite direction, examining additions to buildings and equipment to ensure that transactions that should have been expensed were not in fact capitalized in error (or fraud). The Auditing Insight about the WorldCom fraud provides an example of the importance of this financial statement assertion.

AUDITING INSIGHT — Is Your Telephone Bill an Asset?

WorldCom routinely leased telephone lines from local telephone companies (to carry its voice transmissions). However, rather than record the cost of these telephone lines as an expense on the income statement, the company capitalized them as assets on the balance sheet, resulting in an estimated $11 *billion* fraudulent overstatement of net income. WorldCom management argued that because the leased telephone lines were not fully used to capacity, the expense should be deferred until the lines started to produce revenue (i.e., the matching concept). Moreover, because they controlled the telephone lines as a result of the long-term lease agreements, no one else could use the telephone lines and, therefore, the exclusivity rights should be treated as an asset. (This explanation is analogous to your saying that your monthly phone bill expense is really an asset because no one else can use your phone number while you use it.) An internal auditor uncovered the fraud and reported her findings to the company's board of directors.

Source: WorldCom Board of Directors' Special Investigative Committee Report, June 9, 2003.

Third, to be useful to decision makers, information must be understandable. *Statement of Financial Accounting Concepts (SFAC) No. 2,* "Qualitative Characteristics of Accounting Information," defines *understandability* as "the quality of information that enables users to perceive its significance." The responsibility levied on auditors is to make sure that the financial statements are "transparent." In other words, investors should be able to understand how the company is doing by reading its financial statements and footnotes and should not have to rely on financial experts or lawyers to help them figure out what the fine print is saying. Another way to regard this assertion is to ask whether the disclosures have been written in *plain English.* Consider the following Auditing Insight highlighting the financial disclosures at Enron.

AUDITING INSIGHT — Say What?

Financial analysts generally regarded Enron's financial disclosures in its annual report as incomprehensible. In fact, Enron's management took pride in the fact that no one could figure out what they were doing to generate incredibly high revenues. A 2003 Congressional Joint Committee on Taxation concluded that Enron's tax avoidance schemes (including 692 partnerships in the Cayman Islands) were "so complex that the IRS has been unable to understand them" (*The New York Times,* February 13, 2003). Following is an excerpt from *Enron's 2001 Annual Report* describing some of its business activities:

> Trading Activities. Enron offers price risk management services to wholesale, commercial and industrial customers through a variety of financial and other instruments including forward contracts involving physical delivery, swap agreements, which require payments to (or receipt of payments from) counterparties based on the differential between a fixed and variable price for the commodity, options and other contractual arrangements. Interest rate risks and foreign currency risks associated with the fair value of the commodity portfolio are managed using a variety of financial instruments, including financial futures.

Unfortunately, due in large part to the incomprehensibility of its financial disclosures, no one realized the extreme risks that Enron was taking until it was too late. The company, which reported the fifth-highest revenues in the United States in 2000, filed for bankruptcy in 2001.

Source: Enron 2001 Annual Report.

Importance of Assertions

The financial statement assertions are important and at times can be difficult to comprehend. A student of auditing must remember that the key questions that must be answered about each assertion become the *focal points* for the audit procedures to be performed. In other words, audit procedures are the means to answer the key questions posed by management's financial statement assertions. When evidence-gathering audit procedures are specified, you need to be able to relate the evidence produced by each procedure to one or more specific assertions. In essence, the secret to writing and reviewing a list of audit procedures is to ask, "Which assertion(s) does this procedure produce evidence about?" Then ask, "Does the list of procedures (the *audit plan*) cover all the assertions?" Exhibit 1.6 illustrates how the assertions relate to the financial statements.

EXHIBIT 1.6 Management Assertions and Their Relationship to the Financial Statements

STATEMENT OF FINANCIAL CONDITION
APOLLO SHOES INC.
in thousands

As of December 31	2017	2016
Assets		
Cash	$3,245	$3,509
Accounts Receivable (Net of Allowances of $1,263 and 210, respectively) (Note 3)	15,148	2,738
Inventory (Note 4)	15,813	13,823
Prepaid Expenses	951	352
Current Assets	$35,157	$20,422
Property, Plant, and Equipment (Note 5)	1,174	300
Less Accumulated Depreciation	(164)	(31)
	$1,010	$269
Investments (Note 6)	613	613
Other Assets	14	0
Total Assets	$36,794	$21,304
Liabilities and Shareholders' Equity		
Accounts Payable and Accrued Expenses	$4,675	$3,556
Short-Term Liabilities (Note 7)	10,000	0
Current Liabilities	$14,675	3,556
Long-Term Debt (Note 7)	0	0
Total Liabilities	$14,675	3,556
Common Stock	8,105	8,105
Additional Paid-in Capital	7,743	7,743
Retained Earnings	6,271	1,900
Total Shareholders' Equity	$22,119	$17,748
Total Liabilities and Shareholders' Equity	$36,794	$21,304

The accompanying notes are an integral part of the consolidated financial statements.

Existence—Does this cash really exist?

Rights and Obligations—Does the company really own this inventory?

Valuation or Allocation—Are these investments properly valued?

STATEMENTS OF INCOME
APOLLO SHOES INC.
in thousands (except per share data)

For year ended December 31,	2017	2016
Net Sales (Note 2)	$240,575	$236,299
Cost of Sales	$141,569	$120,880
Gross Profit	$99,006	$115,419
Selling, General and Administrative Expenses	$71,998	$61,949
Interest Expense (Note 7)	$875	0
Other Expense (Income)	($204)	($1,210)
Earnings from Continuing Operations Before Taxes	$26,337	$54,680
Income Tax Expense (Note 10)	$10,271	$21,634
Earnings from Continuing Operations	$16,066	$33,046
Discontinued Operations, Net of tax benefit		($31,301)
Extraordinary Item, Net of tax benefit (Note 11)	($11,695)	
Net Income	$4,371	$1,745
Earnings Per Common Share		
From Continuing Operations	$1.98	$4.08
Other	($1.44)	($3.86)
Net Income	$0.54	$0.22
Weighted shares of common stock outstanding	8,105	8,105

The accompanying notes are an integral part of the consolidated financial statements.

Occurrence—Did these sales transactions really take place?

Completeness—Are all the expenses included? Are they recorded in the correct period?

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
APOLLO SHOES, INC.

1. Summary of Significant Accounting Policies

Business activity The Company develops and markets technologically superior podiatric athletic products under various trademarks, including *SIREN, SPOTLIGHT*, and *SPEAKERSHOE.*

Marketable Securities Investments are valued using the market value method for investments of less than 20%, and by the equity method for investments greater than 20% but less than 50%.

Cash equivalents Cash equivalents are defined as highly liquid investments with original maturities of three months or less at date of purchase.

Inventory valuation Inventories are stated at the lower of First-in, First-out (FIFO) or market.

Property and equipment and depreciation Property and equipment are stated at cost. The Company uses the straight-line method of depreciation for all additions to property, plant, and equipment.

Intangibles Intangibles are amortized on the straight-line method over periods benefited.

Net Sales Sales for 2017 and 2016 are presented net of sales returns and allowances of $4.5 million, and $0.9 million, respectively, and net of warranty expenses of $ 1.1 million, and $0.9 million, respectively.

Income taxes Deferred income taxes are provided for the tax effects of timing differences in reporting the results of operations for financial statements and income tax purposes, and relate principally to valuation reserves for accounts receivable and inventory, accelerated depreciation and unearned compensation.

Net income per common share Net income per common share is computed based on the weighted average number of common and common equivalent shares outstanding for the period.

Reclassification Certain amounts have been reclassified to conform to the 2016 presentation.

Presentation and Disclosure—Are these disclosures understandable? Has everything been disclosed that should be?

2. Significant Customers

Approximately 15%, and 11% of sales are to one customer for years ended December 31, 2017 and 2016, respectively.

Although standards-setting bodies such as the PCAOB and ASB try to neatly categorize transactions, balances, and disclosures according to the different assertions, the *real world* is seldom as orderly. For example, although cutoff procedures provide evidence about completeness, they also provide evidence about valuation and existence. Prematurely recording sales transactions inflates revenue and/or asset values because the transaction did not *occur* by the income statement date. Similarly, if a cutoff test shows a delay in recording a liability, the liability is not only incomplete but *undervalued* as well. Thus, errors in financial statements may affect multiple management assertions.

REVIEW CHECKPOINTS

1.9 What is the difference between financial statement auditing and financial accounting?

1.10 List and briefly explain each of the Auditing Standards Board's management assertions. List at least one key question that auditors must answer with evidence related to each management assertion.

1.11 Why is the Auditing Standards Board's set of management assertions important to auditors? Do these assertions differ from those included in PCAOB standards? If so, how are they different?

PROFESSIONAL SKEPTICISM

LO 1-4
Define *professional skepticism* and explain its key characteristics.

"Doveryai, no Proveryai" (Trust, but Verify)

President Ronald Reagan to Soviet Prime Minister Mikhail Gorbachev during Cold War missile reduction talks

Professional skepticism is defined in the professional auditing standards as having an attitude that "includes a questioning mind and a critical assessment of evidence." Essentially, it is an auditor's responsibility to *not* accept management assertions without corroboration. Stated differently, an auditor must ask management to "prove" each of the relevant assertions with documentary evidence. The occurrence of errors and fraud in financial reports highlights the following basic premise, which underlies the importance of professional skepticism: *A potential conflict of interest always exists between the auditors and the management of the company being audited.* This potential conflict arises because management wants to present the company in the best possible light whereas auditors must ensure that the information about the company's financial condition is "presented fairly."

AUDITING INSIGHT — Why Be Skeptical?

When **Lehman Brothers** filed for bankruptcy in September 2008, it was reportedly the largest bankruptcy in U.S. history. How could such a large firm seem to collapse so suddenly? Some observers blamed the auditors. In fact, back in 2010, auditors at **Ernst & Young** (EY) were identified, along with other investment bankers and senior Lehman executives, for having played a role in the bank's demise in a civil fraud lawsuit filed by the attorney general of New York. The lawsuit described a "cozy" relationship between Lehman and EY because "two of Lehman's chief financial officers were former EY employees" and "Ernst & Young charged Lehman $150 million in audit fees over a seven-year period of time." EY settled the lawsuit in April 2015 for $10 million without the admission of any wrongdoing by its professionals. However, the lawsuit serves as a reminder for auditors to always exhibit professional skepticism.

Sources: "Ernst Accused of Lehman Whitewash," *The Wall Street Journal,* December 22, 2010, p. C1; "Ernst & Young Reaches Settlement with N.Y. Attorney General," *The Wall Street Journal,* April 16, 2015, p. C1.

With full awareness of this potential conflict of interest, auditors must always remain professionally skeptical in their relationships with management, but not adversarial or confrontational. Nevertheless, knowing that a potential conflict of interest always exists causes auditors to perform procedures to search for errors and frauds that could have a material effect on the financial statements. And, even though the vast majority of audits do not contain fraud, auditors have no choice but to exercise professional skepticism at all times and on all audits because of misdeeds perpetrated by just a few people in a few companies. The professional standards emphasize the importance of maintaining and then applying an attitude of professional skepticism throughout the entire audit process.

Auditing firms have long recognized the importance of exercising professional skepticism when making professional judgments. In fact, as illustrated in the following Auditing Insight, firms have increasingly stressed the importance of being skeptical when evaluating documentary evidence. As an auditing student, you can definitely expect to encounter difficult economic transactions as an auditor. When auditors encounter a difficult transaction, they must take the time to fully understand the economic substance of that transaction and then critically evaluate, with skepticism, the evidence provided by the client to justify its accounting treatment. No shortcuts are allowed. Rather, auditors are required to be unbiased and objective when making their professional judgments.

AUDITING INSIGHT

Overcoming Judgment Biases: The Importance of Professional Judgment

Judgment and decision-making researchers in auditing have long known about common biases that can interfere with or obstruct auditors from making excellent professional judgments. One example is the *anchoring bias,* which recognizes the possibility that an auditor might "anchor" on a number provided by a client manager (e.g., an estimate for the allowance for doubtful accounts) and then have difficulty adjusting to the economically correct amount. In its monograph, entitled "Elevating Professional Judgment in Accounting and Auditing," KPMG (2011) outlines a professional judgment framework designed to help auditors to mitigate professional judgment biases like the anchoring bias. In order to do so, auditors must first be aware of the possibility that these biases might interfere with their professional judgment. Beyond awareness, the monograph argues that auditors must follow a disciplined process that includes (1) clarifying the issues and objectives, (2) considering the possible alternatives, (3) gathering and evaluating the relevant evidence, (4) reaching an audit conclusion, and (5) carefully documenting their rationale for the professional judgment reached. And, perhaps most importantly, the monograph emphasizes the importance of an auditor exercising professional skepticism throughout the entire process.

Source: "Elevating Professional Judgment in Accounting and Auditing: The KPMG Professional Judgment Framework" (Montvale, NJ: KMPG, 2011).

Persuading a skeptical auditor is not impossible, just somewhat more difficult than persuading a normal person in an everyday context. Skepticism is a manifestation of objectivity, holding no special concern for preconceived conclusions on any side of an issue. In fact, the auditor should not care about the impact that an economic transaction has on the "bottom line" of a company, only that the accounting rules were followed and were properly applied and that the financial statements are appropriate for the user's needs. Skepticism is not being cynical, hypercritical, or scornful. The properly skeptical auditor asks questions such as the following: (1) What do I need to know? (2) How well do I know it? (3) Does it make sense? and (4) What can go wrong?

Auditors understand that receiving explanations from an entity's management is merely the first step in the professional judgment process, not the last. Auditors must listen to the explanation, and then always test it by examining sufficient competent audit evidence. The familiar phrase "healthy skepticism" should be viewed as a show-me attitude, not a predisposition to accepting unsubstantiated explanations. Auditors must gather the evidence needed, uncover all the implications from the evidence, and then arrive at the most appropriate and supportable conclusion. Time pressure to complete a financial statement audit engagement is no excuse for failing to exercise professional skepticism. Too many auditors have gotten themselves into trouble by accepting a manager's glib explanation and stopping too early in an investigation without seeking corroborating evidence.

AUDITING INSIGHT Professional Skepticism

In its Staff Audit Practice Alert about professional skepticism, the PCAOB expressed serious concern about "whether auditors consistently and diligently apply professional skepticism." The alert recognizes that there are a number of factors that could "impede" the application of professional skepticism but stresses the importance of taking whatever actions are necessary to make sure that professional skepticism is applied in an appropriate manner throughout the audit process.

THE HURTT SKEPTICISM SCALE

How skeptical are you? Answer the following 30 questions to find out. As a benchmark, business students typically fall between 90 to 150 points; auditors score much higher.

Questions	Strongly Disagree					Strongly Agree
1. I often accept other people's explanations without further thought.	1	2	3	4	5	6
2. I feel good about myself.	1	2	3	4	5	6
3. I wait to decide on issues until I can get more information.	1	2	3	4	5	6
4. The prospect of learning excites me.	1	2	3	4	5	6
5. I am interested in what causes people to behave the way that they do.	1	2	3	4	5	6
6. I am confident of my abilities.	1	2	3	4	5	6
7. I often reject statements unless I have proof that they are true.	1	2	3	4	5	6
8. Discovering new information is fun.	1	2	3	4	5	6
9. I take my time when making decisions.	1	2	3	4	5	6
10. I tend to immediately accept what other people tell me.	1	2	3	4	5	6
11. Other people's behavior does not interest me.	1	2	3	4	5	6
12. I am self-assured.	1	2	3	4	5	6
13. My friends tell me that I usually question things that I see or hear.	1	2	3	4	5	6
14. I like to understand the reason for other people's behavior.	1	2	3	4	5	6
15. I think that learning is exciting.	1	2	3	4	5	6
16. I usually accept things I see, read, or hear at face value.	1	2	3	4	5	6
17. I do not feel sure of myself.	1	2	3	4	5	6
18. I usually notice inconsistencies in explanations.	1	2	3	4	5	6
19. Most often I agree with what the others in my group think.	1	2	3	4	5	6
20. I dislike having to make decisions quickly.	1	2	3	4	5	6
21. I have confidence in myself.	1	2	3	4	5	6
22. I do not like to decide until I've looked at all of the readily available information.	1	2	3	4	5	6
23. I like searching for knowledge.	1	2	3	4	5	6
24. I frequently question things that I see or hear.	1	2	3	4	5	6
25. It is easy for other people to convince me.	1	2	3	4	5	6
26. I seldom consider why people behave in a certain way.	1	2	3	4	5	6
27. I like to ensure that I've considered most available information before making a decision.	1	2	3	4	5	6
28. I enjoy trying to determine if what I read or hear is true.	1	2	3	4	5	6
29. I relish learning.	1	2	3	4	5	6
30. The actions people take and the reasons for those actions are fascinating.	1	2	3	4	5	6

Sources: Kathy Hurtt, "Development of a Scale to Measure Professional Skepticism," *Auditing: A Journal of Practice & Theory 29,* no. 1 (May 2010), pp. 149–171; Public Company Accounting Oversight Board, *Staff Audit Practice Alert No. 10: Maintaining and Applying Professional Skepticism in Audits* (Washington, DC: PCAOB, 2012).

Although the SEC places constraints on the common practice of auditors' joining public clients that they have previously audited, close relationships often exist between former colleagues now employed by the client and members of the audit team. In these cases, the audit team must guard against being too trusting in accepting representations about the client's financial statements. Of more concern is the fact that former colleagues have inside knowledge of the firm's practices and procedures, knowing where the audit team will probably look (and where they might not look).

To summarize, due care requires an auditor to be professionally skeptical and question all material representations made by management (whether written or oral) during the professional judgment process. Although this attitude must be balanced by maintaining healthy client relationships, auditors should never assume management to be perfectly honest. The key lies in auditors' skeptical attitude toward gathering and evaluating the evidence necessary to reach supportable conclusions.

REVIEW CHECKPOINT

1.12 Why should auditors act as though there is always a potential conflict of interest between the auditor and the management of the enterprise under audit?

PUBLIC ACCOUNTING

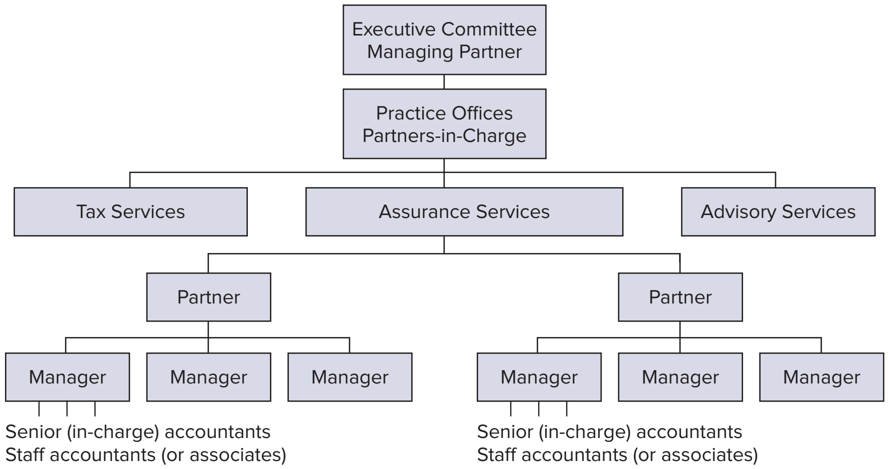
LO 1-5
Describe the organization of public accounting firms and identify the various services that they offer.

The practice of public accounting is conducted in thousands of practice units ranging in size from sole proprietorships (individuals who "hang out a shingle" in front of their homes) to the largest international firms with thousands of professionals. Furthermore, many public accounting firms no longer designate themselves as *CPA firms.* Many of them describe their businesses and their organizations as *professional services firms* or some variation on this term. Exhibit 1.7 shows an organization for a typical public accounting firm. However, some firms differ in their organization. For example, some have other departments such as small business advisory and forensic accounting. Other firms may be organized by industry (e.g., entertainment, oil and gas, health care, financial institutions) to take advantage of firmwide expertise. And still some other firms have different names for their staff and management positions.

Assurance Services

Generally speaking, assurance services involve lending credibility to information, whether that information is financial or nonfinancial. While financial statement auditing services remain the dominant service area, CPAs have also provided assurance to vote counts (Academy Awards), dollar amounts of prizes that sweepstakes have claimed to award, accuracy of advertisements, investment performance statistics, and characteristics claimed for computer software programs. Although assurance services (separate and distinct from auditing) currently represent a fairly small part of a normal firm's operating revenues, the AICPA continues to make an effort to market these additional services to the public and businesses.

EXHIBIT 1.7
Public Accounting Firm Organization



AUDITING INSIGHT Pushing the Envelopes

On Oscar night, Hollywood's Best Kept Secret Award surely goes to the hard-working team of accountants from PwC. For 79 years running, PwC has maintained its role of overseeing the validity of the entire voting process and making sure that integrity is upheld. The system employed by PwC includes the exact tallying of each and every ballot case by voters and making sure that the results are kept confidential from the press. In fact, the two partners assigned to lead the team even commit the winners to memory in case one of the starry-eyed presenters loses the envelope. And, as you may have guessed, these two partners are positioned backstage during the entire event, handing the official ballot to the award presenters as they approach the podium.

Source: www.pwc.com.

At the present time, assurance services primarily include financial statement audit engagements and other nonaudit and attestation engagements. We discuss these services as key examples of assurance services that public accounting firms offer.

Financial Statement Auditing Services

Most of the large, international accounting (Big Four) firms were founded around the turn of the 20th century (late 1800s/early 1900s) during the Industrial Revolution as European financiers sent representatives (individuals whom we now refer to as *auditors*) to check up on their investments (mostly railroads) in the United States. As such, the primary focus of many large international accounting firms' practice has been traditional accounting and auditing services. Audits of traditional financial statements remain the most frequent type of assurance engagement that public companies (and most large and medium nonpublic companies) demand. Exhibit 1.8 shows the auditing (and other assurance services) revenues of the Big Four accounting firms based on their 2015 annual reports. This level of auditing activity usually drops as the size of the public accounting firm decreases. In other words, smaller firms usually provide more nonaudit and attestation services for their clients.

Nonaudit and Attestation Engagements

Basic accounting and review services are "nonaudit" services, performed frequently for medium and small businesses and not-for-profit organizations. Small public accounting firms perform a great deal of this type of nonaudit work. For example, CPAs can perform a *compilation,* which consists of preparing financial statements from a client's books and records, without performing any evidence-gathering work. They can also perform a *review,* in which limited evidence-gathering work is performed but which is narrower in scope than an audit. Although these are the most common attestation engagements, CPAs

EXHIBIT 1.8 **Revenues for the Big Four CPA Firms**

	Deloitte	EY	KPMG	PwC
Total revenues (in billions)	$35.2	$28.7	$24.4	$35.4
Auditing and assurance services revenues (in billions and as a percent of revenue)	$13.3 38%	$11.3 40%	$10.0 41%	$15.2 43%
Tax revenues (in billions and as a percent of revenue)	$6.7 19%	$7.5 26%	$5.3 22%	$8.9 25%
Consulting and advisory services revenues (in billions and as a percent of revenue)	$15.2 43%	$9.9 34%	$9.1 37%	$11.3 32%

Sources: Deloitte, Global Report 2015; EY, Global Review 2015; KPMG International Review 2015; PwC, Global Annual Review 2015.

also can attest to the accuracy of management's discussion and analysis (MD&A) that accompanies the financial statements in an annual report, an entity's internal controls, and hypothetical "what-if" projections relating to mergers or acquisitions.

Tax Services

Local, state, national, and international tax laws are often called "accountant and attorney full-employment acts." The laws are complex, and CPAs perform tax planning services and tax return preparation in the areas of income, gift, estate, property, and other taxation. A large proportion of the practice in small public accounting firms is tax related. Tax laws change frequently, and tax practitioners must spend considerable time in continuing education and self-study to keep current. Exhibit 1.8 shows the tax revenues of the Big Four accounting firms based on their 2015 annual reports. Smaller public accounting firms tend to conduct more tax consulting engagements and fewer audit engagements.

The role of tax consulting in a professional services firm has at times faced scrutiny. The *Statements on Responsibilities in Tax Practice* specifically state that "A CPA has both the right and responsibility to be an advocate for the client" in arguing tax positions with the IRS [TX 112.04]. Can the CPA be an advocate for the client with respect to tax matters and maintain objectivity with regard to other audit matters? Recent guidance from the Public Company Accounting Oversight Board (PCAOB) prohibits an accounting firm from providing auditing services to a public company if the accounting firm provides tax consulting on aggressive interpretations of tax laws or "listed" transactions (those included on the U.S. Treasury Department's list of questionable tax strategies), if contingent fees (i.e., fees depending on a certain outcome) are involved, or if the public accounting firm provides tax services for key company executives. In all three cases, the PCAOB argues that auditor independence would be impaired. Providing normal corporate tax return preparation and advice is permissible as long as the audit committee discusses with the accounting firm the implications of the tax consulting fees on auditor independence and preapproves the relationship in writing. As a result, this remains a common service area for firms to provide to their audit clients, but the firm must always maintain its independence and objectivity.

Consulting and Advisory Services

Prior to the turn of this century (the 1990s), the largest public accounting firms handled a great deal of consulting business. Consulting and management advisory services seemed to present a great new revenue opportunity, and the field appeared to be virtually unlimited. Public accounting firms tried to become "one-stop shopping centers" for clients' auditing, taxation, and business advice needs.

The Securities and Exchange Commission (SEC), the governmental agency charged with investor protection, expressed reservations as to whether the performance of nonaudit services (such as consulting) impaired a public accounting firm's ability to conduct an independent audit. The SEC's concern was that the large amount of revenues generated from consulting services might sway the auditor's opinion on the company's financial statements. The public accounting firms, on the other hand, argued that the provision of consulting services allowed them a closer look at the client's operations, providing a synergistic, positive effect on the audit.

In response to the spate of corporate frauds, Congress resolved this difference of opinion, in part, by passing the Sarbanes–Oxley Act of 2002 (hereafter referred to as *Sarbanes–Oxley*), a broad accounting and corporate governance reform measure. Sarbanes–Oxley prohibits public accounting firms from providing any of the following services to a public audit client: (1) bookkeeping and related services; (2) design or implementation of financial information systems; (3) appraisal or valuation services; (4) actuarial services; (5) internal audit outsourcing; (6) management or human resources services; (7) investment or broker/dealer services; and (8) legal and expert services (unrelated to the audit). As already stated, public accounting firms may provide general corporate tax return preparation and advice and other nonprohibited services to public audit clients if the company's audit committee has approved them in advance.

To briefly summarize these restrictions, Sarbanes–Oxley prohibits public accounting firms from performing any consulting or advisory services in which the auditors may find themselves making managerial decisions or that would result in the firm auditing its own work (e.g., completing a financial information system implementation for its audit client). As a result of Sarbanes–Oxley, most of the large firms now provide consulting only for companies that they do not audit. However, the Big Four firms have still been able to dramatically increase the size of their consulting and advisory services in recent years. As shown in Exhibit 1.8, firm consulting revenues ranged between 32 and 43 percent of the Big Four firms' total revenues in 2015. Of course, public accounting firms are not required to follow Sarbanes–Oxley guidelines for their non-SEC clients, and in those situations, firms can provide an array of consulting and advisory services provided they maintain their independence and objectivity when completing the financial statement audit.

REVIEW CHECKPOINTS

1.13 What are some examples of assurance services performed on nonfinancial information?

1.14 What are some of the major areas of public accounting services?

OTHER KINDS OF ENGAGEMENTS AND INFORMATION PROFESSIONALS

LO 1-6
Describe the audits and auditors in governmental, internal, and operational auditing.

The AAA and the AICPA definitions of auditing clearly apply to the independent financial statement auditors who work in public accounting firms. The word *audit,* however, is also used in other contexts to describe broader types of work. The variety of engagements performed by different kinds of information assurors causes some problems with terminology. In this textbook, *independent auditor, external auditor,* and *CPA* will refer to people doing financial statement audit work with public accounting firms. In the internal and governmental contexts discussed here, auditors are identified as *operational auditors, internal auditors,* and *governmental auditors.* Although all of these professionals are information assurors (and many are certified public accountants), the term *CPA* in this book will refer to financial statement auditors engaged in public practice.

Internal Auditing

The Board of Directors of the Institute of Internal Auditors (IIA) defines **internal auditing** and states its objective as follows:

> Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.[5]

Internal auditors are employed by organizations such as banks, hospitals, city governments, and industrial companies or work for CPA firms that provide internal auditing services. Internal auditors often perform *operational audits.* **Operational auditing** refers to the study of business operations for the purpose of making recommendations about the efficient and effective use of resources, effective achievement of business objectives, and

[5]This definition and other information about internal auditing may be found on the Institute of Internal Auditors' website (www.theiia.org).

compliance with company policies. The goal of operational auditing is to help managers discharge their management responsibilities and improve profitability.

Internal auditors also perform audits of financial reports for internal use or limited external distribution (e.g., reports to regulatory agencies) much like external auditors audit financial statements distributed to outside users. Thus, some internal auditing work is similar to the auditing described elsewhere in this textbook. In addition, the services provided by internal auditors include (1) reviews of internal control systems to ensure compliance with company policies, plans, and procedures; (2) compliance with laws and regulations; (3) appraisals of the *economy* and *efficiency* of operations; and (4) reviews of effectiveness in achieving program results in comparison to established objectives and goals.

It should be noted that the AICPA defines operational auditing performed by independent CPA firms as a distinct type of management consulting service whose goal is to help a client improve the use of its capabilities and resources to achieve its objectives. So, internal auditors consider operational auditing integral to internal auditing and external auditors define it as a type of assurance service offered by public accounting firms. In fact, providing these types of internal auditing services continues to be a growing business for many large CPA firms. However, both the SEC and the PCAOB prohibit CPA firms from providing these services to their own public audit clients.

Governmental Auditing

The U.S. Government Accountability Office (GAO) is an accounting, auditing, and investigating agency of the U.S. Congress, headed by the U.S. Comptroller General. In one sense, GAO auditors are the highest level of internal auditors for the federal government. Many states have audit agencies similar to the GAO. These agencies answer to state legislatures and perform the same types of work described in this section for GAO auditors. In another sense, GAO and similar state agencies are really external auditors with respect to government agencies they audit because they are organizationally independent.

Many government agencies have their own internal auditors and inspectors general. Well-managed local governments also have internal audit departments. For example, most federal agencies (Department of Defense, Department of Human Resources, Department of the Interior), state agencies (education, welfare, controller), and local governments (cities, counties, tax districts) have internal audit staffs. Governmental and internal auditors have much in common.

The GAO shares with internal auditors the same elements of *expanded-scope* services. The GAO, however, emphasizes the accountability of public officials for the efficient, economical, and effective use of public funds and other resources. The generally accepted government auditing standards (GAGAS) define and describe three broad types of audits that may be performed. They are financial audits, attestation engagements, and performance audits.

Financial-related audits include determining whether financial information is presented in accordance with the established and applicable financial reporting framework. There are many types of attestation engagements, including whether the governmental entity's internal control system is suitably designed and implemented to achieve the applicable control objectives.

Attestation engagements would also include a compliance audit function applied with respect to applicable laws and regulations. All government organizations, programs, activities, and functions are created by law, and most are surrounded by regulations that govern the things they can and cannot do. For example, a program established to provide school meals to low-income students must comply with regulations about the eligibility of recipients. A compliance audit of such a program involves a study of schools' policies, procedures, and actual performance in determining eligibility and handing out meal tickets.

Performance audits refer to a wide range of governmental audits that include (1) economy and efficiency audits and (2) program audits. Governments are concerned about accountability for the appropriate use of taxpayers' resources; performance audits are a means of seeking to improve accountability for the efficient and economical use of resources and the achievement of program goals. In addition, the program audit helps determine whether the financial resources being spent are truly helping the government achieve its stated objectives for a particular program. Performance audits, like internal auditors' operational audits, involve studies of the management of government organizations, programs, activities, and functions.

GAO Engagement Examples

- *Federal Information Security: Agencies Need to Correct Weaknesses and Fully Implement Security Programs* (GAO-15-714, September 29, 2015).
- *Federal Student Loans: Education Could Do More to Help Ensure Borrowers Are Aware of Repayment and Forgiveness Options* (GAO-15-663, September 17, 2015).
- *Management Report: Improvements Needed in Controls over the Processes Used to Prepare the U.S. Consolidated Financial Statements* (GAO-15-630, July 30, 2015).
- *Food Safety: Additional Actions Needed to Help FDA's Foreign Offices Ensure Safety of Imported Food* (GAO-15-183, February 27, 2015).
- *Central America: Information on Migration of Unaccompanied Children from El Salvador, Guatemala, and Honduras* (GAO-15-362, February 27, 2015).

Regulatory Auditors

For the sake of clarity, other kinds of auditors deserve separate mention. The U.S. Internal Revenue Service employs auditors. They take the "economic assertions" of taxable income made by taxpayers in tax returns and determine their correspondence with the standards found in the Internal Revenue Code. They also audit for fraud and tax evasion. Their reports can either clear a taxpayer's return or claim that additional taxes are due.

State and federal bank examiners audit banks, savings and loan associations, and other financial institutions for evidence of solvency and compliance with banking and other related laws and regulations. As a result of the financial crisis of 2008/2009 and the resulting Dodd-Frank Act of 2010, these examiners have been in the news frequently as they work to help ensure the safety and security of the U.S. banking system.

REVIEW CHECKPOINTS

1.15 What is *operational* auditing? How does the AICPA view operational auditing?

1.16 What are the three broad types of governmental audits described by the GAGAS issued by the GAO?

1.17 Define what is meant by *compliance* auditing.

1.18 Name some other types of auditors in addition to external, internal, and governmental auditors.

BECOME A PROFESSIONAL AND GET CERTIFIED!

LO 1-7
List and explain the requirements for becoming a certified public accountant (CPA) and other certifications available to an accounting professional.

If you plan to begin your career in accounting (which we hope you do since you are reading this book!), you are on your way to being known as an accounting professional. Congratulations! Being part of a profession implies a higher level of societal responsibility. In order to meet this responsibility, it is absolutely essential that you acquire the knowledge required to do your job; and certification indicates that you have acquired that knowledge. In that spirit, being certified as a CPA is generally regarded as the highest mark of distinction and is required to practice as a financial statement auditor in the United States. In Australia, Canada, and the United Kingdom, the chartered accountant (CA) designation is required to practice as a financial statement auditor. For an information technology (IT) audit professional, a certified information systems auditor (CISA) is the key mark of distinction. In fact, depending on your area of professional service within public accounting, a certified fraud examiner (CFE), certified forensic accountant (CFA), certified information systems security professional (CISSP), or even a certified internal auditor (CIA) certification may be just as important. Outside of public accounting, certification as a certified management accountant (CMA) or as a certified information technology professional (CITP) may be the most appropriate. Regardless of your career choice, a certification adds credibility that will assist you throughout your entire career.

Education

While education requirements vary across the different certifying organizations, we focus on the CPA certification in this book because of its importance to financial statement auditors. For the CPA, the specific education requirements vary by state for both having permission to take the CPA examination and for receiving a CPA certificate. As a result, students must visit the website of their own state's board of accountancy and search for the exact regulations that apply in their home state. As we approach 2020, most states are requiring you to take 150 semester hours of college education before you receive a CPA certificate, but many states now allow you to take the CPA examination after only 120 semester hours of college education. Still other certifications (such as the CIA) allow you to take the exam before you have graduated.

In addition to entry-level education requirements, all certifying organizations have regulations about *continuing professional education* (CPE). At present, the AICPA and most state boards of accountancy require 120 hours of CPE over three years (with no less than 20 hours in any one year). Once certified, accounting professionals obtain CPE hours in a variety of ways: continuing education courses, in-house training, and even college courses. These types of courses range in length from one hour to two weeks, depending on the subject. Many CPE providers offer courses online. If in-house training is not an option, many CPAs obtain their CPE by taking part in training sessions offered by their home state's professional accounting organization or other industry conferences.

Examination

When working as a financial statement auditor, CPAs have a critically important role in protecting the public interest when they attest to the reliability of a company's financial statements. As a result, the profession needs to make sure that only qualified individuals can become certified and then licensed as CPAs. To do so, the AICPA creates and then administers the Uniform CPA Examination. When creating the exam, the AICPA works hard to ensure that the knowledge and skills covered on the exam are aligned with those that are needed to protect the public interest in current practice. In fact, the AICPA just recently conducted a thorough practice analysis to "ensure that the exam measures the right knowledge and skills to protect the public interest and meet the needs of the boards of accountancy as they license CPAs."[6] The practice analysis led the AICPA to make substantial changes to the CPA exam as of April 1, 2017. Due primarily to the outsourcing of routine tasks and significant advances in information technology, the job of a newly licensed CPA has changed, and the AICPA responded with a revised exam, which is now described.

The new CPA exam has an increased emphasis on higher-order skills like problem solving, critical thinking, and analytical ability. The exam still covers Auditing and Attestation (AUD), Financial Accounting and Reporting (FAR), Regulation (REG), and Business Environment and Concepts (BEC). However, the exam is now 16 hours, instead of 14, and the emphasis has shifted toward the completion of more task-based

[6]http://www.journalofaccountancy.com/news/2016/apr/new-cpa-exam-201614166.html

simulations, which allows higher-order skills to be more accurately tested and measured. In the required AUD section, candidates will have four hours to complete 72 multiple-choice questions and eight to nine task-based simulations. The exam score is equally weighted between the multiple-choice questions and task-based simulations. To help candidates prepare for the exam, the AICPA has published detailed blueprints for each of the four sections. Each blueprint is designed to provide clarity about the knowledge content, skills, and types of tasks that might be tested for each exam. The summary blueprint for the AUD section is provided in the accompanying table (with rough approximations of weights given to each content area and skill allocation):

Content Area Allocation	**Weight**
Ethics, Professional Responsibilities, and General Principles	15–25%
Assessing Risk and Developing a Planned Response	20–30%
Performing Further Procedures and Obtaining Evidence	30–40%
Forming Conclusions and Reporting	15–25%
Skill Allocation	**Weight**
Evaluation	5–15%
Analysis	15–25%
Application	30–40%
Remembering and Understanding	30–40%

Source: http://www.aicpa.org/BECOMEACPA/CPAEXAM/NEXTEXAM/Pages/next-cpa-exam.aspx. Summary blueprints for REG, FAR, and BEC can also be found at this site.

Generally speaking, each section of the new CPA exam consists of multiple-choice question and task-based simulations (except for BEC, which also includes graded written communication). The task-based simulations are short case studies in which you will be asked to apply your auditing and accounting knowledge. A simulation may involve identifying a potential problem, electronically researching the topic using a database of authoritative standards, and reporting your findings. Each section's exam blueprint is designed specifically for candidates to help prepare for the exam. Throughout this book, you will have many opportunities to acquire the knowledge necessary to pass the AUD section of the exam.

General information about the new CPA exam can be obtained from a special site set up by the AICPA (available at www.aicpa.org). Because qualifications for taking the CPA examination vary from state to state, you will need to contact your state board of accountancy for an application or more information. You can find your state board of accountancy website through the National Association of State Boards of Accountancy (NASBA) website (www.nasba.org). Exhibit 1.9 lists the requirements for the most commonly recognized professional certifications.

Experience

Although not required to *sit* for a professional exam, experience is required to *become certified.* Most states and territories require a person who has attained the education level and passed the CPA examination to have a period of experience working under a practicing CPA before awarding a CPA certificate. Experience requirements vary across states, but most jurisdictions require two to three years of experience. A few states require that the experience be obtained in a public accounting firm, but most of them accept experience in other organizations (GAO, internal audit, management accounting, Internal Revenue Service, and the like) as long as the applicant performs work requiring accounting judgment and is supervised by a competent accountant, preferably a CPA. Other certifying organizations also have experience requirements.

EXHIBIT 1.9 Certification Requirements

	Certified Public Accountant (CPA)	Certified Information Systems Auditor (CISA)	Certified Internal Auditor (CIA)	Certified Fraud Examiner (CFE)	Certified Management Accountant (CMA)
Education Level	Varies by state; Check with your state board of accountancy	No specific degree requirement	Bachelor's degree or its educational equivalent	Bachelor's degree or its educational equivalent	Bachelor's degree, or pass the CPA examination, or score in the 50th percentile on the GMAT
Experience	Varies by state; Check with your state board of accountancy	5 years of professional information system (IS) auditing, control, or security work experience for certification	2 years of internal auditing experience or its equivalent for certification	2 years of professional experience for certification	2 continuous years of professional experience in management accounting and/ or financial management
Exam Coverage	1. Auditing and attestation (AUD) 2. Financial accounting and reporting (FAR) 3. Regulation (REG) 4. Business environment and concepts (BEC)	1. The process of auditing information systems 2. Governance and management of IT 3. Information systems acquisition, development, and implementation 4. Information systems operations, maintenance, and service management 5. Protection of information assets	1. Internal audit basics 2. Internal audit practice 3. Internal audit knowledge elements	1. Fraud prevention and deterrence 2. Financial transactions and fraud schemes 3. Investigation 4. Law	1. Financial reporting, planning, performance, and control 2. Financial decision making
Test Length	4 parts, 16 hours (as of April 1, 2017)	1 part, 4 hours (150 mc questions)	3 parts, 6.5 hours (325 mc questions)	4 parts (125 mc questions each), 10 hours	2 parts (100 mc questions and two 30-minute essays, each) 8 hours
Passing Score	75%	450 (on an 800-point scale)	600 (on a 750-point scale)	75%	360 per part (on a 500-point scale)
Test Dates	On demand in 1st two months of each calendar quarter	June, Sep, Dec	On demand	Self-administered	On demand during the months of Jan, Feb, May, Jun, Sep, and Oct
Administering Body	American Institute of Certified Public Accountants	Information Systems Audit and Control Association	Institute of Internal Auditors	Association of Certified Fraud Examiners	Institute of Management Accountants
Website	www.aicpa.org	www.isaca.org	www.theiia.org	www.acfe.com	www.imanet.org

State Certificate and License

The AICPA does not issue CPA certificates or licenses to practice. Rather, all states and territories have state accountancy laws and state licensing boards to administer them. After satisfying state requirements for education and experience, successful candidates receive their CPA *certificate* from their state board of accountancy. At the same time, new CPAs must pay a fee to obtain a state *license* to practice or work for a CPA firm that is licensed to practice in their state. Thereafter, state boards of accountancy regulate the behavior of CPAs under their jurisdiction (enforcing state codes of ethics) and supervise the continuing education requirements.

After becoming a CPA licensed in one state, a person can obtain a CPA certificate and license in another state by filing the proper application with the second state board of accountancy, meeting that state's requirements, and obtaining another CPA certificate. Many CPAs hold certificates and licenses in several states. From a global perspective, individuals must be licensed in each country. Similar to CPAs in the United States, *chartered accountants (CAs)* practice in Australia, Canada, Great Britain, and India.

AUDITING INSIGHT — Auditors Make a Run for the Border

Efforts are currently under way through the AICPA and the National Association of State Boards of Accountancy (NASBA) to streamline the licensing process so that CPAs can practice across state lines without having to have 50 different licenses. Under the concept of **substantial equivalency**, as long as the licensing (home) state requires (1) 150 hours of education, (2) successful completion of the CPA exam, and (3) one year of experience, a CPA can practice (either in person or electronically) in another substantial equivalency state without having to obtain a license in that state. The super majority of states and the District of Columbia have enacted provisions to allow CPAs licensed in other states to practice without notification (but agreeing to be under the state's automatic jurisdiction). This *uniform mobility* arrangement is temporary though, because a CPA who relocates to another state must ultimately seek licensing in that state.

Source: AICPA State Regulation and Legislation Team at www.aicpa.org.

Skill Sets and Your Education

The requirements to become certified are rather strenuous, but they may not be enough! Let us take you on a brief tour of the core competencies listed by the AICPA, the Association of Certified Fraud Examiners (ACFE), the Institute of Internal Auditors (IIA), the Institute of Management Accountants (IMA), the Information Systems Audit and Control Association (ISACA), and other guidance-providing groups: mathematics, international culture, psychology, economics, statistics, political science, inductive and deductive reasoning, ethics, group dynamic processes, finance, capital markets, managing change, history of accounting, regulation, information systems, taxation, and (oh, yes) accounting and auditing. Add administrative capability, analytical skills, business knowledge, communication skills (writing and speaking), efficiency, intellectual capability, marketing and selling, model building, people development, capacity for putting client needs first, and more.

We hope you are suitably impressed by this recitation of virtually all of the world's knowledge. You will be very old when you accomplish a fraction of the skill development and education suggested. Now the good news: (1) not everyone needs to be completely knowledgeable in all of these areas upon graduation from college, (2) learning and skill development evolve over a lifetime, and (3) no one expects you to know everything and operate as a "Lone Ranger." Audit teams composed of members specializing in some areas with other members specializing in other areas seem to work best in practice. We do, however, stress the need to continue your education even after you leave school. Learning should be a lifelong pursuit, not something that ends when you receive your diploma.

REVIEW CHECKPOINTS

1.19 Why is continuing education required to maintain certification?

1.20 Why do you think experience is required to become certified?

1.21 What are some of the functions of a state board of public accountancy?

1.22 What are some of the limitations to practicing public accounting across state and national boundaries?

Summary

Decision makers need more than just information; they need reliable and credible information that they can rely upon. Internet buyers rely on website information when purchasing online. Financial analysts and investors use financial reports to help make stock investment decisions. Suppliers and creditors use financial reports to decide whether to grant credit and bank loans. Labor organizations use financial reports to help determine a company's ability to pay wages. Government agencies and Congress use financial information in preparing analyses of the economy and in making laws concerning taxes, subsidies, and the like. These various users rely on independent information assurors such as CPAs to reduce information risk. Auditors (and other information assurance providers) assume the role of certifying (or attesting to) published financial information, thereby offering users the valuable service of providing assurance that information risk is low.

This chapter began by defining information risk and explained how auditing and assurance services play a role in minimizing this risk. The financial statements were explained in terms of the primary assertions that management makes in them, and these assertions were identified as the focal points of the auditors' evidence-gathering work. Auditing is practiced in numerous forms by various practice units, including public accounting firms, the Internal Revenue Service, the U.S. Government Accountability Office, internal audit departments in companies, and several other types of regulatory auditors. Fraud examiners, many of whom are internal auditors and inspectors, have also found a niche in auditing-related activities.

The public accounting profession recognizes that, in today's information economy, information risk exists in areas outside of financial transactions. Assurance services is a broad category of information-enhancement services that build on CPAs' auditing, attestation, accounting, and consulting skills to create products useful to a wide range of decision makers (customers). While reliable information helps make capital markets efficient and helps people know the consequences of a wide variety of economic decisions, CPAs practicing the assurance function are not the only information professionals at work in the economy. Bank examiners, IRS auditors, state regulatory agency auditors (e.g., auditors in a state's insurance department), internal auditors employed by a company, and federal government agency auditors all practice information assurance in one form or another.

Most financial statement auditors aspire to become certified public accountants, which involves successfully completing a rigorous examination, obtaining practical experience, and maintaining competence through continuing professional education. Auditors also obtain credentials as certified internal auditors, certified management accountants, certified information systems auditors, and certified fraud examiners. Each of these fields has large professional organizations that govern the professional standards and quality of practice of its members.

Key Terms

assurance: The lending of credibility to information.
assurance services: The independent professional functions that improve the quality of information, or its context, for decision makers.
attestation: An accounting service resulting in a report on subject matter or an assertion about subject matter that is the responsibility of another party.
attestation engagement: The provision of an opinion on subject matter or an assertion about the subject matter that is the responsibility of another party.
auditing: The systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established criteria and communicating the results to interested users.
business risks: Those factors, events, and conditions that could prevent the organization from achieving its business objectives.
completeness: Management assertion that all of the transactions, events, assets, liabilities, equity interests, and other disclosures that should have been recorded in the financial statements have been recorded.
cutoff: Management assertion that refers to accounting for revenue, expense, and other transactions in the proper period. The cutoff date generally refers to the audit client's year-end balance sheet date.

existence: Management assertion that all assets, liabilities, and equity interests do actually exist.
financial reporting: Process of providing statements of financial position (balance sheets), results of operations (income statements, statements of shareholders' equity, and statements of comprehensive income), changes in cash flows (statements of cash flows), and accompanying disclosure to outside decision makers who do not have access to management's internal sources of information; a company's accountants, under the direction of its management, perform this function.
information risk: The probability that the information circulated by an entity will be false or misleading.
internal auditing: An examination service provided to a company to assist the company to meet its corporate goals and objectives by evaluating and recommending risk management, control, and governance processes.
occurrence: Management assertion that all of the transactions and events that have been recorded are valid, pertain to the entity, and have actually taken place.
operational auditing: An examination designed to evaluate the processes and procedures of an organization or an area within an organization to ensure the process or area is operating efficiently and effectively.
presentation and disclosure: Management assertion that all transactions and events have been presented correctly and that all relevant information has been disclosed to financial statement users, usually in the footnotes to the financial statements.
professional skepticism: A state of mind that is characterized by appropriate questioning and a critical assessment of audit evidence.
rights and obligations: The entity is entitled to all rights of the assets, the liabilities are the legal responsibility of the entity, and all of the disclosed events and transactions pertain to the entity.
substantial equivalency: The process through which CPAs licensed in one state can practice in another state.
valuation or allocation: Management assertion that all assets, liabilities, and equity interests of the entity have been valued in accordance with the relevant financial reporting standards (e.g., GAAP) and are listed in the financial statements at the proper amount and any resulting valuation adjustments have been appropriately recorded in the financial statements.

Multiple-Choice Questions for Practice and Review

connect — All applicable questions are available with *Connect*.

LO 1-2

1.23 Which of the following would be considered an assurance engagement?
   a. Giving an opinion on a prize promoter's claims about the amount of sweepstakes prizes awarded in the past.
   b. Giving an opinion on the conformity of the financial statements of a university with generally accepted accounting principles.
   c. Giving an opinion on the fair presentation of a newspaper's circulation data.
   d. Giving assurance about the average drive length achieved by golfers with a client's golf balls.
   e. All of the above.

LO 1-4

1.24 It is always a good idea for auditors to begin an audit with the professional skepticism characterized by the assumption that
   a. A potential conflict of interest always exists between the auditor and the management of the enterprise under audit.
   b. In audits of financial statements, the auditor acts exclusively in the capacity of an auditor.
   c. The professional status of the independent auditor imposes commensurate professional obligations.
   d. Financial statements and financial data are verifiable.

LO 1-2

1.25 In an attestation engagement, a CPA practitioner is engaged to
   a. Compile a company's financial forecast based on management's assumptions without expressing any form of assurance.
   b. Prepare a written report containing a conclusion about the reliability of a management assertion.
   c. Prepare a tax return using information the CPA has not audited or reviewed.
   d. Give expert testimony in court on particular facts in a corporate income tax controversy.

LO 1-6

1.26 A determination of cost savings obtained by outsourcing cafeteria services is most likely to be an objective of

a. Environmental auditing.
b. Financial auditing.
c. Compliance auditing.
d. Operational auditing.

LO 1-6

1.27 The primary difference between operational auditing and financial auditing is that in operational auditing

a. The operational auditor is not concerned with whether the audited activity is generating information in compliance with financial accounting standards.
b. The operational auditor is seeking to help management use resources in the most effective manner possible.
c. The operational auditor starts with the financial statements of an activity being audited and works backward to the basic processes involved in producing them.
d. The operational auditor can use analytical skills and tools that are not necessary in financial auditing.

LO 1-2

1.28 According to the AICPA, the purpose of an audit of financial statements is to

a. Enhance the degree of confidence that intended users can place in the financial statements.
b. Express an opinion on the fairness with which they present financial position, results of operations, and cash flows in conformity with accounting standards promulgated by the Financial Accounting Standards Board.
c. Express an opinion on the fairness with which they present financial position, results of operations, and cash flows in conformity with accounting standards promulgated by the U.S. Securities and Exchange Commission.
d. Obtain systematic and objective evidence about financial assertions and report the results to interested users.

LO 1-1

1.29 Bankers who are processing loan applications from companies seeking large loans will probably ask for financial statements audited by an independent CPA because

a. Financial statements are too complex for the bankers to analyze themselves.
b. They are too far away from company headquarters to perform accounting and auditing themselves.
c. The consequences of making a bad loan are very undesirable.
d. They generally see a potential conflict of interest between company managers who want to get loans and the bank's needs for reliable financial statements.

LO 1-5

1.30 The Sarbanes–Oxley Act of 2002 prohibits public accounting firms from providing which of the following services to an audit client?

a. Bookkeeping services.
b. Internal auditing services.
c. Valuation services.
d. All of the above.

LO 1-1

1.31 Independent auditors of financial statements perform audits that reduce

a. Business risks faced by investors.
b. Information risk faced by investors.
c. Complexity of financial statements.
d. Timeliness of financial statements.

LO 1-6

1.32 The primary objective of compliance auditing is to

a. Give an opinion on financial statements.
b. Develop a basis for a report on internal control.
c. Perform a study of effective and efficient use of resources.
d. Determine whether client personnel are following laws, rules, regulations, and policies.

LO 1-7

1.33 What requirements are *usually* necessary to become licensed as a certified public accountant?

a. Successful completion of the Uniform CPA Examination.
b. Experience in the accounting field.
c. Education.
d. All of the above.

LO 1-6

1.34 The organization primarily responsible for ensuring that public officials are using public funds efficiently, economically, and effectively is the

a. Governmental Internal Audit Agency (GIAA).
b. Central Internal Auditors (CIA).
c. Securities and Exchange Commission (SEC).
d. Government Accountability Office (GAO).

LO 1-6

1.35 Performance audits usually include [two answers]

a. Financial audits.
b. Economy and efficiency audits.
c. Compliance audits.
d. Program audits.

LO 1-3

1.36 The objective in an auditor's review of credit ratings of a client's customers is to obtain evidence related to management's assertion about

a. Completeness.
b. Existence.
c. Valuation and allocation.
d. Rights and obligations.
e. Occurrence.

LO 1-4

1.37 Jones, CPA, is planning the audit of Rhonda's Company. Rhonda verbally asserts to Jones that all expenses for the year have been recorded in the accounts. Rhonda's representation in this regard

a. Is sufficient evidence for Jones to conclude that the completeness assertion is supported for expenses.
b. Can enable Jones to minimize the work on the gathering of evidence to support Rhonda's completeness assertion.
c. Should be disregarded because it is not in writing.
d. Is not considered a sufficient basis for Jones to conclude that all expenses have been recorded.

LO 1-1

1.38 The risk to investors that a company's financial statements may be materially misleading is called

a. Client acceptance risk.
b. Information risk.
c. Moral hazard.
d. Business risk.

LO 1-3

1.39 When auditing merchandise inventory at year-end, the auditor performs audit procedures to ensure that all goods purchased before year-end are received before the physical inventory count. This audit procedure provides assurance about which management assertion?

a. Cutoff.
b. Existence.
c. Valuation and allocation.
d. Rights and obligations.
e. Occurrence.

LO 1-3

1.40 When auditing merchandise inventory at year-end, the auditor performs audit procedures to obtain evidence that no goods held on consignment are included in the client's ending inventory balance. This audit procedure provides assurance about which management assertion?

a. Completeness.
b. Existence.
c. Valuation and allocation.
d. Rights and obligations.
e. Occurrence.

LO 1-3

1.41 When an auditor reviews additions to the equipment (fixed asset) account to make sure that fixed assets are not overstated, she wants to obtain evidence as to management's assertion regarding

a. Completeness.
b. Existence.
c. Valuation and allocation.
d. Rights and obligations.
e. Occurrence.

LO 1-5

1.42 The Sarbanes–Oxley Act of 2002 generally prohibits public accounting firms from

a. Acting in a managerial decision-making role for an audit client.
b. Auditing the firm's own work on an audit client.
c. Providing tax consulting to an audit client without audit committee approval.
d. All of the above.

LO 1-7

1.43 Substantial equivalency refers to

a. An auditor's tendency not to believe management's assertions without sufficient corroboration.
b. Providing consulting work for another firm's audit client in exchange for the other firm's providing consulting services to one of your clients.
c. The waiving of certification exam parts for an individual holding an equivalent certification from another professional organization.
d. Permitting a CPA to practice in another state without having to obtain a license in that state.

LO 1-2

1.44 Which of the following best describes the relationship between auditing and attestation engagements?

a. Auditing is a subset of attestation engagements that focuses on the certification of financial statements.
b. Attestation is a subset of auditing that provides lower assurance than that provided by an audit engagement.
c. Auditing is a subset of attestation engagements that focuses on providing clients with advice and decision support.
d. Attestation is a subset of auditing that improves the quality of information or its context for decision makers.

LO 1-3

1.45 During an audit of a company's cash balance on a company with operations in only one country, the auditor is most concerned with which management assertion?

a. Existence.
b. Rights and obligations.
c. Valuation or allocation.
d. Occurrence.

LO 1-3

1.46 When auditing an investment in another company, an auditor most likely would seek to conduct which audit procedure to help satisfy the valuation assertion?

a. Inspect the stock certificates evidencing the investment.
b. Examine the audited financial statements of the investee company.
c. Review the broker's advice or canceled check for the investment's acquisition.
d. Obtain market quotations from *The Wall Street Journal* or another independent source.

LO 1-3

1.47 Cutoff tests designed to detect valid sales that occurred before the end of the year but have been recorded in the subsequent year would provide assurance about management's assertion of

a. Presentation and disclosure.
b. Completeness.
c. Rights and obligations.
d. Existence.

LO 1-3

1.48 Which of the following audit procedures probably would provide the most reliable evidence related to the entity's assertion of rights and obligations for the inventory account?
  a. Trace test counts noted during physical count to the summarization of quantities.
  b. Inspect agreements for evidence of inventory held on consignment.
  c. Select the last few shipping advices used before the physical count and determine whether the shipments were recorded as sales.
  d. Inspect the open purchase order file for significant commitments to consider for disclosure.

LO 1-3

1.49 In auditing the accrued liabilities account on the Balance Sheet, an auditor's procedures most likely would focus primarily on management's assertion of
  a. Existence or occurrence.
  b. Completeness.
  c. Presentation and disclosure.
  d. Valuation or allocation.

LO 1-2

1.50 Which of the following *best* describes the focus of the following engagements?

Auditing Engagement	Attestation Engagement	Assurance Engagement	Consulting Services Engagement
a. Any information	Financial statements	Advice and decision support	Financial information
b. Financial information	Advice and decision support	Financial statements	Any information
c. Advice and decision support	Any information	Financial information	Financial statements
d. Financial statements	Financial information	Any information	Advice and decision support

LO 1-7

1.51 Which of the following is a reason to obtain professional certification?
  a. Certification provides credibility that an individual is technically competent.
  b. Certification often is a necessary condition for advancement and promotion within a professional services firm.
  c. Obtaining certification is often monetarily rewarded by an individual's employer.
  d. All of the above.

LO 1-3

1.52 During an audit of an entity's stockholders' equity accounts, the auditor determines whether there are restrictions on retained earnings resulting from loans, agreements, or state law. This audit procedure most likely is intended to verify management's assertion of
  a. Existence or occurrence.
  b. Completeness.
  c. Valuation or allocation.
  d. Presentation and disclosure.

LO 1-3

1.53 When auditing the accounts receivable account on the balance sheet, an auditor's procedures most likely would focus primarily on management's assertion of
  a. Existence.
  b. Completeness.
  c. Presentation and disclosure.
  d. Rights and obligations.

LO 1-3

1.54 An auditor selected items for test counts from the client's warehouse during the physical inventory observation. The auditor then traced these test counts into the detailed inventory listing that agreed to the financial statements. This procedure most likely provided evidence concerning management's assertion of
  a. Rights and obligations.
  b. Completeness.
  c. Existence.
  d. Valuation.

LO 1-3

1.55 An auditor's purpose in auditing the information contained in the pension footnote most likely is to obtain evidence concerning management's assertion about

a. Rights and obligations.
b. Existence.
c. Presentation and disclosure.
d. Valuation.

Exercises and Problems

All applicable Exercises and Problems are available with *Connect*.

LO 1-2

1.56 **Audit, Attestation, and Assurance Services.** Following is a list of various professional services. Identify each by its apparent characteristics as audit engagement, attestation engagement, or assurance engagement. Because audits are a subset of attestation engagements, which are a subset of assurance engagements, choose the most specific description. In other words, if you believe the engagement is an audit engagement, select only audit engagement rather than checking all three. Similarly, the choice of assurance engagement for an audit, while technically correct, would not be the best choice.

	Audit Engagement	Attestation Engagement	Assurance Engagement
Real estate demand studies			
Ballot for awards show			
Utility rates applications			
Newspaper circulation audits			
Third-party reimbursement maximization			
Annual financial report to stockholders			
Rental property operation review			
Examinations of financial forecasts and projections			
Customer satisfaction surveys			
Compliance with contractual requirements			
Benchmarking/best practices			
Evaluation of investment management policies			
Information systems security reviews			
Productivity statistics			
Internal audit strategic review			
Financial statements submitted to a bank loan officer			

LO 1-4

1.57 **Controller as Auditor.** The chairman of the board of Hughes Corporation proposed that the board hire as controller a CPA who had been the manager of the team that conducted Hughes Corporation's audit engagement. The chairman thought that hiring this person would make the annual audit unnecessary and would consequently result in saving the professional fee paid to the auditors. The chairman proposed to give this new controller a full staff to conduct such investigations of accounting and operating data as necessary. Evaluate this proposal.

LO 1-3

1.58 **Management Assertions.** Complete the following chart indicating the corresponding Auditing Standards Board assertions and whether the assertion relates to transactions, balances, or disclosures.

PCAOB Assertion	Corresponding ASB Assertion	Nature of Assertion
Existence or Occurrence		
Rights and Obligations		
Completeness		
Valuation and Allocation		
Presentation and Disclosure		

LO 1-3

1.59 **Management Assertions.** Your audit manager has asked you to explain the PCAOB assertions by using an account on the balance sheet at your audit client. For the accounts receivable account, please define each of the PCAOB assertions, using the accounts receivable account as a way to illustrate each assertion. You are encouraged to reference Exhibit 1.5 to help you answer this question.

LO 1-5, 1-6

1.60 **Operational Auditing.** Bigdeal Corporation manufactures paper and paper products and is trying to decide whether to purchase Smalltek Company. Smalltek has developed a process for manufacturing boxes that can replace containers that use fluorocarbons for expelling a liquid product. The price may be as high as $45 million. Bigdeal prefers to buy Smalltek and integrate its products while leaving the Smalltek management in charge of day-to-day operations. A major consideration is the efficiency and effectiveness of Smalltek's operations. Bigdeal wants to obtain a report on the operational efficiency and effectiveness of the Smalltek sales, production, and research and development departments.

Required:

Who can Bigdeal engage to produce the report resulting from this operational audit? Several possibilities exist. Are there any particular advantages or disadvantages in choosing from among them?

LO 1-1, 1-2

1.61 **Auditor as Guarantor.** Your neighbor, Loot Starkin, invited you to lunch yesterday. Sure enough, it was no "free lunch" because Loot wanted to discuss the annual report of Dodge Corporation. He owns Dodge stock and just received the annual report. Loot says, "Our auditors prepared the audited financial statements and gave an unqualified opinion, so my investment must be safe."

Required:

What misconceptions does Loot Starkin seem to have about the auditor's role with respect to Dodge Corporation?

LO 1-6

1.62 **Identification of Audits and Auditors.** Audits may be characterized as (a) financial statement audits, (b) compliance audits, (c) economy and efficiency audits, and (d) program results audits. The work can be done by independent (external) auditors, internal auditors, or governmental auditors (including IRS auditors and federal bank examiners). Following is a list of the purposes or products of various audit engagements:

	Type of Audit	Type of Auditor
1. Analyze proprietary schools' spending to train students for low-demand occupations.		
2. Determine whether an advertising agency's financial statements are fairly presented in conformity with GAAP.		
3. Study the effectiveness of the Department of Defense's expendable launch vehicle program.		
4. Compare costs of municipal garbage pickup services to comparable services subcontracted to a private business.		
5. Investigate financing terms of tax shelter partnerships.		
6. Study a private aircraft manufacturer's test pilot performance in reporting on the results of test flights.		
7. Conduct periodic examinations by the U.S. Comptroller of Currency of a national bank for solvency.		
8. Evaluate the promptness of materials inspection in a manufacturer's receiving department.		
9. Report on the need for the states to consider reporting requirements for chemical use data.		
10. Render a public report on the assumptions and compilation of a revenue forecast by a sports stadium/racetrack complex.		

Required:

For each of the engagements listed, indicate (1) the type of audit (financial statement, compliance, economy and efficiency, or program results) and (2) the type of auditors you would expect to be involved.

LO 1-3

1.63 **Financial Assertions and Audit Objectives.** You are engaged to examine the financial statements of Spillane Company for the year ended December 31. Assume that on November 1, Spillane borrowed $500,000 from Second National Bank to finance plant expansion. The long-term note agreement provided for the annual payment of principal and interest over five years. The existing plant was pledged as security for the loan. Due to the unexpected difficulties in acquiring the building site, the plant expansion did not begin on time. To use the borrowed funds, management decided to invest in stocks and bonds and on November 16, invested the $500,000 in publicly traded securities.

Required:

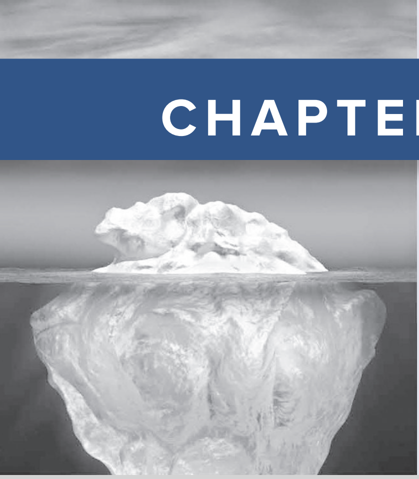
Develop specific assertions (audit objectives) related to securities (assets) based on management's five (PCAOB) general assertions.

LO 1-7

1.64 **Internet Exercise: Professional Certification.** Each state has unique rules for certification concerning education, work experience, and residency. Visit the website for your state board of accountancy and download a list of the requirements for becoming a CPA in your state. Although not all of the state boards of accountancy have websites, you can find those of most states by accessing the National Association of State Boards of Accountancy at its website (www.nasba.org).

LO 1-7

1.65 **Internet Exercise: Professional Certification.** Visit the website of the Institute of Internal Auditors (www.theiia.org), the Institute of Management Accountants (www.imanet.org), the Association of Certified Fraud Examiners (www.acfe.com), or the Information Systems Audit and Control Association (www.isaca.org). Review the information regarding the certifications available. Does the organization explain the benefits of having its certification? What topics are covered on the certification exam? What are the minimum requirements to take the exam? What additional experience is required to receive the certification?



CHAPTER 2

Professional Standards

In today's regulatory environment, it's virtually impossible to violate rules.

Bernard Madoff, money manager, approximately one year prior to being arrested for embezzling $50 billion from investors in a Ponzi scheme

Professional Standards References

Topic	AU-C/ISA Section	AS Section
Overall Objectives of the Independent Auditor	200	1001, 1005, 1010, 1015
Quality Control for an Audit Engagement	220	1220
Audit Planning	300	2101
Supervision of the Audit Engagement	300	1201
Identifying and Assessing the Risks of Material Misstatement	315	2110
Materiality	320	2105
Audit Evidence	500	1105
Reporting on Financial Statements	700	3101
Modifications to Reports on Financial Statements	705	3101
Quality Control	QC 10	1110, QC 10

LEARNING OBJECTIVES

Chapter 2 discusses the standards that govern the conduct of audit examinations (generally accepted auditing standards) and how these standards offer the explicit guidance that must be followed during audits. In addition, Chapter 2 identifies important policies and procedures implemented by auditing firms (through a system of quality control) to ensure that the firms' audits comply with appropriate professional standards and can withstand scrutiny by regulatory bodies. Finally, the chapter discusses external monitoring efforts that evaluate the quality of audit firms' work.

Your objectives are to be able to:

LO 2-1 Understand the development and source of generally accepted auditing standards.

LO 2-2 Describe the fundamental principle of *responsibilities* and how this principle relates to the characteristics and qualifications of auditors.

LO 2-3 Describe the fundamental principle of *performance* and identify the major activities performed in an audit.

LO 2-4 Understand the fundamental principle of *reporting* and identify the basic contents of the auditors' report.

LO 2-5 Understand the role of a system of quality control and monitoring efforts in enabling public accounting firms to meet appropriate levels of professional quality.

INTRODUCTION

The introductory quote from Bernie Madoff suggests that a strong regulatory environment results in compliance with established rules (despite the fact that Madoff himself did not do so!). Who sets the rules and standards for audits? Until 2002, the accounting profession was *self-regulated;* that is, the standards governing audits were established by members of the profession themselves through the **American Institute of Certified Public Accountants (AICPA)**. Although critics indicated that self-regulation was akin to having university students establish the systems used to determine their grades, this practice continued for more than 60 years and, although some concerns were raised during this time, remained largely unchanged.

Motivated to a great extent by the audit failures related to **Enron** and **WorldCom,** Congress passed the Sarbanes–Oxley Act of 2002 (Sarbanes–Oxley). Among other reforms, this act created the **Public Company Accounting Oversight Board (PCAOB)** to provide external and independent oversight over the audits of public entities. (A **public entity** is one that offers registered securities, such as stocks and bonds, for sale to the general public.) Among other matters, the PCAOB is responsible for registering public accounting firms, establishing and enforcing standards for audit engagements, and inspecting the quality of audits conducted by registered public accounting firms.

The PCAOB's inspection process and public reporting of results have received a great deal of media attention. As one of the "Big Four" accounting firms along with **EY, KPMG,** and **PwC, Deloitte** is a premier provider of accounting and auditing services. With worldwide revenues of more than $35 billion in 2015 and more than 225,000 employees operating in more than 150 countries, Deloitte's professionals provide services to leading organizations throughout the world.[1] Clearly, it is important for firms such as Deloitte to implement policies, procedures, and standards to ensure the quality of their work to their clients as well as others who rely on their work in making economic decisions.

In 2011, the PCAOB publicly released portions of an inspection report that criticized Deloitte's internal policies and procedures. (This was the first public disclosure of this nature involving a Big Four firm.) This report concluded that "important issues may exist" regarding procedures established by Deloitte related to

- The comprehensiveness of its audits.
- The professional skepticism of its personnel.
- The quality of its training programs for its professional staff.
- Systems for assessing and monitoring the work of its member firms in other countries.[2]

A recent academic study[3] concluded that the release of this information resulted in a reduction in Deloitte's ability to retain existing clients and attract new clients. In addition, Deloitte's audit fee growth rates declined following the release of this information. These

[1]Data are drawn from Deloitte's 2015 *Global Report*.

[2]"Audit Watchdog Criticized Deloitte Quality Controls in '08," *The Wall Street Journal,* October 18, 2011, p. C3. Each of the remaining Big Four firms have been the subject of similar PCAOB reports.

[3]J. P. Boone, I. K. Khurana, and K. K. Raman, "Did the 2007 PCAOB Disciplinary Order against Deloitte Impose Actual Costs on the Firm or Improve Its Audit Quality?" *The Accounting Review,* March 2015, pp. 405–441.

findings suggest that the PCAOB's actions imposed actual costs on Deloitte through less favorable perceptions of the firm and its work. In all, since 2007, the PCAOB has levied four monetary sanctions against Big Four firms totaling $6.5 million.[4]

This vignette illustrates the public scrutiny placed on policies and procedures implemented by firms to conduct quality audits. Although situations like these, as well as the Madoff fraud referenced in the opening quote to this chapter, are exceptions rather than the rule, accounting firms clearly are being held to a higher standard for the quality of their work, and failures are receiving intense attention in the media. The development of professional auditing standards, actions taken by audit firms to ensure that their audits comply with these standards, and monitoring efforts by external bodies (such as the PCAOB) to evaluate the quality of audit firms' work are the focal points of this chapter.

GENERALLY ACCEPTED AUDITING STANDARDS (GAAS)

LO 2-1
Understand the development and source of generally accepted auditing standards.

At least two historical milestones had a significant impact on the development of auditing standards. In 1938, a scandal of epic proportions broke at **McKesson & Robbins,** a large pharmaceutical company. Price Waterhouse & Co. (now PwC), the company's auditor for more than 10 years, failed to discover that the company had inflated inventory and receivables through the falsification of supporting documents (including one phony shipment from the United States to Australia by truck!). Auditors merely accepted management's assertions about inventory and receivables balances without verifying their existence. The accounting profession reacted quite strongly to the scandal by tasking the AICPA to develop standards that served as the basis for audits of both public and nonpublic (private) entities. From 1939 through 2002, the AICPA's Auditing Standards Board issued *Statements on Auditing Procedure* (1939–1972) and *Statements on Auditing Standards (SASs)* (1972–present) to provide guidance for the conduct of audits.[5]

A second defining moment in the development of auditing standards was the massive frauds at Enron and WorldCom (and the inability of those entities' auditors to identify the frauds). In response to these failures, Sarbanes–Oxley (which was passed by a vote of 99-0 in the U.S. Senate!) created the PCAOB and delegated the responsibility for developing standards for the audits of public entities to this body. The PCAOB issues *Auditing Standards,* which are subject to the formal approval of the Securities and Exchange Commission (SEC). The authorization for developing standards for the audits of nonpublic entities continues to remain with the Auditing Standards Board of the AICPA.

Until recently, PCAOB standards consisted of a combination of *Auditing Standards* issued by the PCAOB and standards issued by the AICPA that had not been superseded by the PCAOB (referred to as *Interim Auditing Standards*). Effective December 31, 2016, the PCAOB has reorganized and combined these standards into a single body of pronouncements. Appendix 2A illustrates how auditors utilize the PCAOB and ASB standards in providing appropriate professional guidance.

The relevant pronouncements of the AICPA and PCAOB are collectively referred to as **generally accepted auditing standards (GAAS)**.[6] GAAS are auditing standards that identify necessary qualifications and characteristics of auditors and guide the conduct of the audit examination. The purpose of GAAS is to meet the objectives of an audit examination, which are (AU-C 200.12):

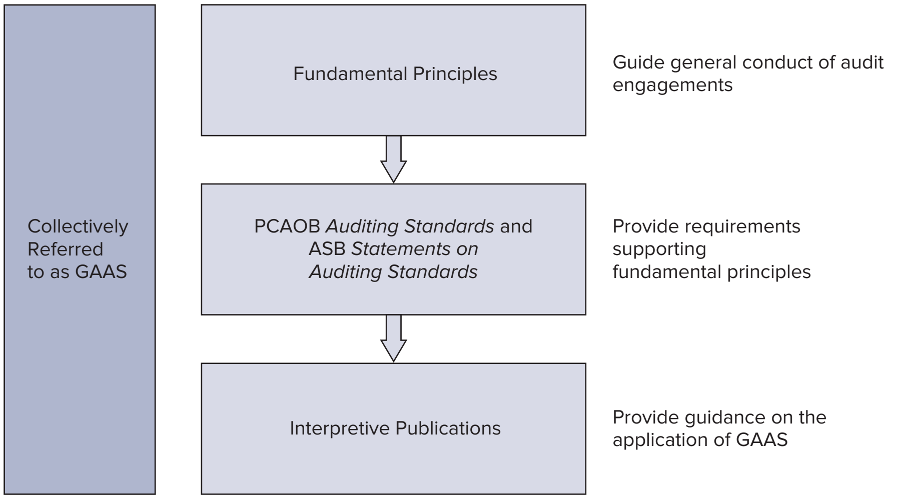
[4]See pcaobus.org/Enforcement/Decisions/Pages/default.aspx for a complete listing of settled disciplinary orders.

[5] *Statements on Auditing Standards (SAS)* are authoritative AICPA pronouncements on auditing theory and practice. *Statements on Auditing Procedure (SAP) Nos. 1–54* were codified into *SAS 1* in 1972.

[6]The auditing standards for public entities are sometimes referred to as *PCAOB Standards* to distinguish them from the standards for nonpublic entities.

- To obtain reasonable assurance about whether the financial statements as a whole are free of material misstatement, whether due to fraud or error.
- To issue a report on the financial statements.

Generally, auditors who do not follow the guidance provided in GAAS are presumed to have performed deficient audits. The auditing standards also includes *interpretive publications* (which includes *Interpretations,* exhibits, *AICPA Audit and Accounting Guides,* and *AICPA Auditing Statements of Position*). Although officially considered less authoritative and less binding than the guidance in the *SASs* and *Auditing Standards,* auditors still must justify any departures from these publications, which provide guidance on the application of GAAS in specific circumstances, including engagements for entities in certain industries. The relationship among these various pronouncements is summarized in the following graphic.



Auditing standards are quite different from *audit procedures.* **Audit procedures** are the particular and specialized actions that auditors take to obtain evidence in a specific audit engagement. **Auditing standards**, on the other hand, are quality guides to the audit that apply to all audits. For example, auditing standards indicate that auditors must determine that recorded accounts receivable are based on actual sales to customers. An audit procedure used to satisfy that standard is to confirm accounts receivable with the company's customers. This difference is the reason auditors' reports refer to an audit "conducted in accordance with *standards* of the Public Company Accounting Oversight Board" [emphasis added] rather than in accordance with audit procedures.

In addition to the standards for U.S. public and nonpublic entities, it is important to note that separate auditing standards have been developed for governmental and foreign entities. A summary of the body charged with establishing standards as well as the standards themselves for various types of audits follows.

	Public Entities	Nonpublic Entities	Governmental Entities	Foreign Entities
Rule-making body	Public Company Accounting Oversight Board (PCAOB)	AICPA Auditing Standards Board (ASB)	U.S. Government Accountability Office (GAO)	International Auditing and Assurance Standards Board (IAASB)
Standards	*Auditing Standards (ASs)*	*Statements on Auditing Standards (SASs)*	*Government Auditing Standards* (The Yellow Book)	*International Standards on Auditing (ISAs)*
Website	www.pcaobus.org	www.aicpa.org	www.gao.gov	www.ifac.org

If an accounting firm audits public and private entities throughout the world, that firm may be subject to multiple (sometimes conflicting) standards issued by the ASB, PCAOB, and IAASB, among others. For this reason, auditors and regulators have a great interest in *convergence*—that is, making the standards coordinated, if not uniform, throughout the world. The *ISAs* are a first step in the development of one consistent set of guidelines that auditors worldwide can follow. Although the focus in this text will be on audits of U.S. public, and nonpublic entities (and therefore pronouncements of the PCAOB and ASB), it is important that students be aware that additional standards exist related to the audits of governmental and foreign entities.

Organization of GAAS

The body of GAAS is based on three fundamental principles identified by the ASB that underlie all audits. These fundamental principles (related to responsibilities of the audit team, performance of the audit, and reporting the results of the engagement) are established to meet the objectives of an audit and are supported by objectives and requirements of specific *SASs*. While these principles have been issued by the ASB and are not formally applicable to the audits of public entities, they are consistent with and reflect the requirements of GAAS for audits of public entities.

Recall from Chapter 1 the definition of *auditing* as

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

Closer examination of the fundamental principles reveals that they closely parallel that definition. For example, the *responsibilities* principle defines objectivity and identifies the important role that objectivity plays in the audit. The *performance* principle requires, among other things, auditors to plan the work (i.e., conduct the audit using a "systematic process") and to "obtain and evaluate evidence" through assessing the risk of material misstatement and gathering sufficient appropriate evidence. Finally, the *reporting* principle provides guidance for "communicating the results" of the audit about whether the financial statements are prepared using "established criteria" (an applicable financial reporting framework, or GAAP).

REVIEW CHECKPOINTS

2.1 Define *generally accepted auditing standards (GAAS)*. What is the purpose of GAAS?

2.2 Who is responsible for developing standards for the audits of public entities? Who is responsible for developing standards for the audits of nonpublic entities?

2.3 Identify the role of the following bodies in the auditing standards-setting process: (1) the AICPA; (2) the PCAOB; (3) the SEC.

2.4 Identify the three fundamental principles underlying GAAS.

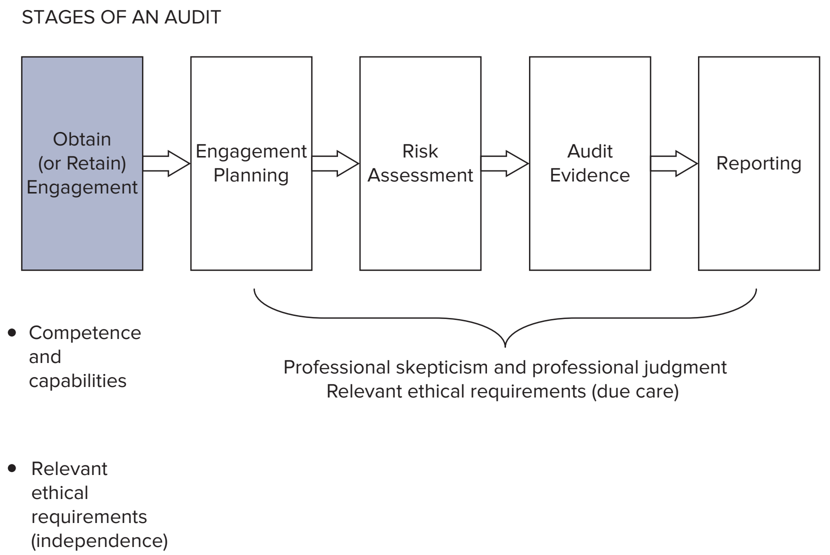
FUNDAMENTAL PRINCIPLE: RESPONSIBILITIES

LO 2-2
Describe the fundamental principle of *responsibilities* and how this principle relates to the characteristics and qualifications of auditors.

The fundamental principle of *responsibilities* relates to the personal integrity and professional qualifications of auditors. This principle addresses the following responsibilities of auditors:

> ***Auditors are responsible for:***
>
> - ***Having appropriate competence and capabilities to perform the audit.***
> - ***Complying with relevant ethical requirements.***
> - ***Maintaining professional skepticism and exercising professional judgment throughout the planning and performance of the audit.***

As shown in the following figure, most of the issues related to responsibilities are addressed before a firm accepts a prospective client. However, professional skepticism and professional judgment must be considered and exercised by the auditor throughout the entire engagement.



Competence and Capabilities

Competence and *capabilities* begin with education in accounting because auditors hold themselves out as experts in accounting standards, financial reporting, and auditing. In addition to university-level education prior to beginning their careers, auditors are required to participate in continuing professional education throughout their careers to ensure that their knowledge keeps pace with changes in the accounting and auditing profession. In fact, one of the important requirements for maintaining a CPA license is sufficient continuing professional education.

Education is only one element of competence and capabilities. Another important dimension is *experience,* which is gained with hands-on practice and on-the-job training. An important component of this experience is the ability to develop and apply professional judgment in real-world audit situations. These situations include various judgments related to gathering evidence as to the fairness of an entity's financial statements and evaluating whether that evidence indicates that the financial statements are prepared according to generally accepted accounting principles. (Professional judgment is also an important component of the performance principle, which will be discussed later.)

Independence and Due Care

The responsibilities principle requires auditors to comply with appropriate ethical requirements; two important requirements relate to *independence* and *due care.* Auditors must maintain independence in mental attitude; that is, auditors are expected to be unbiased and impartial with respect to the financial statements and other information they audit. This "state of mind" is often referred to as the auditor possessing **independence in fact**. This independence allows auditors to form an opinion on the entity's financial statements without being affected by influences that might compromise that opinion.

It is not only important for auditors to be unbiased; they must also *appear* to be unbiased. **Independence in appearance** relates to others' (particularly financial statement users') perceptions of auditors' independence. For example, imagine that the son or daughter of your professor was enrolled in your class. While your professor may truly be unbiased and evaluate their child fairly, it is unlikely that you and your classmates would believe your professor to be independent.

Although independence is a complex concept and many different threats to independence exist, two general types of relationships that are believed to jeopardize (or compromise) independence are

1. *Financial relationships,* such as owning shares of stock in a client or having a loan outstanding to or from a client.
2. *Managerial relationships,* such as the ability to act in a decision-making capacity on behalf of a client or to provide advice on systems or information that will subsequently be audited.

Clearly, the relationships just listed would impair perceptions of auditors' independence, but other considerations are necessary. For example, although it seems safe to conclude that an audit team member's spouse should be restricted from the preceding types of relationships for a client for which the team member is providing services, could that spouse have these types of relationships with respect to a client served by a distant office of the team member's firm? Could the audit team member's third cousin have such relationships?

It is difficult to think of a matter more fundamental to the value of an audit than independence. Without independence, third-party users are not able to rely on the auditor's work and opinion on the entity's financial statements. The preceding discussion identifies some of the major factors affecting independence, but the possible relationships involving auditors, entities, and their personnel are endless; the complexities of these relationships have resulted in a number of interpretations and ethics rulings regarding auditor independence. Many individuals fundamentally question whether auditors can be independent given the fee arrangement they have with their clients. (Imagine the situation if you directly paid your professor instead of the university for your tuition!) In addition, the often long-standing relationships between auditors and their clients have resulted in some attempts to require periodic rotation of audit firms to lessen the impact of financial relationships between these two parties and enhance independence.

Issues related to auditor independence may provide some significant challenges in practice. For example, an investigation in 2000 of independence violations at PwC revealed that ". . . approximately 86.5 percent of PwC partners and 10.5 percent of all other PwC professionals had independence violations."[7] Some more recent examples of independence issues facing major accounting firms are summarized in the accompanying Auditing Insight.

This section introduces the concept of auditor independence and provides a limited overview of issues that impact auditor independence. A detailed discussion of AICPA and SEC rules related to independence (and various interpretations of those rules) is provided in Module B.

[7]"Independent Consultant Finds Widespread Independence Violations at PricewaterhouseCoopers," *SEC Press Release 2000–4,* January 6, 2000.

AUDITING INSIGHT — Independent Auditors?

The following recent incidents illustrate the wide range of issues that can affect auditor independence:

- In 2014, EY withdrew its 2012 and 2013 opinions on the financial statements of **Ventas Inc.** (a Chicago-based real estate investment trust) because of an "inappropriate personal relationship" involving one of its partners (who participated in the audit engagement) and Ventas's chief accounting officer. EY subsequently paid \$9.3 million to settle charges related to this matter.
- In July 2014, the SEC charged EY with violating independence rules by inappropriately lobbying congressional staff on behalf of two audit clients, indicating that ". . . [these activities] put the firm in the position of being an advocate for those audit clients." (Both incidents occurred prior to 2009, and EY no longer engages in lobbying activities on behalf of its audit clients.)
- In January 2014, KPMG agreed to an \$8.2 million settlement with the SEC for providing prohibited nonaudit services (including corporate finance, bookkeeping, and payroll services) to three unnamed audit clients.

Sources: "Ventas Audit Reports Pulled Due to Inappropriate Relationship," *The Wall Street Journal Online,* July 9, 2014; "Ernst & Young to Pay \$9.3 Million to Settle Charges," *The Wall Street Journal Online*, September 19, 2016. "EY Runs Afoul of Auditor-Independence Rules Again," *CFO.com,* July 15, 2014; "KPMG Settles Auditor Independence Charges," *CFO.com,* January 14, 2014.

A second ethical requirement identified by the responsibilities principle is that of due care. **Due care** reflects a level of performance that would be exercised by reasonable auditors in similar circumstances. This standard is often referred to as that of a prudent auditor; auditors are expected to possess the skills and knowledge of others in their profession but are not expected to be infallible. This aspect relates to the competence and capabilities of the auditor to perform the engagement and issue appropriate reports. One specific element of due care noted by the standards is the need for auditors to plan and perform the audit with an appropriate level of professional skepticism as discussed in the following section.

Professional Skepticism and Professional Judgment

Professional skepticism and professional judgment are necessary responsibilities of auditors throughout the entire audit process. **Professional skepticism** (which was introduced in Chapter 1) is a state of mind that is characterized by appropriate questioning and a critical assessment of audit evidence. When exhibiting professional skepticism, auditors do not assume that management is dishonest, nor do they assume that management is unquestionably honest. Rather, auditors evaluate and consider

- Contradictory audit evidence obtained through different procedures.
- The reliability of documentary evidence.
- The reliability of information obtained from management and those charged with governance of the entity (e.g., the audit committee).

Although the preceding discussion suggests that professional skepticism is a relatively straightforward concept, situations occur during the audit that could impede auditors' ability to apply appropriate levels of professional skepticism. A PCAOB *Staff Practice Alert*[8] identified the following conditions that present challenges for auditors maintaining appropriate levels of professional skepticism; these conditions may result in auditors failing to appropriately question, assess, and evaluate evidence, and, ultimately, reach the correct conclusion during their engagement:

- Financial incentives and pressures (such as building or maintaining a long-term audit engagement, facing pressures to keep audit fees low, achieving high levels of client satisfaction, and providing other fee-related services to clients).
- Time pressures (such as completing the audit and report prior to deadlines and scheduling and workload demands on partners and other audit team members).
- Personal relationships developed with clients that provide auditors with an inappropriate level of trust or confidence in management.

[8] *Staff Audit Practice Alert No. 10,* "Maintaining and Applying Professional Skepticism in Audits," PCAOB, December 4, 2012.

Professional judgment is the application of relevant training, knowledge, and experience in making informed decisions about appropriate courses of action during the audit engagement. These judgments relate to the evidence obtained during the audit and the conclusions reached based on this evidence. Auditors are required to demonstrate this characteristic throughout the entire audit process as they do professional skepticism. Professional judgment is required as auditors gather evidence, evaluate evidence, and draw conclusions based on evidence. Professional judgment is particularly important in evaluating the reasonableness of various management estimates required in preparing the entity's financial statements.

In addition to demonstrating appropriate levels of professional judgment, auditors are required to carefully document their professional judgment in such a manner that experienced auditors with no previous relationship with the audit can understand the judgments made in reaching conclusions on significant issues.

AUDITING INSIGHT — Madoff and the Responsibilities Principle

A preliminary investigation of the actions of David Friehling (the individual responsible for the audits of **Bernard L. Madoff Investment Securities LLC**) illustrated the following potential violations of elements of the responsibilities principle:

- Friehling did not verify the existence of assets or securities trades made by Madoff's company, suggesting a lack of professional skepticism and a lack of due care.
- Friehling was the sole auditor at Friehling and Horowitz, raising the question as to whether a "one-man" firm has the capability to effectively audit a company as large as Madoff's.
- Friehling and his family had investment accounts at Madoff's company worth more than $14 million, a conflict of interest that raises questions about his independence.

Source: "Accountant Arrested for Sham Audits," *The Wall Street Journal,* March 19, 2009, p. C1.

REVIEW CHECKPOINTS

2.5 Distinguish between independence in fact and independence in appearance. Can auditors be independent in fact yet not be perceived to be independent in appearance?

2.6 What is *due care?* To what standards are auditors held with respect to due care?

2.7 Define *professional skepticism* and *professional judgment.* During what stages of the audit are auditors required to demonstrate these characteristics?

FUNDAMENTAL PRINCIPLE: PERFORMANCE

LO 2-3
Describe the fundamental principle of *performance* and identify the major activities performed in an audit.

The fundamental principle of *performance* sets forth general quality criteria for conducting an audit. As noted in the preceding section, in addition to the elements of this principle, the performance of the audit is influenced by the need for auditors to exercise *professional skepticism* and *professional judgment* throughout the audit process. The performance principle states that:

To express an opinion, the auditor obtains reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. To obtain reasonable assurance, which is a high but not absolute level of assurance, the auditor:

- ***Plans the work and properly supervises any assistants.***
- ***Determines and applies appropriate materiality level or levels throughout the audit.***

- ***Identifies and assesses risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.***
- ***Obtains sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.***

As the preceding reflects, the performance principle contains five elements: (1) reasonable assurance, (2) planning and supervision, (3) materiality, (4) risk assessment, and (5) audit evidence. These are discussed in the remainder of this section.

Reasonable Assurance

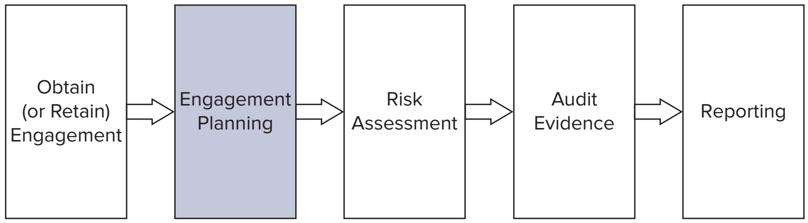
The concept of **reasonable assurance** recognizes that a GAAS audit may not detect all material misstatements and auditors are not "insurers" or "guarantors" regarding the fairness of the entity's financial statements. However, auditors should provide a high level of assurance (or confidence) regarding their work. Auditors provide reasonable assurance through considering various risks relating to the likelihood of material misstatement in the financial statements and performing audit procedures to limit the overall risk to an acceptably low level. This is done through the risk assessment process, an additional element of the performance principle.

Planning and Supervision

After obtaining or retaining the engagement, the next major stage of the audit is planning, as in the following figure. The professional standards contain several considerations for planning and supervising an audit. They are concerned with (1) preparing an audit plan and supervising the audit work, (2) obtaining knowledge of the client's business, and (3) dealing with differences of opinion among the accounting firm's own personnel.

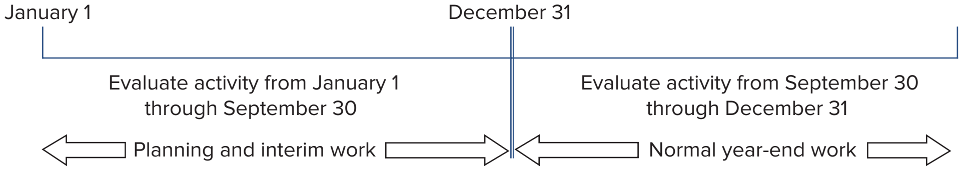
GAAS require the preparation of a written audit plan. An **audit plan** is a list of the audit procedures that auditors need to perform to gather sufficient appropriate evidence on which to base their opinion on the financial statements. The procedures in an audit plan should be stated in enough detail to instruct the assistants about the work to be done. (You will see detailed audit plans later in this textbook.)

STAGES OF AN AUDIT



Auditors are also required to obtain an understanding of the client's business and industry. This knowledge helps auditors identify areas for special attention (the accounts or classes of transactions where frauds or errors might exist), evaluate the reasonableness of accounting estimates made by management, evaluate management's responses to inquiries, and make judgments about the appropriateness of management's choices among accounting principles. Auditors gain this understanding of a business through discussions with management and other client personnel; through experience with other entities in the same industry; and by reviewing AICPA accounting and audit guides, industry publications, other entities' financial statements, business periodicals, and textbooks.

Just as having advance notice of assignments and examinations makes it easier for you (as a student) to perform better on those assignments, timing is important for audit planning. To have time to plan an audit, auditors should be engaged before the client's fiscal year-end. The more advance notice auditors have, the better they are able to provide enough time for planning. The audit team may be able to perform part of the audit at an interim date—a date some weeks or months before year-end—and thereby make the rest of the audit work more efficient. For example, in examining property, plant, and equipment, auditors may evaluate activity in the account balance up to some date during the year (say, September 30) prior to year-end (December 31) and then evaluate activity occurring between that date and December 31 following year-end (the roll-forward period), as shown in the following graphic. Essentially, at December 31, auditors have evaluated the account balance through the interim date (in this case, September 30) and will evaluate the remainder of the activity following year-end. Doing so permits audit work to be "shifted" from after year-end to prior to year-end and allows the audit to be completed on a more timely basis.



Engagement planning is discussed in greater detail in Chapter 3. In addition, planning activities related to the audit of various accounts and cycles are discussed in Chapters 6, 7 8, 9, and 10.

AUDITING INSIGHT Too Late

In its *Form 12b-25* filing with the SEC, **U.S. Premium Beef LLC** disclosed that it dismissed KPMG as its auditor and engaged PwC on February 28, 2012. Because of the late appointment of PwC and its inability to plan and perform the audit on a timely basis (U.S. Premium Beef had a December 31 year-end), the company was unable to meet the deadline for filing its financial statements with the SEC.

Sources: *U.S. Premium Beef LLC Form 12b-25* (dated March 29, 2012); *U.S. Premium Beef LLC Form 8-K* (dated February 28, 2012).

Materiality

The concept of **materiality** recognizes that auditors should focus on matters that are important to financial statement users. One common way of viewing materiality is the dollar amount that would influence the lending or investing decisions of financial statement users. Auditors and users do not expect account balances to be accurate to the penny; after all, many entities round their financial statements to the thousands, or even millions, of dollars! For example, **Walmart** reported net income of $15 billion in 2016; clearly, a misstatement of $1,000 would not affect users' decisions, but a misstatement of $1 billion probably would. Materiality is recognized as part of the objective of an audit, which is "to obtain reasonable assurance about whether the financial statements as a whole are free of *material* misstatement" [emphasis added] (AU-C 200.12). Materiality is commonly established based on percentages of key financial statement subtotals, such as net income, sales or revenues, and total assets.

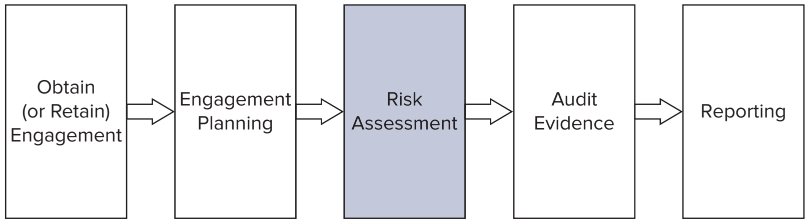
The audit team considers materiality in planning the audit, performing the audit, and evaluating the effect of misstatements on the entity's financial statements. Auditors are responsible only for providing reasonable assurance that misstatements *material* to the entity's financial statements are identified. Stated another way, auditors are not responsible for detecting misstatements that are not material to the financial statements.

Although the concept of materiality appears to be relatively straightforward, implementation of materiality during the audit requires high levels of professional judgment. For example, suppose a small dollar misstatement (in absolute terms) resulted in an entity meeting its earnings expectations or resulted in an entity reporting higher earnings than in the previous year. Certainly, these impacts would likely influence investment decisions, even if the dollar amount is relatively small. Circumstances such as these are referred to as qualitative materiality factors and should also be considered by auditors. The role of materiality in the planning stages of the audit is discussed in more detail in Chapter 3.

Risk Assessment

An important part of the performance principle is for auditors to identify important concerns (or risks) they face in the audit. This process is referred to as *risk assessment:*

STAGES OF AN AUDIT

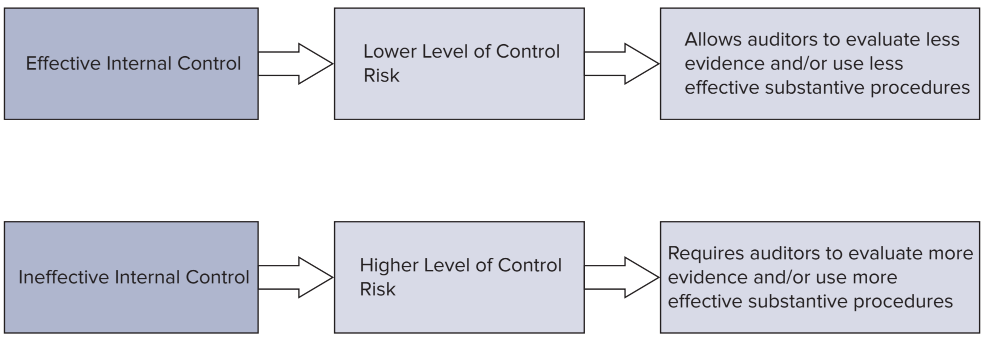


The risk assessment process requires an understanding of the client, its operating environment, and its industry. This includes internal controls operating within the client's accounting information systems that ultimately produce the client's financial statements. **Internal control** may be defined as the policies and procedures implemented by an entity to prevent or detect material accounting frauds or errors and provide for their correction on a timely basis. Satisfactory internal control reduces the probability of frauds or errors in the accounts. This understanding provides the foundation for the work auditors do in assessing the **risk of material misstatement**, a combination of **inherent risk** (the probability that a material misstatement, either an error or fraud, will occur) and **control risk** (the probability that a material misstatement, either an error or fraud, will not be prevented or detected on a timely basis by the entity's internal controls). One way to think of the risk of material misstatement is the likelihood that an error or fraud will exist in the financial statements prior to considering the auditors' work.

The primary purpose of assessing the risk of material misstatement is to help auditors determine the *nature, timing, and extent of further audit procedures* necessary for gathering evidence about the fairness of the entity's financial statements. The process of risk assessment presumes two necessary relationships:

1. Effective internal control reduces the control risk, and auditors thus have a reasonable basis for reducing the necessary effectiveness of further audit procedures.
2. Ineffective internal control increases control risk, and auditors must increase the necessary effectiveness of further audit procedures.

Because these audit procedures are used to obtain evidence with respect to the fairness of the account balance (i.e., to "substantiate" the account balance), they are referred to as **substantive procedures**. The auditors' substantive procedures are reflected in the determination of detection risk, which is discussed in the next section. A depiction of this relationship follows:



The importance of internal control in the audit examination is evidenced by an increase in auditors' responsibility for internal control in the audit of public entities that auditors evaluate (through testing the operating effectiveness of specific controls) and report on the effectiveness of a public entity's internal control over financial reporting. This is one example of auditors' responsibility in the audit of a public entity exceeding that for the audit of a nonpublic entity. Internal control (and the related reports on internal control) is discussed in more detail in Chapter 5; in addition, important elements of internal control related to the audit of various accounts and cycles are discussed in Chapters 6, 7, 8, 9, and 10.

REVIEW CHECKPOINTS

2.8 Define *reasonable assurance.* How does the audit team provide reasonable assurance in the engagement?

2.9 What is an *audit plan*? During which stage of the audit is an audit plan prepared?

2.10 Why is the timing of the auditors' appointment an important matter in the conduct of a financial statement audit?

2.11 What is *materiality*? During what stages of the audit do auditors consider materiality?

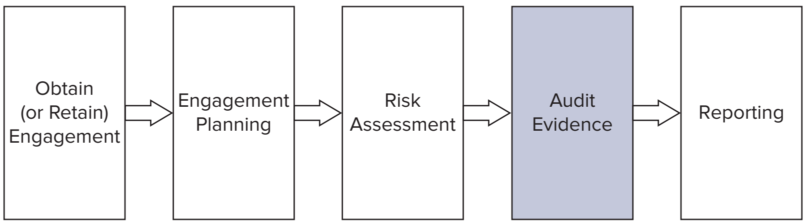
2.12 For what reasons do auditors obtain an understanding of a client's internal control?

2.13 What is the basic relationship between the effectiveness of the client's internal control and the necessary effectiveness of substantive procedures?

Audit Evidence

The final element of the performance principle requires that the audit team collects and evaluates sufficient appropriate evidence to provide a reasonable basis for their opinion.

STAGES OF AN AUDIT



Evidence is the information that auditors use in arriving at the conclusions on which to base the audit opinion and includes the underlying accounting data and all available corroborating information. Examples of evidence include minutes of meetings, confirmations with independent third parties, invoices, analyst reports, and all other information that permits auditors to reach valid, logical conclusions. As noted, the methods auditors use to gather and evaluate this evidence are referred to as *substantive procedures,* which are performed following the auditors' risk assessment process.

The performance principle requires auditors to gather "sufficient appropriate" evidence. To be considered **appropriate**, evidence must be trustworthy (*reliable*) and must provide the audit team with information of interest (*relevant*). Professional standards note the following with respect to the reliability of evidence:

- Evidence created by sources external to the entity is more reliable than that created by the entity. From most to least reliable, sources of evidence are auditors (direct personal knowledge), parties external to the entity (external evidence), and parties internal to the entity (internal evidence).

- Evidence created by sources outside the entity is more reliable when received directly from the external source (direct external evidence) than when received from sources internal to the entity (external-internal evidence).
- Evidence obtained from entities with more effective internal controls is more reliable than that obtained from entities with less effective internal controls.
- Evidence obtained from original source documents is more reliable than that obtained from photocopies, facsimiles, or electronic documents.

AUDITING INSIGHT — Whom Can You Trust?

"The level of fraud and financial deception that took place at HealthSouth is a blatant violation of investor trust, and Ernst & Young is as outraged as the investing public." In a public statement, the accounting firm asserted that HealthSouth, one of its largest clients, tried to deceive the firm's audit team by creating false documents to support fraudulent journal entries. To support the firm's claim, the statement cited a court hearing in which a former HealthSouth employee testified that "he knew of at least three occasions where company executives prepared false documents specifically to conceal fraud from Ernst."

Source: "Did HealthSouth Auditor Ernst Miss Key Clues to Fraud Risks?" *The Wall Street Journal,* April 10, 2003, pp. C1, C3.

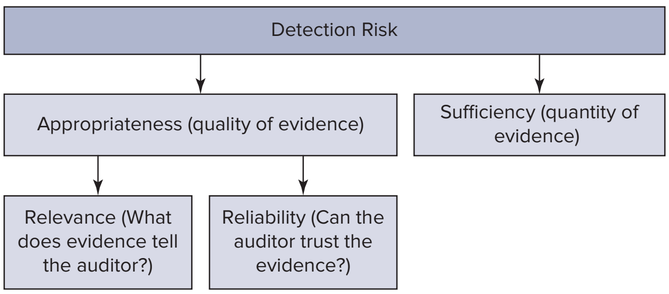
Relevance refers to the nature of information provided by the audit evidence; for example, when auditors confirm accounts receivable with customers, this audit procedure provides evidence that the account is legitimate (i.e., the sale actually took place) but does not provide evidence that the account will ultimately be collectible. The nature of information provided by evidence is operationalized through the management assertions identified and discussed in Chapter 1.

Appropriateness relates to evidence *quality,* and **sufficiency** relates to evidence *quantity.* For large entities, auditors do not audit all of the transactions and components but examine a sample of these items in drawing their conclusions. Sufficiency relates to the number of transactions or components evaluated.

The sufficiency and appropriateness of evidence are reflected in the necessary level of detection risk. **Detection risk** represents the risk that the audit team's substantive procedures will fail to detect a material misstatement. As auditors require a higher quality of evidence (lower detection risk), they must gather more relevant and reliable evidence (appropriateness) and evaluate more transactions or components (sufficiency). Evidence-gathering procedures are discussed in more detail in Chapter 3. In addition, specific approaches to gathering evidence in the examination of various accounts and cycles are discussed in Chapters 6, 7, 8, 9, and 10.

Exhibit 2.1 summarizes the key characteristics of evidence just discussed. Note that both the sufficiency and the appropriateness of audit evidence affect detection risk. Also note that the appropriateness is affected by both the relevance of the evidence and its reliability.

EXHIBIT 2.1
Key Characteristics of Audit Evidence



REVIEW CHECKPOINTS

2.14 Define *audit evidence*.

2.15 Define *external, external-internal,* and *internal documentary evidence.*

2.16 Distinguish between relevance and reliability as these concepts relate to audit evidence. How are relevance and reliability associated with the appropriateness of audit evidence?

2.17 How does the source of evidence affect its reliability?

2.18 How are the sufficiency and appropriateness of evidence related to detection risk?

FUNDAMENTAL PRINCIPLE: REPORTING

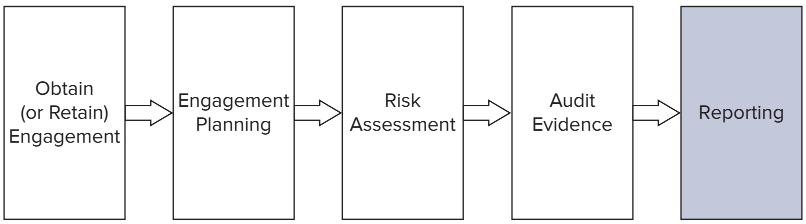
LO 2-4
Understand the fundamental principle of *reporting* and identify the basic contents of the auditors' report.

The ultimate objective of the audit—the report on the audit—is guided by the fundamental principle of reporting, which states

Based on evaluation of the evidence obtained, the auditor expresses in the form of a written report, an opinion in accordance with the auditor's findings, or states that an opinion cannot be expressed. The opinion states whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

As the following graphic shows, reporting is the final stage of an audit and occurs following the gathering of audit evidence.

STAGES OF AN AUDIT



An example of an auditors' report is shown in Exhibit 2.2, and you should review it in relation to the following discussion.

The report in Exhibit 2.2 is the report form used for public entities; differences in wording exist, but the report for nonpublic entities conveys essentially the same information. You should understand the term *financial statements* to include not only the traditional financial statements, but also all footnote disclosures and additional information (e.g., earnings per share calculations) that are integral elements of the basic financial presentation required by GAAP.

The reporting principle requires the auditor to express an opinion on the entity's financial statements (or indicate that an opinion cannot be expressed). With respect to this requirement, the opinion paragraph of Ernst & Young's report begins with the phrase "In our opinion," which represents the expression of an opinion.

In expressing this opinion, the auditor is required to assess the financial statements against an applicable financial reporting framework. A **financial reporting framework** is a

EXHIBIT 2.2 Example Auditors' Report for Public Company (McDonald's Corporation)

Report Title	Report of Independent Registered Public Accounting Firm
Addressee	The Board of Directors and Shareholders of McDonald's Corporation
Introductory Paragraph	We have audited the accompanying consolidated balance sheets of McDonald's Corporation as of December 31, 2015 and 2014, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2015. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.
Scope Paragraph	We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
Opinion Paragraph	In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of McDonald's Corporation at December 31, 2015 and 2014, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2015, in conformity with U.S. generally accepted accounting principles.
Internal Control Paragraph	We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), McDonald's Corporation's internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control–Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated February 25, 2016 expressed an unqualified opinion thereon.
	Ernst & Young LLP (signed) Chicago, Illinois February 25, 2016

set of criteria used to determine the measurement, recognition, presentation, and disclosure of material items in the financial statements; three examples of financial reporting frameworks are GAAP, *International Financial Reporting Standards (IFRS),* or a special purpose framework (such as cash or tax bases). Again, referring to Ernst & Young's report in Exhibit 2.2, the opinion paragraph concludes that **McDonald's** financial statements present its financial condition, results of operations, and cash flows ". . . in conformity with U.S. generally accepted accounting principles" (GAAP). In this case, GAAP are the applicable financial accounting framework.

The report in Exhibit 2.2 is an example of an unmodified (or unqualified) opinion, which concludes that the entity's (in this case, McDonald's) financial statements present its financial condition, results of operations, and cash flows in conformity with GAAP. Other types of opinions that can be expressed include the following:

- An adverse opinion concludes that the entity's financial statements are not presented in conformity with GAAP (or other financial reporting framework such as IFRS).
- A qualified opinion concludes that *except for* a relatively isolated (usually limited) departure, the entity's financial statements are presented in conformity with GAAP (or other financial reporting framework, such as IFRS).
- In some cases (e.g., if the auditors lack independence), auditors may choose not to express an opinion on the entity's financial statements. This type of report is referred to as a disclaimer of opinion. (A disclaimer of opinion is an indication that an opinion cannot be expressed.)

When these situations are encountered, auditors add an explanatory paragraph to their report and would then modify some of the paragraphs of the report shown in Exhibit 2.2. These and other report modifications are discussed further in Chapter 12.