



TENTH EDITION

AUDITING

A RISK-BASED APPROACH TO CONDUCTING A QUALITY AUDIT



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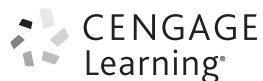


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Dedication

We dedicate this book to our families who encourage and support us through many hours of development, to our students who inspire us to always improve, to our mentors who guide us, to our professional friends who continue to educate us, and to our colleagues who challenge us.

KARLA M. JOHNSTONE
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BRIEF CONTENTS

	Preface	xxiii
	About the Authors	xxxv
CHAPTER 1	Auditing: Integral to the Economy	2
CHAPTER 2	The Auditor's Responsibilities Regarding Fraud and Mechanisms to Address Fraud: Regulation and Corporate Governance	40
CHAPTER 3	Internal Control Over Financial Reporting: Responsibilities of Management and the External Auditors	84
CHAPTER 4	Professional Liability, Auditor Judgment Frameworks, and Professional Responsibilities	130
CHAPTER 5	Professional Auditing Standards and the Audit Opinion Formulation Process	180
CHAPTER 6	A Framework for Audit Evidence	228
CHAPTER 7	Planning the Audit: Identifying and Responding to the Risks of Material Misstatement	284
CHAPTER 8	Specialized Audit Tools: Sampling and Generalized Audit Software	340
CHAPTER 9	Auditing the Revenue Cycle	390
CHAPTER 10	Auditing Cash and Marketable Securities	470
CHAPTER 11	Auditing Inventory, Goods and Services, and Accounts Payable: The Acquisition and Payment Cycle	530

CHAPTER 12	Auditing Long-Lived Assets: Acquisition, Use, Impairment, and Disposal	596
CHAPTER 13	Auditing Debt Obligations and Stockholders' Equity Transactions	634
CHAPTER 14	Activities Required in Completing a Quality Audit	662
CHAPTER 15	Audit Reports on Financial Statements	720
CHAPTER 16	Advanced Topics Concerning Complex Auditing Judgments	770
CHAPTER 17	Other Services Provided by Audit Firms	826
	ACL Appendix	877
	Auditing Standards Appendix	893
	Case Index	899
	Auditing in Practice, Emerging Issues & Focus on Fraud Index	901
	Index	905



CONTENTS

PREFACE xxiii

ABOUT THE AUTHORS xxxv

CHAPTER 1

Auditing: Integral to the Economy 2

Overview of the External Auditing Profession 3

Introduction to the External Auditing Profession 3

External Auditing: A Special Function 4

The Need for Unbiased Reporting and Independent Assurance 6

Overall Objectives in Conducting an Audit 7

Overview of the Audit Opinion Formulation Process 7

Parties Involved in Preparing and Auditing Financial Statements 8

Providers of External Auditing Services 9

Skills and Knowledge Needed to Enter the External Auditing Profession 10

Organizations Affecting the External Auditing Profession 10

Audit Quality 14

Audit Firm Culture 15

Skills and Qualities of the Engagement Team 15

Effectiveness of the Audit Process 16

Reliability and Usefulness of Audit Reporting 17

Factors Outside the Control of Auditors That Affect Audit Quality 17

Achieving Audit Quality and Minimizing Lawsuits 17

Auditor Independence Requirements 17

Review Programs 21

Engagement Letters 22

Audit Firm Limitations 23

Audit Documentation 23

Client Acceptance and Continuance Decisions 23

Summary and Next Steps 28

Significant Terms	28
True/False Questions	30
Multiple-Choice Questions	31
Review and Short Case Questions	33
Fraud Focus: Contemporary and Historical Cases	36
Application Activities	38
Academic Research Cases	39

CHAPTER 2

The Auditor's Responsibilities Regarding Fraud and Mechanisms to Address Fraud: Regulation and Corporate Governance 40

Fraud Defined 42

Misstatements Arising from Misappropriation of Assets	42
Misstatements Arising from Fraudulent Financial Reporting	42

The Fraud Triangle 44

Incentives or Pressures to Commit Fraud	45
Opportunities to Commit Fraud	46
Rationalizing the Fraud	46

Recent History of Fraudulent Financial Reporting 47

Examples of Recent Frauds and Implications for External Auditors	47
The 2010 COSO Report	51
The Enron Fraud: A Key Driver of Regulatory Change	51

An Overview of the Auditor's Fraud-Related Responsibilities and Users' Expectations 53

Fraud-Related Requirements in Professional Auditing Standards	53
---	----

The Sarbanes-Oxley Act of 2002 as a Regulatory Response to Fraud 56

The Post Sarbanes-Oxley World: A Time of Improved Corporate Governance 60

What Is Corporate Governance?	60
Principles of Effective Corporate Governance	61
Responsibilities of Audit Committees	64
Summary and Next Steps	65
Significant Terms	66
True/False Questions	66
Multiple-Choice Questions	67
Review and Short Case Questions	69
Fraud Focus: Contemporary and Historical Cases	75
Application Activities	79
Academic Research Cases	81
Ford and Toyota	82

CHAPTER 3

Internal Control Over Financial Reporting: Responsibilities of Management and the External Auditors 84

Importance of Internal Control Over Financial Reporting 86

Defining Internal Control 86

Terminology: Entity-Wide Controls and Transaction Controls 87

Components and Principles of Internal Control 88

COSO Component: Control Environment 88

COSO Component: Risk Assessment 92

COSO Component: Control Activities 94

COSO Component: Information and Communication 98

COSO Component: Monitoring 99

Management's Responsibilities Related to Internal Control Over Financial Reporting 101

Management's Documentation of Internal Control 102

Management Reporting on Internal Control Over Financial
Reporting 102

Evaluating Internal Control Over Financial Reporting 104

Assessing Deficiencies in Internal Control Over Financial
Reporting 106

Importance of Internal Control to the External Audit 109

Example: Assessing Control Design Effectiveness, Implementation, and
Operating Effectiveness 109

Summary and Next Steps 111

Significant Terms 112

True/False Questions 114

Multiple-Choice Questions 115

Review and Short Case Questions 119

Fraud Focus: Contemporary and Historical Cases 126

Application Activities 127

Academic Research Cases 128

Ford and Toyota 129

CHAPTER 4

Professional Liability, Auditor Judgment Frameworks, and Professional Responsibilities 130

The Legal Environment and the Effects of Lawsuits on Audit Firms 132

Liability Doctrines 132

- Class Action Lawsuits 133
- Contingent-Fee Compensation for Lawyers 133
- Audits Viewed as an Insurance Policy: The Expectations Gap 134
- Applicable Laws and Causes of Legal Action 134**
- Laws from Which Auditor Liability Is Derived and Causes of Legal Action 134
- Parties that May Bring Suit Against Auditors 135
- Auditor Liability Under Contract Law, Common Law, and Statutory Law 136**
- Common-Law Liability to Clients: Breach of Contract 136
- Common-Law Liability to Third Parties 137
- Auditor Liability Under Statutory Law 139**
- Securities Act of 1933 139
- Securities Exchange Act of 1934 140
- Auditor Defenses and Possible Sanctions 141
- Summary of Auditor Liability to Third Parties Under Common and Statutory Law 142
- A Framework for Professional Decision Making 142**
- Importance of Professional Skepticism in Making Professional Judgments 145
- A Framework for Ethical Decision Making 148**
- Resolving Ethical Dilemmas 148
- Applying the Ethical Decision Making Framework 149
- Guidance on Professional Responsibilities and the Impact on Auditors' Decisions 152**
- IESBA's Code of Ethics 152
- AICPA's *Code of Professional Conduct* 153
- Other Guidance on Professional Responsibilities: Sarbanes-Oxley Act, PCAOB, and SEC 160
- Summary and Next Steps 164
- Significant Terms 164
- True/False Questions 166
- Multiple-Choice Questions 167
- Review and Short Case Questions 169
- Fraud Focus: Contemporary and Historical Cases 176
- Application Activities 177
- Academic Research Cases 179

CHAPTER 5

Professional Auditing Standards and the Audit Opinion Formulation Process 180

Professional Auditing Standards 182

Auditing Standards Issued by the AICPA	182
Auditing Standards Issued by the IAASB	183
Auditing Standards Issued by the PCAOB	183
Comparison of the Auditing Standards	183
Principles Underlying the Auditing Standards	184
The Audit Opinion Formulation Process	185
An Overview of the Phases in the Audit Opinion Formulation Process	186
Important Concepts Pervasive Throughout the Audit Opinion Formulation Process	188
Phase I—Making Client Acceptance and Continuance Decisions	192
Phase II—Performing Risk Assessment	193
Phase III—Obtaining Evidence About Internal Control Operating Effectiveness	198
Summary of Audit Decisions Prior to Determining Substantive Procedures	203
Phase IV—Obtaining Substantive Evidence About Accounts, Disclosures, and Assertions	205
Phase V—Completing the Audit and Making Reporting Decisions	208
Summary and Next Steps	210
Significant Terms	210
True/False Questions	211
Multiple-Choice Questions	212
Review and Short Case Questions	217
Fraud Focus: Contemporary and Historical Cases	223
Application Activities	226
Academic Research Case	227

CHAPTER 6

A Framework for Audit Evidence	228
Obtaining Sufficient Appropriate Audit Evidence	230
Appropriateness of Audit Evidence	231
Relevance of Audit Evidence	231
Reliability of Audit Evidence	234
Type and Timing of Audit Procedures	237
Type of Audit Procedures	237
Timing of Procedures	243
Performing Substantive Analytical Procedures	244
Sufficiency of Audit Evidence	250
Sample Sizes	252
Additional Evidence Considerations	253
Evidence Needed for Auditing Management Estimates	253
Using a Specialist/Expert to Assist with Obtaining Evidence	254
Evidence Needed for Related-Party Transactions	255

Documenting Audit Evidence 257

- Documenting Planning and Risk Assessment Procedures 257
- Documenting Audit Work Performed 258
- Documenting Significant Issues and Their Resolution 259
- Characteristics of Quality Audit Documentation 260
- Revisions and Retention of Audit Documentation 261
- Audit Programs 261
- Summary and Next Steps 262
- Significant Terms 262
- True/False Questions 264
- Multiple-Choice Questions 265
- Review and Short Case Questions 269
- Fraud Focus: Contemporary and Historical Cases 274
- Application Activities 277
- Academic Research Cases 280
- Ford and Toyota 282
- ACL 282

CHAPTER 7

Planning the Audit: Identifying and Responding to the Risks of Material Misstatement 284

The Concept of Materiality 286

- A Process for Making Materiality Judgments 287
- Levels of Materiality 288
- Qualitative Considerations 291

Identifying and Assessing Risks of Material Misstatement 292

- Assessing Factors Affecting Inherent Risk 293
- Assessing Factors Affecting Control Risk 302
- Using Planning Analytical Procedures to Assess the Risk of Material Misstatement 304

Responding to Identified Risks of Material Misstatement 308

- Determining Audit Risk and Detection Risk 308
- Planning Audit Procedures to Respond to the Assessed Risks of Material Misstatement 311
- Summary and Next Steps 314
- Significant Terms 314
- True/False Questions 316
- Multiple-Choice Questions 317
- Review and Short Case Questions 320

Fraud Focus: Contemporary and Historical Cases	329
Application Activities	336
Academic Research Cases	337
Ford and Toyota	339

CHAPTER 8

Specialized Audit Tools: Sampling and Generalized Audit Software 340

Overview of Sampling and GAS as Tools for Gathering Audit Evidence 342

Objectives of Sampling and Risks Associated with Sampling 343

Nonsampling and Sampling Risks 344

Nonstatistical and Statistical Sampling 346

Attributes Sampling 348

Steps in Attributes Sampling 348

Nonstatistical Sampling Approach to Testing Controls 359

Using Sampling to Gather Evidence About Misstatements in Account Balances and Associated Assertions 359

Steps in Sampling Account Balances and Associated Assertions 359

Nonstatistical Sampling for Substantive Tests of Account Balances and Associated Assertions 363

Statistical Sampling for Substantive Tests of Account Balances and Associated Assertions: Monetary Unit Sampling (MUS) 364

Using GAS to Obtain Evidence 372

Tasks Performed by GAS 373

Benefits of Using GAS 375

Summary and Next Steps 376

Significant Terms 376

True/False Questions 379

Multiple-Choice Questions 380

Review and Short Case Questions 382

Application Activities 389

Academic Research Case 389

CHAPTER 9

Auditing the Revenue Cycle 390

Significant Accounts, Disclosures, and Relevant Assertions 392

Processing Revenue Transactions 392

Performing Risk Assessment Procedures in the Revenue Cycle 396

- Identifying Inherent Risks 396
- Identifying Control Risks 403
- Performing Planning Analytical Procedures 406
- Responding to Identified Risks of Material Misstatement 410

Obtaining Evidence About Internal Control Operating Effectiveness in the Revenue Cycle 412

- Selecting Controls to Test and Performing Tests of Controls 412
- Considering the Results of Tests of Controls 413

Obtaining Substantive Evidence About Accounts, Disclosures, and Assertions in the Revenue Cycle 415

- Revenue and Accounts Receivable: Performing Substantive Analytical Procedures 416
- Revenue: Substantive Tests of Details 418
- Accounts Receivable: Substantive Procedures Based on the Aged Trial Balance 419
- Accounts Receivable: Substantive Tests of Details—Confirmations 419
- Accounts Receivable: Substantive Procedures for the Allowance Account 428
- Accounts Receivable: Other Substantive Procedures 429
- Performing Substantive Fraud-Related Procedures 430
- Documenting Substantive Procedures 431
- Summary and Next Steps 432
- Significant Terms 432
- True/False Questions 433
- Multiple-Choice Questions 434
- Review and Short Case Questions 437
- Fraud Focus: Contemporary and Historical Cases 452
- Application Activities 462
- Analytical Procedures: A Case in the Context of the Pharmaceutical Industry 464
- Academic Research Cases 466
- Ford and Toyota 468
- ACL 468

CHAPTER 10

Auditing Cash and Marketable Securities 470

Significant Accounts, Disclosures, and Relevant Assertions 472

- Overview of Cash Accounts 472
- Cash Management Techniques 473
- Relevant Financial Statement Assertions 474

Performing Risk Assessment Procedures for Cash Accounts 474

- Identifying Inherent Risks 474
- Identifying Control Risks 476
- Performing Planning Analytical Procedures 481
- Responding to Identified Risks of Material Misstatement 484

Obtaining Evidence About Internal Control Operating Effectiveness for Cash 485

- Selecting Controls to Test and Performing Tests of Controls 485
- Considering the Results of Tests of Controls 488

Obtaining Substantive Evidence About Cash Accounts, Disclosures, and Assertions 488

- Substantive Analytics for Cash Accounts 489
- Substantive Tests of Details for Cash Accounts 489

Auditing Marketable Securities 497

- Significant Accounts, Disclosures, and Relevant Assertions 497
- Performing Risk Assessment Procedures 498
- Obtaining Evidence About Internal Control Operating Effectiveness and Substantive Evidence About Marketable Securities Accounts, Disclosures, and Assertions 500
- Summary and Next Steps 504
- Significant Terms 504
- True/False Questions 505
- Multiple-Choice Questions 506
- Review and Short Case Questions 509
- Fraud Focus: Contemporary and Historical Cases 520
- Application Activities 527
- Academic Research Case 528
- Ford and Toyota 529

CHAPTER 11

Auditing Inventory, Goods and Services, and Accounts Payable: The Acquisition and Payment Cycle 530

Significant Accounts, Disclosures, and Relevant Assertions 532

- Activities Involved in the Acquisition and Payment Cycle 533
- Relevant Financial Statement Assertions 534

Performing Risk Assessment Procedures in the Acquisition and Payment Cycle 535

- Identifying Inherent Risks 535
- Identifying Control Risks 536
- Performing Planning Analytical Procedures 544
- Responding to Identified Risks of Material Misstatement 546

Obtaining Evidence About Internal Control Operating Effectiveness in the Acquisition and Payment Cycle 548

Selecting Controls to Test and Performing Tests of Controls 549

Considering the Results of Tests of Controls 549

Obtaining Substantive Evidence About Accounts, Disclosures, and Assertions in the Acquisition and Payment Cycle 550

Substantive Tests of Inventory and Cost of Goods Sold 550

Substantive Tests of Accounts Payable and Related Expense Accounts 562

Summary and Next Steps 568

Significant Terms 568

True/False Questions 569

Multiple-Choice Questions 570

Review and Short Case Questions 573

Fraud Focus: Contemporary and Historical Cases 584

Application Activities 588

Analytical Procedures: A Case in the Context of the Pharmaceutical Industry 590

Part I: Planning Analytical Procedures 591

Part II: Substantive Analytical Procedures 592

Academic Research Cases 592

Ford and Toyota 594

ACL 594

CHAPTER 12

Auditing Long-Lived Assets: Acquisition, Use, Impairment, and Disposal 596

Significant Accounts, Disclosures, and Relevant Assertions 598

Activities in the Long-Lived Asset Acquisition and Payment Cycle 598

Relevant Financial Statement Assertions 599

Performing Risk Assessment Procedures for Long-Lived Assets 599

Identifying Inherent Risks 599

Identifying Control Risks 601

Performing Planning Analytical Procedures 604

Responding to Identified Risks of Material Misstatement 605

Obtaining Evidence about Internal Control Operating Effectiveness for Long-Lived Asset Accounts and Related Expenses 606

Selecting Controls to Test and Performing Tests of Controls 606

Considering the Results of Tests of Controls 608

Obtaining Substantive Evidence about Accounts, Disclosures, and Assertions for Long-Lived Asset Accounts and Related Expenses 609

- Substantive Analytical Procedures 609
- Substantive Tests of Details for Tangible Assets—Testing Current-Period Additions 611
- Substantive Tests of Details for Tangible Assets—Testing Current-Period Deletions 612
- Substantive Procedures Related to Depreciation Expense and Accumulated Depreciation for Tangible Assets 614
- Substantive Tests of Details for Natural Resources and the Related Expense Accounts 614
- Substantive Tests of Details for Intangible Assets and the Related Expense Accounts 615
- Substantive Procedures Related to Asset Impairment 616
- Substantive Procedures Related to Leases 617
- Performing Substantive Fraud-Related Procedures 617
- Documenting Substantive Procedures 618
- Summary and Next Steps 618
- Significant Terms 618
- True/False Questions 619
- Multiple-Choice Questions 620
- Review and Short Case Questions 622
- Fraud Focus: Contemporary and Historical Cases 629
- Application Activities 631
- Academic Research Cases 632
- Ford and Toyota 633

CHAPTER 13

Auditing Debt Obligations and Stockholders' Equity Transactions 634

Significant Accounts, Disclosures, and Relevant Assertions 636

- Debt Obligations 636
- Stockholders' Equity 637

Performing Risk Assessment Procedures for Debt Obligations and Stockholders' Equity Transactions 639

- Identifying Inherent Risks 639
- Identifying Fraud Risk Factors 639
- Identifying Control Risks 639
- Performing Planning Analytical Procedures 642
- Responding to Identified Risks of Material Misstatement 643

Obtaining Evidence About Internal Control Operating Effectiveness for Debt Obligations and Stockholders' Equity Transactions 643

Obtaining Substantive Evidence in Auditing Debt Obligations and Stockholders' Equity Transactions 643

- Substantive Analytical Procedures—Debt Obligations 644
- Substantive Tests of Details—Debt Obligations 645
- Substantive Tests of Details—Stockholders' Equity Transactions 646
- Performing Substantive Fraud-Related Procedures 648
- Documenting Substantive Procedures 649
- Summary and Next Steps 649
- Significant Terms 650
- True/False Questions 650
- Multiple-Choice Questions 651
- Review and Short Case Questions 653
- Fraud Focus: Contemporary and Historical Cases 656
- Application Activities 658
- Analytical Procedures: A Case in the Context of the Pharmaceutical Industry 659
- Academic Research Case 661

CHAPTER 14

Activities Required in Completing a Quality Audit 662

Review Activities 664

- Reviewing, Summarizing, and Resolving Detected Misstatements 664
- Reviewing and Assessing Contingencies 668
- Reviewing and Assessing Significant Estimates 670
- Reviewing the Adequacy of Disclosures 672
- Reviewing and Assessing Clients' Noncompliance with Laws and Regulations 675
- Evaluating the Going-Concern Assumption 677
- Performing Review Analytical Procedures 680
- Reviewing and Evaluating Management Representations 683
- Reviewing and Assessing Subsequent Events and Subsequently Discovered Facts 683
- Performing an Engagement Quality Review 689
- Consideration of Omitted Procedures Discovered After the Report Date 690

Communicating with Management and the Audit Committee (and Those Charged with Governance) 691

- Communicating with the Audit Committee 691
- Communicating with Management via the Management Letter 694
- Summary and Next Steps 694

Significant Terms	694
True/False Questions	695
Multiple-Choice Questions	697
Review and Short Case Questions	703
Fraud Focus: Contemporary and Historical Cases	710
Application Activities	715
Academic Research Case	718
Ford and Toyota	719

CHAPTER 15

Audit Reports on Financial Statements 720

Principles Underlying Audit Reporting 722

Standard Unqualified Audit Reports on Financial Statements 723

Standard Unqualified Audit Reports: U.S. Public Companies 723

Standard Unqualified Audit Reports: U.S. Nonpublic Companies and Non-U.S. Companies 728

Unqualified Audit Reports with Explanatory Language 729

Explanatory Language: Justified Departure from GAAP 731

Explanatory Language: Inconsistent Application of GAAP 732

Explanatory Language: Substantial Doubt About the Client Being a Going Concern 732

Explanatory Language: Emphasis of a Matter 734

Explanatory Language: Reference to Other Auditors (Group Audits and Component Auditors) 735

Qualified Reports, Adverse Reports, and Disclaimers 738

Qualified Audit Reports 739

Adverse Audit Reports 742

Audit Reports with a Disclaimer of Opinion 743

Comparisons of Modifications to the Standard Unqualified Audit Report 745

Audit Reports on Internal Control Over Financial Reporting 746

Elements of Management's Annual Report on Internal Control Are Incomplete or Improperly Presented 746

Restriction on the Scope of the Engagement 746

Auditor Refers to the Report of Other Auditors as the Basis, in Part, for the Auditor's Own Report 746

Other Information Contained in Management's Annual Report on ICFR 748

Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act Is Misstated	749
Summary and Next Steps	749
Significant Terms	749
True/False Questions	750
Multiple-Choice Questions	751
Review and Short Case Questions	754
Fraud Focus: Contemporary and Historical Cases	764
Application Activities	766
Academic Research Cases	767
Ford and Toyota	769

CHAPTER 16

Advanced Topics Concerning Complex Auditing Judgments 770

Complex Auditing Judgments 773

Identifying Complex Judgments in the Financial Statements 773

Evaluating Misstatements 775

Subjective Differences between the Auditor and the Client 776

Aggregating and Netting Misstatements 776

Intentional Misstatements 776

Considerations Regarding Selective Correction of Misstatements 777

Considering Misstatements in the Statement of Cash Flows 777

Regulatory Guidance Concerning Materiality Judgments 777

Assessing Long-Term Liabilities Involving Significant Subjective Judgment 778

Warranty Reserves 778

Pension Obligations and Other Postemployment Benefits 779

Auditing Merger and Acquisition Activities 781

Valuing the Assets and Liabilities of an Acquisition 781

Measuring Restructuring Charges 783

Auditing Management's Fair Value Estimates and Related Impairment Judgments 784

The Accounting Model for Fair Value Estimates 785

Audit Considerations for Fair Market Estimates and Related Impairments 789

Auditing Financial Instruments 792

Overview of Financial Instruments 792

Audit Considerations for Financial Instruments 794

Evaluating a Client's Internal Audit Function 797

An Overview of Internal Auditing 797

Evaluating the Quality of the Client’s Internal Audit Function	801
Summary and Next Steps	804
Significant Terms	805
True/False Questions	806
Multiple-Choice Questions	807
Review and Short Case Questions	809
Fraud Focus: Contemporary and Historical Cases	819
Application Activities	820
Academic Research Cases	822
Ford and Toyota	824
ACL	824
Using ACL to Perform Benford Analysis	824

CHAPTER 17

Other Services Provided by Audit Firms 826

Nonaudit Attestation Services Provided by Audit Firms 827

Subject Matter of an Attestation Engagement	827
Components of Attestation Services and Parties Involved in Attestation Services	828
Levels of Assurance Provided in an Attestation Engagement	828
Professional Standards for Attestation Engagements	829

Reviews and Compilations 830

Reviews	831
Compilations	833

Reviews of Interim Financial Information for Audit Clients 837

Review Procedures for Interim Financial Information	837
Reporting on Interim Financial Statements	837

Special Considerations for Reporting 839

AU-C 800: Special Considerations—Audits of Financial Statements Prepared in Accordance with Special-Purpose Frameworks	839
AU-C 805: Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement	843
AU-C 806: Reporting on Compliance with Aspects of Contractual Agreements or Regulatory Requirements in Connection with Audited Financial Statements	845

Attestation on Agreed-Upon Procedures, Financial Forecasts and Projections, and Pro Forma Financial Information 847

Agreed-Upon Procedures Engagements (SSAEs No. 10 and 11, AT 201)	847
--	-----

Financial Forecasts and Projections (SSAEs No. 10 and 17, AT 301)	848
Reporting on Pro Forma Financial Information (SSAE No. 10, AT Section 401)	852
Forensic Accounting	854
Sustainability Reporting and Assurance	856
Reporting on Sustainability Activities and Outcomes	858
Providing Assurance on Sustainability Reporting	859
Summary	865
Significant Terms	865
True/False Questions	867
Multiple-Choice Questions	868
Review and Short Case Questions	871
Application Activities	875
Academic Research Case	876
ACL APPENDIX	877
AUDITING STANDARDS APPENDIX	893
CASE INDEX	899
AUDITING IN PRACTICE, EMERGING ISSUES & FOCUS ON FRAUD INDEX	901
INDEX	905



PREFACE

The auditing environment continues to change in dramatic ways, and university graduates entering the profession must be prepared for a high standard of responsibility. Examples of recent and emerging changes include:

- The American Institute of Certified Public Accountants (AICPA) completed its project to clarify its auditing standards with the issuance of Statement on Auditing Standards No. 128, *Using the Work of Internal Auditors*, in 2014.
- The International Auditing and Assurance Standards Board (IAASB) completed its project to clarify its auditing standards and revised some of its clarity standards in 2013.
- The Public Company Accounting Oversight Board (PCAOB) has now issued eighteen Auditing Standards, with the adoption of Auditing Standard No. 18 – *Related Parties*, in 2014.
- The AICPA has a current project to clarify its attestation standards, with approval of the final standards expected in 2015. As part the attestation clarity project, the ASB will continue its general strategy of converging its standards with the standards of the IAASB.
- The AICPA’s Professional Ethics Executive Committee (PEEC) adopted a revised *Code of Professional Conduct* in January 2014, with an effective date of December 15, 2014. Additionally, the *Code* includes two conceptual frameworks with a delayed effective date of December 15, 2015.
- The PCAOB and the IAASB are each considering substantial revisions to the content of the standard audit report.
- The Committee of Sponsoring Organizations (COSO) of the Treadway Commission issued an updated *Internal Control–Integrated Framework* in 2013.

The tenth edition of *Auditing: A Risk-Based Approach to Conducting a Quality Audit* represents the most up-to-date professional guidance available, and reflects the clarified auditing standards of the IAASB and the AICPA and the newest PCAOB standards. It discusses COSO’s updated *Internal Control–Integrated Framework* and integrates discussions of fraud risk throughout the textbook. In short, the tenth edition helps students understand the full range of auditing issues in the evolving global environment.

Just as significantly, the tenth edition features updated end-of-chapter materials and associated online content with grading guidance that have been developed to help students prepare for exams and understand real-life auditing scenarios. This material is updated, streamlined, and user friendly, with each problem linked to a specific learning objective. In addition, students will gain valuable experience by using the professional ACL auditing software that is packaged with each new textbook. New end-of-chapter features include

a *Fraud Focus: Contemporary and Historical Cases* section that highlights contemporary and historical fraud-related cases, a multi-chapter analytical procedures case problem whereby students will gain experience performing analytical procedures, and auditing standards application problems that provide students with practice at completing task-based simulations similar to what they will see on the CPA exam.

Revision Themes and Enhancements of the Tenth Edition

1. **Extended coverage of analytical procedures.** The textbook now contains updated and extended coverage of planning, substantive, and review-related analytical procedures. Updated *Chapter 6* and *Chapter 7* contain discussion of analytical procedures, processes, and best practices, and an end-of-chapter case in the pharmaceutical industry (*Chapters 9, 11, and 13*) is now included, with online excel files containing underlying data.
2. **Online student materials.** Select end-of-chapter materials now contain online student-led problems that enable student interaction and self-grading. This feature will enable integration with a “flipped classroom” approach to instruction and learning.
3. **Student Access to CPA Exam Questions.** With the purchase of this textbook, students receive exclusive access to Roger’s CPA Review (rogerCPAreview.com). Roger’s CPA review questions are also available in the Instructor’s Resource Center, as well as assignable content in CengageNOW.
4. **Auditing Standards Application Problems.** The textbook contains a *Standards Appendix*, and new end-of-chapter homework problems requiring students to review and apply the material in the *Standards Appendix*. These problems provide students with practice at completing task-based simulations similar to what they will see on the CPA exam; they are highlighted with an identifying icon.
5. **Emerging Issues.** A new feature, *Emerging Issues*, is included throughout most chapters and contains up-to-date discussion of contemporary issues to keep students and instructors focused on new trends.
6. **Enhanced Focus on Fraud.** A new feature, *Focus on Fraud*, is included throughout most chapters to highlight fraud-related implications for the audit. End-of-chapter materials include a “Fraud Focus: Contemporary and Historical Cases” section that highlights contemporary and historical fraud-related cases.
7. **Audit Practice Case.** New online content that features very extensive audit working papers and data analysis task requirements is included in the online materials for the textbook. Look for this case at the textbook web site, where the case is located. See “Brony’s Bikes.”
8. **Improved Test Bank.** Tagging for all questions in the Test Bank has been updated to include: Learning Objective, AICPA, Level of Difficulty, accreditation body tagging, and Bloom’s Taxonomy.
9. **Two PowerPoint slide decks for each chapter.** Each chapter now contains a detailed PowerPoint slide deck for instructor use, and a less detailed PowerPoint slide deck for student use. This feature will enable integration with a “flipped classroom” approach to instruction and learning.

Hallmark Pedagogical Features

Continued emphasis on professional skepticism. This emphasis provides students with the tools to learn how to apply the concept of professional skepticism. This edition contains an introduction to this topic in *Chapter 1* as well as in end-of-chapter materials throughout the text, which are highlighted with an identifying icon. This emphasis helps students see the practical application of this concept.

Continued emphasis on professional judgment. In addition to the focus on professional judgment in this textbook, numerous exercises emphasize this key auditing skill, including analyses of Ford's and Toyota's SEC filings and proxy statements. Further, the end-of-chapter materials help ensure that students understand the link between mandatory financial reporting and auditing, risk assessment, transaction cycles, and analytical procedures.

Professional Judgment in Context feature. Each chapter opens with a real-life example from practice that illustrates the judgments involved in auditing. The examples tie to the learning objectives in the chapter and address important topics such as fraud, regulation, audit quality, auditing standards, and professional skepticism. The following provides an example of this feature that is included in *Chapter 5*.

PROFESSIONAL JUDGMENT IN CONTEXT

The Importance of Adhering to Professional Auditing Standards as Illustrated in the Audits Performed by Sherb & Co. LLP

Auditors who adhere to the professional auditing standards are viewed as conducting a quality audit. A lack of adherence to the professional auditing standards heightens the risk that the auditor will provide an unqualified audit opinion on financial statements that are materially misstated. This lesson is highlighted in audits provided by Sherb & Co. LLP. In November 2013, the Securities and Exchange Commission (SEC) announced sanctions against the New York-based audit firm, its founder, two other partners, and an audit manager for their roles in the failed audits of three China-based companies publicly traded in the United States. One of the companies they audited—China Sky One Medical, Inc.—has since been charged by the SEC with financial fraud.

An SEC investigation found that Sherb & Co. LLP, and its auditors, falsely represented in audit reports that they had conducted their audits in accordance with U.S. auditing standards. However, Sherb failed to properly plan and execute audits; failed to obtain sufficient audit evidence on sales, revenue, and bank balances; and ignored factors suggesting the presence of fraud. Further, the auditors failed to exercise professional skepticism and due care. They also failed to maintain complete documentation of their audit work.

To settle the SEC's charges, the firm and the four auditors agreed to be barred from practicing as

accountants for any publicly traded company regulated by the SEC. The firm also agreed to pay a \$75,000 penalty.

The co-director of the SEC's Division of Enforcement indicated that the firm and its auditors failed to live up to their professional obligations in multiple audits during a five-year period.

As you read through this chapter, consider the following questions:

- What is the role of auditing standards and their underlying principles in promoting a quality audit? (LO 1, 2)
- How does the fundamental concept of professional skepticism relate to audit quality? (LO 2)
- What audit evidence is necessary for opining on a client's financial statements? (LO 6)
- How does audit documentation provide evidence related to audit quality? (LO 7)
- What audit activities are conducted during the audit opinion formulation process to provide reasonable assurance about a client's financial statements? (LO 8, 9, 10, 11, 12)
- How does professional judgment and ethical decision making contribute to audit quality? (LO 13)

For further details on this case, see Securities and Exchange Commission Accounting and Auditing Enforcement Release No. 3512 (November 2013).

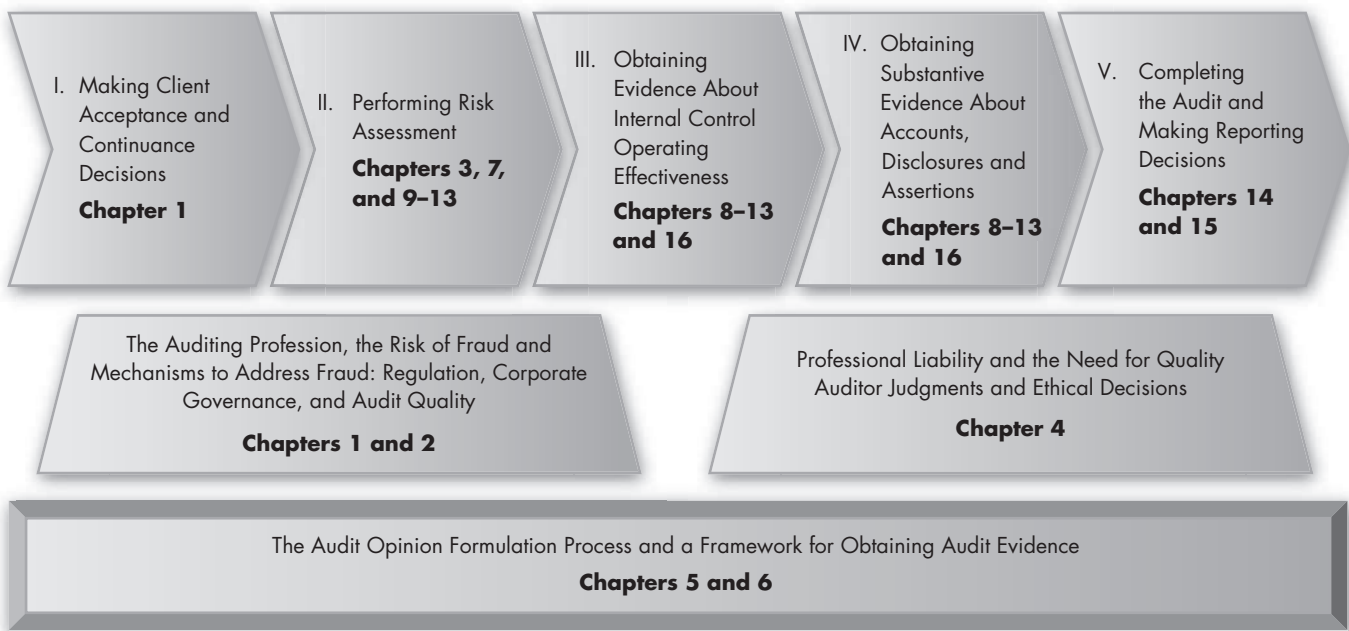
Professional decision-making and ethical decision-making frameworks. Decision-making frameworks, complete with a chapter-opening *Professional Judgment in Context* feature, require students to think about real-life professional and ethical decisions associated with that chapter. End-of-chapter materials continue the use of these professional and ethical decision-making

frameworks to help students address contemporary issues. These problems are marked with identifying icons.

Continued emphasis on the audit opinion formulation process to help organize study. A chapter-opening *Audit Opinion Formulation Process* figure helps students identify the major phases in the audit process and see how those steps within that process relate to specific chapters.

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

Also fundamental to students' understanding is the framework's inclusion of the auditing profession, fraud, regulation, corporate governance, and audit quality. Further fundamentals highlighted in the *Audit Opinion Formulation Process* include discussion of professional liability and the need for quality audit judgments and ethical decisions, as depicted below.



Auditing in Practice features, *Focus on Fraud* features, *Emerging Issues* features, and chapter exhibits. Chapters contain multiple *Auditing in Practice* features, *Focus on Fraud* features, *Emerging Issues* features, and exhibits that highlight important, relevant, and practical examples and information related to chapter topics. Selected end-of-chapter materials require students to review these features and exhibits to answer related questions. Below is an example of an *Auditing in Practice* feature from *Chapter 1*.

Why Is Owning Stock in an Audit Client Unacceptable?

AUDITING IN PRACTICE

In 2005, Susan Birkert was an audit senior working for KPMG on the audit engagement of Comtech Corporation. One of Susan's friends asked her whether she thought that Comtech stock was a good investment. She responded that, indeed, it was a good investment. At that point, her friend asked if she would like him to purchase Comtech stock on her behalf. She agreed and gave her friend \$5,000 to make the purchase under his name rather than hers. She did so because she was aware that owning stock in one's audit client is not allowed because of independence concerns. If auditors own stock in their audit clients, they are not independent of their clients because they are part owners. Therefore, rather than acting in an unbiased manner during the conduct of the audit, they might make judgments that favor the client company rather than

external users of the financial statements. Even if the auditor does not actually behave in a biased manner and is independent in fact, external users may *perceive* an independence conflict—the auditor would not be independent in appearance.

Susan continued working on the Comtech engagement well into 2006, and she lied when she responded to KPMG's yearly written requirements to comply with the firm's independence policies. Prompted by an anonymous tip later in 2006, KPMG launched an internal investigation into the matter and terminated her employment. The PCAOB barred her from serving as an external auditor for a period of at least one year.

For further details on this case, see PCAOB Release No. 105-2007-003.

Following is an example of an *Emerging Issues* feature from *Chapter 6*.

PCAOB Considers Change in Auditing Standard for Auditing Estimates

EMERGING ISSUE

In response to issues identified during the inspection of accounting firms, comments received from members of the PCAOB Standing Advisory Group (SAG), and the Financial Accounting Standards Board's (FASB) proposed accounting standard on financial instruments, the PCAOB staff began drafting a proposal for a standard on auditing

accounting estimates, including fair value measurements and related disclosures. The Board anticipates proposing a standard for public comment during 2014. Timing of standard-setting projects is subject to change. Be sure to check the PCAOB web site for updates on this emerging issue.