Principles of Auditing & Other Assurance Services

O. Ray Whittington

Kurt Pany

Mc Graw Hill Education

Twenty First Edition

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Twenty-first Edition

O. Ray Whittington
CIA, CMA, CPA
DePaul University

Kurt Pany
CFE, CPA
Arizona State University

Mc Graw Hill Education

PRINCIPLES OF AUDITING & OTHER ASSURANCE SERVICES, TWENTY FIRST EDITION

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About the Authors

O. Ray Whittington

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

Kurt Pany

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

Preface

The 21st edition of *Principles of Auditing & Other Assurance Services* provides a carefully balanced presentation of auditing theory and practice. Written in a clear and understandable manner, it is particularly appropriate for students who have had limited or no audit experience. The approach is to integrate auditing material with that of previous accounting financial, managerial, and systems courses.

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

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

1. **A balanced presentation.** The text provides a carefully balanced presentation of auditing and assurance theory and practice. The concepts are written in a clear, concise, and understandable manner. Real company examples are integrated throughout the text to bring this material to life. Finally, Keystone Computers & Networks, Inc., the text's illustrative audit case, is integrated into selected chapters, providing students with hands-on audit experience.
2. **Organization around balance sheet accounts emphasized in previous accounting courses.** Organizing the text around balance sheet accounts is a particularly straightforward and user-friendly way to address the risk assessment–based approach to auditing required by both U.S. and international auditing standards. These standards require an in-depth understanding of the audited company and its environment, a rigorous assessment of the risks of where and how the financial statements could be materially misstated, and an improved linkage between the auditors' assessed risks and the particulars of audit procedures performed in response to those risks. Chapters 5 through 7 of the text describe the risk assessment approach in detail. Chapters 10 through 16 are aligned with the risk assessment approach presented in the professional standards. Accordingly, the suggested audit approach and procedures of the professional standards flow smoothly from the approach suggested in earlier chapters of the text. In short, our organization of the book facilitates student learning of the risk assessment process in a very straightforward manner. Also, although the text chapters are structured around balance sheet accounts, they include a significant amount of material on transaction cycles. For example, Chapter 14 includes detailed coverage of revenue, cash receipts, acquisitions, and disbursements cycles.

3. **CPA examination support.** The text's emphasis on current auditing standards, its many author-created objective questions (including document review simulations), and a new partnership with Roger CPA Review are all aimed at helping students pass the CPA exam. As discussed in detail in the following section, this edition has significantly expanded the number of simulations like the ones included on the CPA exam, with several now included in *Connect*®.
4. **Strong student and instructor support.** McGraw-Hill's *Connect*® and its vast array of instructor and student resources provide a wealth of material to help keep students up to date. Instructor Resources can be accessed at www.mhhe.com/whittington21e as well as Connect.

We are confident that the 21st edition of *Principles of Auditing & Other Assurance Services* will provide students with a clear perspective of today's auditing environment.

O. Ray Whittington
Kurt Pany

Key Features of the Book

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

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

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

Chapter 3: Updated to reflect the most recent AICPA and PCAOB requirements. This includes detailed coverage of the AICPA Code of Professional Conduct and more research-oriented questions. Additional problems requiring an electronic search of the AICPA Code of Professional Conduct are included.

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

Chapters 5 through 7: Material from the risk assessment standards is thoroughly integrated throughout.

Chapter 5: A discussion of the nature of audit evidence. New coverage of data analytics as applied to auditing.

Chapter 6: The risk assessment approach to an audit is concisely summarized in a summary of the audit process.

Chapter 7: Discusses internal control and how it is considered in an audit of financial statements. The 2017 revised COSO Enterprise Risk Management Framework is incorporated. The chapter also includes a brief overview of integrated audits (audits of internal control integrated with financial statement audits) required for certain public companies under PCAOB Auditing Standards, with more detailed coverage provided in Chapter 18. The chapter includes a section on the audit requirements for that increasingly frequent situation in which a client outsources its data processing to a service organization. Finally, it presents the auditors' internal control communication responsibilities.

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

This edition of the text has expanded the number of simulations included in the after-chapter problem material. New are five document review simulations that are based on that new type of simulation included on the CPA exam; these simulaions all relate to the text's integrated case, Keystone Computers & Networks, Inc. All simulations in the text are designed to help students both to learn the material presented and to prepare them to complete such questions on the CPA exam. Many of the simulations are adapted from CPA exam questions released by the AICPA, and others were written by the authors to be similar to those released by the AICPA.

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

Chapter 8: Emphasizes the impact of IT on audits.This chapter has been completely updated for the 21st edition, incorporating suggestions by George Easton, PhD, Emeritus Professor of MIS, San Diego State University.

Chapter 9: Includes attributes and variables sampling. For variables sampling there are stand-alone discussions of classical methods and monetary unit sampling. Many of the problems may be solved either manually or electronically using generalized audit software.

Chapters 10 through 16: These "procedural chapters" deal with internal control and obtaining audit evidence for the various financial statement amounts. The chapters emphasize the risk-based approach stressed in recent AICPA, PCAOB, and international standards. New in these chapters is discussion of data analytical evidence-gathering techniques and Chapter 11's incorporation of the recently issued FASB revenue recognition standard.

Chapter 17: Reflects the new PCAOB reporting standards and the AICPA standards (as well as an appendix on likely future AICPA reporting standard changes). The chapter is heavily revised to reflect recent changes in audit reporting requirements, including the going concern reporting area.

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

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

Chapter 20: Discusses a variety of attestation and other assurance services. The material on attestation services describes the current professional standards. Recent pronouncements on service organization control (SOC) reports are included. Other assurance services are included at both the conceptual and practical levels.

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

New to This Edition

The 21st edition has been revised to reflect a number of events and to update and improve presentations of material, including

- ***Audit Reports—Form Changes.*** In 2017 the Public Company Accounting Standards Board (PCAOB) revised its standard audit report, a revision described by its chair as the first significant change in more than 70 years. Changed are both the report's form (e.g., it begins with the opinion and basis for opinion sections) and its content (e.g., it includes critical audit matters and a more detailed description of audits and auditor responsibilities). PCAOB adoption of a revised standard audit report follows changes adopted by the International Auditing and Assurance Standards Board (IAASB); also, the AICPA's Auditing Standards Board is considering changes. The newly adopted PCAOB and IAASB reports are presented in Chapter 2 and the new PCAOB audit reporting requirements are emphasized further in Chapters 17 and 18.
- ***Audit Reports—Nonpublic Company Reports.*** A new appendix to Chapter 17 highlights the potential future changes in the Auditing Standards Board's audit reporting requirements currently being considered for nonpublic company audit reporting. When changes are adopted, we intend to quickly issue a revised Chapter 17 that incorporates and compares the new PCAOB and Auditing Standards Board reporting requirements.
- ***Audit Reports—Presentation of Critical (Key) Audit Matters.*** The Public Company Accounting Oversight Board and the International Auditing and Assurance Standard Board audit reports require that auditors report on critical audit matters (or key audit matters) in audits of public companies. The text presents this topic in detail in Chapter 17.
- ***Data Analytics.*** The public accounting profession is rapidly incorporating the use of sophisticated data analytics into audits. Accordingly, a number of sections of the text have been revised to emphasize this development. Chapter 5 presents an overview of data analytics, both in business in general and in public accounting. Subsequently, data analytics is considered in the "procedural chapters," Chapters 10 through 16. In addition, a number of new data analytic exercises and problems have been included in the text and generalized audit software data analytical problems (see below) have been updated.
- ***Narrated PowerPoints.*** Narration has been added to the PowerPoints. This may be particularly helpful to the instructor developing either an online or a hybrid (online plus live) course. Also, these items may be made available for students in traditional courses to study from on their own time.
- ***Generalized Audit Software.*** Consistent with the text's increased coverage of data analytics in the various chapters, the data analytical procedures using generalized audit software have been updated and expanded. These materials are available in Connect and in the Instructor and Student Resources. Stand-alone modules for IDEA software (1) overall skills and (2) sampling are provided, while audit sampling exercises are provided for ACL.
- ***Document Review Simulations.*** For many years, the text has been a leader in including simulations such as those that appear on the CPA exam—both those released by the AICPA and author constructed. Beginning in 2016, the CPA exam started including a number of *document review simulations*, meant to test candidate application, analysis, and/or evaluation skills. A document review simulation presents a realistic document as well as related source materials requiring student review. Ordinarily, highlighted words, phrases, or a sentence in the document may or may not be correct, requiring the candidate to select appropriate edits based on the relevant source materials. We have written such simulations and included them in the text's integrated case, Keystone Computers & Networks, Inc. in Chapters 10, 11, 12, 14, and 17. These simulations are presented and may be answered using the text alone or with Connect, in a more realistic CPA exam-like format. Several of these also are offered as auto-graded within Connect.
- ***Update of Chapter 8, Consideration of Internal Control in an Information Technology Environment.*** Years ago almost all paper ledger and journal systems were replaced by computerized processing, often processed in batches of like transactions. More recently, information processing has evolved to such systems as online computer systems, shared service centers, and, now, cloud-based accounting systems. Auditors may encounter any number of such IT infrastructures. Chapter 8 provides an updated overview based on suggestions by George Easton, PhD, Emeritus Professor of MIS, San Diego State University.

Additional changes include

- ***FASB Revenue Recognition Standard.*** Chapter 11 discusses the FASB's new revenue recognition standard and related audit requirements.
- ***Reporting on Going Concern Status.*** Chapter 17 clearly discusses changes in both accounting and auditing requirements for client going concern status.
- ***Audit Sampling.*** Chapter 9's discussion of mean-per-unit sampling is simplified and more intuitive. The term *monetary unit sampling (MUS)* replaces the term *probability-proportional-to-size (PPS) sampling* in Appendix 9A.
- ***Evaluating Audit Findings.*** Chapter 16's discussion of aggregating and evaluating uncorrected misstatements is updated and completely aligned with the most recent relevant audit guides.
- ***Increased Number of Professional Ethics Research Questions.*** Chapter 4 includes additional questions that require students to research professional ethics questions using the AICPA Code of Professional Conduct rather than the text discussion.
- ***Standards Recodification.*** Both the PCAOB Auditing Standards and the AICPA Attestation Standards recently have been recodified. The text's references throughout are to the recodification section numbers.
- ***COSO Enterprise Risk Management Framework.*** Chapter 7 is updated to include the 2017 Enterprise Risk Management Framework.
- ***International Standards for the Professional Practice of Internal Auditing and Compliance Auditing Requirements.*** The 2016 updating of the standards is reflected in Chapter 21 of this edition, as well as the current OMB Compliance Supplement.

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 either are directly from the AICPA or are modeled on AICPA questions that appear in the exam. Instructors may assign the auto-gradable Roger CPA Review multiple-choice questions in Connect, and 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 his or her 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.

Text Features

Illustrative Cases

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

Illustrative Case *Indirect Financial Interests*

A covered member who owns shares in a mutual fund has a direct financial interest in the mutual fund, and an indirect financial interest in the mutual fund's investments. Thus, a covered member could not be involved in the audit of the mutual fund itself due to the direct financial interest. Concerning the mutual fund's investments in companies potentially audited by the covered member's firm, the following apply:

1. Ownership of 5% or less of the outstanding shares of a

The following illustrates how to evaluate whether the underlying investment is material to a *covered member's* net worth. Assume:

- Jano Mutual Fund, a diversified fund, has net assets of $10 million, composed of an investment in shares of client Apple and a variety of other investments.
- The *covered member* owns 6 percent of the outstanding shares of Jano Mutual Fund (a value of $600,000).
- Jano Mutual Fund has 2 percent of its assets invested in Apple (a $200,000 investment).

In this situation, the *covered membe* ... *financial inter-*

Industry Focus Cases

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

Focus on the Airline Industry

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

Auditing Fair Value Information

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

Audit Objectives

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

Primary Audit Objectives:
Valuation ☑
Accuracy ☑

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

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

Primary Audit Objectives:
Existence ☑

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

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

Fraud

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

Errors and Fraud

Auditing standards define **errors** as unintentional misstatements or omissions of amounts or disclosures in the financial statements. Errors may involve mistakes in gathering or processing data, unreasonable accounting estimates arising from oversight or misinterpretation of facts, or mistakes in the application of applicable accounting principles.

Fraud, as the term is used in financial statement auditing (AICPA AU-C 240; PCAOB AS 2401), relates to *intentional* acts that cause a misstatement of the financial statements. Misstatements due to fraud may occur due to either (1) fraudulent financial reporting or (2) misappropriation of assets (also referred to as "defalcation").

END-OF-CHAPTER MATERIAL

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

Review Questions

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

Questions Requiring Analysis

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

Objective Questions

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

Document Review Simulations

A document review simulation presents a realistic document as well as related source materials requiring candidate review. These simulations, new to the CPA exam in 2016 as indicated earlier in the New to This Edition section, ordinarily include highlighted words, phrases, or sentences in the document that may or may not be correct, requiring the candidate to select appropriate edits based on the relevant source documents. We have written a number of such simulations and included them in the text's integrated case, **Keystone Computers & Networks, Inc.**, in Chapters 10, 11, 12, 14, and 17. These simulations are available for assignment within McGraw-Hill's online homework management system, *Connect*.

Problems

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

In-Class Team Cases

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

In-Class Team Case LO 2-3

2–38. Hide-It (HI), a family-owned business based in Tombstone, Arizona, builds custom homes with special features, such as hidden rooms and hidden wall safes. Hide-It has been an audit client for three years.

You are about to sign off on a "clean" opinion on HI's current annual financial statements when Art Hyde, the VP-Finance, calls to tell you that the Arizona Department of Revenue has seized control of a Hide-It bank account that includes about $450,000 of company funds; the account is not currently recorded in the accounting system and you had been unaware of it. In response to your questions about the origin of the funds, Art assures you that the funds, though not recorded as revenue, had been obtained legitimately. He explains that all of the

Research and Discussion Cases

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

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

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

Ethics Cases

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

Ethics Cases

LO 11-1, 2, 6

11–50. You are an assistant auditor with Zaird & Associates, CPAs. Universal Air (UA), your fifth audit client in your eight months with Zaird, is a national airline based in your hometown. UA has continued to grow while remaining healthy financially over the eight years of its existence. Indeed, as you start the audit, you notice that (unaudited) sales are up 30 percent this year (20X1), with earnings up 40 percent. Your firm, Zaird & Associates, has been UA's only auditor.

During the audit you noticed that UA records sales when tickets are sold—debit receivable (or cash), credit sales. In performing substantive procedures relating to receivables, you also

Illustrative Audit Case Exercises

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

Appendix **6C**

Illustrative Audit Case: Keystone Computers & Networks, Inc.

Part I: Audit Planning

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

Spreadsheet Templates

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

LO 6-3, 4 6C–4. The working paper for Keystone Computers & Networks' analytical review ratios is presented in this appendix.

Required:

a. Recalculate the 12/31/X5 ratios using Excel.

b. After completing part (*a*), review the ratios and identify financial statement accounts that should be investigated because the related ratios are not comparable to prior-year ratios, industry averages, or your knowledge of the company.

c. For each account identified in part (*b*), list potential reasons for the unexpected account balances and related ratios.

Internet Assignments

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

LO 6-3 6–37. Perform an Internet search to access the text of the Securities Exchange Act of 1934. Read and summarize the internal control requirements of Section 13(b)(2) of the act.

Required:

Audit Software Assignments

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

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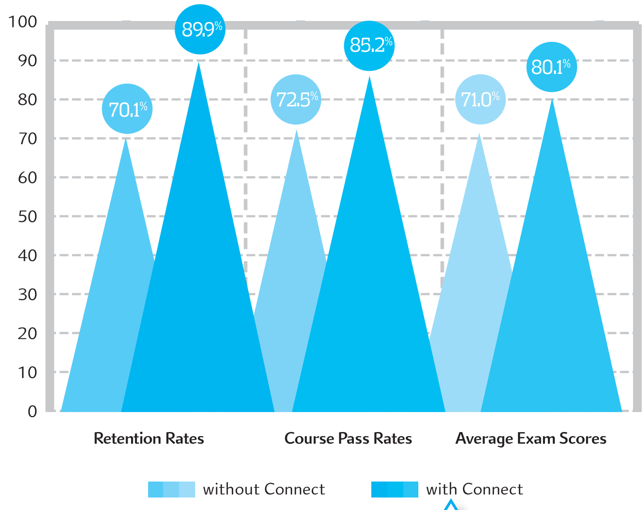

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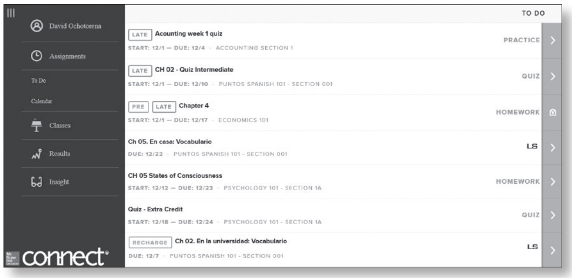

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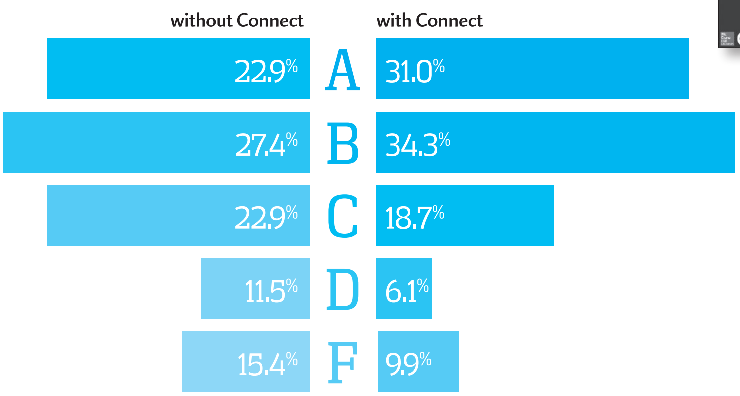

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REFERENCES TO AUTHORITATIVE SOURCES

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

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Ann Brooks
University of New Mexico

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Southern Oregon University

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Fred Christensen
Boise State University

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John Corless
California State University at Sacramento

Naman Desai
University of Central Florida

Martha Doran
San Diego State University

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Hans Dykxhoorn
Western Michigan University

Thomas English
Boise State University

Ruth Epps
Virginia Commonwealth University

Magdy Farag
Cal Poly, Pomona

Gary Frank
University of Akron

Diana Franz
University of Toledo

Lori R. Fuller
University of Delaware

Julie Ann Gardner-Treloar
UCLA

Jacob Gatlin
Athens State University

Earl H. Godfrey Jr.
Gardner-Webb University

Mary Beth Goodrich
University of Texas at Dallas

Jongsoo Han
Rutgers University at Camden

James Hansen
University of Illinois at Chicago

Aretha Hill
North Carolina A&T State University

Theresa Hrncir
Southeastern Oklahoma State University
William Huffman
Missouri Southern State University
Russell Jacques
Saint Leo University
David Jenkins
University of Delaware
Bonita Kramer
Montana State University
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Loyola University, Chicago
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Judith C. Walo
Central Connecticut State University
Thomas Weirich
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Donna Whitten
Purdue University North Central
Jian Zhang
San Jose State University

O. Ray Whittington

Kurt Pany

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CHAPTER

1

The Role of the Public Accountant in the American Economy

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

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

LO 1-1

Describe the nature of assurance services.

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

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

What Are Assurance Services?

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

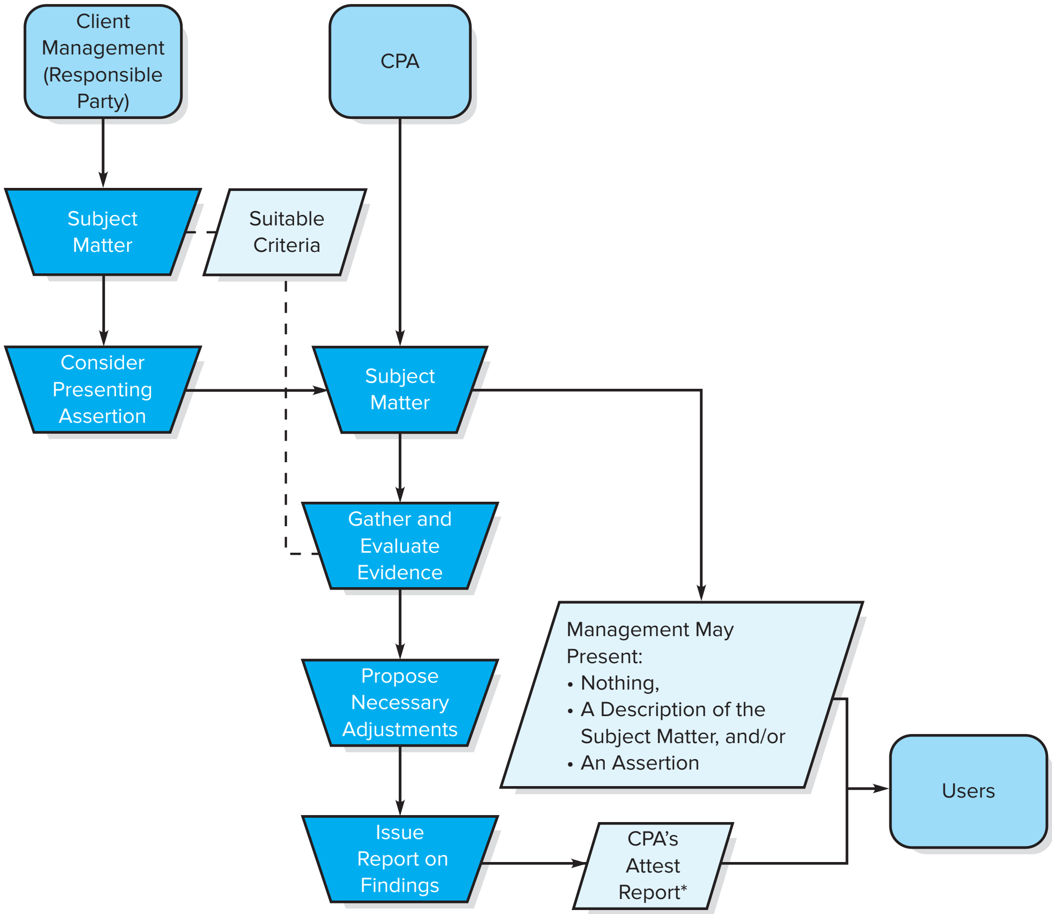
Attest Engagements

LO 1-2

Identify assurance services that involve attestation.

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

FIGURE 1.1
The Attest Function



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

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

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

Figure 1.1 describes the attest function, which begins with the subject matter that is the responsibility of another party, usually management. As an example, consider the situation in which the CPAs attest to a company's internal control over financial reporting. The subject matter of this engagement is internal control over financial reporting—internal control is the responsibility of management. The CPAs may be engaged to report directly on the internal control and express an opinion on whether a company's internal control over financial reporting follows suitable *standards* (benchmarks). Alternatively, they may report on an assertion made by management that the company's internal control follows suitable standards. In this second case, the audit report would include an opinion on whether management's **assertion** is accurate. Managements of large public companies are now required to include in their annual reports an assertion about the effectiveness of internal control over financial reporting and to engage their auditors to attest to the effectiveness of internal control. This form of reporting is described in detail in Chapters 7 and 18.

What standards should the subject matter follow? The standards generally are those established or developed by groups composed of experts and are referred to as **suitable criteria**. In an internal control engagement, the standards may be those that have

Illustrative Case — *The Value of Attest Services*

CPAs have attested that a supermarket chain in Phoenix has the lowest overall prices in that city. The CPAs selected a sample of approximately 1,000 items and compared the prices to those of the various other major supermarkets. Representatives of the supermarket chain stated that the credibility added by the CPAs has helped to convince consumers that the chain's prices are indeed the lowest.

been established by a committee of experts on internal control. In a financial statement audit, another term arises to describe suitable criteria—**financial reporting framework**. The suitable criteria in a financial statement audit are set forth in the financial reporting framework selected by management, often **generally accepted accounting principles (GAAP)**. The CPAs perform a financial statement audit to gather sufficient evidence to issue an audit report with their opinion on whether the financial statements (the subject matter) follow the **applicable financial reporting framework** (that is, the financial reporting framework chosen by management, usually GAAP).

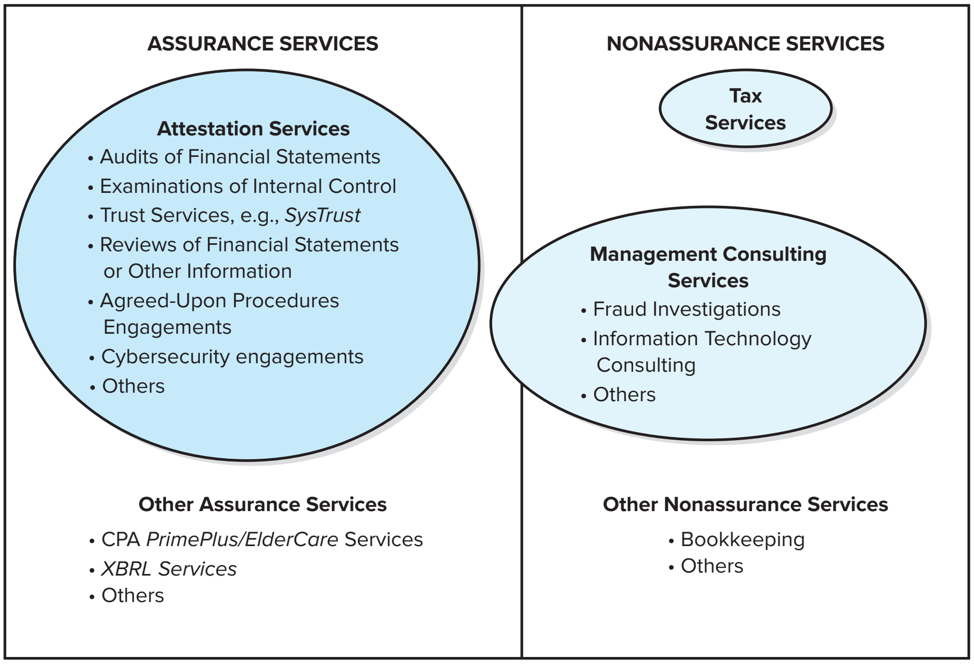
The three forms of attest engagements are examinations, reviews, and the performance of agreed-upon (or selected) procedures. An **examination**, referred to as an *audit* when it involves historical financial statements, provides the highest form of assurance that CPAs can offer. In an examination,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

FIGURE 1.2 **Forms of Attestation**

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

*Referred to as an *audit* when the subject matter is historical financial statements.

FIGURE 1.3
Relationships among Assurance and Other Services.



Assurance and Nonassurance Services

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

Figure 1.3 also illustrates that attestation services are only a portion of the assurance services that are offered by CPAs. A few examples of assurance services that do not involve attestation include:

- CPA *PrimePlus/ElderCare* services—providing assurance to individuals that their elderly family members' needs are being met by institutions and other professionals.
- *XBRL Services*—providing assurance on XBRL-related documents.

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

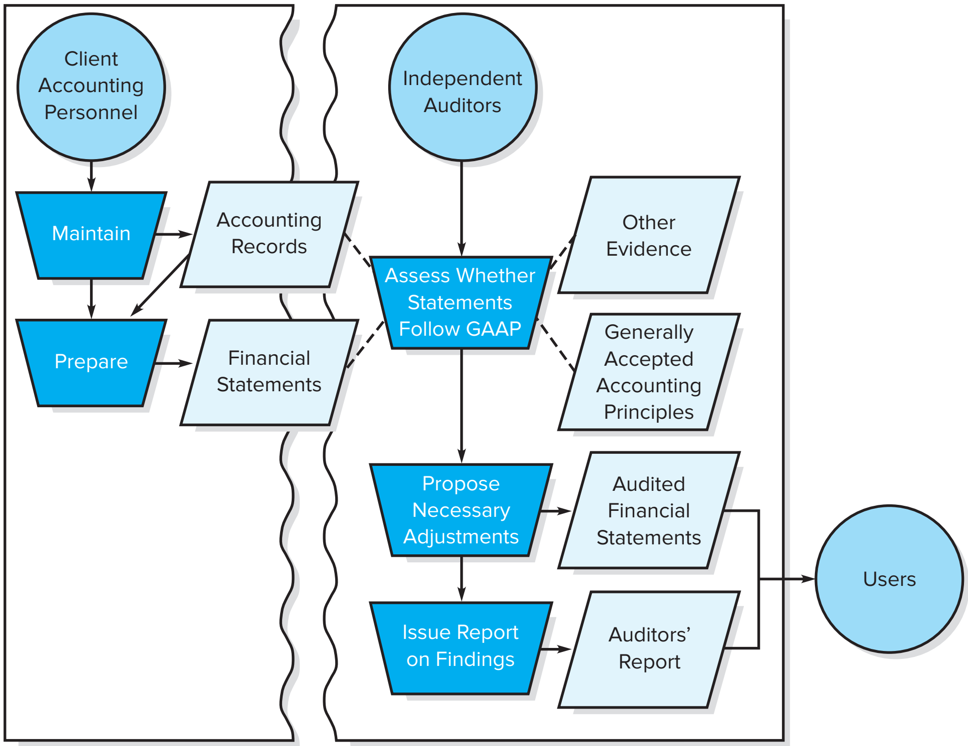
Financial Statement Audits

LO 1-3

Describe the nature of financial statement audits.

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

FIGURE 1.4 **Audit of Financial Statements**



The evidence obtained and evaluated by the auditors focuses on whether the financial statements are presented in accordance with the applicable financial reporting framework, usually generally accepted accounting principles. More specifically, an audit addresses management's assertions that the assets listed in the balance sheet really exist, that the company has rights (by title or contract) to the assets, and that the valuations assigned to the assets have been established in conformity with generally accepted accounting principles. Evidence is gathered to show that the balance sheet contains *all the liabilities* of the company; otherwise the balance sheet might be grossly misleading because certain important liabilities have been accidentally or deliberately omitted. The auditors also obtain evidence that the recorded liabilities are actual obligations of the company and are properly valued. Similarly, the auditors gather evidence about the transactions recorded in the income statement. They demand evidence that the reported sales really occurred, that sales have been recorded at appropriate amounts, and that the recorded costs and expenses are applicable to the current period and all expenses have been recognized. Finally, the auditors consider whether the financial statement amounts are accurate, properly classified, and summarized and whether the notes are informative and complete. Only if sufficient evidence is gathered in support of all these significant assertions can the auditors provide an opinion on whether the financial statements are presented in accordance with generally accepted accounting principles.

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

What Creates the Demand for Audits?

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

Inadequate accounting and reporting, on the other hand, conceal waste and inefficiency, thereby preventing an efficient allocation of economic resources in the society.

LO 1-4

Explain why audits are demanded by society.

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

Economic decisions are made under conditions of uncertainty; there is always a risk that the decision maker will select the wrong alternative and incur a significant loss. The credibility added to the information by auditors actually reduces the decision maker's risk. To be more precise, the auditors reduce information risk, which is the risk that the financial information used to make a decision is materially misstated.

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

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

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

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

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

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

Illustrating the Demand for Auditing

A decision by a bank loan officer about whether to make a loan to a business can be used to illustrate the demand for auditing. Since the bank's objective in making the loan is to earn an appropriate rate of interest and to collect the principal of the loan at maturity, the loan officer is making two related decisions: (1) whether to make the loan at all and

(2) what rate of interest adequately compensates the bank for the level of risk assumed. The loan officer will make these decisions based on a careful study of the company's financial statements along with other information. The risk assumed by the bank related to this customer has two aspects:[1]

1. **Business risk**—the risk associated with a company's survival and profitability. This includes, for example, the risk that the company will not be able to make the interest payments and repay the principal of the loan because of economic conditions or poor management decisions. Business risk is assessed by considering factors such as the financial position of the company, the nature of its operations, the characteristics of the industry in which it operates, and the quality and integrity of its management.
2. **Information risk**—the risk that the information used to assess business risk is not accurate. Information risk includes the possibility that the financial statements might contain material departures from generally accepted accounting principles.

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

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

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

Corporate Governance and Auditing

The term **corporate governance** refers to the rules, processes, and laws by which businesses are operated, regulated, and controlled. Effective corporate governance requires that the interests of a company's management, shareholders, creditors, and other stakeholders be properly balanced. Shareholders elect **boards of directors** to oversee the corporation's activities. In the United States, public companies must establish **audit committees** of their board of directors, ordinarily composed of between three and six independent (nonmanagement) board members.[3] Although details of responsibilities differ among companies, audit committees are charged with areas such as oversight of

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

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

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

financial reporting, regulatory compliance, and risk management. Included in the audit committee's responsibilities is appointment, compensation, and oversight of the work of the company's external auditors. Chapter 7 provides more information on the relationship of corporate governance to internal control, including auditor responsibilities to communicate with audit committees.

Major Auditing Developments of the 20th Century through Today

Although the objectives and concepts that guide present-day audits were almost unknown in the early years of the 20th century, audits of one type or another have been performed throughout the recorded history of commerce and government finance. The original meaning of the word *auditor* was "one who hears" and was appropriate to the era during which governmental accounting records were approved only after a public reading, in which the accounts were read aloud. From medieval times on through the Industrial Revolution, audits were performed to determine whether persons in positions of official responsibility in government and commerce were acting and reporting in an honest manner.

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

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

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

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

FRAUD

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

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

As a result of a number of instances of fraudulent financial reporting, the major accounting organizations[4] sponsored the *National Commission on Fraudulent Financial Reporting* (the Treadway Commission) to study the causes of fraudulent reporting and make recommendations to reduce its incidence. The commission's final report, which was issued in 1987, made a number of recommendations for auditors, public companies, regulators, and educators. Many of the recommendations for auditors were enacted by the AICPA in a group of *Statements on Auditing Standards* known as the *expectation gap* standards. The commission's recommendations about internal control led to the development of an internal control framework, titled *Internal Control—Integrated Framework*, to be used to evaluate the internal control of an organization. The development of these internal control criteria increased the demand for attestation by auditors to the effectiveness of internal control. As an example, the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 was passed requiring management of large financial institutions to engage CPAs to attest to the effectiveness of assertions by management about the effectiveness of the institution's controls over financial reporting.

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

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

A factor overlaying a number of changes has been fast-paced changes in information technology. From small computer accounting systems to large mainframe computers, from networked enterprisewide information systems to "cloud based" accounting systems, from over-the-counter sales to the general use of the Internet to initiate and process transactions, auditing methods have had to adapt. While technology has not changed the basic objective of the financial statement audit, it has resulted in the need to develop innovative computer testing techniques and tools to assure audit effectiveness. Currently, auditors are beginning to use sophisticated data analytics, artificial intelligence, and drones to improve the effectiveness and efficiency of audits.

Many of the ideas mentioned in this brief historical sketch of the development of auditing will be analyzed in detail in later sections of this book. Our purpose at this point is merely to orient you with a quick overall look at some of the major auditing

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