

GLOBAL
EDITION



Auditing and Assurance Services

SIXTEENTH EDITION

Alvin A. Arens • Randal J. Elder • Mark S. Beasley • Chris E. Hogan

ALWAYS LEARNING

PEARSON



AUDITING AND ASSURANCE SERVICES

AN INTEGRATED APPROACH

SIXTEENTH EDITION

GLOBAL EDITION

ALVIN A. ARENS

Former PricewaterhouseCoopers
Emeritus Professor
Michigan State University

RANDAL J. ELDER

Syracuse University
Professor

MARK S. BEASLEY

North Carolina State University
Deloitte Professor of Enterprise Risk Management

CHRIS E. HOGAN

Michigan State University
Professor

PEARSON

Boston Columbus Indianapolis New York San Francisco Amsterdam
Cape Town Dubai London Madrid Milan Munich Paris Montréal Toronto
Delhi Mexico City São Paulo Sydney Hong Kong Seoul Singapore Taipei Tokyo

Vice President, Business Publishing: Donna Battista
Editor-in-Chief: Adrienne D'Ambrosio
Acquisitions Editor: Ellen Geary
Editorial Assistant: Christine Donovan
Assistant Acquisitions Editor, Global Editions:
Ananya Srivastava
Associate Project Editor, Global Edition: Amrita Kar
Project Manager, Global Editions: Ruchi Sachdev
Manager, Media Production, Global Edition: Vikram Kumar
Senior Manufacturing Controller, Production, Global
Edition: Trudy Kimber
Vice President, Product Marketing: Maggie Moylan
Director of Marketing, Digital Services and
Products: Jeanette Koskinas
Executive Field Marketing Manager: Adam Goldstein
Field Marketing Manager: Natalie Wagner
Product Marketing Assistant: Jessica Quazza
Team Lead, Program Management: Ashley Santora
Program Manager: Daniel Petrino
Team Lead, Project Management: Jeff Holcomb
Project Manager: Roberta Sherman

Operations Specialist: Carol Melville
Creative Director: Blair Brown
Art Director: Jon Boylan
Vice President, Director of Digital Strategy
and Assessment: Paul Gentile
Manager of Learning Applications: Paul DeLuca
Director, Digital Studio: Sacha Laustsen
Digital Studio Manager: Diane Lombardo
Digital Editor: Sarah Peterson
Digital Studio Project Manager: Andra Skaalrud
Digital Studio Project Manager: Alana Coles
Digital Studio Project Manager: Robin Lazrus
Digital Content Team Lead: Noel Lotz
Digital Content Project Lead: Martha LaChance
Full-Service Project Management and Composition:
Integra Software Services
Interior Designer: Integra Software Services
Cover Designer: Lumina Datamatics
Cover Photo: (c) kotoffei/Shutterstock
Printer/Binder: Lego
Cover Printer: Lego

Microsoft and/or its respective suppliers make no representations about the suitability of the information contained in the documents and related graphics published as part of the services for any purpose. All such documents and related graphics are provided "as is" without warranty of any kind. Microsoft and/or its respective suppliers hereby disclaim all warranties and conditions with regard to this information, including all warranties and conditions of merchantability, whether express, implied or statutory, fitness for a particular purpose, title and non-infringement. In no event shall Microsoft and/or its respective suppliers be liable for any special, indirect or consequential damages or any damages whatsoever resulting from loss of use, data or profits, whether in an action of contract, negligence or other tortious action, arising out of or in connection with the use or performance of information available from the services.

The documents and related graphics contained herein could include technical inaccuracies or typographical errors. Changes are periodically added to the information herein. Microsoft and/or its respective suppliers may make improvements and/or changes in the product(s) and/or the program(s) described herein at any time. Partial screen shots may be viewed in full within the software version specified.

Microsoft® and Windows® are registered trademarks of the Microsoft Corporation in the U.S.A. and other countries. This book is not sponsored or endorsed by or affiliated with the Microsoft Corporation.

Pearson Education Limited
Edinburgh Gate
Harlow
Essex CM20 2JE
England

and Associated Companies throughout the world

Visit us on the World Wide Web at:
www.pearsonglobaleditions.com

© Pearson Education Limited 2017

The rights of Alvin A. Arens, Randal J. Elder, Mark S. Beasley and Chris E. Hogan to be identified as the authors of this work have been asserted by them in accordance with the Copyright, Designs and Patents Act 1988.

Authorized adaptation from the United States edition, entitled Auditing and Assurance Services Sixteenth Edition: An Integrated Approach, ISBN 978-0-13-406582-3 by Alvin A. Arens, Randal J. Elder, Mark S. Beasley and Chris E. Hogan, published by Pearson Education © 2017.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without either the prior written permission of the publisher or a license permitting restricted copying in the United Kingdom issued by the Copyright Licensing Agency Ltd, Saffron House, 6–10 Kirby Street, London EC 1N 8TS.

All trademarks used herein are the property of their respective owners. The use of any trademark in this text does not vest in the author or publisher any trademark ownership rights in such trademarks, nor does the use of such trademarks imply any affiliation with or endorsement of this book by such owners.

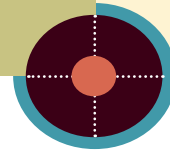
ISBN-10: 1-292-14787-3
ISBN-13: 978-1-292-14787-1

British Library Cataloguing-in-Publication Data
A catalogue record for this book is available from the British Library

10 9 8 7 6 5 4 3 2 1

Typeset in Albertina MT Pro Regular by Integra
Printed and bound by Lego Italy

CONTINUING THE LEGACY OF ALVIN A. ARENS



ALVIN A. ARENS: The author team of Randy Elder, Mark Beasley, and newest member of the author team, Chris Hogan, are pleased to continue the outstanding legacy of our book's founding author, Al Arens, in this 16th edition of *Auditing and Assurance Services: An Integrated Approach*. As was done for the 15th edition, we again dedicate this new edition to Al's memory.

Randy and Mark joined Al as coauthors on this textbook in the 8th edition, and have been honored to continue Al's leadership in helping shape classroom instruction and student learning about auditing concepts and their practical implementation around the world. Since the first edition was published, this textbook has impacted audit education for over 30 years in the U.S. and globally, including seven different language translations. Al's leadership at national and international levels and his commitment to expanding knowledge through the development of educational materials, including this textbook, continue to inspire us as we strive to advance his legacy for future generations of auditing professionals.

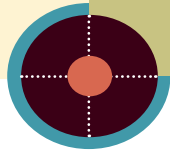


November 24, 1935 – December 6, 2010

Al was the PricewaterhouseCoopers Auditing Professor and member of the Accounting & Information Systems faculty in the Eli Broad College of Business at Michigan State University from 1968 through 2007. Thus, we are especially pleased to have Chris Hogan, Professor at Michigan State University, join the author team on this edition, continuing the Michigan State connection started by Al.

Among his many honors, Al was selected as one of five national auditing educators to hold a Price Waterhouse Auditing professorship, was honored as AICPA Educator of the Year, served on the AICPA Auditing Standards Board, and was President of the American Accounting Association. Al taught accounting, mainly auditing, with a passion that is legendary. He had a heart for sharing his knowledge of auditing with students throughout his career.

This 16th edition continues his outstanding legacy in audit education.



ABOUT THE AUTHORS

ALVIN A. ARENS

Al Arens, founding author of this textbook, was the PricewaterhouseCoopers Professor of Accounting Emeritus at Michigan State University. In addition to writing books on auditing, he was a coauthor of computerized accounting supplements and he was actively involved in the continuing education of practitioners with local and regional CPA firms. Al was a past president of the American Accounting Association and a former member of the AICPA Auditing Standards Board. He practiced public accounting with both a local CPA firm and the predecessor firm to Ernst & Young. He received many awards including the AAA Auditing Section Outstanding Educator award, the AICPA Outstanding Educator award, the national Beta Alpha Psi Professor of the Year award, and many teaching and other awards at Michigan State.

RANDAL J. ELDER

Randy Elder, who has served as a coauthor of this textbook since the 8th edition, is Professor of Accounting at Syracuse University. He teaches undergraduate and graduate auditing courses, and has received several teaching awards. His research focuses on audit quality and current audit firm practices and he served as the team leader for the American Accounting Association Auditing Section PCAOB research synthesis teams on audit confirmations and audit sampling. He has extensive public accounting experience with a large regional CPA firm, frequently teaches continuing education for a large international CPA firm, and is a member of the AICPA and Michigan Association of CPAs.

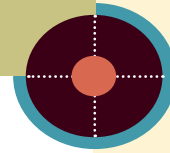
MARK S. BEASLEY

Mark Beasley, who has also served as a coauthor of this textbook since the 8th edition, is the Deloitte Professor of Enterprise Risk Management and Professor of Accounting at North Carolina State University. He has taught undergraduate and graduate auditing courses, and has received several teaching awards including membership in NC State's Academy of Outstanding Teachers. He has extensive professional audit experience with the predecessor firm to Ernst & Young and has extensive standards-setting experience working with the Auditing Standards Board as a Technical Manager in the Audit and Assurance Division of the AICPA. He served on the ASB Fraud Standard Task Force responsible for developing SAS 99, the ASB Antifraud Programs and Controls Task Force, and the Advisory Council overseeing the COSO Enterprise Risk Management—Integrated Framework project. He served over seven years as a member of the COSO Board, representing the AAA.

CHRIS E. HOGAN

We are pleased to have **Chris Hogan** join us as a coauthor for this 16th edition. Chris is a Professor of Accounting in the Eli Broad College of Business at Michigan State University. We are thrilled to continue the Michigan State connection started by Al Arens. Chris teaches graduate auditing and her research focuses on internal controls and integrated audits, audit firm client portfolios, and the impact of regulation on audit markets. Chris has auditing experience with Price Waterhouse, one of the predecessor firms to PricewaterhouseCoopers, LLP. She has served in multiple leadership roles within the American Accounting Association, including serving as President of the Auditing Section and on the Audit Committee of the AAA.

CONTENTS



PREFACE 17

THE AUDITING PROFESSION

PART

1

THE DEMAND FOR AUDIT AND OTHER ASSURANCE SERVICES

CHAPTER

1

LEARNING OBJECTIVES 27

Nature of Auditing 28

Distinction Between Auditing and Accounting 30

Economic Demand for Auditing 30

Assurance Services 32

Types of Audits 36

Types of Auditors 38

Certified Public Accountant 40

Summary 41

Essential Terms 41

Review Questions 42

Multiple Choice Questions from CPA Examinations 42

Discussion Questions and Problems 44

THE CPA PROFESSION

CHAPTER

2

LEARNING OBJECTIVES 48

Certified Public Accounting Firms 49

Structure of CPA Firms 51

Sarbanes–Oxley Act and Public Company Accounting Oversight Board 53

Securities and Exchange Commission 54

American Institute of Certified Public Accountants (AICPA) 55

International and U.S. Auditing Standards 56

Organization of U.S. Auditing Standards 58

Quality Control 62

Summary 64

Essential Terms 65

Review Questions	65
Multiple Choice Questions from CPA Examinations	66
Discussion Questions and Problems	68

CHAPTER

3

AUDIT REPORTS

LEARNING OBJECTIVES 70

Standard Unmodified Opinion Audit Report for Nonpublic Entities	71
Conditions for Standard Unmodified Opinion Audit Report	74
Standard Audit Report and Report on Internal Control Over Financial Reporting Under PCAOB Auditing Standards	74
Unmodified Opinion Audit Report with Emphasis-of-Matter Explanatory Paragraph or Nonstandard Report Wording	78
Modifications to the Opinion in the Audit Report	82
Materiality	84
Discussion of Conditions Requiring a Modification of Opinion	87
Auditor's Decision Process for Audit Reports	90
International Accounting and Auditing Standards	92
Summary	93
Essential Terms	93
Review Questions	94
Multiple Choice Questions from CPA Examinations	95
Discussion Questions and Problems	96

CHAPTER

4

PROFESSIONAL ETHICS

LEARNING OBJECTIVES 102

What Are Ethics?	103
Ethical Dilemmas	104
Special Need for Ethical Conduct in Professions	107
Code of Professional Conduct	109
Independence Rule	113
Sarbanes–Oxley and Related Independence Requirements	117
Other Rules of Conduct	120
Enforcement	127
Summary	129
Essential Terms	129
Review Questions	129
Multiple Choice Questions from CPA Examinations	130
Discussion Questions and Problems	132
Cases	135

LEGAL LIABILITY

CHAPTER

5

LEARNING OBJECTIVES 138

Changed Legal Environment	139
Distinguishing Business Failure, Audit Failure, and Audit Risk	140
Legal Concepts Affecting Liability	141
Liability to Clients	143
Liability to Third Parties Under Common Law	146
Civil Liability Under the Federal Securities Laws	148
Criminal Liability	154
The Profession's Response to Legal Liability	155
Summary	156
Essential Terms	156
Review Questions	157
Multiple Choice Questions from CPA Examinations	158
Discussion Questions and Problems	160
Case	164

THE AUDIT PROCESS

PART

2

AUDIT RESPONSIBILITIES AND OBJECTIVES

CHAPTER

6

LEARNING OBJECTIVES 166

Objective of Conducting an Audit of Financial Statements	167
Management's Responsibilities	168
Auditor's Responsibilities	169
Professional Skepticism	172
Professional Judgment	174
Financial Statement Cycles	176
Setting Audit Objectives	181
Management Assertions	182
Transaction-Related Audit Objectives	185
Balance-Related and Presentation and Disclosure-Related Audit Objectives	186
How Audit Objectives Are Met	190
Summary	192
Essential Terms	192
Review Questions	193
Multiple Choice Questions from CPA Examinations	194
Discussion Questions and Problems	196

AUDIT EVIDENCE

LEARNING OBJECTIVES 219

Nature of Evidence	220
Audit Evidence Decisions	221
Persuasiveness of Evidence	222
Types of Audit Evidence	225
Analytical Procedures	232
Common Financial Ratios	236
Audit Documentation	239
Summary	247
Essential Terms	247
Review Questions	248
Multiple Choice Questions from CPA Examinations	249
Discussion Questions and Problems	251
Case	258
ACL Problem	259

AUDIT PLANNING AND MATERIALITY

LEARNING OBJECTIVES 260

Planning	261
Accept Client and Perform Initial Audit Planning	262
Understand the Client's Business and Industry	266
Perform Preliminary Analytical Procedures	271
Materiality	274
Materiality for Financial Statements as a Whole	275
Determine Performance Materiality	278
Estimate Misstatement and Compare with Preliminary Judgment	281
Summary	283
Essential Terms	283
Review Questions	285
Multiple Choice Questions from CPA Examinations	287
Discussion Questions and Problems	289
Case	296
Integrated Case Application—Pinnacle Manufacturing: Part I	297
ACL Problem	300

ASSESSING THE RISK OF MATERIAL MISSTATEMENT

LEARNING OBJECTIVES 301

Audit Risk	302
Risk Assessment Procedures	303

Considering Fraud Risk	307
Identification of Significant Risks	308
Audit Risk Model	309
Assessing Acceptable Audit Risk	313
Assessing Inherent Risk	316
Relationship of Risks to Evidence and Factors Influencing Risks	318
Relationship of Risk and Materiality to Audit Evidence	323
Summary	324
Essential Terms	324
Review Questions	324
Multiple Choice Questions from CPA Examinations	326
Discussion Questions and Problems	328
Cases	332
Integrated Case Application—Pinnacle Manufacturing: Part II	334

ASSESSING AND RESPONDING TO FRAUD RISKS

CHAPTER 10

LEARNING OBJECTIVES	337
Types of Fraud	338
Conditions for Fraud	339
Assessing the Risk of Fraud	343
Corporate Governance Oversight to Reduce Fraud Risks	347
Responding to the Risk of Fraud	351
Specific Fraud Risk Areas	353
Responsibilities When Fraud Is Suspected	359
Documenting the Fraud Assessment	363
Summary	363
Essential Terms	364
Review Questions	364
Multiple Choice Questions from CPA Examinations	365
Discussion Questions and Problems	367
Case	372
Integrated Case Application—Pinnacle Manufacturing: Part III	373
ACL Problem	374

INTERNAL CONTROL AND COSO FRAMEWORK

CHAPTER 11

LEARNING OBJECTIVES	375
Internal Control Objectives	376
Management and Auditor Responsibilities for Internal Control	377
COSO Components of Internal Control	379
Internal Controls Specific to Information Technology	389

Impact of IT Infrastructure on Internal Control	395
Summary	397
Essential Terms	397
Review Questions	399
Multiple Choice Questions from CPA Examinations	400
Discussion Questions and Problems	401
Case	405

CHAPTER
12

ASSESSING CONTROL RISK AND REPORTING ON INTERNAL CONTROLS

LEARNING OBJECTIVES 407

Obtain and Document Understanding of Internal Control	408
Assess Control Risk	411
Tests of Controls	417
Decide Planned Detection Risk and Design Substantive Tests	421
Auditor Reporting on Internal Control	422
Evaluating, Reporting, and Testing Internal Control for Nonpublic and Smaller Public Companies	425
Impact of IT Environment on Control Risk Assessment and Testing	426
Summary	430
Essential Terms	430
Review Questions	432
Multiple Choice Questions from CPA Examinations	433
Discussion Questions and Problems	435
Case	443
ACL Problem	445
Integrated Case Application—Pinnacle Manufacturing: Part IV	445

CHAPTER
13

OVERALL AUDIT STRATEGY AND AUDIT PROGRAM

LEARNING OBJECTIVES 448

Types of Tests	449
Selecting Which Types of Tests to Perform	454
Evidence Mix	458
Design of the Audit Program	459
Summary of Key Evidence-Related Terms	467
Summary of the Audit Process	469
Summary	473

Essential Terms	473
Review Questions	474
Multiple Choice Questions from CPA Examinations	475
Discussion Questions and Problems	476
Cases	482

APPLICATION OF THE AUDIT PROCESS TO THE SALES AND COLLECTION CYCLE

PART
3

AUDIT OF THE SALES AND COLLECTION CYCLE: TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS

CHAPTER
14

LEARNING OBJECTIVES 486

Accounts and Classes of Transactions in the Sales and Collection Cycle 487

Business Functions in the Cycle and Related Documents and Records 488

Methodology for Designing Tests of Controls and Substantive

Tests of Transactions for Sales 492

Sales Returns and Allowances 503

Methodology for Designing Tests of Controls and Substantive

Tests of Transactions for Cash Receipts 504

Audit Tests for Uncollectible Accounts 508

Effect of Results of Tests of Controls and Substantive

Tests of Transactions 508

Summary 509

Essential Terms 510

Review Questions 510

Multiple Choice Questions from CPA Examinations 512

Discussion Questions and Problems 514

Case 519

Integrated Case Application—Pinnacle Manufacturing: Part V 520

ACL Problem 521

AUDIT SAMPLING FOR TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS

CHAPTER
15

LEARNING OBJECTIVES 522

Representative Samples 523

Statistical Versus Nonstatistical Sampling and Probabilistic Versus

Nonprobabilistic Sample Selection 524

Sample Selection Methods	525
Sampling for Exception Rates	528
Application of Nonstatistical Audit Sampling	529
Statistical Audit Sampling	543
Application of Attributes Sampling	546
Summary	552
Essential Terms	552
Review Questions	553
Multiple Choice Questions from CPA Examinations	554
Discussion Questions and Problems	556
Case	561
Integrated Case Application—Pinnacle Manufacturing: Part VI	561
ACL Problem	563

CHAPTER
16

COMPLETING THE TESTS IN THE SALES AND COLLECTION CYCLE: ACCOUNTS RECEIVABLE

LEARNING OBJECTIVES 564

Methodology for Designing Tests of Details of Balances	565
Designing Tests of Details of Balances	571
Confirmation of Accounts Receivable	577
Developing Tests of Details Audit Program	583
Summary	587
Essential Terms	587
Review Questions	587
Multiple Choice Questions from CPA Examinations	589
Discussion Questions and Problems	590
Case	597
Integrated Case Application—Pinnacle Manufacturing: Part VII	598
ACL Problem	603

CHAPTER
17

AUDIT SAMPLING FOR TESTS OF DETAILS OF BALANCES

LEARNING OBJECTIVES 604

Comparisons of Audit Sampling for Tests of Details of Balances and for Tests of Controls and Substantive Tests of Transactions	605
Nonstatistical Sampling	606
Monetary Unit Sampling	615
Variables Sampling	623
Illustration Using Difference Estimation	628

Summary 631
Essential Terms 632
Review Questions 632
Multiple Choice Questions from CPA and CIA Examinations 633
Discussion Questions and Problems 635
Cases 640
ACL Problem 642

APPLICATION OF THE AUDIT PROCESS TO OTHER CYCLES

PART
4

AUDIT OF THE ACQUISITION AND PAYMENT CYCLE: TESTS OF CONTROLS, SUBSTANTIVE TESTS OF TRANSACTIONS, AND ACCOUNTS PAYABLE

CHAPTER
18

LEARNING OBJECTIVES 644

**Accounts and Classes of Transactions in the Acquisition
and Payment Cycle 645**

Business Functions in the Cycle and Related Documents and Records 646

**Methodology for Designing Tests of Controls and Substantive Tests of
Transactions 649**

**Methodology for Designing Tests of Details of Balances for Accounts
Payable 656**

Summary 664

Essential Terms 664

Review Questions 665

Multiple Choice Questions from CPA Examinations 666

Discussion Questions and Problems 668

Case 674

COMPLETING THE TESTS IN THE ACQUISITION AND PAYMENT CYCLE: VERIFICATION OF SELECTED ACCOUNTS

CHAPTER
19

LEARNING OBJECTIVES 676

Types of Other Accounts in the Acquisition and Payment Cycle 677

Audit of Property, Plant, and Equipment 677

Audit of Prepaid Expenses 685

Audit of Accrued Liabilities	688
Audit of Income and Expense Accounts	689
Summary	693
Essential Terms	693
Review Questions	693
Multiple Choice Questions from CPA Examinations	694
Discussion Questions and Problems	696
Cases	699

CHAPTER
20

AUDIT OF THE PAYROLL AND PERSONNEL CYCLE

LEARNING OBJECTIVES 702

Accounts and Transactions in the Payroll and Personnel Cycle	703
Business Functions in the Cycle and Related Documents and Records	703
Methodology for Designing Tests of Controls and Substantive Tests of Transactions	706
Methodology for Designing Substantive Analytical Procedures and Tests of Details of Balances	712
Summary	716
Essential Terms	716
Review Questions	716
Multiple Choice Questions from CPA Examinations	717
Discussion Questions and Problems	719
Case	723

CHAPTER
21

AUDIT OF THE INVENTORY AND WAREHOUSING CYCLE

LEARNING OBJECTIVES 725

Business Functions in the Cycle and Related Documents and Records	726
Parts of the Audit of Inventory	729
Audit of Cost Accounting	731
Substantive Analytical Procedures	734
Physical Observation of Inventory	735
Audit of Pricing and Compilation	737
Integration of the Tests	741
Summary	743
Essential Terms	743
Review Questions	744
Multiple Choice Questions from CPA Examinations	745
Discussion Questions and Problems	746
Case	753

AUDIT OF THE CAPITAL ACQUISITION AND REPAYMENT CYCLE

CHAPTER
22

LEARNING OBJECTIVES 755

Accounts in the Cycle 756
Notes Payable 757
Owners' Equity 761
Summary 767
Essential Terms 767
Review Questions 768
Multiple Choice Questions from CPA Examinations 768
Discussion Questions and Problems 770

AUDIT OF CASH AND FINANCIAL INSTRUMENTS

CHAPTER
23

LEARNING OBJECTIVES 776

Types of Cash and Financial Instruments Accounts 777
Cash in the Bank and Transaction Cycles 779
Audit of the General Cash Account 780
Fraud-Oriented Procedures 788
Audit of Financial Instruments Accounts 793
Summary 796
Essential Terms 796
Review Questions 797
Multiple Choice Questions from CPA Examinations 798
Discussion Questions and Problems 799

COMPLETING THE AUDIT

PART
5

COMPLETING THE AUDIT

CHAPTER
24

LEARNING OBJECTIVES 806

Perform Additional Tests for Presentation and Disclosure 807
Review for Contingent Liabilities and Commitments 808
Review for Subsequent Events 813
Final Evidence Accumulation 817
Evaluate Results 821
Issue the Audit Report 825
Communicate with the Audit Committee and Management 825
Subsequent Discovery of Facts 827
Summary 829

Essential Terms	829
Review Questions	830
Multiple Choice Questions from CPA Examinations	831
Discussion Questions and Problems	833
Case	837

PART
6

OTHER ASSURANCE AND NONASSURANCE SERVICES

CHAPTER
25

OTHER ASSURANCE SERVICES

LEARNING OBJECTIVES 839

Review, Compilation, and Preparation Services	840
Review of Interim Financial Information for Public Companies	846
Attestation Engagements	847
Reports on Controls at Service Organizations (SOC Reports)	851
Prospective Financial Statements	853
Agreed-Upon Procedures Engagements	854
Other Audits or Limited Assurance Engagements	855
Summary	857
Essential Terms	858
Review Questions	859
Multiple Choice Questions from CPA Examinations	860
Discussion Questions and Problems	861

CHAPTER
26

INTERNAL AND GOVERNMENTAL FINANCIAL AUDITING AND OPERATIONAL AUDITING

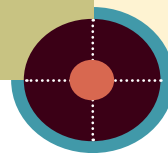
LEARNING OBJECTIVES 866

Internal Financial Auditing	867
Governmental Financial Auditing	870
Operational Auditing	873
Summary	880
Essential Terms	880
Review Questions	881
Multiple Choice Questions from CPA, CIA, and CMA Examinations	881
Discussion Questions and Problems	884

INDEX 888

CREDITS 896

PREFACE



INTEGRATED APPROACH FOR RISK ASSESSMENT AND AUDIT DECISION MAKING

Auditing and Assurance Services: An Integrated Approach is an introduction to auditing and other assurance services. It is intended for either a one-quarter or one-semester course at the undergraduate or graduate level. This book is also appropriate for introductory professional development courses for CPA firms, internal auditors, and government auditors.

The primary emphasis in this text is on the auditor's decision-making process in a financial statement audit, as well as an integrated audit of both financial statements and internal control over financial reporting required for accelerated filer public companies. We believe that the most fundamental concepts in auditing concern determining the nature and amount of evidence the auditor should gather after considering the unique circumstances of each engagement. If students of auditing understand the objectives to be accomplished in a given audit area, the risks related to the engagement, and the decisions to be made, they should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained.

Our objective is to provide up-to-date coverage of globally recognized auditing concepts with practical examples of the implementation of those concepts in real-world settings. The collective experience of the author team in the practice of auditing is extensive. We have all worked in the auditing profession involving both large international audit firms and regional firms. Members of our author team have taught extensively in continuing education for either large international or small CPA firms and have been involved in standards setting activities of the Auditing Standards Board and the PCAOB. One author served over seven years as one of the board members of the Committee of Sponsoring Organizations of the Treadway Commission (COSO). These experiences provide unique perspectives about the integration of auditing concepts in real-world settings.

As the title of this book reflects, our purpose is to integrate the most important internationally recognized concepts of auditing in a logical manner to assist students in understanding audit decision making and evidence accumulation in today's complex, global auditing environment. For example, developments related to issues affecting auditing in a global and economically volatile environment are described throughout the book and are emphasized in selected mid-chapter vignettes and homework problems. Key concepts related to risk assessment as emphasized in standards issued by the Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB), including emphasis on significant risks, are integrated into all of the planning chapters, as well as each chapter dealing with a particular transaction cycle and related accounts. Our coverage of internal control is related to tests of controls and substantive tests of transactions that are performed in a financial statement audit and an integrated audit of financial statements and internal control over financial reporting, with an emphasis on the requirements of PCAOB Auditing Standards. Tests of controls and substantive tests of transactions are, in turn, related to the tests of details of financial statement balances for the area. Audit sampling is applied to the evaluation of audit evidence rather than treated as a separate topic. Risk assessment, technology, fraud, and auditing of internal control issues are integrated throughout the chapters.

WHAT'S NEW IN THIS EDITION

Current Coverage

New auditing standards are released without regard to textbook revision cycles. As auditing instructors, we appreciate how critical it is to have the most current content available. This edition includes complete coverage of the AICPA Clarity Project, including guidance in the recently issued SAS No. 130 *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* and new PCAOB standards including Standard No. 18, *Related Parties*. We are committed to continually providing you with up-to-date content in this dynamic global auditing environment and will keep you updated with highlights posted on our Web site of major changes in new standards as they are issued.

AICPA Clarity Projects

As part of the effort to converge U.S. auditing standards with international standards, the AICPA Auditing Standards Board (ASB) recently completed its Clarity Project to redraft most of the existing GAAS standards to not only align them with the ISAs, but to also make them easier to read, understand, and apply. Chapter 2 provides an overview of the major implications of the clarified standards, including the new principles that provide the framework to help auditors fulfill the objectives of the audit of financial statements in accordance with AICPA auditing standards and the new Codification of Statements on Auditing Standards. Chapter 3 contains examples of the new standard auditor's report format updated by the Clarified SASs. All remaining chapters of the textbook reflect the various revisions resulting from the issuance of the Clarity standards.

The AICPA's Accounting and Review Services Committee (ARSC) has largely completed a similar Clarity Project affecting compilation and review standards with the issuance of SSARS No. 21, *Statement on Standards for Accounting and Review Services: Clarification and Recodification*. In redrafting SSARS, the ARSC used similar redrafting standards as those used by the Auditing Standards Board. Changes resulting from the redrafting of SSARS are addressed in Chapter 25. Additionally, that chapter also highlights forthcoming changes in Statements on Standards for Attestation Engagements (SSAEs) resulting from the AICPA's Clarity Project affecting attestation standards, which was recently voted for final issuance by the ASB.

Coverage of Revised AICPA Code of Professional Conduct

The AICPA recently restructured its *Code of Professional Conduct* to align it with international standards. The organization of the *Code* now presents the Principles as part of the Preface and then includes Rules for members in public practice separately from Rules for members in business and others. Chapter 4 has been substantially revised to provide an overview of the key elements of the revised *Code* based on this new structure.

Expanded Coverage of Professional Skepticism and Auditor Judgment

With the profession's continued focus on the importance of applying appropriate levels of professional skepticism, we have expanded coverage of this topic in Chapter 6, along with integrated coverage in later chapters, including Chapter 10, which addresses the auditor's responsibilities for detecting fraud. We discuss the importance of a questioning mindset and the need to critically evaluate audit evidence to strengthen student awareness of the elements of effective professional skepticism.

To assist auditors with maintaining an appropriate level of professional skepticism when making professional judgments during an audit, this edition features the Center for Audit Quality's *Professional Judgment Resource*, which outlines key elements of a process that auditors apply when making professional judgments. Chapter 6 illustrates an effective decision-making process that guides auditors' thinking to help them be aware of their own judgment tendencies, traps, and biases. We have added homework problems that expose students to this judgment framework and a number of the common traps and biases.

The requirements of the Sarbanes–Oxley Act of 2002 and the PCAOB Auditing Standard 5 (AS 5) that impact accelerated filer public companies, and the risk assessment standards issued by the Auditing Standards Board are integrated throughout the text. Chapter 2 emphasizes the importance of understanding the client’s business and its environment, including internal control. Chapter 3 highlights reporting on internal controls over financial reporting for auditors of accelerated filer public companies.

We have always emphasized understanding the client’s business and industry in planning. For the 16th edition we reorganized Chapters 8–12 to include expanded coverage of the auditor’s performance of risk assessment procedures, including the identification of significant risks. Chapter 9 addresses the performance of risk assessment procedures to address the risk of material misstatement, followed in Chapter 10 with discussion of assessing and responding to the risk of fraud.

Our coverage in Chapters 11 and 12 of internal controls, including coverage of IT general and application controls, has been restructured to reflect key elements of COSO’s 2013 revision of its *Internal Control—Integrated Framework* and to better integrate the auditor’s consideration of both manual and automated controls. Chapter 11 introduces students to important elements of effective internal controls, including those related to IT, while Chapter 12 outlines the auditor’s responsibilities to understand the design and operating effectiveness of internal control, and also highlights auditor reports on internal control over financial reporting. Subsequent chapters that focus on the transaction cycles include extensive coverage of internal controls to help students understand how the auditor’s consideration of internal controls is integrated for audits of the financial statements and internal controls over financial reporting.

Chapter 1 introduces the importance of considering international auditing standards developments, followed by discussion in Chapter 2 about the role of the International Auditing and Assurance Standards Board (IAASB) in the issuance of international standards on auditing (ISAs) and the Auditing Standards Board’s efforts to converge U.S. standards to international standards. Chapter 3 highlights implications for auditor reports on companies reporting under International Financial Reporting Standards (IFRS). Several chapters throughout the book include text or mid-chapter vignette coverage of international issues, and international issues are also addressed in homework problems.

With the increasing volume and complexity of various types of financial instruments and challenges associated with fair value accounting, Chapter 23 addresses issues associated with auditing financial instruments and obtaining sufficient appropriate audit evidence for fair value account estimates. We believe this guidance will help strengthen student understanding of the challenges associated with auditing financial instruments.

With more organizations taking advantage of cloud computing options and third party IT service providers, there is a greater need for information about the design and operating effectiveness of internal controls provided by these external service providers. This 16th edition contains expanded coverage of service organization control (SOC) reports issued by service center auditors. Both Chapters 12 and 25 reflect the new guidance for service auditors reporting on internal controls at service organizations, including coverage of the different types of reports provided in SOC 1, SOC 2, and SOC 3 engagements.

**Expanded Coverage
on Risk Assessment
Procedures and
Understanding Internal
Control**

**Emphasis on
International Issues**

**Coverage of Financial
Instruments**

**Service Organization
Controls (SOC) Reports**

New Coverage of Preparation Service Engagements

The issuance of SSARS No. 21 introduced a new type of nonattest engagement service that allows nonissuers to engage a CPA to help management prepare monthly, quarterly, or annual financial statements without providing any assurance on the financial statements or issuing a report, even if the financial statements are expected to be used by, or provided to, a third party. Chapter 25 describes this new type of service and distinguishes it from compilation and review engagement requirements.

New Concept Checks

A new feature in the 16th edition is the inclusion of Concept Checks periodically within each chapter that highlight short-answer questions to help students recap content covered within different sections of the chapter. These short in-chapter review questions are intended to help call student attention to key concepts as they read the material in the chapter.

Expanded Homework Material

We are excited about the inclusion of a number of changes to the end-of-chapter homework material for all chapters. For the 16th edition, we have partnered with Becker CPA Review to include new multiple choice problems from their CPA exam preparation materials. These problems, which are included in all 26 chapters, are labeled with the Becker logo. Additionally, each chapter identifies new or revised Discussion Questions and Problems that instructors can use in class to generate discussion about important topics addressed in each chapter. These problems are highlighted by an “in-class” discussion icon in the margin next to the related homework problem. Each chapter also identifies homework problems that require students to research standards and other material using the Internet. While many of these research problems expose students to standards, such as those on the PCAOB Web site, other problems require students to examine recently issued financial statements or other corporate filings, or they expose students to best practices thought papers as part of the assignment. Sample problems, assignable in MyAccountingLab, provide an introduction to the CPA Exam format and an opportunity for early practice with CPA exam-style questions.

Data Analysis Problems

CPA firms expect auditors to analyze data using spreadsheets and audit software. A number of the problems in the text can be completed using Excel templates available on the text Web site. These problems are indicated by a spreadsheet icon in the margin next to the problem. CPA firms increasingly emphasize data analytics and increasingly use audit software to perform audit testing including tests for fraud. We have included selected problems using ACL in several chapters in the text. These problems are related to the topic of the chapter so that students can see how audit software is used to perform specific types of audit tests. Guidance for students on the use of ACL is included on the text Web site.

Hillsburg Hardware Annual Report

The annual report for the Hillsburg Hardware Company is included as an insert to the text. Financial statements and other information included in the annual report are used in examples throughout the text to illustrate chapter concepts. The annual report also includes management’s report on internal control required by Section 404a and the auditor’s report required by Section 404b, consistent with PCAOB Auditing Standard No. 5.

Pinnacle Manufacturing Integrated Case

The Pinnacle Manufacturing integrated case is based on a large, multi-division company. The case has been revised and expanded to now consist of seven parts included at the end of the chapter to which that part relates. Each part of the case is designed to give students hands-on experience, and the parts of the case are connected so that students will gain a better understanding of how the parts of the audit are integrated by the audit process.

The text is divided into six parts. The chapters are relatively brief and designed to be easily read and comprehended by students.

Part 1, The Auditing Profession (Chapters 1–5) The book begins with an opening vignette featuring a Big 4 public accounting firm’s assurance report contained in the Corporate Sustainability Report issued by United Parcel Service (UPS), to help students see the increasingly important role of auditors in providing assurance on a broad range of information important to key stakeholders. Chapter 1 introduces key provisions of the Sarbanes–Oxley Act, including the creation of the PCAOB and Section 404 internal control reporting requirements. Chapter 2 covers the CPA profession, with particular emphasis on the standards setting responsibilities of the International Auditing and Assurance Standards Board (IAASB) and the PCAOB and how those responsibilities differ from those of the AICPA Auditing Standards Board (ASB). Chapter 2 provides in-depth coverage of the AICPA Clarity Project and resulting changes to AICPA auditing standards. Chapter 3 provides a detailed discussion of audit reports issued under AICPA and PCAOB standards, including a separate section on the report on internal control over financial reporting for an accelerated filer public company. The chapter also emphasizes conditions affecting the type of report the auditor must issue and the type of audit report applicable to each condition under varying levels of materiality. Chapter 4 explains ethical dilemmas, professional ethics, and independence, and it features the newly revised AICPA *Code of Professional Conduct*. Chapter 5 ends this part with an investigation of auditors’ legal liability.

Part 2, The Audit Process (Chapters 6–13) The first two of these chapters deal with auditor and management responsibilities, professional skepticism, a professional judgment framework for auditor decision making, audit objectives, general concepts of evidence accumulation, and audit documentation, including the management assertions and evidence concepts in the risk assessment standards. Chapter 8 deals with planning the engagement, including understanding the company’s business and its industry as part of the auditor’s risk assessment procedures, using analytical procedures as an audit tool, and making preliminary judgments about materiality. Chapter 9 provides expanded coverage of the auditor’s performance of risk assessment procedures used to assess the risk of material misstatement due to fraud or error and how the auditor responds to risks of significant misstatement with further audit procedures. Fraud auditing is the focus of Chapter 10, which builds upon risk assessment concepts covered in the previous chapter to illustrate how risk assessment includes the assessment of fraud risk. The chapter also includes specific examples of fraud and discusses warning signs and procedures performed in response to heightened fraud risk. Chapter 11 outlines the key components of an effective system of internal controls over financial reporting, consistent with the 2013 revision of COSO’s *Internal Control—Integrated Framework*. Because most internal control systems are heavily dependent on information technologies, this chapter integrates coverage of IT general controls and application controls. Chapter 12 shows how effective internal controls can reduce planned audit evidence in the audit of financial statements, and it outlines procedures auditors perform as tests of those controls to support a low control risk assessment. The chapter also describes how auditors of accelerated filer public companies integrate evidence to provide a basis for their report on the effectiveness of internal control over financial reporting with the assessment of control risk in the financial statement audit. Chapter 13 summarizes Chapters 6 through 12 and integrates them with the remainder of the text.

Part 3, Application of the Audit Process to the Sales and Collection Cycle (Chapters 14–17) These chapters apply the concepts from Part 2 to the audit of sales, cash receipts, and the related income statement and balance sheet accounts. The appropriate audit procedures for accounts in the sales and collection cycle are related to internal control and audit objectives for tests of controls, substantive tests of transactions, and tests of details of balances in the context of both the audit of financial statements and the audit of internal control over financial reporting.

Students also learn to apply audit sampling to the audit of sales, cash receipts, and accounts receivable. Chapter 15 begins with a general discussion of audit sampling for tests of controls and substantive tests of transactions. Similarly, Chapter 17 begins with general sampling concepts for tests of details of balances. The next topic in each chapter is extensive coverage of nonstatistical sampling. The last part of each chapter covers statistical sampling techniques.

Part 4, Application of the Audit Process to Other Cycles (Chapters 18–23) Each of these chapters deals with a specific transaction cycle or part of a transaction cycle in much the same manner as Chapters 14 through 17 cover the sales and collection cycle. Each chapter in Part 4 demonstrates the relationship of internal controls, tests of controls, and substantive tests of transactions for each broad category of transactions to the related balance sheet and income statement accounts. We integrate discussion of implications related to the audit of internal control throughout all these transaction cycle chapters. Cash and financial instruments are studied late in the text to demonstrate how the audit of cash and financial instrument balances is related to most other audit areas.

Part 5, Completing the Audit (Chapter 24) This part includes only one chapter, which deals with performing additional tests to address presentation and disclosure objectives, summarizing all audit tests, reviewing audit documentation, obtaining management representations in an integrated audit of financial statements and internal control, communicating with those charged with governance, and all other aspects of completing an audit.

Part 6, Other Assurance and Nonassurance Services (Chapters 25 and 26) The last two chapters deal with various types of engagements and reports, other than the audit of financial statements using generally accepted accounting principles. Topics covered include assurance services; review, compilation, and preparation services; agreed-upon procedures engagements; attestation engagements; other audit engagements; internal financial auditing; governmental financial auditing; and operational auditing. This edition also includes expanded coverage of service organization control (SOC) reports on internal controls at external service providers.

SUPPLEMENTS

Instructor's Resource Center www.pearsonglobaleditions.com/arens This password-protected site is accessible from the catalog page for *Auditing and Assurance Services, 16th ed.*, and hosts the following resources:

Image Library The Image Library allows access to most of the images and illustrations featured in the text.

Instructor's Resource Manual Suggestions for each chapter include: Homework problems, how learning objectives correlate with chapter problem material, and visual aids that can be added to PowerPoint slides or used on document cameras or overhead projectors. Chapters have been designed so that their arrangement and selection provide maximum flexibility in course design. Sample syllabi and suggested term projects are provided.

Solutions Manual Included are detailed solutions to all the end-of-chapter exercises, problems, and cases. Guidelines for responses to review questions and discussion questions are offered.

Test Item File & TestGen The **Test Item File** includes multiple choice exercises, true/false responses, essay questions, and questions related to the chapter vignettes. To assist the instructor in selecting questions for use in examinations and quizzes, each question has been assigned one of three difficulty ratings—easy, medium, or challenging. In addition, questions that uniquely relate to the integrated audits of large public companies or to the provisions of the Sarbanes–Oxley Act and Section 404 have been separately labeled for easy identification by the professor. TestGen testing software is an easy-to-use computerized testing program. It can create exams as well as evaluate and track student results. All Test Item File questions are available in the TestGen format.

PowerPoint Slides PowerPoint presentations are available for each chapter of the text. Instructors have the flexibility to add slides and/or modify the existing slides to meet course needs.

Enhanced Companion Web Site Pearson's Learning on the Internet Partnership offers the most expansive Internet-based support available. Our Web site provides a wealth of resources for students and faculty. Periodically, faculty will be able to access electronic summaries and PowerPoint slides of the most recent changes to professional standards and summaries of major issues affecting the auditing profession. This will help instructors to stay informed of emerging issues.

MyAccountingLab[®] MyAccountingLab is an online homework, tutorial, and assessment program designed to work with this text to engage students and improve results. Within its structured environment, students practice what they learn, test their understanding, and receive immediate feedback to help them better absorb course material and understand difficult concepts.

ACKNOWLEDGMENTS

We acknowledge the American Institute of Certified Public Accountants for permission to quote extensively from Statements on Auditing Standards, the *Code of Professional Conduct*, Uniform CPA Examinations, and other publications. The willingness of this major accounting organization to permit the use of its materials is a significant contribution to the book and audit education.

We gratefully acknowledge the contributions of the following reviewers for their suggestions and support in the 16th edition as well as previous editions:

Sherri Anderson, *Sonoma State University*
Stephen K. Asare, *University of Florida*
David Baglia, *Grove City College*
Brian Ballou, *Miami University*
William E. Bealing, Jr., *Bloomsburg University*
Stanley F. Biggs, *University of Connecticut*
Robert Braun, *Southeastern Louisiana University*
Joe Brazel, *North Carolina State University*
Billy Brewster, *University of Texas–Arlington*
Frank Buckless, *North Carolina State University*
Joseph V. Calmie, *Thomas Nelson Community College*
Eric Carlsen, *Kean College of New Jersey*
David Chan, *St. John's University*
Freddie Choo, *San Francisco State University*
Karl Dahlberg, *Rutgers University*
Frank Daroca, *Loyola Marymount University*
Stephen Del Vecchio, *University of Central Missouri*
Todd DeZoort, *University of Alabama–Tuscaloosa*
Magdy Farag, *California State Polytechnic University, Pomona*
William L. Felix, *University of Arizona*
Michele Flint, *Daemen College*
David S. Gelb, *Seton Hall University*
Stephanie Geter, *University of Cincinnati*
David Gilbertson, *Western Washington University*
John Giles, *North Carolina State University*
Lori Grady, *Bucks County Community College*
Charles L. Holley, *Virginia Commonwealth University*
Steve Hunt, *Western Illinois University*
Greg Jenkins, *Virginia Tech University*
James Jiambalvo, *University of Washington*
Ambrose Jones, III, *University of North Carolina–Greensboro*
David S. Kerr, *University of North Carolina at Charlotte*
William R. Kinney, Jr., *University of Texas at Austin*
W. Robert Knechel, *University of Florida*

Jason MacGregor, *Baylor University*
John Mason, *University of Alabama–Tuscaloosa*
Heidi H. Meier, *Cleveland State University*
Alfred R. Michenzi, *Loyola College in Maryland*
Charles R. (Tad) Miller, *California Polytechnic State University, San Luis Obispo*
Lawrence C. Mohrweis, *Northern Arizona University*
Norma Montague, *Wake Forest University*
Curtis Mullis, *University of Alabama*
Patricia M. Myers, *Brock University*
Kathy O'Donnell, *SUNY Buffalo*
Kristine N. Palmer, *Longwood College*
Vicki S. Peden, *California State Polytechnic University, Pomona*
Ron Reed, *University of Northern Colorado*
Pankaj Saksena, *Indiana University South Bend*
Cindy Seipel, *New Mexico State University*
Scott Showalter, *North Carolina State University*
Philip H. Siegel, *Troy University*
Robert R. Tucker, *Fordham University*
Barb Waddington, *Eastern Michigan University*
Karl Wang, *University of Mississippi*
Jeanne H. Yamamura, *University of Nevada, Reno*
Doug Ziegenfuss, *Old Dominion University*

We especially thank the Pearson book team for their hard work and dedication, including Ellen Geary, Acquisitions Editor; Daniel Petrino, Program Manager; Christine Donovan, Editorial Assistant; Donna Battista, Vice President of Business Publishing; Maggie Moylan, Vice President, Product Marketing; Natalie Wagner, Senior Field Marketer; Jessica Quazza, Product Marketing Assistant; Ashley Santora, Team Lead, Program Management; Roberta Sherman, Project Manager; and Jeff Holcomb, Team Lead, Project Management.

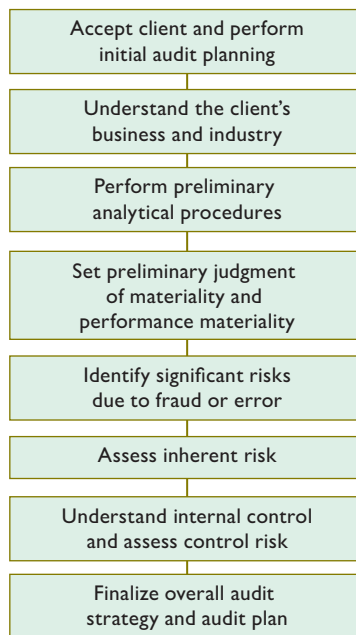
A. A. A.
R. J. E.
M. S. B.
C. E. H.

Pearson would like to thank and acknowledge Loo Choo Hong (Wawasan Open University), Eric Leung (The Chinese University of Hong Kong), Jeff NG (The Chinese University of Hong Kong), Junaid Shaikh (Curtin University) and A. Ramin (Khazar University) for contributing to the Global Edition, and Raymond Wong Kin Ho (The Chinese University of Hong Kong), Mabel Lam (The Open University of Hong Kong) and Helen S.M. Wong (The Hong Kong Polytechnic University) for reviewing the Global Edition.

Summary of the Audit Process

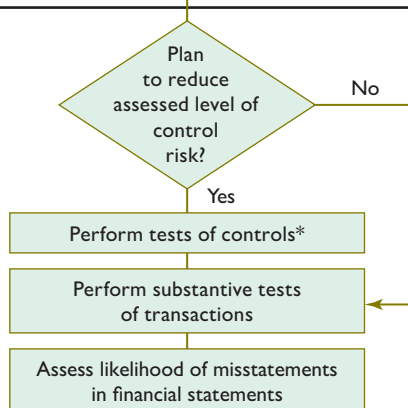
PHASE I

Plan and design an audit approach



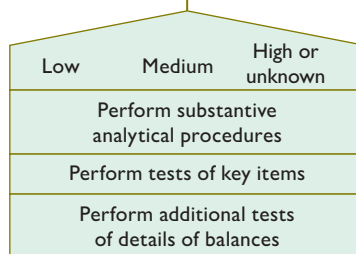
PHASE II

Perform tests of controls and substantive tests of transactions



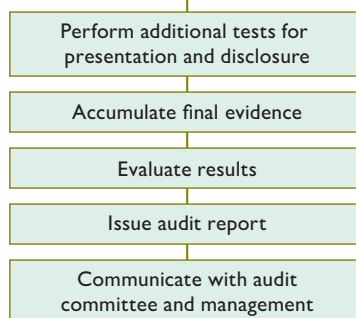
PHASE III

Perform substantive analytical procedures and tests of details of balances



PHASE IV

Complete the audit and issue an audit report



*The extent of tests of controls is determined by planned reliance on controls. For public companies required to have an audit of internal control, testing must be sufficient to issue an opinion on internal control over financial reporting.



PART

THE AUDITING PROFESSION

CHAPTERS 1–5

These first five chapters in **PART I** provide background for performing financial audits, which is our primary focus. This background will help you understand why auditors perform audits the way they do.

- **Chapters 1 and 2** describe assurance services, including auditing and the role of certified public accounting (CPA) firms and other organizations in performing audits of financial statements and other information.
- **Chapter 3** provides a detailed discussion of audit reports, which are the final products of audits.
- **Chapters 4 and 5** emphasize the regulation and oversight of CPA firms through ethical standards and the legal responsibilities of auditors.

THE DEMAND FOR AUDIT AND OTHER ASSURANCE SERVICES

CHAPTER

1

Monozukuri by KOBELCO

Kobe Steel, Ltd. (KOBELCO), one of Japan's leading steelmakers and supplier of aluminum and copper products, has been around for more than a century since their establishment in 1905. Apart from involving themselves in the metal industry, KOBELCO has interests in wholesale power supply, machinery, construction machinery, real estate, and electronic materials.

KOBELCO conducts Corporate Social Responsibility (CSR) activities that contribute to the environment and society through *monozukuri* (or manufacturing). The literal translation of *monozukuri* is 'production'. 'Mono' means the the thing which is made and 'Zukuri' means the act of making. The closest concept in the English language to *monozukuri* is 'craftsmanship'. This is a key element of the company's philosophy. Japan is a country that is prone to many natural disasters like typhoons, earthquakes and landslides. The company aims to protect lives and livelihoods from these disasters. It is constantly developing technology in different fields using the *monozukuri* concept.



It is important to note that natural disasters management is costly. It was estimated that S\$14.5 to \$34.6 billion lost in the 2011 Tōhoku earthquake and tsunami. 15,893 people were confirmed dead, 6,152 were injured, and 2,572 people are still reported missing. Any repeat of the Tōhoku earthquake and tsunami will be devastating to Japan. *Monozukuri* disaster protective technologies could hopefully mitigate both human tragedy and monetary losses from similar disasters in the future.

KOBELCO established a Compliance Committee to advise the board of directors to facilitate discussion, make proposals, and conduct follow-up verification related to important CSR issues (especially environmental management activities). KOBELCO has adopted specific CSR guidelines in the form of their Corporate Code of Ethics. The CSR Committee compiles information concerning the CSR activities and publishes it each year in the form of the Kobe Steel Group Sustainability Report. For example, KOBELCO donated 200 million yen and relief goods in the form of construction equipment valued at 100 million yen to the Tōhoku earthquake and tsunami relief.

The company requires their corporate auditing system to be strong and independent as required in the Companies Act of Japan. The Audit and Supervisory Board would have independent members that are independent of the Board of Directors and members from within the management. Apart from the external auditors, the company engages a team of Internal Auditors who operate as an independent entity in the company.

Sources: KOBELCO's CSR website http://www.kobelco.co.jp/english/about_kobelco/csr/index.html (Accessed 9 October 2015), SA Partners (2012) Toyota's Monozukuri, SA Partners LLP, Caerphilly, United Kingdom apartners.com/wp-content/uploads/2012/08/Toyotas-Monozukuri.pdf (Accessed 9 October 2015).

Each chapter's opening story illustrates important auditing principles based on realistic situations. Some of these stories are based on public information about real companies, whereas others are fictitious. Any resemblance in the latter stories to real firms, companies, or individuals is unintended and purely coincidental.

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- I-1 Describe auditing.
- I-2 Distinguish between auditing and accounting.
- I-3 Explain the importance of auditing in reducing information risk.
- I-4 List the causes of information risk, and explain how this risk can be reduced.
- I-5 Describe assurance services and distinguish audit services from other assurance and nonassurance services provided by CPAs.
- I-6 Differentiate the three main types of audits.
- I-7 Identify the primary types of auditors.
- I-8 Describe the requirements for becoming a CPA.

The opening example involving KOBELCO illustrates the increasingly important role CSR and corporate governance reporting, compliance and assurance to a broad range of stakeholders. Of course, reporting on the financial statements of public companies, as well as private companies, government units, and nonprofit entities, remains a primary role of auditors. In addition, auditors provide assurance on internal control over financial reporting for larger public companies.

This chapter introduces auditing and other assurance services provided by auditors, as well as auditors' role in society. These services provide value by offering assurance on financial statements, the effectiveness of internal control, and many other types of information. There is also a discussion of the types of audits and auditors, including the requirements for becoming a certified public accountant (CPA).

NATURE OF AUDITING

OBJECTIVE 1-1

Describe auditing.

We have introduced the role of auditors in society and how auditors provide assurance on financial statements. Auditors also provide assurance on the effectiveness of internal control over financial reporting, as well as many other types of information such as corporate sustainability reports. We now examine auditing more specifically using the following definition:

Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent, independent person.

The definition includes several key words and phrases. For ease of understanding, we'll discuss the terms in a different order than they occur in the description.

Information and Established Criteria

To do an audit, there must be information in a *verifiable form* and some standards (*criteria*) by which the auditor can evaluate the information. This information can take many forms. Auditors routinely perform audits of quantifiable information, including companies' financial statements and individuals' federal income tax returns. Auditors also audit more subjective information, such as the effectiveness of computer systems and the efficiency of manufacturing operations.

The criteria for evaluating information also vary depending on the information being audited. In the audit of historical financial statements by CPA firms, the criteria may be U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS). This means that in an audit of Apple's financial statements, the CPA firm will determine whether Apple's financial statements have been prepared in accordance with GAAP. For an audit of internal control over financial reporting, the criteria will be a recognized framework for establishing internal control, such as *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (widely known as COSO).

For the audit of tax returns by the Internal Revenue Service (IRS), the criteria are found in the Internal Revenue Code. In an IRS audit of Apple's corporate tax return, the internal revenue agent uses the Internal Revenue Code as the criteria for correctness, rather than GAAP.

For more subjective information, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts. For example, in an audit of the effectiveness of specific aspects of computer operations, the criteria might include the allowable level of input or output errors.

Accumulating and Evaluating Evidence

Evidence is any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including:

- Electronic and documentary data about transactions
- Written and electronic communication with outsiders

- Observations by the auditor
- Oral testimony of the auditee (client)

To satisfy the purpose of the audit, auditors must obtain a sufficient quality and quantity of evidence. Auditors must determine the types and amount of evidence necessary and evaluate whether the information corresponds to the established criteria. This is a critical part of every audit and the primary subject of this book.

The auditor must be qualified to understand the criteria used and must be *competent* to know the types and amount of evidence to accumulate in order to reach the proper conclusion after examining the evidence. The auditor must also have an *independent mental attitude*. The competence of those performing the audit is of little value if they are biased in the accumulation and evaluation of evidence.

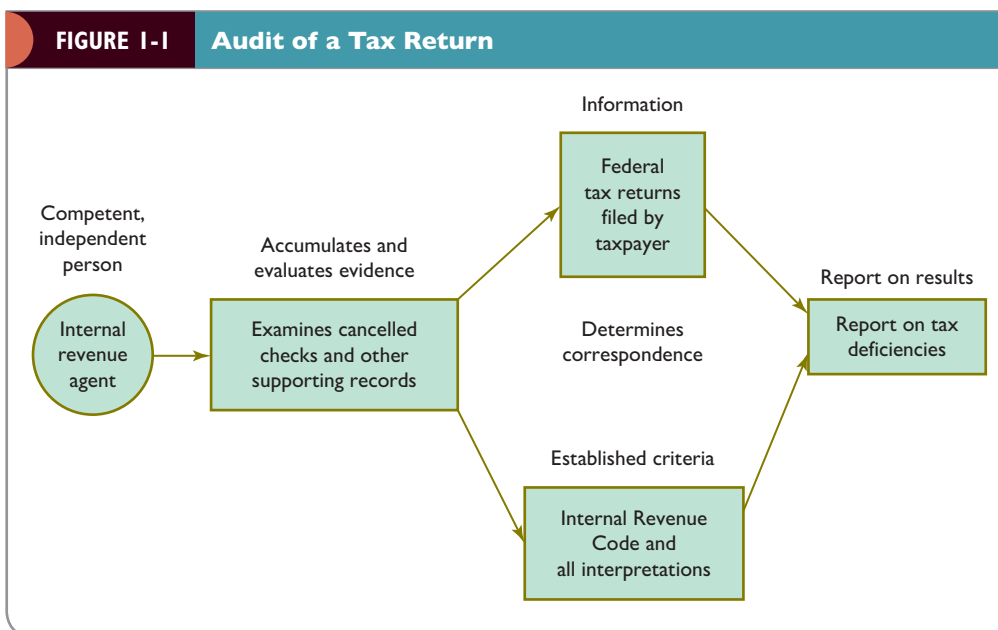
Auditors strive to maintain a high level of independence to keep the confidence of users relying on their reports. Auditors reporting on company financial statements are often called **independent auditors**. Even though such auditors are paid fees by the company, they are normally sufficiently independent to conduct audits that can be relied on by users. Even internal auditors—those employed by the companies they audit—usually report directly to top management and the board of directors, keeping the auditors independent of the operating units they audit.

The final stage in the auditing process is preparing the **audit report**, which communicates the auditor’s findings to users. Reports differ in nature, but all must inform readers of the degree of correspondence between the information audited and established criteria. Reports also differ in form and can vary from the highly technical type usually associated with financial statement audits to a simple oral report in the case of an operational audit of a small department’s effectiveness.

The key parts in the description of auditing are illustrated in Figure 1-1 using an IRS agent’s audit of an individual’s tax return as an example. To determine whether the tax return was prepared in a manner consistent with the requirements of the federal Internal Revenue Code, the agent examines supporting records provided by the taxpayer and from other sources, such as the taxpayer’s employer. After completing the audit, the internal revenue agent issues a report to the taxpayer assessing additional taxes, advising that a refund is due, or stating that there is no change in the status of the tax return.

Competent, Independent Person

Reporting



DISTINCTION BETWEEN AUDITING AND ACCOUNTING

OBJECTIVE 1-2

Distinguish between auditing and accounting.

Many financial statement users and the general public confuse auditing with accounting. The confusion results because most auditing is usually concerned with accounting information, and many auditors have considerable expertise in accounting matters. The confusion is increased by giving the title “certified public accountant” to many individuals who perform audits.

Accounting is the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making. To provide relevant information, accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting information. In addition, accountants must develop a system to make sure that the entity’s economic events are properly recorded on a timely basis and at a reasonable cost.

When auditing accounting data, auditors focus on determining whether recorded information properly reflects the economic events that occurred during the accounting period. Because U.S. or international accounting standards provide the criteria for evaluating whether the accounting information is properly recorded, auditors must thoroughly understand those accounting standards.

In addition to understanding accounting, the auditor must possess expertise in the accumulation and interpretation of audit evidence. It is this expertise that distinguishes auditors from accountants. Determining the proper audit procedures, deciding the number and types of items to test, and evaluating the results are unique to the auditor.

ECONOMIC DEMAND FOR AUDITING

OBJECTIVE 1-3

Explain the importance of auditing in reducing information risk.

To illustrate the need for auditing, consider the decision of a bank officer in making a loan to a business. This decision will be based on such factors as previous financial relationships with the business and the financial condition of the business as reflected by its financial statements. If the bank makes the loan, it will charge a rate of interest determined primarily by three factors:

1. *Risk-free interest rate.* This is approximately the rate the bank could earn by investing in U.S. treasury notes for the same length of time as the business loan.
2. *Business risk for the customer.* This risk reflects the possibility that the business will not be able to repay its loan because of economic or business conditions, such as a recession, poor management decisions, or unexpected competition in the industry.
3. *Information risk.* **Information risk** reflects the possibility that the information upon which the business risk decision was made was inaccurate. A likely cause of the information risk is the possibility of inaccurate financial statements.

Auditing has no effect on either the risk-free interest rate or business risk, but it can have a significant effect on information risk. If the bank officer is satisfied that there is minimal information risk because a borrower’s financial statements are audited, the bank’s risk is substantially reduced and the overall interest rate to the borrower can be reduced. The reduction of information risk can have a significant effect on the borrower’s ability to obtain capital at a reasonable cost. For example, assume a large company has total interest-bearing debt of approximately \$10 billion. If the interest rate on that debt is reduced by only 1 percent, the annual savings in interest is \$100 million.

Causes of Information Risk

As society becomes more complex, decision makers are more likely to receive unreliable information. There are several reasons for this: remoteness of information, biases and motives of the provider, voluminous data, and the existence of complex exchange transactions.