

PART 1 The Auditing Profession

1 The Demand for Audit and Other Assurance Services 3

Learning Objectives 3

Nature of Auditing 4

Distinction Between Auditing and Accounting 6

Economic Demand for Auditing 6

Assurance Services 8

Types of Audits 14

Types of Auditors 15

Certified Public Accountant 17

Summary 18

Essential Terms 18

Review Questions 19

Multiple Choice Questions from CPA Examinations 19

Discussion Questions and Problems 20

Internet Problem 1-1: Assurance Services 23

2 The CPA Profession 25

Learning Objectives 25

Certified Public Accounting Firms 26

Activities of CPA Firms 27

Structure of CPA Firms 28

Sarbanes–Oxley Act and Public Company Accounting Oversight Board 30

Securities and Exchange Commission 31

American Institute of Certified Public Accountants (AICPA) 32

Generally Accepted Auditing Standards 33

Statements on Auditing Standards 36

International Standards on Auditing 36

Quality Control 37

Summary 39

Essential Terms 39

Review Questions 40

Multiple Choice Questions from CPA Examinations 41

Discussion Questions and Problems 42

Internet Problem 2-1: CPA Vision Project 44

3

Audit Reports 45

Learning Objectives 45

Standard Unqualified Audit Report 46

Combined Reports on Financial Statements and Internal Control Over Financial Reporting 49

Unqualified Audit Report with Explanatory Paragraph or Modified Wording 51

Departures from an Unqualified Audit Report 54

Materiality 56

Discussion of Conditions Requiring a Departure 58

Auditor's Decision Process for Audit Reports 62

Impact of E-Commerce on Audit Reporting 64

Summary 64

Essential Terms 64

Review Questions 65

Multiple Choice Questions from CPA Examinations 66

Discussion Questions and Problems 67

Internet Problem 3-1: Research Annual Reports 72

4

Professional Ethics 73

Learning Objectives 73

What Are Ethics? 74

Ethical Dilemmas 75

Special Need for Ethical Conduct in Professions 78

Code of Professional Conduct 80

Independence 83

Independence Rule of Conduct and Interpretations 86

Other Rules of Conduct 90

Enforcement 97

Summary 99

Essential Terms 99

Review Questions 99

Multiple Choice Questions from CPA Examinations 99

Discussion Questions and Problems 101

Cases 104

Internet Problem 4-1: AICPA *Code of Professional Conduct*—Ethics Rulings and Case 106

5

Legal Liability 107

Learning Objectives 107

Changed Legal Environment 108

Distinction Among Business Failure, Audit Failure, and Audit Risk 109

Legal Concepts Affecting Liability 110

Liability to Clients 112

Liability to Third Parties Under Common Law 114

Civil Liability Under the Federal Securities Laws 117

Criminal Liability 121

The Profession's Response to Legal Liability 122

Protecting Individual CPAs from Legal Liability 124

Summary 125

Essential Terms 125

Review Questions 126

Multiple Choice Questions from CPA Examinations 127

Discussion Questions and Problems 128

Case 131

Internet Problem 5-1: SEC Enforcement 131

PART 2 The Audit Process

6 Audit Responsibilities and Objectives 133

Learning Objectives 133

Objective of Conducting an Audit of Financial Statements 134

Management's Responsibilities 135

Auditor's Responsibilities 136

Financial Statement Cycles 139

Setting Audit Objectives 144

Transaction-Related Audit Objectives 146

Balance-Related Audit Objectives 148

How Audit Objectives Are Met 150

Summary 152

Essential Terms 153

Review Questions 153

Multiple Choice Questions from CPA Examinations 154

Discussion Questions and Problems 155

Case 159

Internet Problem 6-1: Assertions and Evidence Associated with New Assurance Services 160

7 Audit Evidence 161

Learning Objectives 161

Nature of Evidence 162

Audit Evidence Decisions 163

Persuasiveness of Evidence 164

Types of Audit Evidence 167

Audit Documentation 174

Summary of Audit Documentation 183

Essential Terms 183

Review Questions 184

Multiple Choice Questions from CPA Examinations 185

Discussion Questions and Problems 186

Cases 189

Internet Problem 7-1: Electronic Evidence 192

8 Audit Planning and Analytical Procedures 193

Learning Objectives 193

Planning 194

Accept Client and Perform Initial Audit Planning 194

Understand the Client's Business and Industry 199

Assess Client Business Risk 204

Perform Preliminary Analytical Procedures 205

Summary of the Purposes of Audit Planning 207

Analytical Procedures 208

Five Types of Analytical Procedures 209

Common Financial Ratios 215

Summary of Analytical Procedures 217

Essential Terms 217

Review Questions 217

Multiple Choice Questions from CPA Examinations 218

Discussion Questions and Problems 220

Cases 224

Integrated Case Application—Pinnacle Manufacturing: Part I 227
Internet Problem 8-1: Industry Research and Client Acceptance 229
Internet Problem 8-2: Obtain Client Background Information 229

9

Materiality and Risk 231

Learning Objectives 231

Materiality 232

Set Preliminary Judgment about Materiality 233

Allocate Preliminary Judgment about Materiality to Segments
(Tolerable Misstatement) 236

Estimate Misstatement and Compare with Preliminary Judgment 238

Risk 239

Types of Risks 241

Assessing Acceptable Audit Risk 243

Assessing Inherent Risk 245

Relationship of Risks to Evidence and Factors Influencing Risks 248

Evaluating Results 252

Essential Terms 255

Review Questions 255

Multiple Choice Questions from CPA Examinations 256

Discussion Questions and Problems 258

Cases 263

Integrated Case Application—Pinnacle Manufacturing: Part II 266

Internet Problem 9-1: Materiality and Tolerable Misstatement 267

10

Section 404 Audits of Internal Control and Control Risk 269

Learning Objectives 269

Internal Control Objectives 270

Management and Auditor Responsibilities Related to Internal Control 271

COSO Components of Internal Control 274

Obtain and Document Understanding of Internal Control 283

Assess Control Risk 287

Tests of Controls 292

Decide Planned Detection Risk and Design Substantive Tests 295

Section 404 Reporting on Internal Control 295

Evaluating, Reporting, and Testing Internal Control for Nonpublic Company 297

Summary 299

Essential Terms 300

Review Questions 301

Multiple Choice Questions from CPA Examinations 303

Discussion Questions and Problems 304

Case 309

Integrated Case Application—Pinnacle Manufacturing: Part III 310

Internet Problem 10-1: Corporate Governance 312

11

Fraud Auditing 313

Learning Objectives 313

Types of Fraud 314

Conditions for Fraud 315

Assessing the Risk of Fraud 319

Corporate Governance Oversight to Reduce Fraud Risks 322

Responding to the Risk of Fraud 327

Specific Fraud Risk Areas 329

Responsibilities when Fraud is Suspected 334

Summary 337
Essential Terms 337
Review Questions 338
Multiple Choice Questions from CPA Examinations 338
Discussion Questions and Problems 340
Case 342
Internet Problem 11-1: Fraud Best Practices 343

12 The Impact of Information Technology on the Audit Process 345

Learning Objectives 345

How Information Technologies Enhance Internal Control 346
Assessing Risks of Information Technology 347
Internal Controls Specific to Information Technology 348
Impact of Information Technology on the Audit Process 354
Issues for Different IT Environments 359
Summary 363
Essential Terms 364
Review Questions 364
Multiple Choice Questions from CPA Examinations 365
Discussion Questions and Problems 366
Case 371
Internet Problem 12-1: COBIT 373

13 Overall Audit Plan and Audit Program 375

Learning Objectives 375

Types of Tests 376
Selecting Which Types of Tests to Perform 380
Impact of Information Technology on Audit Testing 383
Evidence Mix 384
Design of the Audit Program 385
Summary of Key Evidence-Related Terms 394
Summary of the Audit Process 395
Essential Terms 398
Review Questions 398
Multiple Choice Questions from CPA Examinations 399
Discussion Questions and Problems 401
Cases 405
Internet Problem 13-1: Assessing Effects of Evidence Mix 407

PART 3 Application of the Audit Process to the Sales and Collection Cycle

14 Audit of the Sales and Collection Cycle: Tests of Controls and Substantive Tests of Transactions 409

Learning Objectives 409

Accounts and Classes of Transactions in the Sales and Collection Cycle 410
Business Functions in the Cycle and Related Documents and Records 411
Methodology for Designing Tests of Controls and Substantive Tests of Transactions for Sales 416
Sales Returns and Allowances 425
Methodology for Designing Tests of Controls and Substantive Tests of Transactions for Cash Receipts 426
Audit Tests for Uncollectible Accounts 430
Additional Internal Controls over Account Balances 431

Effect of Results of Tests of Controls and Substantive Tests of Transactions 431
Summary 432
Essential Terms 432
Review Questions 433
Multiple Choice Questions from CPA Examinations 434
Discussion Questions and Problems 435
Case 440
Integrated Case Application—Pinnacle Manufacturing: Part IV 441
Internet Problem 14-1: Electronic Signatures 441

15 **Audit Sampling for Tests of Controls and Substantive Tests of Transactions 443**

Learning Objectives 443
Representative Samples 444
Statistical Versus Nonstatistical Sampling and Probabilistic Versus
 Nonprobabilistic Sample Selection 445
Nonprobabilistic Sample Selection Methods 446
Probabilistic Sample Selection Methods 447
Sampling for Exception Rates 449
Application of Nonstatistical Audit Sampling 451
Statistical Audit Sampling 466
Sampling Distribution 466
Application of Attributes Sampling 467
Essential Terms 472
Review Questions 473
Multiple Choice Questions from CPA Examinations 474
Discussion Questions and Problems 475
Case 479
Integrated Case Application—Pinnacle Manufacturing: Part V 479
Internet Problem 15-1: Sampling for U.S. Census 481

16 **Completing the Tests in the Sales and Collection Cycle: Accounts Receivable 483**

Learning Objectives 483
Methodology for Designing Tests of Details of Balances 484
Designing Tests of Details of Balances 491
Confirmation of Accounts Receivable 497
Developing Tests of Details Audit Program 502
Essential Terms 505
Review Questions 505
Multiple Choice Questions from CPA Examinations 506
Discussion Questions and Problems 507
Case 513
Integrated Case Application—Pinnacle Manufacturing: Part VI 513
Internet Problem 16-1: Revenue Recognition 514

17 **Audit Sampling for Tests of Details of Balances 519**

Learning Objectives 519
Comparisons of Audit Sampling for Tests of Details of Balances and for
 Tests of Controls and Substantive Tests of Transactions 520
Nonstatistical Sampling 520
Monetary Unit Sampling 529
Variables Sampling 539
Illustration Using Difference Estimation 544
Essential Terms 550

Review Questions 550
Multiple Choice Questions from CPA Examinations 552
Discussion Questions and Problems 553
Cases 556
Internet Problem 17-1: Audit Sampling Strategies 557

PART 4 Application of the Audit Process to Other Cycles

18 Audit of the Payroll and Personnel Cycle 559

Learning Objectives 559

Accounts and Transactions in the Payroll and Personnel Cycle 560
Business Functions in the Cycle and Related Documents and Records 560
Methodology for Designing Tests of Controls and Substantive Tests of Transactions 564
Methodology for Designing Tests of Details of Balances 569
Summary 573

Essential Terms 573

Review Questions 573

Multiple Choice Questions from CPA Examinations 574

Discussion Questions and Problems 575

Case 578

Internet Problem 18-1: Outsourcing the Payroll Function 579

19 Audit of the Acquisition and Payment Cycle: Tests of Controls, Substantive Tests of Transactions, and Accounts Payable 581

Learning Objectives 581

Accounts and Classes of Transactions in the Acquisition and Payment Cycle 582
Business Functions in the Cycle and Related Documents and Records 582
How E-Commerce Affects the Acquisition and Payment Cycle 586
Methodology for Designing Tests of Controls and Substantive Tests of Transactions 586
Methodology for Designing Tests of Details of Balances for Accounts Payable 592
Summary 599

Essential Terms 600

Review Questions 601

Multiple Choice Questions from CPA Examinations 602

Discussion Questions and Problems 603

Case 608

Internet Problem 19-1: Managing the Accounts Payable Function 610

20 Completing the Tests in the Acquisition and Payment Cycle: Verification of Selected Accounts 611

Learning Objectives 611

Types of Other Accounts in the Acquisition and Payment Cycle 612
Audit of Property, Plant, and Equipment 612
Audit of Prepaid Expenses 620
Audit of Accrued Liabilities 622
Audit of Income and Expense Accounts 624
Summary 628

Essential Terms 628

Review Questions 628

Multiple Choice Questions from CPA Examinations 629

Discussion Questions and Problems 630

Cases 632

Internet Problem 20-1: Managing Fixed Assets 634

21	Audit of the Inventory and Warehousing Cycle 637
	Learning Objectives 637
	Business Functions in the Cycle and Related Documents and Records 638
	How E-Commerce Affects Inventory Management 641
	Parts of the Audit of Inventory 641
	Audit of Cost Accounting 643
	Analytical Procedures 646
	Methodology for Designing Tests of Details of Balances 646
	Physical Observation of Inventory 648
	Audit of Pricing and Compilation 651
	Integration of the Tests 654
	Summary 655
	Essential Terms 656
	Review Questions 656
	Multiple Choice Questions from CPA Examinations 657
	Discussion Questions and Problems 658
	Case 663
	Internet Problem 21-1: Using Inventory Count Specialists 664

22	Audit of the Capital Acquisition and Repayment Cycle 665
	Learning Objectives 665
	Accounts in the Cycle 666
	Notes Payable 668
	Owners' Equity 673
	E-Commerce and Capital Acquisition 678
	Summary 679
	Essential Terms 679
	Review Questions 679
	Multiple Choice Questions from CPA Examinations 680
	Discussion Questions and Problems 681
	Internet Problem 22-1: Stock Exchange Requirements 684

23	Audit of Cash Balances 685
	Learning Objectives 685
	Cash in the Bank and Transaction Cycles 686
	Types of Cash Accounts 688
	Audit of the General Cash Account 689
	Fraud-Oriented Procedures 696
	Audit of the Imprest Payroll Bank Account 701
	Audit of Imprest Petty Cash 701
	Summary 702
	Essential Terms 702
	Review Questions 703
	Multiple Choice Questions from CPA Examinations 704
	Discussion Questions and Problems 704
	Case 708
	Internet Problem 23-1: Electronic Money 709

PART 5 Completing the Audit

24	Completing the Audit 711
	Learning Objectives 711
	Review for Contingent Liabilities and Commitments 712

Review for Subsequent Events 717
Final Evidence Accumulation 720
Evaluate Results 723
Issue the Audit Report 728
Communicate with the Audit Committee and Management 728
Subsequent Discovery of Facts 730
Essential Terms 731
Review Questions 732
Multiple Choice Questions from CPA Examinations 733
Discussion Questions and Problems 735
Case 738
Internet Problem 24-1: Subsequent Events 739

PART 6 Other Assurance and Nonassurance Services

25 Other Assurance Services 741

Learning Objectives 741
Attestation Engagements 742
SysTrust Services 747
Prospective Financial Statements 747
Agreed-Upon Procedures Engagements 750
Review and Compilation Services 750
Review of Interim Financial Information for Public Companies 755
Other Audits or Limited Assurance Engagements 756
Summary 761
Essential Terms 761
Review Questions 761
Multiple Choice Questions from CPA Examinations 762
Discussion Questions and Problems 764
Internet Problem 25-1: Reporting on Quarterly Financial Information 768

26 Internal and Governmental Financial Auditing and Operational Auditing 769

Learning Objectives 769
Internal Financial Auditing 771
Governmental Financial Auditing 773
Operational Auditing 776
Summary 784
Essential Terms 784
Review Questions 785
Multiple Choice Questions from CPA, IIA, and CMA Examinations 786
Cases 788
Internet Problem 26-1: Institute of Internal Auditors 791

Index 793