GLOBAL EDITION

Auditing and Assurance Services

International Perspectives

SEVENTEENTH EDITION

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

AUDITING AND ASSURANCE SERVICES INTERNATIONAL PERSPECTIVES

SEVENTEENTH EDITION GLOBAL EDITION

		a nemiên dâ râi
TOHIG TAP.	THONG	TIN THU VIEN
04	-	04
0	54	02

RANDAL J. ELDER

The University of North Carolina at Greensboro Dixon Hughes Goodman Professor and Department Head

MARK S. BEASLEY

North Carolina State University Deloitte Professor of Enterprise Risk Management

CHRIS E. HOGAN

Michigan State University Russell E. Palmer Endowed Professor and Department Chairperson

ALVIN A. ARENS

Michigan State University Former PricewaterhouseCoopers Emeritus Professor



Harlow, England • London • New York • Boston • San Francisco • Toronto • Sydney • Dubai • Singapore • Hong Kong Tokyo • Seoul • Taipei • New Delhi • Cape Town • Sao Paulo • Mexico City • Madrid • Amsterdam • Munich • Paris • Milar

ABOUT THE AUTHORS

RANDAL J. ELDER

Randy Elder, who has served as a coauthor of this textbook since the 8th edition, is Dixon Hughes Goodman Professor and Department Head of Accounting and Finance at the University of North Carolina at Greensboro. 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.

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 Chris Hogan joined us as a coauthor starting with the 16th edition. Chris is the Russell E. Palmer Endowed Professor of Accounting and Department Chairperson 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.

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.



PREFACE 16

THE AUDITING PROFESSION

THE DEMAND FOR AUDIT AND OTHER ASSURANCE SERVICES

LEARNING OBJECTIVES 29 Nature of Auditing 30 Distinction Between Auditing and Accounting 32 Economic Demand for Auditing 32 Assurance Services 34 Types of Audits 38 Types of Auditors 40 Certified Public Accountant 42 Summary 43 Essential Terms 43 Review Questions 44 Discussion Questions and Problems 44 CHAPTER

PART

1

THE CPA PROFESSION

LEARNING OBJECTIVES 49 Certified Public Accounting Firms 50 Structure of CPA Firms 52 Sarbanes–Oxley Act and Public Company Accounting Oversight Board 54 Securities and Exchange Commission 55 American Institute of Certified Public Accountants (AICPA) 56 International and U.S. Auditing Standards 57 Organization of U.S. Auditing Standards 59 Quality Control 63 Summary 65 Essential Terms 66 Review Questions 67 Discussion Questions and Problems 67 снартея 2

CHAPTER

3

OTHER ASSURANCE SERVICES

LEARNING OBJECTIVES 71

Review, Compilation, and Preparation Services 72 Review of Interim Financial Information for Public Companies 78 Attestation Engagements 79 Reports on Controls at Service Organizations (SOC Reports) 83 Prospective Financial Statements 85 Agreed-Upon Procedures Engagements 87 Other Audits or Limited Assurance Engagements 87 Summary 90 Essential Terms 91 Review Questions 92 Discussion Questions and Problems 93

CHAPTER

INTERNAL AND GOVERNMENTAL FINANCIAL AUDITING AND OPERATIONAL AUDITING

LEARNING OBJECTIVES 97

Internal Financial Auditing 98 Governmental Financial Auditing 101 Operational Auditing 104 Summary 111 Essential Terms 111 Review Questions 112 Discussion Questions and Problems 113

PART
2

THE AUDIT PROCESS

AUDIT RESPONSIBILITIES AND OBJECTIVES

LEARNING OBJECTIVES 118 Objective of Conducting an Audit of Financial Statements 119 Management's Responsibilities 120 Auditor's Responsibilities 121 Professional Skepticism 125 Professional Judgment 126 Financial Statement Cycles 129 Setting Audit Objectives 133 Management Assertions 134 Transaction-Related Audit Objectives 137 Balance-Related Audit Objectives 139 How Audit Objectives Are Met 142 Summary 145

Essential Terms 145 Review Questions 146 Discussion Questions and Problems 147

AUDIT EVIDENCE

LEARNING OBJECTIVES 153

Nature of Evidence 154 Audit Evidence Decisions 155 Persuasiveness of Evidence 156 Types of Audit Evidence 159 Analytical Procedures 167 Use of Data Analytics and Other Advanced Technologies 170 Common Financial Ratios 174 Audit Documentation 177 Contents and Organization 178 Summary 184 Essential Terms 184 Review Questions 186 Discussion Questions and Problems 187

AUDIT PLANNING AND MATERIALITY

LEARNING OBJECTIVES 195

Planning 196 Accept Client and Perform Initial Audit Planning 197 Understand the Client's Business and Industry 202 Perform Preliminary Analytical Procedures 207 Materiality 210 Materiality for Financial Statements as a Whole 211 Determine Performance Materiality 214 Estimate Misstatement and Compare with Preliminary Judgment 216 Summary 218 Essential Terms 220 Review Questions 221 Discussion Questions and Problems 222 Case 230 Integrated Case Application—Pinnacle Manufacturing: Part I 231



CHAPTER

CONTENTS

CHAPTER 8

ASSESSING THE RISK OF MATERIAL MISSTATEMENT

LEARNING OBJECTIVES 234 Audit Risk 235 Risk Assessment Procedures 236 Considering Fraud Risk 240 Identification of Significant Risks 241 Audit Risk Model 242 Assessing Acceptable Audit Risk 246 Assessing Inherent Risk 249 Relationship of Risks to Evidence and Factors Influencing Risks 252 Relationship of Risk and Materiality to Audit Evidence 256 Summary 257 Essential Terms 258 **Review Questions** 258 Discussion Questions and Problems 259 Case 264 Integrated Case Application-Pinnacle Manufacturing: Part II 265

CHAPTER 9

ASSESSING AND RESPONDING TO FRAUD RISKS

LEARNING OBJECTIVES 267 Types of Fraud 268 Conditions for Fraud 269 Assessing the Risk of Fraud 273 Corporate Governance Oversight to Reduce Fraud Risks 277 Responding to the Risk of Fraud 281 Specific Fraud Risk Areas 284 Responsibilities When Fraud Is Suspected 289 Documenting the Fraud Assessment 293 Summary 294 Essential Terms 294 Review Questions 295 Discussion Questions and Problems 296 Integrated Case Application—Pinnacle Manufacturing: Part III 302

CHAPTER 10

INTERNAL CONTROL AND COSO FRAMEWORK

LEARNING OBJECTIVES 303 Internal Control Objectives 304 Management and Auditor Responsibilities for Internal Control 305 COSO Components of Internal Control 308 Internal Controls Specific to Information Technology 317 Impact of IT Infrastructure on Internal Control 324

Summary 326 Essential Terms 326 Review Questions 328 Discussion Questions and Problems 329 Case 333

ASSESSING CONTROL RISK AND REPORTING ON INTERNAL CONTROLS

LEARNING OBJECTIVES 335
Obtain and Document Understanding of Internal Control 336
Assess Control Risk 339
Tests of Controls 344
Decide Planned Detection Risk and Design Substantive Tests 350
Auditor Reporting on Internal Control 350
Evaluating, Reporting, and Testing Internal Control for Nonpublic and Smaller Public Companies 353
Impact of IT Environment on Control Risk Assessment and Testing 355
Summary 359
Essential Terms 359
Review Questions 361
Discussion Questions and Problems 362
Case 370
Integrated Case Application—Pinnacle Manufacturing: Part IV 372

OVERALL AUDIT STRATEGY AND AUDIT PROGRAM

LEARNING OBJECTIVES 374

Types of Tests 375 Selecting Which Types of Tests to Perform 381 Evidence Mix 384 Design of the Audit Program 386 Summary of Key Evidence-Related Terms 395 Summary of the Audit Process 396 Summary 400 Essential Terms 400 Review Questions 401 Discussion Questions and Problems 402 Cases 408



CHAPTER 12

COSO Components of Internal Control 308 Internal Controls Specific to Information Technology 317 Impact of IT Infrastructure on Internal Control 324

Summary 326 Essential Terms 326 Review Questions 328 Discussion Questions and Problems 329 Case 333

ASSESSING CONTROL RISK AND REPORTING ON INTERNAL CONTROLS

LEARNING OBJECTIVES 335 Obtain and Document Understanding of Internal Control 336 Assess Control Risk 339 Tests of Controls 344 Decide Planned Detection Risk and Design Substantive Tests 350 Auditor Reporting on Internal Control 350 Evaluating, Reporting, and Testing Internal Control for Nonpublic and Smaller Public Companies 353 Impact of IT Environment on Control Risk Assessment and Testing 355 Summary 359 Essential Terms 359 Review Questions 361 Discussion Questions and Problems 362 Case 370 Integrated Case Application—Pinnacle Manufacturing: Part IV 372

OVERALL AUDIT STRATEGY AND AUDIT PROGRAM

LEARNING OBJECTIVES 374

Types of Tests 375 Selecting Which Types of Tests to Perform 381 Evidence Mix 384 Design of the Audit Program 386 Summary of Key Evidence-Related Terms 395 Summary of the Audit Process 396 Summary 400 Essential Terms 400 Review Questions 401 Discussion Questions and Problems 402 Cases 408 CHAPTER

12

PART 3

APPLICATION OF THE AUDIT PROCESS TO THE SALES AND COLLECTION CYCLE

chapter 13

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

LEARNING OBJECTIVES 412

Accounts and Classes of Transactions in the Sales and Collection Cycle 413 Business Functions in the Cycle and Related Documents and Records 414 Methodology for Designing Tests of Controls and Substantive Tests of Transactions for Sales 419 Sales Returns and Allowances 431 Methodology for Designing Tests of Controls and Substantive Tests of Transactions for Cash Receipts 431 Audit Tests for Uncollectible Accounts 435 Effect of Results of Tests of Controls and Substantive Tests of **Transactions 436** Summary 437 Essential Terms 438 **Review Ouestions** 438 Discussion Questions and Problems 439 Case 446 Integrated Case Application—Pinnacle Manufacturing: Part V 447

AUDIT SAMPLING FOR TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS

LEARNING OBJECTIVES 448

Representative Samples 449 Statistical Versus Nonstatistical Sampling and Probabilistic Versus Nonprobabilistic Sample Selection 450 Sample Selection Methods 451 Sampling for Exception Rates 454 Application of Nonstatistical Audit Sampling 455 Statistical Audit Sampling 471 Application of Statistical Attributes Sampling 473 Summary 478 Essential Terms 478 Review Questions 479 Discussion Questions and Problems 480 Case 486 Integrated Case Application—Pinnacle Manufacturing: Part V1 486

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

LEARNING OBJECTIVES 488

Methodology for Designing Tests of Details of Balances 489 Designing Tests of Details of Balances 495 **Confirmation of Accounts Receivable** 502 Developing Tests of Details Audit Program 508 Summary 511 Essential Terms 511 Review Questions 512 Discussion Questions and Problems 513 Case 520

Integrated Case Application—Pinnacle Manufacturing: Part VII 521

AUDIT SAMPLING FOR TESTS **OF DETAILS OF BALANCES**

LEARNING OBJECTIVES 526

Comparisons of Audit Sampling for Tests of Details of Balances and for Tests of Controls and Substantive Tests of Transactions 527 Nonstatistical Sampling 528 Monetary Unit Sampling 537 Variables Sampling 546 Illustration Using Difference Estimation 551 Summary 554 Essential Terms 555 **Review Questions** 555 Discussion Questions and Problems 557 Cases 562

APPLICATION OF THE AUDIT PROCESS TO OTHER CYCLES

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

LEARNING OBJECTIVES 565

Accounts and Classes of Transactions in the Acquisition and Payment Cycle 566 Business Functions in the Cycle and Related Documents and Records 567 Methodology for Designing Tests of Controls and Substantive Tests of **Transactions 570**







CHAPTER 16

CHAPTER

15



Methodology for Designing Tests of Details of Balances for Accounts Payable 577 Summary 586 Essential Terms 586

Essential Terms 586 Review Questions 587 Discussion Questions and Problems 588 Case 594

CHAPTER 18

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

LEARNING OBJECTIVES 597

Types of Other Accounts in the Acquisition and Payment Cycle 598 Audit of Property, Plant, and Equipment 598 Audit of Prepaid Expenses 606 Audit of Accrued Liabilities 609 Audit of Income and Expense Accounts 611 Summary 614 Essential Terms 615 Review Questions 615 Discussion Questions and Problems 616 Cases 619

CHAPTER 19

AUDIT OF THE PAYROLL AND PERSONNEL CYCLE

LEARNING OBJECTIVES 622

Accounts and Transactions in the Payroll and Personnel Cycle 623 Business Functions in the Cycle and Related Documents and Records 623 Methodology for Designing Tests of Controls and Substantive Tests of Transactions 626

Methodology for Designing Substantive Analytical Procedures and Tests of Details of Balances 632

Summary 636 Essential Terms 636 Review Questions 637 Discussion Questions and Problems 638 Case 642

AUDIT OF THE INVENTORY AND WAREHOUSING CYCLE

LEARNING OBJECTIVES 644

Business Functions in the Cycle and Related Documents and Records 645 Parts of the Audit of Inventory 647 Audit of Cost Accounting 650 Substantive Analytical Procedures 653 Physical Observation of Inventory 654 Audit of Pricing and Compilation 658 Integration of the Tests 661 Summary 663 Essential Terms 663 Review Questions 664 Discussion Questions and Problems 665 Case 672

AUDIT OF THE CAPITAL ACQUISITION AND REPAYMENT CYCLE

LEARNING OBJECTIVES 674 Accounts in the Cycle 675 Notes Payable 676 Owners' Equity 680 Summary 687 Essential Terms 687 Review Questions 687 Discussion Questions and Problems 688

AUDIT OF CASH AND FINANCIAL INSTRUMENTS

LEARNING OBJECTIVES 693

Types of Cash and Financial Instruments Accounts 694 Cash in the Bank and Transaction Cycles 696 Audit of the General Cash Account 697 Fraud-Oriented Procedures 705 Audit of Financial Instruments Accounts 710 Summary 713 Essential Terms 713 Review Questions 714 Discussion Questions and Problems 715

снартея 21

CHAPTER

20

CHAPTER 22

COMPLETING THE AUDIT

снартек 23

COMPLETING THE AUDIT

LEARNING OBJECTIVES 721

Perform Additional Tests for Presentation and Disclosure 722 Review for Contingent Liabilities and Commitments 723 Review for Subsequent Events 728 Final Evidence Accumulation 731 Evaluate Results 737 Issue the Audit Report 741 Communicate with the Audit Committee and Management 741 Subsequent Discovery of Facts 743 Summary 745 Essential Terms 745 Review Questions 746 Discussion Questions and Problems 747 Case 751

24

AUDIT REPORTS

LEARNING OBJECTIVES 752

Standard Unmodified Opinion Audit Report for Nonpublic Entities 753 Conditions for Standard Unmodified Opinion Audit Report 756 Standard Audit Report and Report on Internal Control over Financial Reporting Under PCAOB Auditing Standards 757 Unmodified Opinion Audit Report with Emphasis-of-Matter Explanatory Paragraph or Nonstandard Report Wording 763 Modifications to the Opinion in the Audit Report 767 Materiality 768 Discussion of Conditions Requiring a Modification of Opinion 772 Auditor's Decision Process for Audit Reports 776 International Accounting and Auditing Standards 778 Summary 778 Essential Terms 779 Review Questions 779 Discussion Questions and Problems 780

PROFESSIONAL ETHICS

LEARNING OBJECTIVES 786

What Are Ethics? 787 Ethical Dilemmas 788 Special Need for Ethical Conduct in Professions 791 Code of Professional Conduct 793 Independence Rule 798 Sarbanes–Oxley and Related Independence Requirements 802 Other Rules of Conduct 805 Enforcement 812 Summary 814 Essential Terms 815 Review Questions 815 Discussion Questions and Problems 816 Cases 819

INDEX 822

CREDITS 838

снартег 25