

Whittington • Pany

# Principles of Auditing

AND OTHER ASSURANCE SERVICES

FOURTEENTH EDITION

## Major Updates in *Principles of Auditing and Other Assurance Services*, 14th Edition

### Chapter 1

- Inclusion of coverage of the Sarbanes-Oxley Act of 2002 and the Public Company Accounting Oversight Board.
- Discussion of the accounting profession's credibility crisis, including such events as the Enron and WorldCom cases, and the conviction of Andersen LLP.

### Chapter 2

- Updating of quality control and additional coverage of the Public Company Accounting Oversight Board.

### Chapter 3

- Coverage of the most recent pronouncements on auditor independence, including the "covered member" concept.
- Inclusion of the new Institute of Internal Auditors Code of Ethics.
- Discussion of new requirements arising from the Sarbanes-Oxley Act of 2002.

### Chapter 4

- Major revision using suggestions of legal liability scholar Professor Marianne Jennings.
- Discussion of future oversight by the Public Company Accounting Oversight Board.

### Chapter 5

- A new section on auditing fair value estimates that reflects *SAS No. 101*.
- Revision of audit documentation requirements based on *Statement on Auditing Standards (SAS) No. 96* and the Sarbanes-Oxley Act of 2002.

### Chapter 6

- Concise, yet detailed coverage of *SAS No. 99—Consideration of Fraud in a Financial Statement Audit*.
- Increased emphasis on the business risk approach to auditing.
- Increased coverage of the linkage between audit risk and audit procedures.

### Chapter 7

- Enhanced coverage of the need for information technology skills as required by *SAS No. 94—The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*.
- Discussion of WorldCom's use of management override.
- Discussion of new requirements of the Sarbanes-Oxley Act of 2002.
- A new appendix describing anti-fraud program and control measures based on *SAS No. 99's* approach to considering fraud in a financial statement audit.

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### **Chapter 8**

- A general updating of coverage to reflect *SAS No. 94* and other IT-related topics.

### **Chapter 9**

- A focus case illustration on the use of generalized audit software in sampling.
- Additional problem material.

### **Chapters 10–16**

- Integration of *SAS No. 99* on fraud throughout.
- Realistic ethics cases that present situations a beginning auditor may encounter during the first year in public accounting are presented in Chapters 10, 11, and 12.

### **Chapter 18**

- Revision to reflect *SAS No. 100* on interim reviews.
- Inclusion of recent changes in *Accounting and Review Services* to allow certain compilations to be performed with no accountant report.

### **Chapter 19**

- Updated coverage of the profession's Trust Services.

### **Chapter 20**

- Complete revision of compliance auditing using input of Mr. Norwood J. Jackson, KPMG partner, formerly a member of the Auditing Standards Board and the Deputy Controller, Office of Federal Financial Management, United States Office of Management and Budget.

### **Some New Illustrative Cases**

- WorldCom Irregularities (p. 10)
- CPA Firms Spin Off Consulting Practices (p. 17)
- Audit Clients Hire Audit Firm Personnel (p. 70)
- Auditor Independence and Nonattest Services (p. 73)
- Arthur Andersen Dissolution (p. 81)
- WorldCom and Accounting Fraud (p. 190)

# Principles of Auditing and Other Assurance Services

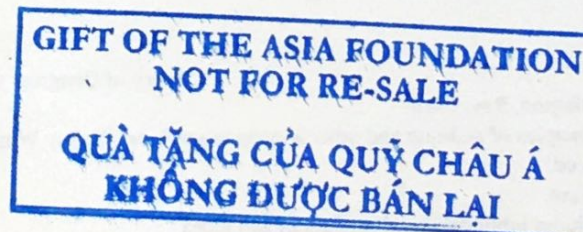
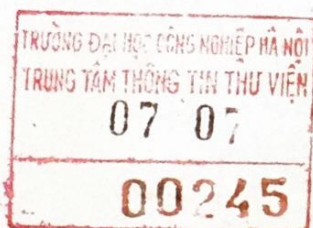
Fourteenth Edition

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# About the Authors

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

## **Kurt Pany**

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

# Preface

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Over the past few years we have seen unprecedented changes in the auditing profession. These changes were precipitated by the revelation that management of a number of large public companies, including Enron and WorldCom, systematically misstated the financial statements of the companies over a number of years. As a result, we have witnessed congressional hearings about the accounting profession, the criminal conviction and liquidation of the international accounting firm of Arthur Andersen LLP, and the passage of the Sarbanes-Oxley Act of 2002, which takes from the profession the major portion of its self-regulatory authority. The goal of the fourteenth edition of *Principles of Accounting and Other Assurance Services* is to provide you with a **clear perspective of the new auditing environment**.

How do we do this?

1. **Balanced presentation.** This text provides a carefully balanced presentation of auditing and assurance theory and practice. The concepts are written in a clear, concise, and understandable manner suitable for students who have not had significant audit experience. Real company examples are integrated throughout the text to bring this material to life. Lastly, the Keystone Computers is the text's illustrative audit case integrated into selected chapters that provides students with hands-on audit experience.
2. **Clarifying the changes to the profession.** The authors have included all the new legal and standards changes affecting the auditing profession to provide you with the most current and up-to-date auditing text available. Please refer to the inside front cover for a detailed list of the changes.
3. **Maintaining a clear perspective.** The Online Learning Center provides instructors and students with a wealth of material to help keep students up-to-date. The OLC receives daily updates from *The New York Times* and McGraw-Hill's PowerWeb so you always know the breaking news affecting the profession. The OLC also contains quizzing and other resources to help students in this course.

Just as the windows on the cover provide a clear perspective of the environment outside, *Principles of Auditing and Other Assurance Services*, 14/e, will provide students with a clear perspective of the new auditing environment.

*O. Ray Whittington*

*Kurt Pany*

# Key Features of the Book

**Sarbanes-Oxley Act of 2002** and the resulting **Public Company Accounting Oversight Board** profoundly affect public accountants, CPA firms, and their clients. Most notably, the public accounting profession is no longer largely self-regulating, CPAs must issue a publicly available report on the internal control of each publicly traded client, and top management must certify its financial statements. The text carefully integrates coverage of the act's nature and effects on the profession in selected chapters. Also included is coverage of financial frauds, such as those involving Enron and WorldCom that led to passage of the act.

The first 9 chapters of the text emphasize the philosophy and environment of the profession, with special attention paid to the nature and economic purpose of auditing and assurance services, professional standards, professional conduct, legal liability, audit evidence, audit planning, consideration of internal control, audit sampling, audit working papers, and general records.

**Auditor legal liability** in Chapter 4 has been thoroughly updated based on suggestions by legal scholar Professor Marianne Jennings of Arizona State University.

Chapter 6 has been revised to include the dramatic changes required by Statement on Auditing Standards No. 99, *The Auditor's Consideration of Fraud in a Financial Statement Audit*.

Chapters 7 and 8 reflect the profession's most recent pronouncements relating to information technology and internal control.

1. The Role of the Public Accountant in the American Economy
2. Professional Standards
3. Professional Ethics
4. Legal Liability of CPAs
5. Audit Evidence and Documentation
6. Planning the Audit; Linking Audit Procedures to Risk
7. Internal Control
8. Consideration of Internal Control in an Information Technology Environment
9. Audit Sampling



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

**International Auditing Standards** are discussed as appropriate. These standards are becoming increasingly significant with the development of international markets for securities.

10. Cash and Financial Investments
11. Accounts Receivable, Notes Receivable, and Revenue
12. Inventories and Cost of Goods Sold
13. Property, Plant, and Equipment: Depreciation and Depletion
14. Accounts Payable and Other Liabilities
15. Debt and Equity Capital
16. Auditing Operations and Completing the Audit
17. Auditors' Reports
18. Special Reports and Accounting and Review Services
19. Other Assurance Services
20. Internal, Operational, and Compliance Auditing

Chapters 10 through 16 (the "procedural chapters") deal with internal control and obtaining evidence about the various financial statement accounts; they emphasize a risk-based approach to selecting appropriate auditing procedures. They also provide a description of the business risk approach to audits that has been adopted by many large CPA firms and is the approach included in the recently issued exposure draft of the proposed Statement on Auditing Standards on Risk Assessment. Chapters 10 through 16 also thoroughly integrate the requirements of SAS No. 99.

Chapters 17 and 18 present the auditors' reporting responsibilities related to financial information—audit reports, special reports, and reports on accounting and review services.

Chapter 19 presents a variety of attestation and other assurance services. The material on attestation services has been updated for changes just adopted by the public accounting profession. **Other assurance services** are included at both a conceptual and practical level. At a conceptual level the text provides a discussion of the nature of assurance services, and a comparison of assurance services, attestation services, and audits. At the practical level it includes detailed discussions of the public accounting profession's new types of engagements, including Trust Services (which include the previous "stand-alone" services of *WebTrust* and *SysTrust*) and *ElderCare*.

Chapter 20's discussion of compliance auditing has been modified based on the suggestions of Mr. Norwood J. Jackson, former Deputy Controller, Office of Federal Management, U.S. Office of Management and Budget.

# FEATURES OF THIS EDITION

This text includes a variety of features to enhance the learning experience:

## Illustrative Cases

Actual business and accounting examples are used to illustrate key chapter concepts. The cases are boxed and appear throughout the text. New cases have been added for recent alleged audit failures.

### Illustrative Case

The situation in which audit clients hire audit firm personnel is difficult. On the one hand, it provides great professional opportunities for individuals who enter the public accounting profession. On the other, independence concerns have led to the restrictions presented in this section.

Questions were raised about the number of ex-Arthur

years Arthur Andersen served as auditor, 86 employees left the firm and accepted positions at Enron.

In addition, questions arose as to the nature of the relationship between continuing Arthur Andersen employees and those of Enron. Again, *The Wall Street Journal* reported that Arthur Andersen auditors and consultants "shared in office birthdays, frequented lunch time parties

## Industry Focus Cases

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

### Focus on the Airline Industry

"Ticketless" travel has become increasingly important within the airline industry. Under these systems a passenger may book a flight over the telephone or by computer and be assigned a reservation number rather than being issued a ticket. Since no ticket is created until the passenger checks in for the flight, the auditor is limited in the extent to which he or she can examine "paper" support for transactions. Accordingly, audit procedures must be developed relating to the associated revenues and receivables. Auditors often choose to test the computer controls in such situations.

# Illustrative Documents

Documents included in the various procedural chapters (10 through 16) provide concise, realistic examples of the documents associated with the various transaction cycles. See the back endpapers of this text for the complete figure.

**Sales**

78644

PURCHASE ORDER  
Pilot Stores  
1425 G St.  
Irvine, CA 92345

To: Wood Supply Co. Date: Nov. 10, 200X  
21 Main St.  
Suisun, CA 95483 Ship via: Jon Trucking

Terms: 2/10, n/40

Enter our order for

Qty	Description	Price	Total
20 doz.	Q Clamps #26537489	\$235.00	\$4700.00
10	120 hp Generators 748	355.00	3550.00

Wood Supply Co.  
By: Bill Jones

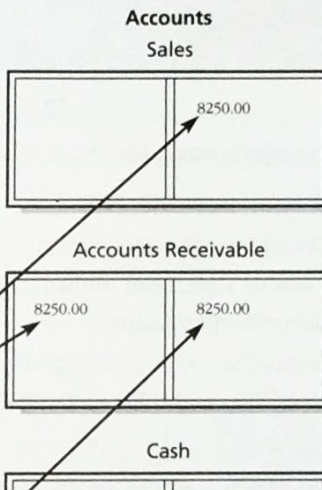
7462537

INVOICE  
Wood Supply Co.  
21 Main St.  
Suisun City, CA 94585

Sold to: Pilot Stores Date: Nov. 27, 200X  
1425 G St.  
Irvine, CA 92345 Your order no.: 78644

Shipped: Nov. 25, 200X  
Shipped via: Jon Trucking

Qty	Description	Price	Total
20 doz.	Q Clamps	\$235.00	\$4700.00
10	120 hp Generators	355.00	3550.00
			\$8250.00



# Audit Objectives

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

Primary Audit Objectives:	
Clerical accuracy	<input checked="" type="checkbox"/>

## 1. Obtain or Prepare Analyses of the Investment Accounts and Related Revenue, Gain, and Loss Accounts and Reconcile Them to the General Ledger

The analysis of financial investments will show the beginning and ending balances for the year, purchases and sales of investments during the year, interest and dividends earned, and realized and unrealized gains and losses. The auditors may verify the beginning balances of investments by reference to the prior year's audit working papers. If numerous purchases