CONTENTS

PREFACE, xxiii
ABOUT THE AUTHORS, xxxi

CHAPTER 1

Auditing: Integral to the Economy, 2
Overview of the External Auditing Profession, 3
Introduction to the External Auditing Profession, 3
External Auditing: A Special Function, 4
The Need for Unbiased Reporting and Independent Assurance, 6
Overall Objectives in Conducting an Audit, 7
Overview of the Audit Opinion Formulation Process, 8
Parties Involved in Preparing and Auditing Financial Statements, 9
Providers of External Auditing Services, 9
Skills and Knowledge Needed to Enter the External Auditing Profession, 10
Organizations Affecting the External Auditing Profession, 11

Audit Quality, 14
Audit Firm Culture, 15
Skills and Qualities of the Engagement Team, 15
Effectiveness of the Audit Process, 16
Reliability and Usefulness of Audit Reporting, 16
Factors Outside the Control of Auditors That Affect Audit Quality, 16

Achieving Audit Quality and Minimizing Lawsuits, 16
Auditor Independence Requirements, 17
Review Programs, 19
Engagement Letters, 20
CHAPTER 2

The Risk of Fraud and Mechanisms to Address Fraud: Regulation, Corporate Governance, and Audit Quality, 32

Fraud Defined, 34
Misstatements Arising From Misappropriation of Assets, 34
Misstatements Arising from Fraudulent Financial Reporting, 34

The Fraud Triangle, 35
Incentives or Pressures to Commit Fraud, 37
Opportunities to Commit Fraud, 37
Rationalizing the Fraud, 38

Recent History of Fraudulent Financial Reporting, 38
Examples of Recent Frauds and Implications for External Auditors, 38
The Third COSO Report, 41
The Enron Fraud: A Key Driver of Regulatory Change, 42

An Overview of the Auditor's Fraud-Related Responsibilities and Users' Expectations, 44

The Sarbanes–Oxley Act of 2002 as a Regulatory Response to Fraud, 45

The Post Sarbanes-Oxley World: A Time of Improved Corporate Governance, 49
What Is Corporate Governance? 49
Principles of Effective Corporate Governance, 50
Responsibilities of Audit Committees, 53
Summary and Next Steps, 53
Significant Terms, 54
True-False Questions, 54
Multiple-Choice Questions, 55
Review and Short Case Questions, 58
CHAPTER 3

Internal Control over Financial Reporting: Management’s Responsibilities and Importance to the External Auditors, 72

Importance of Internal Control Over Financial Reporting, 74

Importance of Internal Control to the External Audit, 74

Defining Internal Control, 75

Components and Principles of Internal Control, 77

COSO Component: Control Environment, 78
COSO Component: Risk Assessment, 81
COSO Component: Control Activities, 83
COSO Component: Information and Communication, 87
COSO Component: Monitoring, 88

Management’s Responsibilities Related to Internal Control Over Financial Reporting, 90

Documentation of Internal Control, 91

Reporting on Internal Control Over Financial Reporting, 91

Evaluating Internal Control Over Financial Reporting, 92

Summary and Next Steps, 97

Significant Terms, 97

True-False Questions, 99

Multiple-Choice Questions, 100

Review and Short Case Questions, 103

CHAPTER 4

Professional Liability and the Need for Quality Auditor Judgments and Ethical Decisions, 114

The Legal Environment and the Effects of Lawsuits on Audit Firms, 116

Liability Doctrines, 116
Chapter 5

Professional Auditing Standards and the Audit Opinion Formulation Process, 156

Professional Auditing Standards, 158
Auditing Standards Issued by the AICPA, 158
Auditing Standards Issued by the IAASB, 159
Planning the Audit: Identifying and Responding to the Risks of Material Misstatement, 266

Assessing Materiality, 268
Materiality Guidance, 268
SEC Views on Materiality, 270
Changes in Materiality Judgments Throughout the Audit Opinion Formulation Process, 270

Identifying and Assessing Risks of Material Misstatement, 271
Assessing Factors Affecting Inherent Risk, 272
Assessing Factors Affecting Control Risk, 279
Analytical Procedures and Brainstorming Activities to Assess the Risks of Material Misstatement, 282

Responding to Identified Risks of Material Misstatement, 286
Determining Detection Risk and Audit Risk, 286
CHAPTER 8

Specialized Audit Tools: Sampling and Generalized Audit Software, 316

Overview of Sampling and GAS as Tools for Gathering Audit Evidence, 318

Objectives of Sampling and Risks Associated with Sampling, 319
Nonsampling and Sampling Risks, 320

Nonstatistical and Statistical Sampling, 322

Attributes Sampling, 323
Steps in Attributes Sampling, 324
Nonstatistical Sampling Approach to Testing Controls, 334

Using Sampling to Gather Evidence about Misstatements in Account Balances and Associated Assertions, 335
Steps in Sampling Account Balances and Associated Assertions, 335
Nonstatistical Sampling for Substantive Tests of Account Balances and Associated Assertions, 339

Statistical Sampling for Substantive Tests of Account Balances and Associated Assertions: Monetary Unit Sampling (MUS), 340

Using Generalized Audit Software to Obtain Evidence, 347
Tasks Performed by GAS, 348
Benefits of using GAS, 350
Summary and Next Steps, 351
Significant Terms, 351
True-False Questions, 354
Multiple-Choice Questions, 355
Review and Short Case Questions, 358
Academic Research Case, 365
CHAPTER 13

Auditing Debt Obligations and Stockholders’ Equity Transactions, 594

Significant Accounts, Disclosures, and Relevant Assertions, 596
Debt Obligations, 596
Stockholders’ Equity, 597

Performing Risk Assessment Procedures for Debt Obligations and Stockholders’ Equity Transactions, 598
Identifying Inherent Risks, 599
Identifying Fraud Risk Factors, 599
Identifying Control Risks, 601
Performing Preliminary Analytical Procedures, 602
Responding to Identified Risks of Material Misstatement, 602
Obtaining Evidence about Internal Control Operating Effectiveness for Debt Obligations and Stockholders' Equity Transactions, 603

Obtaining Substantive Evidence in Auditing Debt Obligations and Stockholders' Equity Transactions, 603
Substantive Analytical Procedures—Debt Obligations, 603
Substantive Tests of Details—Debt Obligations, 605
Substantive Tests of Details—Stockholders' Equity Transactions, 606
Performing Substantive Fraud-Related Procedures, 608
Documenting Substantive Procedures, 609
Summary and Next Steps, 609
Significant Terms, 609
True-False Questions, 610
Multiple-Choice Questions, 611
Review and Short Case Questions, 613
Contemporary and Historical Cases, 616
Application Activities, 618
Academic Research Case, 619

CHAPTER 14

Activities Required in Completing a Quality Audit, 620

Review Activities, 622
Reviewing, Summarizing, and Resolving Detected Misstatements, 622
Reviewing Contingencies, 625
Reviewing Significant Estimates, 627
Reviewing the Adequacy of Disclosures, 629
Auditors' Responsibilities Regarding Clients' Noncompliance with Laws and Regulations, 630
Evaluating the Going-Concern Assumption, 632
Performing Analytical Review of the Financial Statements, 635
Evaluating Management Representations, 637
Reviewing Subsequent Events and Subsequently Discovered Facts, 640
Consideration of Omitted Procedures Discovered after the Report Date, 644
Performing an Engagement Quality Review, 644

Communicating with Management and the Audit Committee (And Those Charged with Governance), 645
Responsibilities of External Auditors to Communicate with the Audit Committee, 645
Communicating with Management via the Management Letter, 647
Issues Relating to Audit Firm Portfolio Management, Audit Partner Rotation, and Audit Firm Rotation, 649
Client Acceptance and Continuance Decisions, 649
Partner Rotation and Audit Firm Rotation, 653
Summary and Next Steps, 656
Significant Terms, 656
True-False Questions, 658
Multiple-Choice Questions, 660
Review and Short Case Questions, 666
Contemporary and Historical Cases, 674
Application Activities, 679
Academic Research Case, 682
Ford and Toyota, 683

CHAPTER 15

Audit Reports on Financial Statements, 684
Principles Underlying Audit Reporting, 686
Standard Unqualified Audit Reports on Financial Statements, 686
Standard Unqualified Audit Reports: U.S. Public Companies, 686
Standard Unqualified Audit Reports: U.S. Nonpublic Companies and Non-U.S. Companies, 690
Unqualified Audit Reports with Explanatory Language, 691
Explanatory Language: Justified Departure from GAAP, 691
Explanatory Language: Inconsistent Application of GAAP, 691
Explanatory Language: Substantial Doubt About the Client Being a Going Concern, 692
Explanatory Language: Emphasis of a Matter, 693
Explanatory Language: Reference to Other Auditors, 695
Qualified Reports, Adverse Reports, and Disclaimers, 697
Qualified Audit Reports, 698
Adverse Audit Reports, 700
Audit Reports with a Disclaimer of Opinion, 701
Comparisons of Modifications to the Standard Unqualified Audit Report, 704
Audit Reports on Internal Control Over Financial Reporting, 704
Elements of Management’s Annual Report on Internal Control Are Incomplete or Improperly Presented, 705
Restriction on the Scope of the Engagement, 705
Auditor Refers to the Report of Other Auditors as the Basis, in Part, for the Auditor's Own Report, 705
Other Information Contained in Management’s Annual Report on ICFR, 705
Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act Is Misstated, 705
Summary and Next Steps, 708
Significant Terms, 708
True-False Questions, 709
Multiple-Choice Questions, 710
Review and Short Case Questions, 712
Contemporary and Historical Cases, 721
Application Activities, 723
Academic Research Cases, 724
Ford and Toyota, 725

CHAPTER 16

Advanced Topics Concerning Complex Auditing Judgments, 726

Complex Auditing Judgments, 728
Identifying Complex Judgments in the Financial Statements, 728

Making Materiality Judgments, 729
Purpose of Materiality Judgments and Common Benchmarks and Thresholds, 730
Common Difficulties in Making Materiality Judgments, 733

Evaluating Misstatements, 734
Subjective Differences between the Auditor and the Client, 735
Aggregating and Netting Misstatements, 736
Intentional Misstatements, 736
Considerations Regarding Selective Correction of Misstatements, 736
Considering Misstatements in the Statement of Cash Flows, 737
Regulatory Guidance Concerning Materiality Judgments, 737

Assessing Long-Term Liabilities Involving Significant Subjective Judgment, 737
Warranty Reserves, 738
Pension Obligations and Other Postemployment Benefits, 739

Auditing Merger and Acquisition Activities, 740
Valuing the Assets and Liabilities of an Acquisition, 740
Measuring Restructuring Charges, 742
Auditing Management’s Fair Value Estimates and Related Impairment Judgments, 743
The Accounting Model for Fair Value Estimates, 743
Audit Considerations for Fair Market Estimates and Related Impairments, 747

Auditing Financial Instruments, 751
Overview of Financial Instruments, 751
Audit Considerations for Financial Instruments, 754

Assessing Deficiencies in Internal Control over Financial Reporting, 756
Assessing Likelihood and Magnitude of Potential Misstatements, 757

Evaluating a Client’s Internal Audit Function, 759
An Overview of Internal Auditing, 759
Evaluating the Quality of the Client’s Internal Audit Function, 763
Summary and Next Steps, 766
Significant Terms, 766
True-False Questions, 768
Multiple-Choice Questions, 769
Contemporary and Historical Cases, 783
Application Activities, 785
Academic Research Cases, 787
Ford and Toyota, 788
ACL, 788
Using ACL to Perform Benford Analysis, 789

CHAPTER 17

Other Services Provided by Audit Firms, 790

Attestation Services Provided by Audit Firms, 791
Subject Matter of an Attestation Engagement, 791
Components of Attestation Services and Parties Involved in Attestation Services, 792
Levels of Assurance Provided in an Attestation Engagement, 792
Professional Standards for Attestation Engagements, 793

Reviews and Compilations, 794
Reviews, 794
Compilations, 798

Reviews of Interim Financial Information for Public Companies, 800
Review Procedures for Interim Financial Information, 800
Reporting on Interim Financial Statements, 801
Special Considerations for Reporting, 801
AU-C Section 800: Special Considerations—Audits of Financial Statements Prepared in Accordance with Special-Purpose Frameworks, 803
AU-C Section 805: Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement, 805
AU-C Section 806: Reporting on Compliance with Aspects of Contractual Agreements or Regulatory Requirements in Connection with Audited Financial Statements, 807

Attestation on Agreed-Upon Procedures, Financial Forecasts and Projections, and Pro Forma Financial Information, 809
SSAEs No. 10 and 11, AT Section 201: Agreed-Upon Procedures Engagements, 809
SSAEs No. 10 and 17, AT Section 301: Financial Forecasts and Projections, 812
SSAE No. 10, AT Section 401: Reporting on Pro Forma Financial Information, 816

Forensic Accounting, 818

Sustainability Reporting and Assurance, 819
Reporting on Sustainability Activities and Outcomes, 820
Providing Assurance on Sustainability Reporting, 825
Summary, 828
Significant Terms, 829
True-False Questions, 831
Multiple-Choice Questions, 832
Review and Short Case Questions, 835
Application Activities, 838
Academic Research Case, 839

ACL APPENDIX, 841
CASE INDEX, 857
INDEX, 859
Performing Risk Assessment Procedures in the Acquisition and Payment Cycle, 504
  Identifying Inherent Risks, 504
  Identifying Control Risks, 506
  Performing Preliminary Analytical Procedures, 513
  Responding to Identified Risks of Material Misstatement, 515

Obtaining Evidence about Internal Control Operating Effectiveness in the Acquisition and Payment Cycle, 517
  Selecting Controls to Test and Performing Tests of Controls, 517
  Considering the Results of Tests of Controls, 517

Obtaining Substantive Evidence about Accounts, Disclosures, and Assertions in the Acquisition and Payment Cycle, 518
  Substantive Tests of Inventory and Cost of Goods Sold, 518
  Substantive Tests of Accounts Payable and Related Expense Accounts, 529
  Summary and Next Steps, 535
  Significant Terms, 536
  True-False Questions, 537
  Multiple-Choice Questions, 538
  Review and Short Case Questions, 541
  Contemporary and Historical Cases, 550
  Application Activities, 555
  Academic Research Cases, 556
  Ford and Toyota, 558
  ACL, 558

CHAPTER 12

Auditing Long-Lived Assets: Acquisition, Use, Impairment, and Disposal, 560

Significant Accounts, Disclosures, and Relevant Assertions, 561
  Activities in the Long-Lived Asset Acquisition and Payment Cycle, 562
  Relevant Financial Statement Assertions, 563

Performing Risk Assessment Procedures for Long-Lived Assets, 563
  Identifying Inherent Risks, 563
  Identifying Control Risks, 565
  Performing Preliminary Analytical Procedures, 567
  Responding to Identified Risks of Material Misstatement, 569

Obtaining Evidence about Internal Control Operating Effectiveness for Long-Lived Asset Accounts and Related Expenses, 571
CHAPTER 9

Auditing the Revenue Cycle, 366
Significant Accounts, Disclosures, and Relevant Assertions, 368
Processing Revenue Transactions, 368

Performing Risk Assessment Procedures in the Revenue Cycle, 372
Identifying Inherent Risks, 372
Identifying Control Risks, 379
Performing Preliminary Analytical Procedures, 384
Responding to Identified Risks of Material Misstatement, 386

Obtaining Evidence about Internal Control Operating Effectiveness in the Revenue Cycle, 386
Selecting Controls to Test and Performing Tests of Controls, 386
Considering the Results of Tests of Controls, 389

Obtaining Substantive Evidence about Accounts, Disclosures, and Assertions in the Revenue Cycle, 389
Revenue: Substantive Analytical Procedures, 390
Revenue: Substantive Tests of Details, 391
Accounts Receivable: Substantive Procedures Based on the Aged Trial Balance, 392
Accounts Receivable: Substantive Tests of Details—Confirmations, 393
Accounts Receivable: Substantive Procedures for the Allowance Account, 400
Accounts Receivable: Other Substantive Procedures, 401
Performing Substantive Fraud-Related Procedures, 402
Documenting Substantive Procedures, 403
Summary and Next Steps, 404
Significant Terms, 404
True-False Questions, 405
Multiple-Choice Questions, 406
Review and Short Case Questions, 409
Contemporary and Historical Cases, 424
Application Activities, 434
Academic Research Cases, 435
Ford and Toyota, 436
ACL, 436

CHAPTER 10

Auditing Cash and Marketable Securities, 438
Significant Accounts and Relevant Assertions, 440
Auditing Standards Issued by the PCAOB, 159
Comparison of the Auditing Standards, 159
Principles Underlying the Auditing Standards, 159

The Audit Opinion Formulation Process, 161
An Overview of the Phases in the Audit Opinion Formulation Process, 162
Important Concepts Affecting the Audit Opinion Formulation Process, 163
Phase I Making Client Acceptance and Continuance Decisions, 168
Phase II Performing Risk Assessment, 169
Phase III Obtaining Evidence about Internal Control Operating Effectiveness, 175
Summary of Audit Decisions Prior to Determining Substantive Procedures, 180
Phase IV Obtaining Substantive Evidence about Accounts, Disclosures, and Assertions, 182
Phase V Completing the Audit and Making Reporting Decisions, 185

Audit Example: Assessing Control Design Effectiveness, Implementation, and Operating Effectiveness, 187
Management Assessment of Controls, 187
Auditor Assessment of Controls, 188
Summary and Next Steps, 189
Significant Terms, 189
True-False Questions, 191
Multiple-Choice Questions, 192
Review and Short Case Questions, 196
Contemporary and Historical Cases, 203
Application Activities, 204
Academic Research Cases, 205
Appendix, 206

CHAPTER 6

A Framework for Audit Evidence, 212
Obtaining Sufficient Appropriate Audit Evidence, 214
Appropriateness of Audit Evidence, 215
Relevance of Audit Evidence, 215
Reliability of Audit Evidence, 218
Type and Timing of Audit Procedures, 221
Type of Audit Procedures, 221
Timing of Procedures, 227
Performing Substantive Analytical Procedures, 228