

AUDITING

A SYSTEMATIC APPROACH



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A Systematic Approach

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AUDITING

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This book is dedicated to my wife, Teddie
and my children, Stacy and Mark
for their support, encouragement, and love

ABOUT THE AUTHOR

Professor William F. Messier, Jr., is the Price Waterhouse LLP Professor at the Fisher School of Accounting, University of Florida. He holds a Professor II position at the Institute for Accounting and Auditing, Norwegian School of Economics and Business Administration and he is a visiting professor at SDA Bocconi in Milan, Italy. Professor Messier has a B.B.A. from Siena College, an M.S. from Clarkson University, and an M.B.A. and D.B.A. from Indiana University. He is a CPA in Florida and Massachusetts.

Professor Messier has served as the Chairperson of the Auditing Section of the American Accounting Association. He is Co-Editor of the *Journal of Accounting Literature* and he has authored or coauthored over 45 articles in accounting, decision science, and computer science journals.

PREFACE

The last twenty years have seen tremendous change in the practice of public accounting. Corporations have restructured their businesses and moved to expand their activities globally. Changes in technology have increased the speed with which information is transmitted within and between entities. In addition, there has been a growing demand by various groups for auditors to assume more responsibility as a part of their role in society. Events such as illegal acts by organizations, bankruptcies of major corporations, and the savings-and-loan crisis have led to critical questions about the auditor's role in those events. While such changes and events represent challenges for auditors, they also offer significant opportunities for auditors to make a contribution to the effective and efficient flow of information and capital in our society.

These changes require that auditing students have a thorough understanding of the audit process. I believe that this is best accomplished by having students understand the basic concepts that underlie the audit process and how to apply those concepts to a financial statement audit. This first edition of *AUDITING: A Systematic Approach* presents an up-to-date description of the audit environment and audit practice. As the title indicates, the book takes a *systematic approach* to the audit process by first introducing the three basic concepts that underlie the audit process: *materiality*, *audit risk*, and *evidence*. These concepts are then applied to each major accounting cycle and related account balances using a risk-based approach. For example, each accounting cycle chapter starts with a discussion of inherent risk factors that are relevant for the cycle and account balances. The assessment of control risk is then described, followed by discussion of the nature, timing, and extent of evidence necessary to reach the appropriate level of detection risk.

In covering these important concepts and their applications, the book focuses on the decision-making processes followed by auditors. Much of auditing practice involves the use of auditor judgment. If a student understands these basic concepts and how to apply them on an audit engagement, he or she will have developed the knowledge necessary to practice in today's dynamic audit environment.

The book can be used in a one-semester or one-quarter introductory auditing course, or in a two-course sequence at the undergraduate and graduate level. It can also be used in introductory professional development courses for CPAs, internal auditors, and government auditors.

ORGANIZATION

AUDITING: A Systematic Approach is divided into seven parts:

Part	Description	Chapters
One	Introduction to Auditing and Financial Statement Audits	1-2
Two	Basic Auditing Concepts: Materiality, Audit Risk, and Evidence	3-4
Three	Planning the Audit and Understanding Internal Control	5-7
Four	Statistical Tools for Auditing	8-9
Five	Auditing Accounting Applications and Related Accounts	10-17
Six	Completing the Audit and Reporting Responsibilities	18-19
Seven	Professional Responsibilities and Other Forms of Services	20-22

Part One. Introduction to Auditing and Financial Statement Audits

This part of the textbook introduces auditing, attestation, and assurance services, and focuses on financial statement audits. Chapter 1 covers auditing by discussing the demand for auditing services, the types of audit engagements, types of auditors, the public accounting profession, groups that impact the profession, and auditing standards. Chapter 2 provides an overview of financial statement audits. It presents the management assertions contained in financial statements and their relationship to audit objectives, and it covers the three fundamental concepts that underlie the audit process: materiality, audit risk, and evidence. The chapter concludes with a brief overview of audit reporting.

Part Two. Basic Auditing Concepts: Materiality, Audit Risk, and Evidence

Part Two provides detailed coverage of the three basic concepts that underlie the audit process. Chapter 3 presents a discussion of materiality and audit risk and their role in the auditor's decision-making process. The audit risk model is also discussed in this chapter. Chapter 4 provides detailed coverage of the concepts related to evidential matter including coverage of the various types of audit evidence used by auditors and the basics of working paper documentation.

Part Three. Planning the Audit and Understanding Internal Control

Part Three is devoted to audit planning and understanding internal control. Chapter 5 outlines an organized approach to audit planning and covers the different types of audit tests with detailed coverage of analytical procedures. Chapter 6 covers the auditor's consideration of internal control when planning and performing an audit including the basic framework for assessing control risk. Chapter 7 extends the coverage of internal control to include the effect of computer processing on the audit and discusses the tools available to the auditor for auditing in a computerized audit environment.

Part Four. Statistical Tools for Auditing

This part of the book presents the application of statistical and nonstatistical sampling techniques to auditing. Chapter 8 contains an overview of the types of audit sampling, the requirements of auditing standards, and the use of attribute sampling as applied to tests of controls. Chapter 9 applies statistical sampling to testing account balances and mainly focuses on the use of monetary-unit sampling. Classical variable sampling techniques are covered in the appendix to Chapter 9.

Part Five. Auditing Accounting Applications and Related Accounts

Part Five contains a detailed description of the application of the internal control concepts and evidence-gathering procedures to various accounting cycles. Chapters 10-17 present a discussion of inherent risk considerations, the assessment of control risk, and substantive testing for each accounting cycle and its related account balances.

Part Six. Completing the Audit and Reporting Responsibilities

Part six covers the steps followed at the end of the audit and provides expanded coverage of audit reporting. Chapter 18 discusses contingent liabilities, commitments, and subsequent events, and also covers the final evidential evaluation process followed by the auditor. Chapter 19 presents the details of audit reporting and covers a number of special reporting issues.

Part Seven. Professional Responsibilities and Other Forms of Services

Part Seven is devoted to the auditor's professional responsibilities and presents a discussion of other services offered by auditors. Chapter 20 reviews the Code of Professional Conduct and quality control standards. Chapter 21 reviews the legal environment that confronts the auditing profession. Finally, Chapter 22 discusses the attestation standards and presents detailed coverage of accounting and review services.

DISTINGUISHING FEATURES OF THIS TEXT

AUDITING: A Systematic Approach has a number of important features:

- The text takes a systematic approach to the audit process by building on the basic auditing concepts of materiality, audit risk, and evidential matter.
- The text follows a risk-based approach to auditing with materiality and audit risk presented in a manner that is consistent with auditing standards.

- A cycles approach is followed with the components of the audit risk model addressed in each cycle chapter.
- The discussion of internal control in each accounting cycle assumes some level of computerization. As a result, the effect of computer processing on the audit is introduced immediately after, and as an extension of, the consideration of internal control. The use of EDP audit techniques is presented as a part of the discussion of auditing each accounting cycle and account balance.
- An overview of sampling is presented at the beginning of Chapter 8 and provides the student with a frame of reference for studying statistical and nonstatistical sampling techniques. The two chapters on sampling also present the use of microcomputer software for statistical sampling applications.
- The end-of-chapter materials contain review questions, multiple-choice questions from CPA examinations, and problems. The review questions provide a quick way for students to test their knowledge of the learning objectives for each chapter. The multiple-choice questions provide a sound basis for testing the chapter material included on the CPA examination. The problems are drawn from the CPA and CIA examinations and from problems developed by the author.
- Most chapters also contain discussion cases. Many of these cases were developed from real-world examples and require the student to research the answer using various information sources. For example, one case in Chapter 2 asks the student to compare the U.S. audit report with the audit reports of BMW (Germany), Solvay (Belgium), and Sandoz (Switzerland). This discussion case points out the differences that exist between countries in public reporting by independent auditors.
- The text can easily incorporate the use of the Simulated Case for Audit Decision-Making (SCAD).

INTEGRATED CASE

The book contains an integrated case company, **Calabro Paging Services**, that is introduced in Chapter 2. This case is based on a real-world company and is used to demonstrate important auditing concepts throughout the book.

SUPPLEMENTS

The **Instructor's Guide** includes the author's suggestions on an approach to teaching the material in each chapter, an outline of the topics, and other instructional aids. The *Instructor's Guide* is supplemented with **Power-**

Point slides for each chapter. This allows the instructor to use the PowerPoint presentation in the classroom or use the slides as overheads.

The **Solutions Manual** contains thorough and up-to-date solutions to the book's end-of-chapter materials. The **Test Bank** includes additional multiple-choice questions adapted from professional examinations. All test questions are available in a computerized format for IBM DOS, IBM Windows, and Mac systems. Professors may use this software to create, edit, and print a variety of tests.

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William F. Messier, Jr.

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