

Auditing and Assurance Services

SEVENTH EDITION



DAVID N. RICCHIUTE

Auditing and Assurance Services

7th edition

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SOUTH-WESTERN

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Auditing and Assurance Services, 7e

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Cover to Cover Publishing, Inc.

Printer:

Quebecor World
Taunton, MA

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Cover Image:

Tom White Images, Inc.

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Library of Congress Cataloging-in-Publication Data

Ricchiute, David N.

Auditing and assurance services / David N. Ricchiute--7th ed.
p. cm.

Includes bibliographical references and index.

ISBN 0-324-11776-0

1. Auditing. I. Title

HF5667 .R58 2002

657'.45--dc21

2001055076

Preface

to the instructor

Auditing and assurance services education has undergone dramatic change in at least three ways:

- An awakening that practitioners have a comparative advantage in offering professional services that transcend the *boundaries* of financial statements,
- An understanding that *client strategies* affect engagement risk, and
- A transition away from first-person delivery by classroom instructors only and toward third-person *discovery* by students both within and outside of the classroom.

Each has influenced the seventh edition. To transcend the *boundaries* of financial statements, *Auditing and Assurance Services* exposes students to both the demand for and the supply of the profession's flagship service, *financial statement audits*, and to the nature of the value-added *assurance services* decision makers demand in the information age. For example, on the supply of auditing, the text explains how auditors leverage off of publicly available data sources to assemble information about a client in the pharmaceutical industry (Chapter 5). On the nature of assurance services, the text illustrates how Consumers Union and Underwriters Laboratories have captured so completely the markets they serve (Chapters 1, 2, 3, and 20), and how Deloitte & Touche LLP and Gradient Technologies have partnered to offer services on Internet security (Chapter 6).

To incorporate *client strategies*, the seventh edition revises Chapter 5, "The Audit and Assurance Service Process," to introduce client strategy templates, a tool that practitioners use to summarize a client's industry and strategies, to assess risk, and to identify assurance service opportunities. To encourage *discovery learning*, the seventh edition integrates academic research, illustrates with real companies, links class discussion and key assignments to student skills, offers working paper review cases, and proposes research projects that expose students to data bases, annual reports, and the professional literature. For example, the text explains what research reveals about time budget pressure, auditor-client disagreements, and management discretion in earnings manipulation. And a research project asks the question, why wouldn't a client correct the circumstances that give rise to a qualified opinion? Accounting education at the turn of the century demands that educators expose students both to auditing services and to market opportunities in assurance and attestation services. The expanding scope of knowledge in the information age demands that students take responsibility for life-long, discovery learning.

to the student

Auditing and Assurance Services conveys experience about professional services for which most students will have little or no prior understanding—a limitation that places students' comprehension at risk. Prose fiction presents a similar hurdle, but the fiction writer's task is different, in part because much of the writer's craft centers on narrative properties that set a story in motion by accessing plausible scenes from a reader's existing memories. In auditing and assurance services education, however, students typically have no prescribed scenes about practice, since they've had little prior exposure to information systems, evidence, and the like, thereby providing few memories on which the learning experience might draw. But the limitation of no prior understanding also presents an opportunity: The student comes to the material with no biases or expectations that limit the boundaries of understanding, providing the textbook and the instructor with a unique opportunity to shape professional practice into insight and to make seemingly sterile professional tasks come to life. I urge you as a student to exploit the material presented in this text by allowing its chapters to awaken in you a curiosity about auditing and assurance services and about how practitioners come to some of the complex decisions and judgment processes inherent in practice today.

features

Client Strategies

Not unlike Ernst & Young's *Business Process Analysis* and KPMG's *Business Measurement Process*, the client strategy template introduced in Chapter 5 offers students a means to visualize audit clients not only from the level of financial transactions but, also, from the vantage point of management's risks, the strategies management undertakes to overcome risk, and the transactions and events that are the product of management's strategies. For example, Chapter 5 explains how discount demands from managed care groups, patient co-payments for prescription drugs, and physician incentives to prescribe generics—none of which are captured at the transaction level of a company—can translate into competitive pricing demands that compel financial analysts to predict at-risk growth strategies, and auditors to revise audit risk, for a research-based pharmaceutical company.

Assurance Services

Consistent with the work of the AICPA *Special Committee on Assurance Services* (Elliot Committee), the seventh edition integrates assurance and attestation services throughout the text. For example, the text introduces assurance services offered by *Consumers Union* (Chapters 1, 3, 17), by *Underwriters Laboratories* (Chapters 2, 5), and by a number of public accounting firms (Chapters 1, 6, 9, 11, 14, 15, 17, 19) and also introduces attestation services offered by public accounting firms, including services by *PricewaterhouseCoopers* for Wilson Sporting Good's assertions (Chapters 1, 2), *PricewaterhouseCoopers* for Stanley H. Kaplan's SAT improvement assertions (Chapter 1), *KPMG* on ethics management (Chapter 19), *Ernst & Young* for CoreStates Financial's internal control assertions (Chapter 6), and the *Deloitte & Touche/Gradient Technologies* partnered service on Internet security (Chapter 6), among a host of others in Chapter 17.

Real-World Illustrations

To ground otherwise abstract issues in reality, the seventh edition offers numerous examples of real-world applications in practice. For example, in addition to audit report illustrations (Chapter 3) and legal liability cases (Chapter 20), some of the companies and issues illustrated include: Chapter 1: Intel (Internet financial statements), HarperCollins (information services consulting); Chapter 2: Delphi Automotive Systems, J.P.Morgan Chase, Sprint (nonaudit fees); Citizens Utilities (materiality); Chapter 5: Merck & Co. (auditing in the pharmaceutical industry), Chevron (vision charts); Chapter 6: Levi Straus & Co., Lockheed Martin (Internet technology), Verizon (home page management and global markets); Chapter 10: General Electric (receivables), Wal-Mart (cash equivalents), Union Carbide (revenue recognition policies), MicroStrategy, Chambers Development (revenue recognition), Taco Bell, Burger King (area franchise fees); Chapter 11: Bank of America (purchase consulting services), Camp Fire Girls & Boys, General Motors (outsourced information services); Chapter 12: Coca-Cola (payables and accruals), Westinghouse, Columbia Gas System Inc. (Superfund compliance costs); Chapter 14: IBM, AT&T, Battle Mountain Gold Company (impaired assets); Chapter 16: Motorola (revenue surprises); Chapter 17: Marriott, PepsiCo, Xerox (health care provider quality), Lucent Technologies (letters for underwriters); Chapter 19: PTL Club (unethical business practices).

Management Discretion and Earnings Manipulation

In addition to mapping financial statement assertions to audit procedures and explaining the procedures in detail, the seventh edition incorporates key accounting issues into each of the five chapters devoted to substantive tests of account balances (Chapters 10, 12, 13, 14, and 15), and addresses crucial questions about each: For example, How have the SEC and the Panel on Audit Effectiveness characterized the nature and extent of earnings manipulation in public companies? What are management's incentives and how can those incentives be impounded into earnings manipulation? What are the legal liability and ethical implications of the issue? The accounting issues addressed are: earnings manipulation and revenue recognition (Chapter 10), accounting for environmental liabilities (Chapter 12), accounting for postretirement health care obligations (Chapter 13), accounting for impaired assets (Chapter 14), and accounting for financial instruments (Chapter 15).

Working Paper Review

The center of gravity in an auditor's early career employment evaluations rests squarely on his or her performance in preparing audit working papers. To help equip students to *prepare* working papers, the seventh edition incorporates working paper *review* cases. The working papers are realistic, replicate papers and issues illustrated in the text, and are designed to lend insight into what reviewers are likely to look for. The cases appear in Chapters 4, 10, 12, 14, and 15, and include common early career audit areas, such as accounts receivable front summary schedules, receivables confirmations, intercompany and interbank transfers, bank reconciliations, accounts payable, accrued property taxes, physical inventory observations, fixed assets and accumulated depreciation, and marketable securities.

Research Projects

The seventh edition includes over forty end-of-chapter research projects linked to the professional literature, publicly available data sources, and annual reports of the student's/instructor's choice. The projects are intended as out-of-class, discovery-learning exercises that do not necessarily lend themselves to unambiguous solutions. For example, the research projects address issues such as: becoming familiar with the profession's controversies, self-regulation and the Public Oversight Board, preparing client strategy templates, reporting on financial distress, unethical business practices, litigation against public accounting firms, tort reform, using the Internet to understand a client's industry, managing change in a selected industry, management discretion in earnings manipulation, internal control and transaction cycles in a selected industry, annual reports and the audit process, assurance services and retail electronic commerce, and internal auditing in selected industries.

Integration of Information Technology

Information technology pervades contemporary practice, largely because most all audit and assurance service clients are computerized. As a result, rather than address computers as a free-standing chapter, the seventh edition

- Integrates information technology and internal control in Chapter 6, introducing systems such as local area networks, telecommunications, end user computing, service bureaus, and Internet technology; and computer-assisted audit techniques such as base case system evaluation, test data, integrated test facilities, parallel simulation, audit hooks, audit modules, and transaction tagging.
- Introduces automated working papers, data base management systems software, spreadsheet software, and text retrieval software in Chapter 6, and
- Illustrates computer-assisted audit techniques in Chapters 9, 10, 11, 12, and 14.

Integration of Academic Research

The seventh edition incorporates the results of relevant academic research about, for example: Chapter 2: independence, audit risk, materiality; Chapter 3: auditor changes, predicting audit qualifications, financial distress, market reaction to bankruptcy filings; Chapter 5: audit committee effectiveness, auditor–client disagreements, communication between predecessor and successor auditors, time budget pressure, analytical procedures, evidence planning, the review process; Chapter 6: heuristics and biases; Chapter 10: revenue recognition, management incentives, share prices and management changes, predicting takeover targets, qualified opinions and share prices; Chapter 13: the choice of alternatives affecting health care obligations; Chapter 14: discretionary write downs; Chapter 17: the voluntary purchase of quarterly reviews.

Risk and Evidence

The text, particularly Chapters 2, 4, and 5 and Part II (Method), explicitly incorporates the audit risk model from *SAS No. 47*, "Audit Risk and Materiality in Conducting an Audit," and the financial statement assertions from *SAS No. 31*, "Evidential Matter." The seventh edition devotes seven chapters to tests of controls and to substantive tests within four major transaction cycles: the revenue/

receipt cycle (Chapters 9 and 10), the expenditure/disbursement cycle (Chapters 11, 12, and 13), the conversion cycle (Chapter 14), and the financing cycle (Chapter 15).

Professional Literature and Articles

The text provides extensive discussion of, and references to, the professional literature, including the Auditing Standards Board's *Statements on Auditing Standards* and *Statements on Standards for Attestation Services*; contemporary articles from magazines, journals, and newspapers like the *Journal of Accountancy*, *Auditing: A Journal of Practice & Theory*, *The Accounting Review*, *The Wall Street Journal*, *Accounting Today*, *Public Accounting Report*, and *Business Week*, and important reports and monographs such as *Internal Control: Integrated Framework* (the COSO Report), and Mautz and Sharaf's *The Philosophy of Auditing*.

Edit/Update

All of the chapters have been edited for clarity of exposition and updated for, among other things:

- The 2000 report of the Public Oversight Board's Panel on Audit Effectiveness (Chapters 2, 5, 6, 10, 16);
- The AICPA's *CPA Vision Project: 2011 and Beyond* (Chapter 1);
- The SEC's 2000 rules for independence (Chapters 2, 19);
- SEC *Staff Accounting Bulletin No. 99*, "Materiality" (Chapter 3);
- SEC *Staff Accounting Bulletin No. 101*, "Revenue Recognition" (Chapters 10, 16);
- The AICPA's *Audit Issues in Revenue Recognition* (Chapters 10, 16);
- The AICPA's Audit Practice Release *Revenue Recognition* (Chapters 10, 16);
- The AICPA's Audit Practice Release *Audit Sampling* (Chapters 7, 8);
- The work of the AICPA *Special Committee on Assurance Services* (Chapters 1, 2, 17); and
- Recent *Statements on Auditing Standards* and *Statements on Standards for Attestation Engagements* on attestation standards, information technology, audit adjustments, audit committee communications, fraud, management representations, establishing an understanding with clients, communications between predecessor and successor auditors, internal control, internal auditing, letters for underwriters, using specialists, compliance auditing, and compliance attestation, among others.

Sampling (optional)

Depending on the objectives of a course, instructors may choose to cover Chapters 7 and 8 (which introduce attributes estimation, sequential sampling, probability proportional to size (PPS) sampling, and nonstatistical sampling), and/or may selectively cover sampling in Chapters 9 through 12, which illustrate audit sampling applications as follows:

Tests of controls:

- Chapter 9: Attributes estimation applied to billing.
- Chapter 11: Sequential sampling applied to cash disbursements.

Substantive tests:

- Chapter 10: PPS sampling applied to accounts receivable.
- Chapter 12: Nonstatistical sampling applied to accounts payable.

organization

The seventh edition of *Auditing and Assurance Services* is organized in four parts.

Part One: Responsibilities and Evidence

Chapters 1, 2, and 3 introduce assurance, attestation, and audit services; professional standards; and reports. Chapter 1, an overview of the public accounting profession, distinguishes among consulting, assurance, attestation, and audit services; addresses the demand for financial statement audits; raises the suspicion that financial statement audits may be obsolete; and introduces operational audits and compliance audits. Chapter 2, “Standards, Materiality, and Risk,” introduces the need for assurance standards, the AICPA’s *generally accepted auditing standards* (GAAS) and *attestation standards*, the role of materiality and risk, and the standards of quality control and quality (peer) review in monitoring the performance of public accounting firms. Chapter 3, “Reports,” introduces reports on assurance and attestation services, the standard audit report, the required circumstances and wording for modifications to a standard report, and reporting requirements for comparative financial statements and for financial statements prepared for use in a foreign country.

Chapters 4, 5, and 6 introduce evidence, client strategies and the audit and assurance processes, and the consideration of internal control in a financial statement audit. Chapter 4, “Evidence,” addresses evidence and its relationship to financial statement assertions and procedures; the cognitive biases that can interfere with interpreting evidence; the nature of tests of controls, substantive tests, and analytical procedures; the major activities in the audit process—including the decision to accept an engagement, planning, and interim and year-end audit work—and the purpose and content of working papers. Chapter 5, “The Audit and Assurance Service Process,” introduces client strategy templates and balanced scorecards, summarizes the audit process, and introduces the assurance process in a performance-measurement benchmarking service. Chapter 6, “Internal Control and Information Technology,” discusses information systems, the components of internal control—the control environment, risk assessment, control activities, information and communication, and monitoring—how an auditor considers internal controls when planning and performing a financial statement audit, and computer applications in auditing that are then illustrated in Chapters 9, 10, 11, 12, and 14.

Part Two: Method

Chapters 7 and 8, optional chapters, address the role of sampling in audit tests. Chapter 7, “Sampling in Tests of Controls,” introduces and illustrates three sampling for attributes plans—attribute estimation, sequential (stop-or-go) sampling, and discovery sampling—and a nonstatistical sampling plan. Chapter 8, “Sampling in Substantive Tests,” addresses two statistical sampling plans for variables—probability proportional to size (PPS) sampling and difference estimation—and a nonstatistical sampling plan.

Chapters 9 through 15 introduce, discuss, and illustrate the detailed tests of controls and substantive tests used in contemporary audit practice, and also identify opportunities for assurance and attestation services. Chapters 9 and 10 address the revenue/receipt cycle, sales and cash receipts transactions, accounts receivable, cash balances, and management discretion and earnings manipulation

in revenue recognition. Chapters 11, 12, and 13 turn attention to the expenditure/disbursement cycle, including purchases and cash disbursement transactions, accounts payable, prepaid expenses, accrued liabilities, personnel and payroll, and management discretion in accounting for environmental liabilities and for postretirement health care benefits. Chapters 14 and 15 introduce tests of controls and substantive tests applicable to inventory, fixed assets, investments, debt, equity, and management discretion in accounting for impaired assets and for financial instruments.

Chapter 16 completes the discussion of procedures, addressing a practitioner's considerable responsibilities when completing an engagement—for example, auditing accounting estimates, the review for subsequent events, communicating with the audit committee, inquiries of a client's legal counsel, management representation letters, and forming an opinion on financial statements.

Part Three: Assurance and Attestation Services, Compliance and Internal Auditing

Chapters 17 and 18 focus on engagements other than financial statement audits and two additional, and highly prominent, types of auditing in the U.S. Chapter 17, "Assurance and Attestation Services," discusses examples of assurance services for the 21st century and a variety of contemporary attestation services, including reviews of financial statements, interim financial information, internal control, letters for underwriters, personal financial statements, financial forecasts and projections, and the application of accounting principles. Chapter 18, "Compliance and Internal Auditing," introduces the governmental auditor's compliance audit under generally accepted government auditing standards, the GAO's "Yellow Book," and the *Single Audit Act*, and discusses the internal auditor's operational audit.

Part Four: Ethics and Liability

Chapters 19 and 20 introduce practitioners' responsibilities for ethical behavior and legal liability. Chapter 19, "Professional Ethics," focuses on the principles and rules of conduct underlying the AICPA's *Code of Professional Conduct*, and the formal mechanisms used to enforce the AICPA and state society codes of conduct. Chapter 20, "Legal Liability," identifies the major issues central to the legal liability cases involving independent auditors; describes an auditor's potential liability under common law, the *Securities Act of 1933*, and the *Securities Exchange Act of 1934*; and explains an auditor's responsibility to detect and report fraud and illegal acts.

end-of-chapter materials

The end of each chapter includes:

- Key terms (referenced to the chapter page on which the term is introduced and to a comprehensive Glossary at the end of the book)
- Extensive references to
 - Authoritative literature (e.g., SASs, SSAEs)
 - Professional reports
 - Articles and books
- Review questions

- Multiple choice questions
- Problems and discussion cases
- Research projects

A comprehensive case—"YOU'RE AHEADSM" *A Long Distance Cost Savings Initiative*—a review of the first six chapters, appears at the end of Chapter 6.

supplemental materials

Several teaching and learning aids are new to this edition or substantially revised:

- **Solutions Manual, 0-324-11779-5.** (Prepared by David N. Ricchiute, University of Notre Dame.) The solutions manual contains the solutions to all review questions, multiple choice questions, problems, and discussion cases. Solutions have been error-checked to ensure their accuracy and reliability.
- **Instructor's Manual, 0-324-11783-3.** (Prepared by Rebecca M. Evans, Matanuska-Susitna College, University of Alaska, Anchorage.) Expanded for the seventh edition, the instructor's manual contains a complete set of lecture notes for each chapter, sample syllabi, and transparency masters.
- **Test Bank, 0-324-11778-7.** Extensively revised and expanded for the seventh edition, the test bank offers multiple choice questions, short-answer questions, and problems.
- **ExamView Testing Software, 0-324-11780-9.** This supplement contains all of the questions in the printed test bank. This program is an easy-to-use test creation software compatible with Microsoft Windows. Instructors can add or edit questions, instructions, and answers, and select questions (randomly or numerically) by previewing them on the screen. Instructors can also create and administer quizzes online, whether over the Internet, a local area network (LAN), or a wide area network (WAN).
- **PowerPoint Presentations.** (Prepared by Gail Wright, Bryant College.) Completely new for this edition, selected transparencies of key concepts and exhibits from the text are available in PowerPoint presentation software.
- **Instructor's Resource CD-ROM, 0-324-14560-8.** Key instructor ancillaries (solutions manual, instructor's manual, test bank, and PowerPoint slides) are provided on CD-ROM, giving instructors the ultimate tool for customizing lectures and presentations.
- **Web Site (<http://ricchiute.swcollege.com>).** A Web site designed specifically for *Auditing and Assurance Services*, seventh edition, includes online and downloadable instructor and student resources. The Web site features an interactive study center organized by chapter, with crossword puzzles, online quizzes with automatic feedback, and brief as well as in-depth Internet cases.
- **Computer-Assisted Auditing with Great Plains Dynamics, 0-324-16079-8.** (By Mark W. Lehman, Mississippi State University.) *Computer-Assisted Auditing* gives students a real-world audit experience using a market-leading, commercial software package, Great Plains Dynamics. Great Plains Dynamics software is a comprehensive enterprise resource planning system that offers users a variety of modules, including electronic commerce and multi-currency applications. A series of 15 projects allows the student to learn the software hands-on using the client information provided in the software. At the end of each project, there are questions that allow the student to apply these new skills.

- **Geld and Klein Financial Services, Inc., 0-324-15090-3.** (By Ryan R. Fox, Deloitte & Touche LLP.) This comprehensive auditing case study is designed to reinforce the theoretical concepts learned in an auditing course. Geld and Klein is a real-life audit example that incorporates both textbook theory and real-life practice. Audit theory is applied to relevant financial and nonfinancial data in order to express an opinion on the financial statements. A significant portion of this product is delivered on the Web to better emulate actual business audits.

acknowledgments

I gratefully acknowledge the following people for comments and suggestions:

Michael Akers Marquette University	at Pomona
Joyce Allen Xavier University	Robert Eskew Purdue University
John Anderson Virginia Polytechnic Institute and State University	Rebecca Evans University of Alaska, Anchorage
Barbara Apostolou Louisiana State University	Dick Fremgen University of Notre Dame
Joseph Botana Lakeland College	Linda Frye Northwest Missouri State University
Edmund Boyle University of Rhode Island	Stephen Goldberg Purdue University
Freddie Choo San Francisco State University	Jeremy Griffin Deloitte & Touche LLP
Bill Coyle Babson College	David Kerr Texas A&M University
David Davidson California State University at Long Beach	Ron King Washington University
John Delaney Southwestern University	Matt Kipp Skadden Arps Slate Meagher and Flom LLP
Rajib Doogar University of Illinois at Urbana- Champaign	Mark Kovarik PricewaterhouseCoopers LLP
Phillip Driscoll Syracuse University	Joyce Lambert University of New Orleans
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Doug Prawitt
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Sri Ramamoorti
Andersen LLP

John Rigsby
Mississippi State University

Michael Ruble
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Donna Rudderow
Franklin University

Glen Sanderson
Illinois State University

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