

A photograph of a bamboo forest with a path leading through it. The path is paved and curves through the dense bamboo grove. The bamboo stalks are tall and thin, creating a vertical rhythm. The ground is covered with fallen leaves and bamboo debris. The lighting is soft, suggesting a shaded forest environment.

AUDITING & ASSURANCE SERVICES

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McGRAW-HILL INTERNATIONAL EDITION



Auditing and Assurance Services

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AUDITING AND ASSURANCE SERVICES

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Auditing and Assurance Services

Some people come into our lives and quickly go. Some stay awhile and leave footprints on our hearts and we are never quite the same.

Anonymous

We dedicate this book to the following educators whose footprints we try to follow:

Professor Homer Bates
(University of North Florida)

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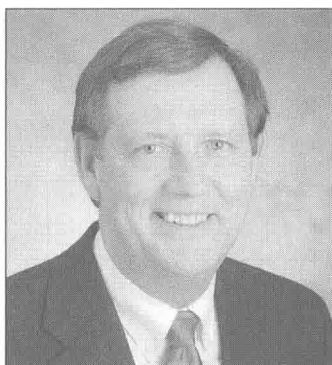
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Meet the Authors



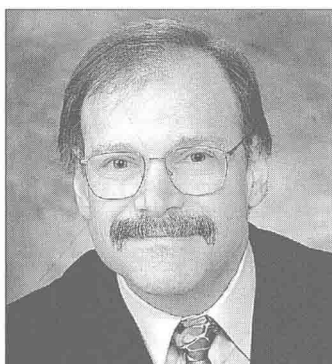
Timothy J. Louwers teaches financial auditing, fraud auditing, and information systems auditing at Louisiana State University, where he currently holds the Marjory Ourso Excellence in Teaching Professorship. Professor Louwers received his PhD in accounting from Florida State University in 1993, and the American Accounting Association recognized his dissertation as the 1994 Outstanding Auditing Dissertation. Prior to beginning his academic career, he worked in public accounting with KPMG.

Professor Louwers has authored or co-authored six books and over 30 articles on a wide range of accounting, auditing, and technology-related topics. Professor Louwers is also a respected lecturer on auditing and technology-related issues and has taught Continuing Education programs through the Texas Society of CPAs and the University of Houston's Center for Executive Development. He has received a number of teaching excellence awards, including Beta Alpha Psi (Delta Gamma Chapter) Professor of the Year while at the University of Houston and two Halliburton Teaching Excellence Awards. He has appeared on both local and national television broadcasts, including MSNBC and CNN news programs.



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Professor Ramsay has been active in the American Accounting Association, serving on the Professionalism and Ethics committee, the Notable Contributions to Accounting Literature Award Screening Committee, and the Annual Meeting Committee as auditing section chair. He is also active in the AAA Auditing section as chairman of the 2003 Mid-Year Meeting and a member of the nominations committee. Professor Ramsay previously worked nine years for Arthur Young & Company serving clients in the restaurant, mining, electronics, and manufacturing sectors. He also worked four years as Vice President, Controller for Chi-Chi's, Inc., a publicly held restaurant company.



David H. Sinason is an Associate Professor of Accountancy at Northern Illinois University (NIU), teaching Auditing and Assurance Services and directing the NIU Internal Audit program. He received a BS in engineering from the University of Illinois; BBA and MAcc in Accounting from the University of North Florida (UNF); and a PhD in Accounting from Florida State University (FSU). Professor Sinason has certifications as a Certified Public Accountant, Certified Internal Auditor, Certified Financial Services Auditor, and Certified Fraud Examiner. Professor Sinason has over 30 publications, mostly in the areas of assurance services, fraud prevention and detection, and auditor liability.

Professor Sinason has taught at UNF, FSU, and NIU in the areas of Accounting Information Systems, Auditing and Assurance Services, and Financial Accounting. He has received teaching awards at each of the universities where he has taught including the 2002–2003 Department of Accountancy and Northern Illinois University Awards for Excellence in Undergraduate Teaching.



Jerry R. Strawser is Dean of the Mays Business School at Texas A&M University. In addition, he holds the Development Council Chair of Business and the Leland/Weinke Chair in Accounting. Prior to his appointment at Texas A&M University, Professor Strawser served as interim Dean of the C.T. Bauer College of Business at the University of Houston and Arthur Andersen & Co. Alumni Professor of Accounting.

Professor Strawser has co-authored three textbooks and over 60 journal articles. In addition to his academic experience, Professor Strawser has prior public accounting experience at two Big Five accounting firms. He has also developed and delivered numerous executive development programs to organizations such as Continental Airlines, Conoco Phillips, KPMG, Minute Maid, PricewaterhouseCoopers, McDermott International, Shell, Southwest Bank of Texas, and the Texas Society of Certified Public Accountants. Professor Strawser is a Certified Public Accountant in the state of Texas and earned his BBA and PhD in Accounting from Texas A&M University. In addition, he currently serves on the Major Case Enforcement Committee of the Texas State Board of Public Accountancy.

Louwers/Ramsay/Sinason/Strawser

In the aftermath of Enron, WorldCom, Tyco, and others, the accounting profession—the auditing profession in particular—is ready for a fresh start, ready to take a step in a new direction and lead the next generation of accounting professionals down the path to success.

Louwers/Ramsay/Sinason/Strawser, *Auditing and Assurance Services*, is the most current book on the market, including coverage of the creation of the **Public Companies Accounting Oversight Board (PCAOB)**, the passage of the **Sarbanes-Oxley Act**, and all of the **major pronouncements and exposure drafts issued by the AICPA through Fall 2003**. The market leader in fraud coverage, this is THE book to help your students learn key auditing concepts, understand the audit process, and build awareness of potential fraud.

Engage Your Students

Auditing and Assurance Services doesn't just teach auditing concepts, it places them in an exciting context by using financial information and articles from companies with which students are familiar, including **AOL TimeWarner, Compaq Computer, Disney, Hewlett-Packard, and Wal-Mart**. To pique students' interest even more, the authors base cases in EACH chapter on fraud cases pulled from recent headlines—including companies such as **Phar-Mor, Enron, Critical Path, WorldCom**, and more. And to further hold students' attention, the Louwers author team uses a conversational, yet professional, tone—hailed by reviewers as a key strength of this book!

investment accounts can vary a great deal among clients. The involvement of senior officials in a relatively small number of high-dollar transactions makes control risk assessment a process tailored specifically to the company's situation. Some companies enter into complicated financing and investment transactions, while others keep to the simple transactions.

AUDITING INSIGHT Goodwill Impairment

Following the merger of Time Warner and America Online (to form AOL Time Warner) in 2001, a total of \$103.5 billion of goodwill was recognized to reflect the difference between the value of the AOL shares issued and the book value of the net assets of Time Warner. During the first quarter of 2002, an impairment charge of \$54 million was taken; an additional \$46 billion charge was taken during the fourth quarter of that same year. The end result? AOL

Time Warner has written off almost the entire amount of goodwill that was recorded upon the merger. In addition, the market value of AOL Time Warner shares has decreased by \$100 billion since the merger.

Source: "AOL Reports \$86.7 Billion Loss and Says Ted Turner Will Resign," *The Wall Street Journal*, January 20, 2003, p. A1.

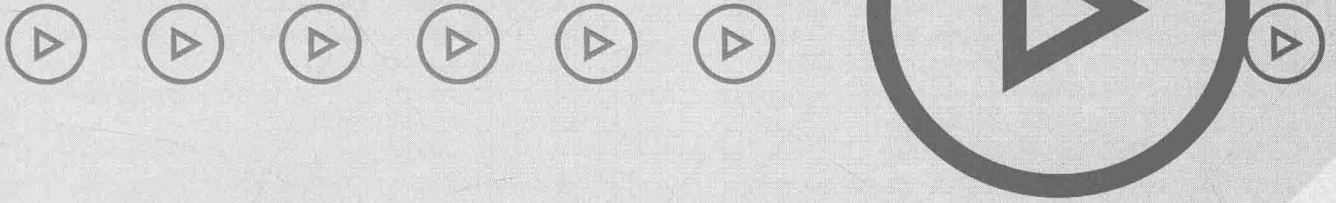
Review Checkpoints

- 10.5 What is a compensating control? Give some examples for finance and investment cycle accounts.
- 10.6 What are some of the specific relevant aspects of management's control over the estimation process? What are some inquiries auditors can make?
- 10.7 When a company has produced an estimate of an investment value...

Cutting-Edge Coverage

With all the recent changes to the accounting profession, an updated, cutting-edge text is crucial to your auditing course. *Auditing and Assurance Services* has the essential coverage. And unlike their competitors, the authors do not cover technology as an afterthought. Instead *Auditing and Assurance Services* integrates technology while students learn the audit process, including planning in an electronic environment, logical internal controls, and the use of Computer Assisted Audit Tools and Techniques (CAATs) to gather evidence. End-of-chapter materials include electronic audit documentation that send students to the text website to work problems that mimic those on the New Uniform CPA Exam.

A New Direction for Auditing



Fraud Awareness

The fraud coverage in *Auditing and Assurance Services* is extensive and will help hold students' attention and make them see why learning auditing is relevant. Fraud coverage is found throughout the text and in the supplements: Chapter 3 is entitled Management Fraud and Audit Risk, Chapter 6 covers

Employee Fraud and the Audit of Cash, Module D focuses on the Certified Fraud Examiner Exam, and The Apollo Shoes Case is the ONLY stand-alone fraud case currently available on the market. More importantly, each chapter features fraud cases drawn from recent headlines.

CHAPTER SIX

Employee Fraud and the Audit of Cash

When a man tells you that he got rich through hard work, ask him: "Whose money is this?" Discuss actual cash fraud cases and describe how the schemes were uncovered.

Rather than... Sophisticated

Compendium Section	Document Reference	Topic
Various	ED (2003)	Sarbanes-Oxley
110	SAS 1	Responsible
	SAS 2	Due Care

Case 6.1

Case of the Missing Petty Cash

PROBLEM
Petty cash embezzlement.

METHOD
The petty cash custodian (1) brought postage receipts from home and paid them from the fund, (2) persuaded the supervisor to sign blank authorization slips the custodian could use when the supervisor was away and used these to pay for fictitious meals and minor supplies, and (3) took cash to get through the weekend, replacing it the next week.

AUDIT TRAIL
Postage receipts were from a distant post office station the company did not use. The blank authorization slips were dated on days the supervisor was absent. The fund was cash short during the weekend and for a few days the following week.

AMOUNT
The fund was small (\$500), but the custodian replenished it about every two working days, stealing about \$50 each time. With about 260 working days per year and 130 reimbursements, the

Flexible Organization

Auditing and Assurance Services teaches students auditing concepts by explaining the concepts in the context of the audit process. Coverage of the audit process begins in Chapter 3 and concludes in Chapter 12. Modules A–H, featuring additional optional topics, follow the main text chapters. These modules can be taught at the instructor's discretion without disrupting the flow of the text. A large number of cases augment the coverage of the audit process to give students a real-world perspective.

KEY FEATURES OF AUDITING

ALL CHAPTERS

- Up-to-date actual company examples: The authors have gone to great lengths to incorporate excerpts from annual reports, articles from the business and popular press, and other citations of financial reporting and auditing stories in the media. Some of the companies referenced in the text include: AOL TimeWarner, Bristol-Myers Squibb, Compaq Computer, Disney, Dynegy, Hewlett-Packard, Wal-Mart, Xerox, Wilson Sporting Goods, WorldCom, Reebok, Enron, Sunbeam, Waste Management, Arthur Andersen, Polaroid, U-Haul Corporation, Priceline.com, Amazon.com, Cisco Systems, Continental Airlines, H.J. Heinz, and Citibank.
- Visual graphics to aid student understanding.
- Realistic audit programs and audit documentation.
- Inclusion of simulations in end of chapter material which mimic new CPA Exam questions.
- End-of-chapter glossaries of key terms for quick and convenient review by students.
- The text covers relevant issues facing the auditing profession, including the creation of the Public Companies Accounting Oversight Board, the passage of the Sarbanes-Oxley Act, and all of the major pronouncements and exposure drafts issued by the AICPA through Fall 2003.
- Cycle chapters: Discussion of specific inherent risks for each cycle of the audit process and concluding examples of how the audit risk model would be used for each cycle.

PART I: Auditing and Assurance Services in the 21st Century

CHAPTER 1 Auditing and Assurance Services

- Coverage of assurance services.
- Discussion of the Sarbanes-Oxley Act of 2002 and the creation of the Public Companies Accounting Oversight Board (PCAOB).

CHAPTER 2 Professional Standards

- Chapter introduction covers the McKesson & Robbins fraud that led to the creation of generally accepted auditing standards (GAAS).
- Integration of generally accepted auditing standards into the phases of the audit.
- Discussion of the PCAOB and its standard-setting and monitoring roles.

CHAPTER 3 Management Fraud and Audit Risk

- Chapter introduction discusses the Enron-Andersen audit and its consequences on companies, their employees, and their recent hires.
- Coverage includes SAS 99 with emphasis on management fraud.

CHAPTER 4 Engagement Planning

- Chapter introduction discusses Andersen's planning of the Enron engagement.
- The chapter also focuses on auditing in an electronic environment with emphasis on the use of Computer-Assisted Audit Tools and Techniques (CAATs).

CHAPTER 5 Internal Control Evaluation: Assessing Control Risk

- Chapter includes discussion of Enron's control environment.
- Business process measurement and risk-based auditing are also covered.
- The chapter also introduces the Committee of Sponsoring Organizations' (COSO) new Enterprise Risk Model (ERM).

PART II: Performing the Financial Audit

CHAPTER 6 Employee Fraud and the Audit of Cash

- More coverage of SAS 99, with emphasis on employee fraud.
- Real world examples of employee fraud include a copy of an actual altered bank statement.
- Audit of cash included here as the first example of applied substantive procedures.

CHAPTER 7 Revenue and Collection Cycle

- Focus on revenue recognition and SAB 101.
- Detailed discussion of the MiniScribe fraud.
- Detailed discussion of applying the audit risk model to the revenue cycle.

- Summary of revenue-related restatement reported by the GAO called "Rogues of Revenue Recognition."
- Brief discussion of applying controls in a small business.
- List of common responses to confirmations, and what they mean to an auditor.
- Steps for review of collectibility.
- Sales cutoff procedures.

CHAPTER 8 Acquisition and Expenditure Cycle

- Brief discussion of the WorldCom case.
- Summary of cost and expense-related restatements from the GAO report.

PART II: Performing the Financial Audit (continued)

CHAPTER 9 Production and Payroll Cycle

- Extensive discussion of the Phar-Mor fraud.
- Real case example of gross margin manipulation.
- Consolidated inventory testing in one chapter.
- Detailed example of cutoff error.
- Enhanced discussion of pricing and compilation testing.
- Discussion of Cisco Systems inventory write-down.

CHAPTER 10 Finance and Investment Cycle

- Discussion of Enron's use of Special Purpose Entities (SPEs).
- Brief examples of synthetic leases.
- Examples of effects of goodwill impairment charges.
- Realistic example program for long-term debt and interest expense.
- Discussion of Auditing Fair Value Measurements (SAS 101).

CHAPTER 11 Completing the Audit

- Overview of major events performed in completing the audit examination.
- Examples of subsequent events and dual-dating of audit reports from actual corporate disclosures.
- Summary of major communications between the auditor, client, and client's audit committee.
- Example of issues arising from KPMG's audit of Xerox regarding internal control deficiencies.
- Withdrawal of Andersen's audit opinion on the financial statements of Dynegy, Inc.

CHAPTER 12 Reports on Audited Financial Statements

- Report decision trees.
- Actual reports as illustrations for the different types of reports issued.

PART III: Other Topics

MODULE A Assurance and Other Public Accounting Services

- Latest changes to assurance service engagements.
- In-depth discussion of attestation engagements other than audit engagements.
- Auditors' responsibilities for interim financial information.
- Discussion of Other Comprehensive Basis of Accounting (OCBOA).
- Discussion of auditors' responsibilities when client utilizes a service organization.

MODULE B Professional Ethics

- Latest changes to the ethics standards.

MODULE C Legal Liability

- Recent cases involving auditor liability.
- Impact of Sarbanes-Oxley on auditors' legal liability.

MODULE D Internal, Governmental, and Fraud Audits

- Discussion of internal audit and governmental audit as elements of the audit profession.
- Discussion of fraud auditing as an element of the audit profession.

MODULE E Overview of Sampling

MODULE F Attribute Sampling

MODULE G Variables Sampling

- The discussion of sampling is presented in three modules that can be incorporated at any point throughout the course for maximum instructor flexibility. In addition, each

sampling module is completely stand-alone and can be used without reference to any of the remaining modules. This feature allows the instructor to include as much or as little sampling in his or her course as desired.

- An introductory sampling module that illustrates the basic sampling process in a nonaudit context is included to allow students to focus on issues related to sampling without mastering all of the technical aspects of sampling. In addition, this introductory module briefly discusses the application of sampling to the auditor's study and evaluation of internal control and substantive procedures. This module is ideal for the instructor who wishes to provide coverage of sampling in preparation for the Uniform CPA Examination without spending excessive time on this subject.
- Modules on attribute and variables sampling focus on a step-by-step application of sampling concepts and techniques through the use of a comprehensive problem. The use of a single, comprehensive example allows students to see theoretical concepts applied to a real-world example.

MODULE H Information Systems Auditing

- Includes advances in audit technology.
- Discussion of computer fraud and abuse.
- Brief discussion of computer forensics.



SUPPLEMENTS

For Instructors...



INSTRUCTOR'S RESOURCE CD-ROM (ISBN 0072954108)

Contains author-written essential course supplements such as the Instructor's Manual/Solutions Manual, Test Bank Word Files, Computerized Testbank by Brownstone, and PowerPoint® Presentations.

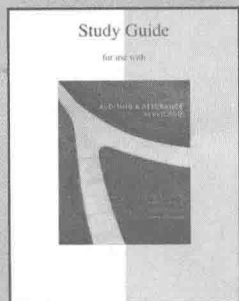
ONLINE LEARNING CENTER (OLC)

(www.mhhe.com/louwers1e)

The text website includes premium content for students for FREE with the purchase of a new book, including daily and weekly news feeds from *The New York Times* and PowerWeb as well as the interactive fraud case, The Apollo Shoes Case. The Instructor Edition of the *Auditing and Assurance Services* OLC is password-

protected and another convenient place for instructors to access essential course supplements. Additional resources for professors include: Solutions to the Apollo Shoes Case, Web Resources, Auditing News, and Text Updates.

For Students...



STUDY GUIDE (ISBN 0072835559)

The study guide reviews the highlights of *Auditing and Assurance Services* and includes an overview and summary of each chapter in the textbook. Following each chapter summary is a self-assessment section that includes true/false, completion, and multiple-choice questions, as well as problems. Solutions to all items in the self-assessment section are included.

ONLINE LEARNING CENTER (OLC)

(www.mhhe.com/louwers1e)

The text website includes premium content for students for FREE with the purchase of a new book, including daily and weekly news feeds from *The New York Times* and PowerWeb as well as the interactive fraud case, The Apollo Shoes Case. The Student Edition of the *Auditing and Assurance Services* OLC also contains many

tools designed to help students study, including simulations tied to end-of-chapter material, a Sample Study Guide Chapter, Web Resources, and Auditing News.

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The American Institute of Certified Public Accountants has generously given permission for liberal quotations from official pronouncements and other AICPA publications, all of which lend authoritative sources to the text. In addition, several publishing houses, professional associations, and accounting firms have granted permission to quote and extract from their copyrighted material. Their cooperation is much appreciated because a great amount of significant auditing thought exists in this wide variety of sources.



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Few understand the enormous commitment of time and energy that it takes to put together a textbook. As authors, we are constantly scanning *The Wall Street Journal* and other news outlets for real-world examples to illustrate theoretical discussions, rereading and rewriting each other's work to make sure that key concepts are understandable, and double-checking our solutions to end-of-chapter problems. Among the few who do understand the time and energy commitment are our family members (Barbara Louwers; Sue Ramsay; Karen Sinason and Matthew, Joshua, and Adam Sinason; and Susan and Meghan Strawser) who uncomplainingly endured endless refrains of "I just need a couple more minutes to finish this section." Words cannot express our gratitude to each of them for their patience and unending support.

Tim Louwers
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