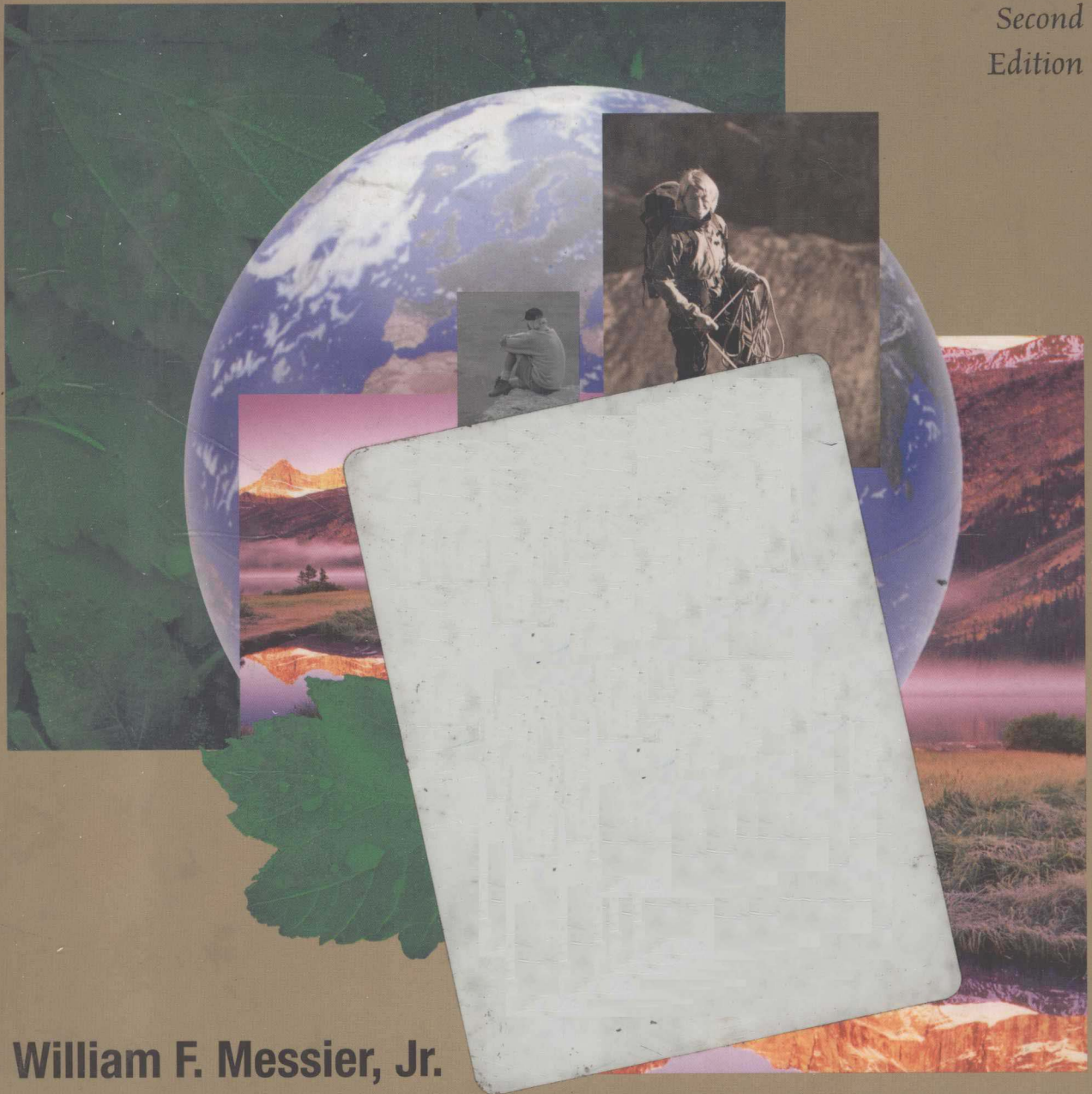


AUDITING & ASSURANCE SERVICES

A SYSTEMATIC APPROACH

*Second
Edition*



William F. Messier, Jr.

AUDITING & ASSURANCE SERVICES

A SYSTEMATIC APPROACH

Second Edition

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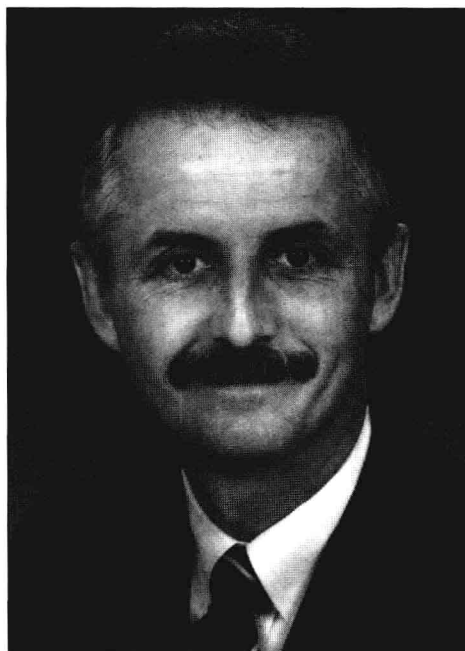
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*This book is dedicated to my wife, Teddie
and my children, Stacy and Mark
for their support, encouragement, and love.*

About the Author

Professor William F. Messier, Jr., is the Deloitte & Touche Professor at the School of Accountancy, Georgia State University. 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 BBA from Siena College, an MS from Clarkson University, and an MBA and DBA from Indiana University. He is a CPA in Florida and has taught at the Universities of Florida and Michigan.

Professor Messier has served as the Chairperson of the Auditing Section of the American Accounting Association and as co-editor of the *Journal of Accounting Literature*. He currently serves on the AICPA's International Auditing Standards Subcommittee. Professor Messier has authored or coauthored over 45 articles in accounting, decision science, and computer science journals.



Preface

In recent years, tremendous changes have affected the practice of public accounting. Changes in technology, including the extraordinary growth of electronic commerce, have increased the speed with which information is transmitted within and between entities. This has allowed corporations to more easily expand their activities globally. Two other issues have more directly affected the public accounting profession. First, there has been a growing demand by various groups for auditors to assume more responsibility as part of their role in society. The profession has responded to this challenge by issuing an auditing standard that has increased the auditor's responsibility to detect fraud. Second, there is a growing emphasis for auditors to provide assurance services, including assurance on information system reliability, electronic commerce, and health care performance measurement. These types of services build on the auditor's traditional attributes of competence, objectivity, and independence. Although these new services are likely to be a major source of revenues for public accounting firms, it must be remembered that financial statement audits still represent a major, ongoing source of revenues for public accounting firms, and many of our students will continue to be heavily involved in financial statement audits. Such changes and events represent challenges for auditors; they also offer significant opportunities for auditors to contribute to the effective and efficient flow of information and capital in our society.

The changes impacting the profession require that students thoroughly understand the audit process, broadly defined to include assurance services. 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 various audit and assurance services. The second edition of *Auditing and Assurance Services: A Systematic Approach* contains a number of significant changes and revisions that respond to this changing environment. First, Chapter 1 contains a more detailed overview of the relationship between assurance, attestation, and auditing services, while Chapter 21 covers assurance and attestation engagements. Second, Chapter 3 has been revised to include a much broader view of the auditor's risk assessment process consistent with current practice. The chapter includes detailed discussion of client business risk. Third, the book includes a new case for a mail-order retailer, EarthWear Clothiers, that is used throughout the book to demonstrate important concepts. There are Internet home pages for EarthWear and its auditors. EarthWear's home page has assurance provided through a CPA *WebTrustSM* engagement. Last, the book has a new design format, more extensive learning objectives, and Internet problems.

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 an overview of the information system followed by 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 know how to practice in today’s dynamic audit environment.

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

Organization

Auditing and Assurance Services: A Systematic Approach is divided into eight parts:

Part	Description	Chapters
I	Introduction to Auditing and Assurance Services	1–2
II	Basic Auditing Concepts: Materiality, Audit Risk, and Evidence	3–4
III	Planning the Audit and Understanding Internal Control	5–7
IV	Statistical Tools for Auditing	8–9
V	Auditing Accounting Applications and Related Accounts	10–16
VI	Completing the Audit and Reporting Responsibilities	17–18
VII	Professional Responsibilities	19–20
VIII	Assurance, Attestation, and Other Forms of Services	21

Part I:
Introduction
to Auditing
and Assurance
Services

This part of the textbook introduces auditing, attestation, and assurance services. Chapter 1 covers auditing by discussing the demand for auditing services; the relationship between auditing, attestation, and assurance services; the types of audit engagements and types of auditors; the public accounting profession; issues faced by the profession; organizations that impact the profession; and auditing standards. Chapter 1 also describes EarthWear Clothiers, a fictitious company based on a real-world entity. This case is used throughout the text to demonstrate important concepts. EarthWear and its auditors have home pages that can be used for various case assignments. Chapter 2 provides a unique overview of financial statement audits. It presents the management assertions contained in financial statements and their relationship to audit objectives, the auditor’s responsibility for errors and fraud, and the auditor as a business and industry expert; and it covers the three fundamental concepts that underlie the audit

process: materiality, audit risk, and evidence. The chapter also includes a brief overview of sampling, ethics and independence, and audit reporting.

**Part II: Basic
Auditing
Concepts:
Materiality,
Audit Risk,
and Evidence**

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

**Part III:
Planning the
Audit and
Understanding
Internal
Control**

Part III is devoted to audit planning and understanding internal control. Chapter 5 outlines an organized approach to audit planning and describes 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 information technology on the audit and discusses the tools available to the auditor for auditing in an information technology environment.

**Part IV:
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 focuses on the use of monetary-unit sampling. Classical variable sampling techniques are covered in the appendix to Chapter 9.

**Part V:
Auditing
Accounting
Applications
and Related
Accounts**

Part V describes the application of internal control concepts and evidence-gathering procedures to various accounting cycles. Chapters 10–16 discuss inherent risk considerations, the assessment of control risk, and substantive testing for each accounting cycle and its related account balances.

**Part VI:
Completing
the Audit and
Reporting
Responsibilities**

Part VI focuses on the steps followed at the end of the audit and provides expanded coverage of audit reporting. Chapter 17 discusses contingent liabilities, commitments, and subsequent events, and also describes the final evidential evaluation process followed by the auditor. Chapter 18 presents the details of audit reporting and covers a number of special reporting issues.

**Part VII:
Professional
Responsibilities**

Part VII is devoted to the auditor's professional responsibilities. Chapter 19 reviews the Code of Professional Conduct and quality control standards. Chapter 20 discusses the legal environment that confronts the auditing profession.

**Part VIII:
Assurance,
Attestation, and
Other Forms
of Services**

Part VIII covers assurance services, including the demand for such services. It also presents detailed examples of two assurance services. Chapter 21 introduces the attestation standards, describes two attestation services, and discusses accounting and review services.

Distinguishing Features of This Text

Auditing and Assurance Services: A Systematic Approach has a number of important features:

- The text takes a systematic approach to the audit process by building on the basic 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 and current practice.
- 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 IT 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 to give the student 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 allow students to quickly 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 Internet assignments and discussion cases. The Internet assignments involve solving problems related to the EarthWear case and gathering various types of accounting and

industry information. Many of the discussion cases were developed from real-world examples and require the student to research the answers using various information sources.

- The text can easily incorporate the use of the Simulated Case for Audit Decision Making (SCAD).

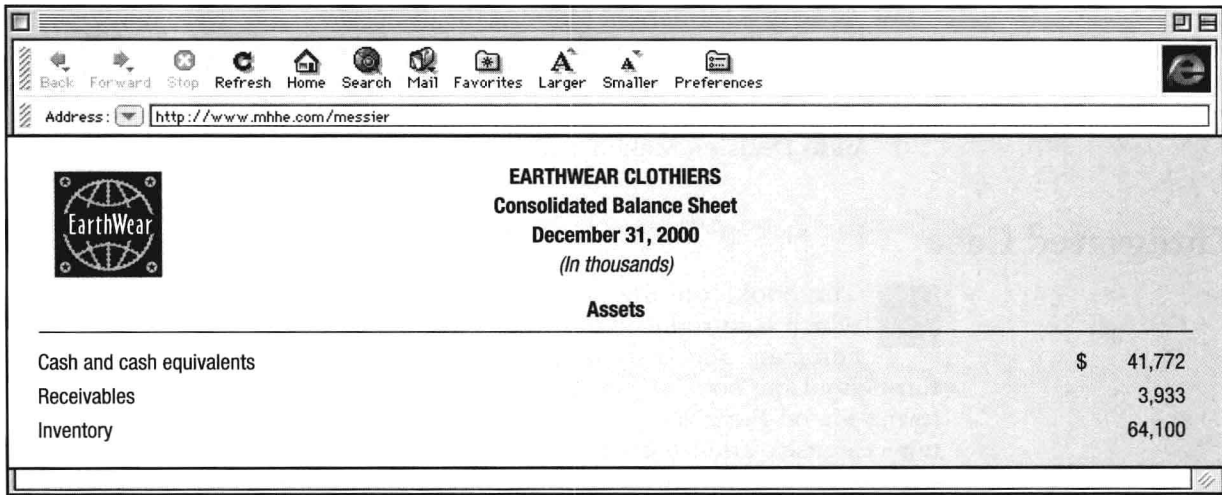
Integrated Case



The book contains a new integrated case company, EarthWear, which is introduced in Chapter 1. This case is based on a real-world company and is used to demonstrate important auditing concepts throughout the book. A home page for the company contains extensive information on EarthWear, and a home page for the company's auditors contains extensive audit-related information. These pages can be accessed from www.mhhe.com/earthwear and www.mhhe.com/willisandadams. There are also numerous problems and Internet assignments related to EarthWear throughout the text. The Calabro Paging Services case that was included in the first edition has been shortened and included as a discussion problem in Chapter 3. It is also used in various chapters to demonstrate important concepts with an alternative industry. A number of problems in the book are based on the Calabro case.

Supplements

- The **Instructor's Manual** (0-07-290830-0) includes the author's suggestions on an approach to teaching the material in each chapter, an outline of the topics, and other instructional aids.
- **Ready Shows** (0-07-233236-0) PowerPoint® slides are available for each chapter. This allows the instructor to use the PowerPoint® presentation in the classroom or use the slides as overheads.
- The **Solutions Manual** (0-07-290829-7) contains thorough, up-to-date solutions to the book's end-of-chapter materials.
- The **Test Bank** (0-07-290831-9) includes additional multiple-choice questions adapted from professional examinations. All test questions are available in a computerized format, **Computest** (0-07-231745-0). Professors may use this software to create, edit, and print a variety of tests. All of the instructor supplements are available on an **Instructor's CD-ROM** (0-07-231747-7).
- **Ready Notes** (0-07-290832-7), a new supplement for students, contains PowerPoint® screen printouts to facilitate note-taking during a PowerPoint® presentation.
- **Communication for Accountants: Effective Strategies for Students and Professionals** (0-07-038390-1), authored by Maurice Hirsch of Southern Illinois University–Carbondale and Susan Gabriel and Rob Anderson, both of St. Louis University, is a brief and inexpensive handbook that addresses the need for accountants to communicate effectively through both writing and speaking.



EARTHWEAR CLOTHIERS
Consolidated Balance Sheet
December 31, 2000
(In thousands)

Assets

Cash and cash equivalents	\$ 41,772
Receivables	3,933
Inventory	64,100

- The **Web site (www.mhhe.com/messier)** serves as an extension of the text, and from it students and instructors can access regularly undated materials that include applications of auditing practices, a link to the EarthWear annual report, downloadable supplements, and links to industry sites and information sources.

Acknowledgments and Development Focus

I would like to acknowledge the American Institute of Certified Public Accountants for permission to quote from auditing standards, the Code of Professional Conduct, the Uniform CPA Examination, and the *Journal of Accountancy*. I would also like to thank Bill Kinney and the PricewaterhouseCoopers LLP Foundation for granting permission to use selected case materials, and for providing permission to use PW STAT in Chapters 8 and 9.

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William F. Messier, Jr.

Contents in Brief

Preface

xxxi

PART I	INTRODUCTION TO AUDITING AND ASSURANCE SERVICES	I
1	An Introduction to Auditing and Assurance Services	3
2	An Overview of Financial Statement Auditing	39
PART II	BASIC AUDITING CONCEPTS: MATERIALITY, AUDIT RISK, AND EVIDENCE	65
3	Materiality and Audit Risk	67
4	Evidential Matter, Types of Evidence, and Working Paper Documentation	112
PART III	PLANNING THE AUDIT AND UNDERSTANDING INTERNAL CONTROL	143
5	Audit Planning and Types of Audit Tests	145
6	Internal Control in a Financial Statement Audit	186
7	The Effects of Information Technology on the Audit Function	230
PART IV	STATISTICAL TOOLS FOR AUDITING	271
8	Audit Sampling: An Overview and Application to Tests of Controls	273
9	Audit Sampling: An Application to Substantive Tests of Account Balances	311
PART V	AUDITING ACCOUNTING APPLICATIONS AND RELATED ACCOUNTS	347
10	Auditing the Revenue Cycle and Related Accounts	349
11	Auditing the Purchasing Cycle and Related Accounts	408
12	Auditing the Payroll Cycle and Related Accounts	451
13	Auditing the Inventory Cycle and Related Accounts	479
14	Auditing Selected Asset Accounts: Prepaid Expenses and Property, Plant, and Equipment	511
15	Auditing Long-Term Liabilities, Stockholders' Equity, and Income Statement Accounts	534
16	Auditing Cash and Investments	554

PART VI	COMPLETING THE AUDIT AND REPORTING RESPONSIBILITIES	587
17	Completing the Engagement	589
18	Reports on Audited Financial Statements and Special Reporting Issues	618
PART VII	PROFESSIONAL RESPONSIBILITIES	659
19	The Code of Professional Conduct and Quality Control Standards	661
20	Legal Liability	702
PART VIII	ASSURANCE, ATTESTATION, AND OTHER FORMS OF SERVICES	739
21	Assurance, Attestation, and Other Forms of Services	741
	<i>Glossary</i>	<i>782</i>
	<i>Index</i>	<i>787</i>

CONTENTS

Preface

xxxi

Part I	INTRODUCTION TO AUDITING AND ASSURANCE SERVICES	I
I	An Introduction to Auditing and Assurance Services	3
	The Demand for Auditing	5
	Auditing, Attestation, and Assurance Services	7
	<i>Auditing</i>	7
	<i>Attestation</i>	9
	<i>Assurance</i>	10
	Types of Audits	11
	<i>Financial Statement Audits</i>	11
	<i>Compliance Audits</i>	12
	<i>Operational Audits</i>	12
	<i>Forensic Audits</i>	12
	Types of Auditors	13
	<i>External Auditors</i>	13
	<i>Internal Auditors</i>	13
	<i>Government Auditors</i>	14
	<i>Forensic Auditors</i>	15
	The Public Accounting Profession	15
	<i>Issues Currently Affecting the Profession</i>	15
	<i>Public Accounting Firms</i>	18
	<i>Types of Services</i>	20
	Organizations That Affect Financial Statement Audits	22
	<i>American Institute of Certified Public Accountants (AICPA)</i>	22
	<i>Public Oversight Board</i>	24
	<i>Financial Accounting Standards Board</i>	25
	<i>Government Accounting Standards Board</i>	25
	<i>Securities and Exchange Commission</i>	25
	<i>Independence Standards Board</i>	26
	Generally Accepted Auditing Standards	26
	<i>General Standards</i>	27
	<i>Standards of Field Work</i>	28
	<i>Standards of Reporting</i>	28
	Statements on Auditing Standards	29
	Review Questions	30