

Second International Edition

# AUDITING & ASSURANCE SERVICES

Aasmund Eilifsen, William F. Messier Jr,  
Steven M. Glover & Douglas F. Prawitt

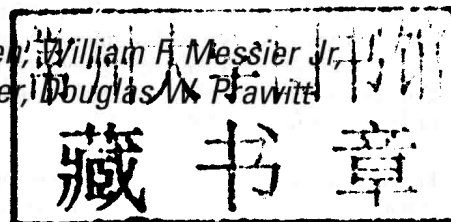




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Aasmund Eilifsen, William F. Messier Jr, Steven M. Glover, Douglas F. Prawitt  
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# Dedication

This book is dedicated to Bente, Christoffer, Sigrid, Lars Eirik, Kristian and Gustav.  
—Aasmund Eilifsen

This book is dedicated to Teddie, Stacy, Mark, Bob, Brandon and Zachary.  
—William F. Messier, Jr

This book is dedicated to Tina, Jessica, Andrew, Jennifer, Anna, Wayne and Penny.  
—Steven M. Glover

This book is dedicated to Meryll, Nathan, Matthew, Natalie, Emily, AnnaLisa, Leah, George and Diana.  
—Douglas F. Prawitt



# Preface

As we all know, this decade has brought possibly the most far-reaching changes in the history of modern financial markets and the international financial statement auditing environment. In the face of the challenges presented during this unprecedented period, we are committed to providing lecturers and students with the most complete and up-to-date materials possible so their hard work and energy in teaching and studying represents an investment in the latest, most current concepts. We are confident that the changes made in this edition will make it easier for lecturers to teach effectively and for students to learn more efficiently.

## What's new in the Second International Edition?

Although the auditing environment has become even more complex and demanding, at the same time it is increasingly important that students gain a deep understanding and working knowledge of fundamental auditing concepts and how they are applied. We have worked hard to make this book the most 'student-friendly' auditing book on the market. In this new international edition we have focused on making the book even clearer and easier to understand and on encouraging students to think more clearly and deeply about what they are studying. This is accomplished primarily by:

- (1) Introducing 'stop and think' and 'pause to test your intuition' phrases at key places throughout the chapters to encourage students to internalize key concepts more fully
- (2) Clarifying explanations and adding easy-to-understand examples throughout the book
- (3) Making several chapters more concise, and enhancing the focus on key concepts by deleting non-central detail
- (4) Improving end-of-chapter and supplementary materials throughout the book and on the website by clarifying or replacing existing questions and problems.

This Second International Edition also contains important updates to reflect the recent landmark changes in the international professional standards. The International Federation of Accountants (IFAC) and its boards are established as the global leaders in professional standards. The international professional standards are the basis for the conduct of audits all over the world. In 2009 the International Auditing and Assurance Standards Board (IAASB) completed its comprehensive programme to update and enhance the clarity of the set of International Standards on Auditing (ISAs). The 36 updated and clarified ISAs include substantive new requirements and introduced significant changes to audits. The implementation and appropriate application of the clarified ISAs is critical for the success of the auditing profession in the coming years.

Education and professional training of auditors worldwide need to take action at the earliest opportunity to deal with the new set of clarified ISAs and the clarified International Standard on Quality Control. The new ISAs are integrated throughout all the chapters in this book. Because of their increasing complexity and importance to the audit process, this Second International Edition also includes extended discussions of auditing of accounting estimates, including fair value accounting estimates; and auditing of group financial statements. Additionally, in 2009 the International Ethics Standards Board for Accountants (IESBA) issued a revised and stringent Code of Ethics for Professional Accountants. The Code of Ethics clearly identifies the requirements and establishes acceptable behaviour for professional accountants around the world.

## How does Auditing & Assurance Services Second International Edition prepare students for the accounting profession?

The recent implosion of financial markets has had a significant effect on the auditing profession. Upon graduation students will need to operate in this new, ever-changing environment. It is therefore crucial to learn from the most up-to-date resources. Once again, the author team of *Auditing & Assurance Services Second International Edition* is dedicated to providing the most current professional content and real-world application, as well as helping prepare students for the licensing requirements. This book combines a genuine international perspective and relevant international regulatory requirements with the conceptual

and systematic approach to auditing inherent in the 7th edition of *Auditing & Assurance Services: A Systematic Approach* (Messier, Glover and Prawitt, 2010). In this Second International Edition we continue to reinforce the fundamental values central to the first edition, as follows.

**International Approach.** The book has a genuine international perspective on auditing. Auditing network firms operate globally and cross borders, and professional practice and regulation are driven by international events and initiatives. Thus, students and practising auditors need to understand how the international environment shapes the profession and international professional standards. The International Federation of Accountants (IFAC) and its boards are consolidated as *the* global standard setter. In 2004 the International Auditing and Assurance Standards Board (IAASB) launched an ambitious project designed to improve the clarity of its pronouncements. In 2009 IAASB completed its clarity project and released 36 updated and clarified International Standards on Auditing (ISAs) and a clarified International Standard on Quality Control. IAASB decided that all clarified standards would become effective for audits of financial statements for periods beginning on or after 15 December 2009. Members of the Forum of Firms, an association of over 20 of the largest international networks of audit firms, began to use the clarified ISAs swiftly. Countries and jurisdictions all over the world implement and apply these clarified ISAs. The ISAs are integrated into this book and numerous international real-world cases are inserted to illustrate concepts and application of the standards. In addition, separate chapters cover international assurance and related services engagement standards, and the revised Code of Ethics for Professional Accountants.

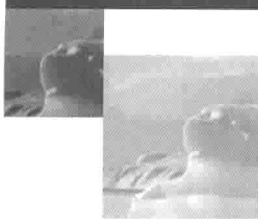
**Student Engagement.** The authors believe students are best served by acquiring a strong understanding of the basic concepts that underlie the audit process and how to apply those concepts to various audit and assurance services. The primary purpose for an auditing text is not to serve as a reference manual but to facilitate student learning, and this text is written accordingly. The text is accessible to students through straightforward writing and the use of engaging, relevant real-world examples, illustrations and analogies. The text explicitly encourages students to think through fundamental concepts and to avoid trying to learn auditing through rote memorization. New to this edition, students are prompted by the text to 'stop and think' at important points in the text, in order to help them apply the principles covered. Consistent with this aim, the text's early chapters avoid immersing students in unnecessary detail about such topics as independence and reporting requirements, focusing instead on students' understanding of fundamental audit concepts. Additionally, the case involving EarthWear Clothiers, a mail-order retailer, has been updated and integrated throughout the book. Finally, the addition of 'practice insights' throughout the book engages students and helps them understand the practical nature of auditing.

**A Systematic Approach.** The underlying concepts of auditing and the audit process are basically universal. The text continues to take a systematic approach to the audit process by first introducing the three underlying concepts: audit risk, materiality and evidence. 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. These concepts are then applied to each major business process and related account balances using a risk-based approach.

**Decision Making.** In covering these important concepts and their applications, the book focuses on critical judgements and decision-making processes followed by auditors. Much of auditing practice involves the application of auditor judgement. If a student understands these basic concepts and how to apply them to an audit engagement, he or she will be more effective in today's dynamic audit environment.

Thank you for your support of this text and the many compliments we have received regarding the First International Edition. We are gratified by the enthusiastic response the text has received as we have done our best to create a clear, easy-reading, student-friendly auditing textbook. We welcome your suggestions and hope you will be impressed with the updates we have made in this Second International Edition.

**Aasmund Eilifsen, William F. Messier Jr, Steven M. Glover, Douglas F. Prawitt**



# Guided Tour

## LEARNING OBJECTIVES

Upon completion of this chapter you will:

- ❖ LO 1 Understand why studying auditing can be valuable to you and why it is different from studying accounting
- ❖ LO 2 Be able to explain why there is a demand for auditing and assurance
- ❖ LO 3 Understand intuitively the demand for auditing and the desired characteristics of auditors and audit services through an analogy to a building surveyor and a building survey
- ❖ LO 4 Understand the relationships between auditing and assurance

## Learning Objectives and Relevant Accounting and Auditing Pronouncements

Each chapter opens with a set of learning objectives, summarizing what you should learn from each chapter. There is also a list of relevant pronouncements.

## Figures, Tables and Exhibits

Each chapter provides a number of figures, tables and exhibits to help you to visualize the various models, and to illustrate and summarize important concepts.

## Key terms

**Advisory services.** Consulting services that may include organization, personnel, finances, operational procedures, engagement, specific audit and the audit and any appropriate third findings.

**Analytical procedures.** Evaluation of financial relationships among both financial and non-financial data.

**Applicable financial reporting framework.** The management and, where appropriate, those who prepare financial statements that is acceptable in view of financial statements, or that is required by law.

**Assertions.** Representations by management, or those who prepare financial statements, as used by the auditor to identify misstatements that may occur.

**Audit committee.** A committee ordinarily composed of members of the entity's system of internal control.

## Key Terms

Each chapter ends with a summary of the key terms used and their definitions. These words are also highlighted at the relevant point in the chapter.

## Practice Insight boxes

These brief insights into practice demonstrate the realities of auditing in the real world.

## Review Questions

- LO 1 2-1 Briefly discuss the key events place in the auditing profession.
- LO 1 2-2 Discuss how the events that have shaped the profession since the first audit.
- LO 2 2-3 What is meant by joint and several liability?
- LO 3 2-4 What are the functions of the auditor?
- LO 3 2-5 What role do IASB, IFRS, and the IASB acceptance in global financial reporting?
- LO 4 2-6 List the five categories of audit engagement standards and why they are important.
- LO 5 2-7 List the sections an ISA is organized into.
- LO 6 2-8

## Review Questions

These questions encourage you to review and apply the knowledge you have acquired from each chapter. They are pitched at different levels.

**Exhibit 2-1 Examples of Audit and Non-Audit Fees in 2001**

Company	Auditor	Types of Fees
GlaxoSmithKline	PricewaterhouseCoopers	Audit
BP	Ernst & Young	Audit
HSBC	KPMG	Audit
Other	KPMG, PricewaterhouseCoopers, Deloitte	Audit
Volvo	Deloitte	Audit
Amazon	PricewaterhouseCoopers	Audit

*Source: Annual reports 2001. Audit and Non-Audit Fees by Audit Firm*

## A Series of Scandals

Starting in October 2001 with the investigation of the giant Enron, a series of high-profile accounting scandals involved corporate giants (e.g. Adelphi, global insurance firm (e.g. Merrill Lynch), mutual fund firms, and countries experienced incidents of

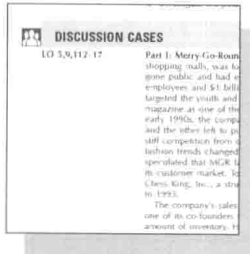
reputation brought about by a string of audit failures, conviction on charges of obstruction of justice. These Supreme Court a few years later, the total damage for years of existence is enjoyed a sterling reputation as auditing firms.

## Practice Insight 2.1

In 1932, Arthur Edward Andersen was indicted on contributions to the accounting profession. Mr. Andersen and his mother was 'Think Straight - Talk Straight' right thing. Mr. Andersen was the founder of the which he served as senior partner until his death. In 1998, the dairy food giant Parmalat, once a favorite of investors for one of the largest and most profitable food companies.

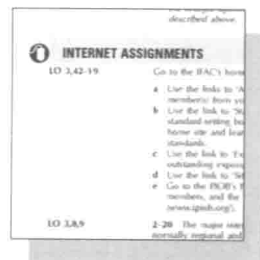
## Problems

This end-of-chapter feature is the perfect way to practise the techniques you have been taught and apply the methodology to real-world situations.



## Discussion Cases

Detailed questions based on real-world examples are posed at the end of every chapter to test understanding.



## Internet Assignments

With a wealth of information available on the Internet, these exercises challenge you to find it and make use of it. They are designed to familiarize you with important websites.





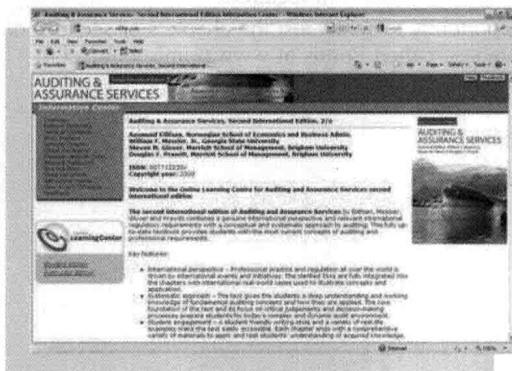
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Online Learning Centre (OLC)



After completing each chapter, log on to the supporting Online Learning Centre website. Take advantage of the study tools offered to reinforce the material you have read in the text, and to develop your knowledge of auditing in a fun and effective way.

## Resources for lecturers include:

- PowerPoint slides
- Solutions to questions and problems in the book
- Instructors' Manual

## Also available for students:

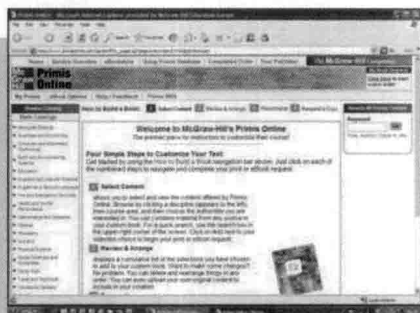
- Weblinks
- PowerPoint slides



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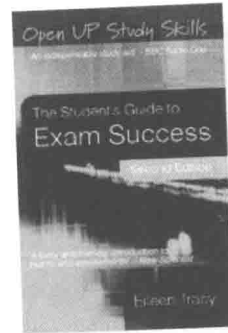
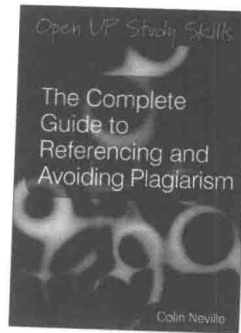
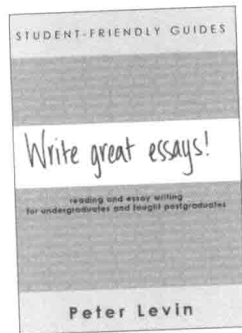
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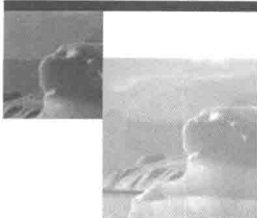
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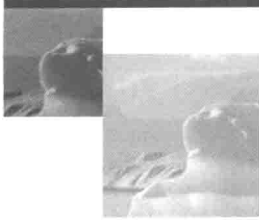
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