

Second International Edition

AUDITING & ASSURANCE SERVICES

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

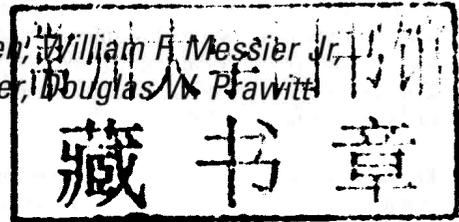




Auditing & Assurance Services

Second International Edition

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



McGraw-Hill
Higher Education

London Boston Burr Ridge, IL Dubuque, IA Madison, WI New York San Francisco
St. Louis Bangkok Bogotá Caracas Kuala Lumpur Lisbon Madrid Mexico City Milan
Montreal New Delhi Santiago Seoul Singapore Sydney Taipei Toronto

Auditing & Assurance Services *Second International Edition*
Aasmund Eilifsen, William F. Messier Jr, Steven M. Glover, Douglas F. Prawitt
ISBN-13 978-0-07-712250-8
ISBN-10 0-07-712250-X



Published by McGraw-Hill Education
Shoppenhangers Road
Maidenhead
Berkshire
SL6 2QL
Telephone: 44 (0) 1628 502 500
Fax: 44 (0) 1628 770 224
Website: www.mcgraw-hill.co.uk

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

Library of Congress Cataloguing in Publication Data

The Library of Congress data for this book has been applied for from the Library of Congress

Senior Acquisitions Editor: Mark Kavanagh
Development Editor: Karen Harlow
Marketing Manager: Vanessa Boddington
Senior Production Editor: James Bishop

Cover design by ego creative ltd
Printed and bound in Great Britain by Bell & Bain Ltd, Glasgow

Published by McGraw-Hill Education (UK) Limited an imprint of The McGraw-Hill Companies, Inc., 1221 Avenue of the Americas, New York, NY 10020. Copyright © 2010 by McGraw-Hill Education (UK) Limited. All rights reserved. No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written consent of The McGraw-Hill Companies, Inc., including, but not limited to, in any network or other electronic storage or transmission, or broadcast for distance learning.

Fictitious names of companies, products, people, characters and/or data that may be used herein (in case studies or in examples) are not intended to represent any real individual, company, product or event.

ISBN-13 978-0-07-712250-8
ISBN-10 0-07-712250-X

© 2010. Exclusive rights by The McGraw-Hill Companies, Inc. for manufacture and export. This book cannot be re-exported from the country to which it is sold by McGraw-Hill.



Mixed Sources
Product group from well-managed
forests and other controlled sources
www.fsc.org Cert no. TT-COC-002769
© 1996 Forest Stewardship Council

The McGraw-Hill Companies



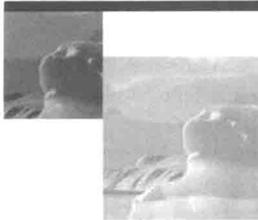
Dedication

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

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.

LO 14 2-14 How might the three categories of the financial statements auditor?

PROBLEMS

LO 5,6,72-15

Dale Bouche, the new independent auditor, told Jones that the audited financial statements had accepted the engaged month. Bouche agreed the loan if it was given. Jones hired two accountants several hours telling if they were considered "independent" auditors. The date in the accounts statements. The new auditor gave Jones the financial statements and prepared

DISCUSSION CASES

LO 3,9,112-17

Part I: Merry Go-Round shopping malls, was to give public and had employees and \$1 billion targeted the youth and magazine as one of the early 1990s, the company and the other left to staff competition from fashion trends changed speculated that MGR is in "retail market." In China King, Inc., a store in 1993.

The company's sales one of its co-founders amount of inventory is

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.

discussed above.

INTERNET ASSIGNMENTS

LO 3,42-19

Go to the BAC's home

- a. Use the link to "A membership form vs
- b. Use the link to "90 standard writing, but have one and local standards.
- c. Use the link to "E outstanding reports.
- d. Use the link to "90
- e. Go to the BAC's 90 members, and the www.bac.org.

LO 3,8,9 2-20 The major case normally essential and



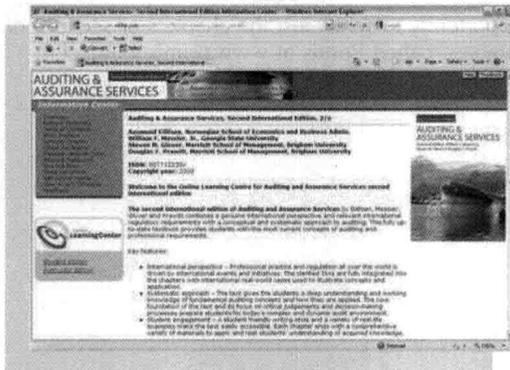
Technology to enhance learning and teaching

Visit www.mcgraw-hill.co.uk/textbooks/eilifsen today



Online
Learning Center

Online Learning Centre (OLC)



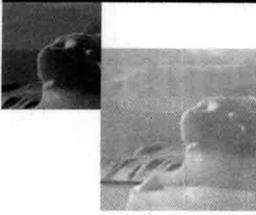
After completing each chapter, log on to the supporting Online Learning Centre website. Take advantage of the study tools offered to reinforce the material you have read in the text, and to develop your knowledge of auditing in a fun and effective way.

Resources for lecturers include:

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

Also available for students:

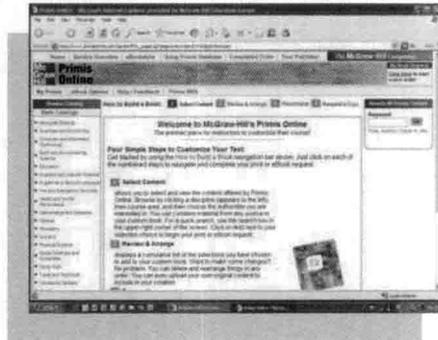
- *Weblinks*
- *PowerPoint slides*



Custom Publishing Solutions: Let us help make our content your solution

At McGraw-Hill Education our aim is to help lecturers to find the most suitable content for their needs delivered to their students in the most appropriate way. Our **custom publishing solutions** offer the ideal combination of content delivered in the way which best suits students and lecturers.

Our custom publishing programme offers lecturers the opportunity to select just the chapters or sections of material they wish to deliver to their students from a database called Primis at www.primisonline.com



Primis contains over two million pages of content from:

- textbooks
- professional books
- case books – Harvard Articles, Insead, Ivey, Darden, Thunderbird and BusinessWeek
- Taking Sides – debate materials

Across the following imprints:

- McGraw-Hill Education
- Open University Press
- Harvard Business School Press
- US and European material

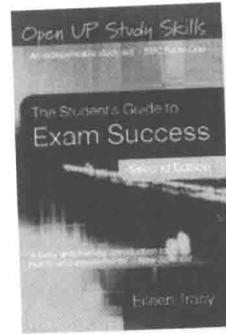
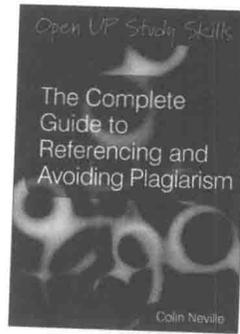
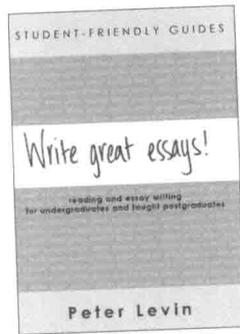
There is also the option to include additional material authored by lecturers in the custom product – this does not necessarily have to be in English.

We will take care of everything from start to finish in the process of developing and delivering a custom product to ensure that lecturers and students receive exactly the material needed in the most suitable way.

With a Custom Publishing Solution, students enjoy the best selection of material deemed to be the most suitable for learning everything they need for their courses – something of real value to support their learning. Teachers are able to use exactly the material they want, in the way they want, to support their teaching on the course.

Please contact your local McGraw-Hill representative with any questions or alternatively contact Warren Eels **e:** warren_eels@mcgraw-hill.com.

Make the grade!



30% off any Study Skills book!

Our Study Skills books are packed with practical advice and tips that are easy to put into practice and will really improve the way you study. Topics include:

- techniques to help you pass exams
- advice to improve your essay writing
- help in putting together the perfect seminar presentation
- tips on how to balance studying and your personal life.

www.openup.co.uk/studyskills

Visit our website to read helpful hints about essays, exams, dissertations and much more.

Special offer! As a valued customer, buy online and receive 30% off any of our Study Skills books by entering the promo code **getahead**



Acknowledgements

Publisher Acknowledgements

Our thanks go to the following reviewers for their comments at various stages in the text's development:

Caroline Aggestam, Copenhagen Business School
Bernice Beukes, University of Pretoria, South Africa
Joost van Buuren, Nyenrode Business University
Christine Cheong, Temasek Polytechnic, Singapore
Frank Conaty, NUI Galway
John Dunn, University of Strathclyde
David Godsell, University of Kent
Bijan Hesni, University of Westminster
Claus Holm, University of Aarhus
Olafur Kristinnsson, University of Iceland
Brian Leigh, Manchester Metropolitan University
Anna Noteborg, Erasmus University Rotterdam
Ann Vanstraelen, Maastricht University
Bent Warming-Rasmussen, University of Southern Denmark, Kolding
Mike Woodrow, Lancaster University
Henning Zulch, University of Leipzig

Author Acknowledgements

First and foremost, we would like to thank our families for their continuous support. We would like to acknowledge the International Auditing and Assurance Standards Board for quotations from international professional standards, and the International Ethics Standards Board for Accountants for quotations from the Code of Ethics for Professional Accountants. Finally, we would like to extend our gratitude to Director Roger Kjelløkken of PricewaterhouseCoopers for his careful reading of and feedback on the text, and Professor Atle Johnsen at the Department of Accounting, Auditing, and Law, Norwegian School of Economics and Business Administration, for all our valuable discussions on accounting issues.

Every effort has been made to trace and acknowledge ownership of copyright and to clear permission for material reproduced in this book. The publishers will be pleased to make suitable arrangements to clear permission with any copyright holders whom it has not been possible to contact.



About the Authors



Professor Aasmund Eilifsen is Director of the Graduate Auditing Program and Professor in Auditing at the Department of Accounting, Auditing, and Law, Norwegian School of Economics and Business Administration. He received his PhD from the same institution. He was a visiting faculty member at the University of Washington, Seattle, and the University of Florida, Gainesville. He has been a member of the European Accounting Association's (EAA) Standing Scientific Committee and serves at the Scientific Committee of the European Auditing Research Network (EARNet). Professor Eilifsen is on the editorial boards of *Auditing: A Journal of Practice & Theory*, the *International Journal of Accounting* and the *International Journal of Auditing*. He has authored or co-authored over 25 articles in journals and books, primarily in the areas of auditor judgement and decision making, audit education and audit practice. Professor Eilifsen has since 1999 served as the Academic Member on the Norwegian Auditing Standards Committee and holds a part-time position as adviser at the Norwegian Institute of Public Accountants. He has also served as an expert witness in audit litigation cases.



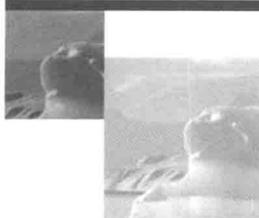
Professor William F. Messier, Jr holds the Kenneth and Tracy Knauss Endowed Chair in Accounting at the Department of Accounting, University of Nevada, Las Vegas. He is also the PricewaterhouseCoopers Professor II at the Department of Accounting, Auditing, and Law at the Norwegian School of Economics and Business Administration. Professor Messier holds 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 held faculty positions at the University of Florida (Price Waterhouse Professor) and Georgia State University (Deloitte & Touche Professor). Professor Messier was a visiting faculty member at SDA Bocconi in Milan and the University of Michigan. Professor Messier served as the Academic Member of the AICPA's Auditing Standards Board and as Chair of the AICPA's International Auditing Standards Subcommittee. He is a Past-Editor of *Auditing: A Journal of Practice & Theory* and formerly President of the Auditing Section of the American Accounting Association. Professor Messier was the recipient of the AAA Auditing Section's Outstanding Educator Award (2009) and the Distinguished Service in Auditing Award (2008). He has also served as an expert witness in a number of audit litigation cases.



Professor Steven M. Glover is the Mary & Ellis Professor of Accounting at the Marriott School of Management, Brigham Young University. Professor Glover is a CPA in Utah and holds a PhD and BS from the University of Washington and an AA in Business from BYU – Idaho. He previously worked as an auditor for KPMG LLP and as a director in the national office of PricewaterhouseCoopers LLP. Professor Glover serves on the audit committee of a non-profit organization and has served on the board of advisers for technology companies, and he actively consults with public companies and public accounting firms. He has also served as an expert witness. Professor Glover is the President Elect of the Auditing Section of the American Accounting Association. He has been on auditing-related task forces of the AICPA. Professor Glover is on the editorial boards of *Auditing: A Journal of Practice & Theory*, *The Accounting Review* and *Accounting Horizons*. He has authored or co-authored over 25 articles and books primarily focused in the areas of auditor decision making, audit education and audit practice.



Professor Douglas F. Prawitt is the Glen Ardis Professor of Accountancy at the Marriott School of Management, Brigham Young University. Professor Prawitt is a CPA in Utah. He holds a PhD from the University of Arizona, and BS and MAcc degrees from Brigham Young University. Professor Prawitt was awarded the Marriott School's Teaching Excellence and Outstanding Researcher awards in 1998 and 2000. He received the Merrill J. Bateman Student Choice Teaching Award in 2002 and BYU's Wesley P. Lloyd Award for Distinction in Graduate Education in 2006. He consults actively with international and local public accounting firms. Over the past five years he has worked extensively with the Committee of Sponsoring Organizations (COSO) on the COSO *Enterprise Risk Management Framework* and *Internal Control over Financial Reporting – Guidance for Smaller Public Companies* projects. Professor Prawitt has also served in several capacities with the American Accounting Association and is on the editorial boards of *Auditing: A Journal of Practice & Theory*, *Behavioral Research in Accounting* and *Accounting Horizons*. He has authored or co-authored over 25 articles and books, primarily in the areas of auditor judgement and decision making, audit education and audit practice. Finally, he served a three-year appointment to the AICPA Auditing Standards Board from 2005–2008.



Brief Table of Contents

Preface	<i>xiii</i>
Guided Tour	<i>xv</i>
Website	<i>xvii</i>
Acknowledgements	<i>xx</i>
About the Authors	<i>xxi</i>

PART I Introduction to Assurance and Financial Statement Auditing

1	An Introduction to Assurance and Financial Statement Auditing	3
2	The Financial Statement Auditing Environment	39

PART II Basic Auditing Concepts: Risk Assessment, Materiality and Evidence

3	Risk Assessment and Materiality	75
4	Audit Evidence and Audit Documentation	113

PART III Planning the Audit and Internal Control

5	Audit Planning and Types of Audit Tests	143
6	Internal Control in a Financial Statement Audit	185
7	Auditing Internal Control Over Financial Reporting	222

PART IV Statistical and Non-Statistical Sampling Tools for Auditing

8	Audit Sampling: An Overview and Application to Tests of Controls	257
9	Audit Sampling: An Application to Substantive Tests of Account Balances	291

PART V Auditing Business Processes

10	Auditing the Revenue Process	329
11	Auditing the Purchasing Process	373
12	Auditing the Human Resource Management Process	408
13	Auditing the Inventory Management Process	431
14	Auditing the Financing/Investing Process: Prepaid Expenses; Intangible Assets and Goodwill, and Property, Plant and Equipment	459
15	Auditing the Financing/Investing Process: Long-Term Liabilities, Stockholders' Equity and Income Statement Accounts	481
16	Auditing the Financing/Investing Process: Cash and Investments	499

PART VI Completing the Audit and Reporting Responsibilities

17	Completing the Audit Engagement	525
18	Reports on Audited Financial Statements	550

PART VII Professional Responsibilities

19	Professional Ethics, Independence and Quality Control	577
----	---	-----

PART VIII <i>Assurance, Related Services and Internal Auditing</i>	
20 Assurance, Related Services and Internal Auditing	615
<i>Index</i>	650



Detailed Table of Contents

Preface	xiii
Guided Tour	xv
Website	xvii
Acknowledgements	xx
About the Authors	xxi

PART I *Introduction to Assurance and Financial Statement Auditing*

1 An Introduction to Assurance and Financial Statement Auditing	3
The Study of Auditing	5
The Demand for Auditing and Assurance	5
An Assurance Analogy: The Case of the Building Surveyor	8
Auditing and Assurance Defined	10
Fundamental Concepts in Conducting a Financial Statement Audit	11
Sampling: Inferences Based on Limited Observations	14
The Audit Process	14
Conclusion	20
Key Terms	21
Review Questions	22
Problems	22
Discussion Case	23
Internet Assignments	24
EarthWear Annual Report 2009 (see colour section)	
2 The Financial Statement Auditing Environment	39
A Time of Challenge and Change for Auditors	40
Auditors' Legal Liability	43
International Organizations that Affect the Accounting Profession	44
Auditing Standards	49
Society's Expectations and the Auditor's Responsibilities	53
Ethics, Independence and the IFAC Code of Ethics for Professional Accountants	54
Audit Firms	54
Types of Services Offered by Audit Firms	56
Types of Auditors	58

The Context of Financial Statement Auditing	60
A Model of Business	61
A Model of Business Processes: Five Components	62
Management Assertions	64
Conclusion	65
Key Terms	66
Review Questions	67
Problems	68
Discussion Cases	68
Internet Assignments	70

PART II *Basic Auditing Concepts: Risk Assessment, Materiality and Evidence*

3 Risk Assessment and Materiality	75
Audit Risk	76
The Audit Risk Model	77
The Auditor's Risk Assessment Process	80
Evaluate the Entity's Risk Assessment Process	86
Assessing the Risk of Material Misstatements Due to Error or Fraud	86
The Auditor's Response to the Results of the Risk Assessments	92
Evaluation of Audit Test Results	93
Documentation of the Auditor's Risk Assessment and Response	94
Communications about Fraud to Management, Those Charged with Governance and Others	96
Materiality	96
Advanced Module: Auditing of Accounting Estimates, Including Fair Value Accounting Estimates	102
Key Terms	105
Review Questions	106
Problems	107
Discussion Cases	110
Internet Assignment	111
4 Audit Evidence and Audit Documentation	113
The Relationship of Audit Evidence to the Audit Report	114