

Whittington • Pany

Principles of Auditing

AND OTHER ASSURANCE SERVICES

FOURTEENTH EDITION

Principles of Auditing and Other Assurance Services

Fourteenth Edition

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PRINCIPLES OF AUDITING AND OTHER ASSURANCE SERVICES

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Preface

Over the past few years we have seen unprecedented changes in the auditing profession. These changes were precipitated by the revelation that management of a number of large public companies, including Enron and WorldCom, systematically misstated the financial statements of the companies over a number of years. As a result, we have witnessed congressional hearings about the accounting profession, the criminal conviction and liquidation of the international accounting firm of Arthur Andersen LLP, and the passage of the Sarbanes-Oxley Act of 2002, which takes from the profession the major portion of its self-regulatory authority. The goal of the fourteenth edition of *Principles of Accounting and Other Assurance Services* is to provide you with a **clear perspective of the new auditing environment**.

How do we do this?

1. **Balanced presentation.** This text provides a carefully balanced presentation of auditing and assurance theory and practice. The concepts are written in a clear, concise, and understandable manner suitable for students who have not had significant audit experience. Real company examples are integrated throughout the text to bring this material to life. Lastly, the Keystone Computers is the text's illustrative audit case integrated into selected chapters that provides students with hands-on audit experience.
2. **Clarifying the changes to the profession.** The authors have included all the new legal and standards changes affecting the auditing profession to provide you with the most current and up-to-date auditing text available. Please refer to the inside front cover for a detailed list of the changes.
3. **Maintaining a clear perspective.** The Online Learning Center provides instructors and students with a wealth of material to help keep students up-to-date. The OLC receives daily updates from *The New York Times* and McGraw-Hill's PowerWeb so you always know the breaking news affecting the profession. The OLC also contains quizzing and other resources to help students in this course.

Just as the windows on the cover provide a clear perspective of the environment outside, *Principles of Auditing and Other Assurance Services*, 14/e, will provide students with a clear perspective of the new auditing environment.

O. Ray Whittington

Kurt Pany

Key Features of the Book

Sarbanes-Oxley Act of 2002 and the resulting **Public Company Accounting Oversight Board** profoundly affect public accountants, CPA firms, and their clients. Most notably, the public accounting profession is no longer largely self-regulating, CPAs must issue a publicly available report on the internal control of each publicly traded client, and top management must certify its financial statements. The text carefully integrates coverage of the act's nature and effects on the profession in selected chapters. Also included is coverage of financial frauds, such as those involving Enron and WorldCom that led to passage of the act.

The first 9 chapters of the text emphasize the philosophy and environment of the profession, with special attention paid to the nature and economic purpose of auditing and assurance services, professional standards, professional conduct, legal liability, audit evidence, audit planning, consideration of internal control, audit sampling, audit working papers, and general records.

Auditor legal liability in Chapter 4 has been thoroughly updated based on suggestions by legal scholar Professor Marianne Jennings of Arizona State University.

Chapter 6 has been revised to include the dramatic changes required by Statement on Auditing Standards No. 99, *The Auditor's Consideration of Fraud in a Financial Statement Audit*.

Chapters 7 and 8 reflect the profession's most recent pronouncements relating to information technology and internal control.

1. The Role of the Public Accountant in the American Economy
2. Professional Standards
3. Professional Ethics
4. Legal Liability of CPAs
5. Audit Evidence and Documentation
6. Planning the Audit; Linking Audit Procedures to Risk
7. Internal Control
8. Consideration of Internal Control in an Information Technology Environment
9. Audit Sampling

Keystone Computers & Networks, Inc. is the text's **Illustrative Audit Case**. This feature has been updated in this edition and illustrates audit methods and provides realistic, thought-provoking case exercises. Although each portion of the case is designed to stand alone, if used in combination, the case will help the student develop problem-solving skills in planning (Chapter 6), in considering internal control and testing account balances (Chapters 11 and 14), and in completing the audit (Chapter 17). The case incorporates the use of computerized accounting applications and also integrates the fundamentals of audit sampling from Chapter 9.

International Auditing Standards are discussed as appropriate. These standards are becoming increasingly significant with the development of international markets for securities.

10. Cash and Financial Investments
11. Accounts Receivable, Notes Receivable, and Revenue
12. Inventories and Cost of Goods Sold
13. Property, Plant, and Equipment: Depreciation and Depletion
14. Accounts Payable and Other Liabilities
15. Debt and Equity Capital
16. Auditing Operations and Completing the Audit
17. Auditors' Reports
18. Special Reports and Accounting and Review Services
19. Other Assurance Services
20. Internal, Operational, and Compliance Auditing

Chapters 10 through 16 (the "procedural chapters") deal with internal control and obtaining evidence about the various financial statement accounts; they emphasize a risk-based approach to selecting appropriate auditing procedures. They also provide a description of the business risk approach to audits that has been adopted by many large CPA firms and is the approach included in the recently issued exposure draft of the proposed Statement on Auditing Standards on Risk Assessment. Chapters 10 through 16 also thoroughly integrate the requirements of SAS No. 99.

Chapters 17 and 18 present the auditors' reporting responsibilities related to financial information—audit reports, special reports, and reports on accounting and review services.

Chapter 19 presents a variety of attestation and other assurance services. The material on attestation services has been updated for changes just adopted by the public accounting profession. **Other assurance services** are included at both a conceptual and practical level. At a conceptual level the text provides a discussion of the nature of assurance services, and a comparison of assurance services, attestation services, and audits. At the practical level it includes detailed discussions of the public accounting profession's new types of engagements, including Trust Services (which include the previous "stand-alone" services of *WebTrust* and *SysTrust*) and *ElderCare*.

Chapter 20's discussion of compliance auditing has been modified based on the suggestions of Mr. Norwood J. Jackson, former Deputy Controller, Office of Federal Management, U.S. Office of Management and Budget.

FEATURES OF THIS EDITION

This text includes a variety of features to enhance the learning experience:

Illustrative Cases

Actual business and accounting examples are used to illustrate key chapter concepts. The cases are boxed and appear throughout the text. New cases have been added for recent alleged audit failures.

Illustrative Case

The situation in which audit clients hire audit firm personnel is difficult. On the one hand, it provides great professional opportunities for individuals who enter the public accounting profession. On the other, independence concerns have led to the restrictions presented in this section.

Questions were raised about the number of ex-Arthur

years Arthur Andersen served as auditor, 86 employees left the firm and accepted positions at Enron.

In addition, questions arose as to the nature of the relationship between continuing Arthur Andersen employees and those of Enron. Again, *The Wall Street Journal* reported that Arthur Andersen auditors and consultants "shared in office birthdays, frequented lunch time parties

Industry Focus Cases

These cases use examples from specific industries to provide students with detailed "real world" illustration of points being emphasized in the text. These cases show the importance of having a thorough knowledge of the audit client's business and industry. Like the illustrative cases, these cases are boxed and appear throughout the text.

Focus on the Airline Industry

"Ticketless" travel has become increasingly important within the airline industry. Under these systems a passenger may book a flight over the telephone or by computer and be assigned a reservation number rather than being issued a ticket. Since no ticket is created until the passenger checks in for the flight, the auditor is limited in the extent to which he or she can examine "paper" support for transactions. Accordingly, audit procedures must be developed relating to the associated revenues and receivables. Auditors often choose to test the computer controls in such situations.

Illustrative Documents

Documents included in the various procedural chapters (10 through 16) provide concise, realistic examples of the documents associated with the various transaction cycles. See the back endpapers of this text for the complete figure.

7462537			
INVOICE Wood Supply Co. 21 Main St. Suisun City, CA 94585			
Sold to: <u>Pilot Stores</u>		Date: <u>Nov. 27, 200X</u>	
<u>1425 G St.</u>		Your order no.: <u>78644</u>	
<u>Irvine, CA 92345</u>		Shipped: <u>Nov. 25, 200X</u>	
		Shipped via: <u>Jon Trucking</u>	
Qty	Description	Price	Total
20 doz.	Q Clamps	\$235.00	\$4700.00
10	120 hp Generators	355.00	3550.00
			<u>\$ 8250.00</u>

Sales

78644			
PURCHASE ORDER Pilot Stores 1425 G St. Irvine, CA 92345			
To: <u>Wood Supply Co.</u>	Date: <u>Nov. 10, 200X</u>		
<u>21 Main St.</u>	Ship via: <u>Jon Trucking</u>		
<u>Suisun, CA 95483</u>	Terms: <u>2/10, n/40</u>		
Enter our order for			
Qty	Description	Price	Total
20 doz.	Q Clamps	\$235.00	\$4700.00
10	#26537489 120 hp Generators	355.00	3550.00
		748	
Wood Supply Co. By: <u>Bill Jones</u>			

Accounts Sales

	8250.00
--	---------

Accounts Receivable

8250.00	8250.00
---------	---------

Cash

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Audit Objectives

The use of Audit Objectives is a basic tool in audit program design. These help focus on the *reason* a procedure is being done and provide a check to assure that all management assertions in the financial statements are audited.

Primary Audit Objectives:	
Clerical accuracy	<input checked="" type="checkbox"/>

1. Obtain or Prepare Analyses of the Investment Accounts and Related Revenue, Gain, and Loss Accounts and Reconcile Them to the General Ledger

The analysis of financial investments will show the beginning and ending balances for the year, purchases and sales of investments during the year, interest and dividends earned, and realized and unrealized gains and losses. The auditors may verify the beginning balances of investments by reference to the prior year's audit working papers. If numerous purchases

Illustrations, Tables, and Flowcharts

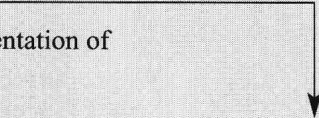
These are used throughout to enhance and clarify the presentation.

Chapter Summaries

The summaries recap the most important information presented in the chapter.

Chapter Objectives

These objectives provide a concise presentation of each chapter's most important concepts.



Chapter Objectives

After studying this chapter, you should be able to:

- Describe the character of assurance services.
- Identify assurance services that involve attestation.
- Describe the nature of financial statement audits.
- Explain why audits are demanded by society.
- Describe how the credibility of the accounting profession was affected by the large number of companies reporting accounting irregularities in 2001 and 2002.

Key Terms Introduced or Emphasized

This is a glossary of each chapter's most important terms. The terms are boldface within the chapter and are defined at the end of the chapter. Placing the definitions at the end of each chapter allows the student to quickly find the meaning of unfamiliar terms while reading the material. The glossary also serves as an excellent review tool and helps the student see how well he or she understands the major ideas presented.

END-OF-CHAPTER PROBLEM MATERIAL

The questions, problems, case material, and audit case exercises at the end of each chapter are divided as follows: Review Questions; Questions Requiring Analysis; Problems; In-Class Team Exercises; Ethics Cases; Research and Discussion Cases; and Audit Case Exercises.

Review Questions

The Review Questions are closely related to the material in the chapter and provide a convenient means of determining whether students have grasped the major concepts and details contained in that chapter.

Questions Requiring Analysis

The Questions Requiring Analysis require thoughtful consideration of a realistic auditing situation and the application of professional standards. A number of these questions are taken from CPA and CIA examinations, and others describe actual practice situations. These questions, which are generally shorter than the problems, tend to stress value judgments and conflicting opinions.

Problems

Many of the Problems are drawn from CPA and CIA examinations. In selecting these problems, consideration was given to ones appearing in recent professional exams. However, older questions are included when they are superior to others available.

Research and Discussion Cases

These cases involve controversial situations that do not lend themselves to clear-cut answers. Students are required to research appropriate professional literature and to then apply critical thinking skills to logically formulate and justify their personal positions on the issues involved in each case. The cases acquaint students with the professional literature, develop research and communication skills required on the new CPA exam, and demonstrate that several diverse, yet defensible, positions may be argued persuasively in a given situation.

Research and Discussion Case



3-42. The International Bank of Commerce (IBC) is an audit client of your public accounting firm. IBC is a multinational financial institution that operates in 23 countries. During the current year's audit, you have discovered the following problems:

- a. Improper loans were made to stockholders and other related parties, and
- b. Loans were recorded on the books that appear to be either false or deceitful.

You are especially concerned about these findings because it appears that members of senior management were aware of, and participated, in these illegal activities. In accordance with *SAS No. 54*, "Illegal Acts by Clients," you have communicated these illegal acts to IBC's audit committee of the board of directors. However, you are not satisfied with the committee's reaction to the situation. The chairman of the audit committee thanked you cordially, but the committee took no action to investigate the activities or prevent their occurrence in the future.

Audit Case Exercises

These exercises all pertain to the text's updated continuing integrated case, **Keystone Computers & Networks, Inc.** While each exercise may "stand alone," when used in combination, these case exercises take the student from the original planning of an audit through testing of controls, substantive testing, and accumulation and analysis of uncorrected misstatements. Exercises are included in Chapters 6, 11, 14, and 16.

Spreadsheet Templates

Spreadsheet templates are available on the text's website to be used in conjunction with selected audit case exercises. The exercises with templates are identified by a floppy disk logo in the margin.



Required:

- 6C-4. A partially completed analytical ratios working paper for Keystone Computers & Networks, Inc., is presented on page 223.
- Complete the working paper by computing the financial ratios for 20X5.
 - After completing part *a*, review the ratios and identify financial statement accounts that should be investigated because the related ratios are not comparable to prior-year ratios and industry averages.

Ethics Cases

In-Class Ethics Cases, new to this edition, allow the instructor to discuss ethical issues in an integrated manner throughout the course. The cases present a series of situations which result in ethical dilemmas of the type that beginning accountants may expect to encounter in practice. These cases are included in selected chapters.

Ethics Case

- 6-42. Tammy Potter, a new partner with the regional CPA firm of Tower & Tower, was recently appointed to the board of directors of a local civic organization. The chairman of the board of the civic organization is Lewis Edmond, who is also the owner of a real estate development firm, Tierra Corporation.

Potter was quite excited when Edmond indicated that his corporation needed an audit, and he wished to discuss the matter with her. During the discussion, Potter was told that Tierra Corporation needed the audit to obtain a substantial amount of additional financing to acquire another company. Presently, Tierra Corporation is successful, profitable, and committed to growth. The audit fee for the engagement should be substantial.

In-Class Team Cases

These cases are meant to be solved in class either by teams of students or, if the instructor prefers, by individuals. They help provide the student with an active learning environment to apply key concepts included in each chapter.

In-Class Team Cases



Required:

- 3–40. The issue of whether the performance of nonattest (consulting) services for audit clients impairs independence of the auditors has been widely debated within the public accounting profession. Restrictions on the performance of consulting is a major aspect of the Sarbanes-Oxley Act of 2002.
- a. Describe the restrictions that are placed on the performance of nonattest services for audit clients by the Sarbanes-Oxley Act of 2002.
 - b. List arguments for restricting nonattest services for audit clients.
 - c. List arguments against restricting nonattest services for audit clients.
 - d. Present your opinion and support it with one or more of the arguments listed above.
- 3–41. You are the Partner-in-Charge of a large metropolitan office of a regional public accounting firm. Two members of your professional staff have come to you to discuss problems that may

Internet Assignments

Internet assignments are included among the end-of-chapter problem material for selected chapters. These assignments require students to use the **Internet** to do audit research and are identified with a WWW logo in the margin.



Required:

- 6–33. *Internet Exercise.* SEC filings of certain public companies can be accessed from EDGAR (Electronic Data Gathering and Retrieval System), which has the following Internet address: **www.sec.gov/edgarhp.htm**.
- a. Use EDGAR to locate a company in the software industry.
 - b. Access the latest Form 10-K for the company and read “Management’s Discussion and Analysis” from Form 10-K.

Required:

SUPPLEMENTS

Website

A Website, www.mhhe.com/business/accounting/whittington14e, provides links to various sites referred to in the text and updates that reflect changes in auditing standards that have occurred subsequent to publication of the text. The site includes a multiple-choice quiz and solutions for each chapter to allow students to measure their mastery of key concepts. It also includes the Keystone Case spreadsheets referred to in selected end-of-chapter problems. The Instructor's portion contains downloadable supplements.

Study Guide

A Study Guide (ISBN 0072835044), written by the text's authors, enables students to review text material and to test their understanding. The guide includes a summary of each chapter's highlights and an abundance of objective questions and exercises. Since the guide includes answers to the questions and exercises, it provides immediate feedback to students.

Instructor's Resource CD-ROM

The Instructor's Resource CD-ROM (ISBN 0072835052) allows you to access the text's ancillary materials in one convenient CD. This includes the Instructor's Lecture Guide, the Solutions Manual, Test Bank, Computerized Test Bank, Spreadsheets, and PowerPoint presentations.

Instructor's Lecture Guide and Solutions Manual

Our Instructor's Lecture Guide includes topical outlines of each chapter, the authors' personal comments on each chapter, and numerous instructional aids, including transparency masters. A Solutions Manual includes thorough and up-to-date solutions to the text's questions, problems, and exercises. These are included on the Instructor's Resource CD-ROM and on the text's website.

Test Bank

The Test Bank includes both original questions and problems, and questions adapted from various professional examinations. It has been significantly expanded in this edition by the inclusion of approximately 180 additional multiple-choice and essay-type questions. This is included on the Instructor's Resource CD-ROM.

Computerized Test Bank

Computerized Test Bank by Brownstone Research Group is the computerized version of the test bank. The advanced-feature exam generator allows instructors to add and edit questions; save and reload multiple tests; insert instructions to students; and select questions based on type, level of difficulty, or objective. These also are included on the Instructor's Resource CD-ROM.

PowerPoint Presentations

PowerPoint presentations are available to assist in classroom presentations and are located on the Website and Instructor's Resource CD-ROM.

REFERENCES TO AUTHORITATIVE SOURCES

Numerous references are made to the pronouncements of the American Institute of Certified Public Accountants (AICPA), the Institute of Internal Auditors (IIA), the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), and the Securities and Exchange Commission (SEC). Special attention is given to the *Code of Professional Conduct*, *Statements on Standards for Accounting and Review Services*, *Statements on Standards for Attestation Engagements*, *Statements on Auditing Standards*, and guidelines developed for other types of assurance services. The cooperation of the AICPA and the IIA in permitting the use of their published materials and of questions from the CPA and CIA examinations brings to the text an element of authority not otherwise available.

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