



11TH EDITION

AUDITING

A RISK-BASED APPROACH

JOHNSTONE | GRAMLING | RITTENBERG





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Cover Image: cozyta/Shutterstock.com,
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Library of Congress Control Number: 2017960519

ISBN: 978-1-337-61945-5

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The auditing environment continues to change in significant ways. University graduates entering the auditing profession today should be prepared for a high standard of responsibility, should be ready to serve the public interest, and should recognize the emerging issues and continuing points of focus facing auditors. Examples of today's emerging issues and continuing points of focus facing the profession include:

- New accounting guidance from the Financial Accounting Standards Board on *leases* and *revenue recognition*.
- Increased need for *critical thinking* and *professional skepticism*.
- Increased and growing use of *data analytics tools*.
- Continued and increasing importance of *ethical and professional decision making*.
- Continued efforts toward *international convergence of auditing standards* of the American Institute of Certified Public Accountants (AICPA) and the International Auditing and Assurance Standards Board (IAASB).
- *Reorganization of the Public Company Accounting Oversight Board (PCAOB) auditing standards* to provide auditors and others with a logical framework and easy access to the standards governing the conduct of audits of public companies.
- The *IAASB's issuance of new and revised auditor reporting standards*, which require auditors to provide more transparent and informative reports on the companies they audit, including the disclosure of *key audit matters*.
- The *PCAOB's adoption of a new auditing standard on the auditor's report*, including the disclosure of *critical audit matters*.

The eleventh edition of *Financial Statement Auditing: A Risk-Based Approach* represents the most up-to-date professional auditing guidance available and reflects the many emerging issues and continuing points of focus in the profession. This text provides students with the tools they need to understand the full range of issues associated with conducting a quality financial statement audit in an evolving national and global context.

Revision Themes and New Enhancements in the Eleventh Edition

Coverage of Emerging Data Analytics Tools. Data analytics tools include qualitative and quantitative techniques and processes that auditors use to enhance their productivity and effectiveness in terms of extracting, categorizing, identifying, and analyzing patterns in their client's data. Emerging data analytics tools facilitate testing 100% of a population, enabling the auditor to focus on potentially erroneous transactions or risky areas of the audit. These emerging tools also include sophisticated data visualization tools, for example, Tableau. Data analytics tools also include familiar platforms such as Excel, ACL, and IDEA; the landscape is changing dramatically and quickly in this space, so instructors and students must be adaptive to fast-paced change. We introduce

key terms and explain data analytics tools in an expanded *Chapter 8*, with an entirely new section, “Using Data Analytics Tools to Obtain and Evaluate Evidence.” We also include end-of-chapter problems to reinforce opportunities to employ data analytics tools within *Chapter 8* and the following cycle chapters (e.g., data analytics in the revenue cycle in *Chapter 9*).

Auditing Standards Exhibit—PCAOB, AICPA, and IAASB—appears inside the front cover of this textbook. This exhibit allows for easy access to relevant standards, and provides a platform for relative comparisons across each of the standards-setting bodies. End-of-chapter problems require students to review and apply the material in the *Auditing Standards Exhibit*. These problems provide students with practice completing task-based simulations similar to what they will see on the CPA exam; we highlight these problems with an identifying icon.

Three New Learning Engagement Features. Students today demand more than case facts and standard lectures. They require opportunities to engage with the instructor and classmates on important topics facing the profession.

- ***“Why It Matters” feature.*** This feature helps students see beyond the factual insights provided in the chapters. Elements include for example, extensions based on in-the-news examples that illustrate fundamental features and applications of text facts, professional standards in foreign jurisdictions, and interesting points that may be tangential to the text facts, but that should facilitate students’ deep engagement with the chapter. Certain of these features are noted as relating to an International Focus.
- ***“Prompt for Critical Thinking—It’s Your Turn!” feature.*** This feature encourages students to engage in critical thinking as they acquire knowledge relevant to each chapter. This feature is intentionally creative in form and substance, and varies widely in structure based upon the learning objective to which it is related. As an example of one such prompt, students are asked to consider auditors’ responsibilities with respect to internal controls around the Foreign Corrupt Practices Act.
- ***“What Do You Think?—For Classroom Discussion” feature.*** This feature provides an avenue by which instructors can facilitate preparation for class, cognitive engagement, and critical thinking through discussions with other students. Like the *Prompt for Critical Thinking* feature, *What Do You Think?* is creative in form and substance and varies in unexpected ways to spark students’ interest in engagement with the chapter topic. This feature is an ideal way for instructors to facilitate an interesting class discussion using a flipped-classroom approach (either involving the entire class or within small teams).

Below we provide examples of each of these three new learning engagement features that appear in *Chapter 14* (“Completing a Quality Audit”) with respect to the learning objective “Obtaining Remaining Audit Evidence on Noncompliance with Laws and Regulations.”

- The *Why It Matters* feature articulates the motivation for and provisions of the Foreign Corrupt Practices Act (FCPA).
- The *Prompt for Critical Thinking* feature extends this discussion by prompting students to think about corruption, how to measure it, and its variation across different jurisdictions.
- The *What Do You Think?* feature encourages students to consider the applicability of the FCPA in today’s business and auditing environment.

Compliance with the Foreign Corrupt Practices Act (FCPA) of 1977

This feature highlights an important law that many companies have failed to comply with.

The FCPA was written to respond to SEC investigations in the 1970s revealing that over 400 companies had made questionable or illegal payments of over \$300 million to foreign officials, politicians, and political parties. The payments involved bribery of foreign officials to facilitate business operations in their respective foreign countries. The main provisions of the FCPA include:

- No U.S. person or company that has securities listed on U.S. markets may make a payment to a foreign official for the purpose of obtaining or retaining business. This provision is commonly called the anti-bribery provision of the FCPA.
- Companies that have securities listed on U.S. markets must make and keep financial records that accurately and fairly reflect the transactions of the company and must design and maintain an adequate system of internal accounting controls.
- Certain payments to foreign officials are acceptable. These include grease payments, which are payments made to an official to expedite the performance of the duties that the official would already be bound to perform.

Before reading this text, had you heard of the Transparency International corruption perception index? Think critically about what you know about the political and economic structure of the following countries. In the spaces below, (1) rank the six countries

from most corrupt to least corrupt just from what you know, and (2) guess what their ranking is on a scale from 0–100 on the corruption perception index from 0 (highly corrupt) to 100 (very clean):

Country (in alphabetical order)	Rank (1 = most to 6 = least corrupt among this list)	Estimated corruption perception index (0 – 100)
Belgium		
Brazil		
New Zealand		
Somalia		
South Korea		
United States of America		

After ranking the countries, visit Transparency International and compare your answers and estimates against theirs:

https://www.transparency.org/news/feature/corruption_perceptions_index_2016#table

What are your reactions to what you have learned? What rankings surprised you? How accurate were your rankings?

For Classroom Discussion

The FCPA of 1977 was enacted a LONG time ago!

1. Do you think it is still relevant today? Why or why not?
2. Review the following SEC website:

<https://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml> What are your impressions? What surprises you? What companies on this

list are well-known? Focus on one of the enforcement actions (perhaps at the discretion of your instructor) and explain how the company violated the FCPA.

Updates to “Focus on Fraud” Feature. The authors continue their use of this learning engagement feature, which provides compelling examples of recent frauds, and the role of the auditor in preventing, detecting, or (sometimes) *not* detecting those frauds. Below we provide an example of this learning feature that appears in *Chapter 14* (“Completing a Quality Audit”) with respect to the learning objective “Obtaining Remaining Audit Evidence on Noncompliance with Laws and Regulations.”

Triton Energy and Noncompliance with Laws and Regulations

This feature describes a historically important case involving noncompliance with the Foreign Corrupt Practices Act (FCPA) of 1977.

Triton Energy engages in the exploration and production of crude oil and natural gas in many areas around the world. Triton has traditionally operated in relatively high-risk, politically unstable areas where larger and better-known producers do not operate. Top Triton Indonesia officials (President, CFO, Commercial Manager, and Controller) were investigated by the SEC for violations of the Foreign Corrupt Practices Act. These violations included:

- Improper payments were made to a middleman who used the funds to reduce Triton Indonesia’s tax liability.
- Improper payments were made to a middleman who used the funds to ensure a favorable governmental audit.
- Improper payments were made to a middleman who used the funds to obtain corporate tax refunds from government officials.

- The recording of false journal entries by Triton Indonesia’s Commercial Manager and Controller were made to cover up the improper payments.

These improper payments and false journal entries were facilitated because Triton’s CEO, Bill Lee, was an aggressive top manager who provided weak tone at the top in terms of his failure to encourage compliance with applicable laws and regulations, failure to discourage improper payments, and failure to implement internal controls to deter improper payments. Triton was ultimately fined \$300,000 related to the scandal.

For further details, see the SEC’s Securities Exchange Act of 1934 Release No. 38343 and Accounting and Auditing Enforcement Release No. 889, February 27, 1997.

- To help students prepare for the CPA exam, MindTap for Auditing includes two pre- and post-tests using author-selected multiple-choice questions from Becker Professional Education, all tailored to this edition’s critical learning objectives.
- “*Check Your Basic Knowledge*” feature. To enhance and expand on the *Becker CPA Exam Questions* feature, each chapter includes additional true-false and multiple-choice questions *within the chapter text itself*.

Following the discussion of each learning objective within the chapters, we challenge students to answer four questions (two true-false and two multiple-choice) to alert students to their effective learning, or alternatively, to their lack of understanding (which should encourage students to more carefully acquire the concepts relating to each particular learning objective). Taken collectively, the Becker CPA Exam Questions and Check Your Basic Knowledge questions ensure that students have the opportunity to challenge themselves during reading the chapter, thereby tracking their learning, and after reading the chapter.

- *Updated and Expanded Chapter Examples and End-of-Chapter problems*, including “*Review Questions and Short Cases*,” “*Application Activities*,” along with more extensive longer cases: “*Fraud Focus: Contemporary and Historical Cases*.” To help instructors identify these problems, the text includes the following icons that highlight overall themes: *Ethics, Fraud, Professional Skepticism, International Issues, and Auditing Standards Application Activities*. We also rely extensively on using facts from SEC Accounting, Auditing, and Enforcement Releases (AAERs) and PCAOB Enforcement Actions in the cases to illustrate the regulatory implications of auditors’ judgments and decisions. For most chapters, we have updated the *Academic Research Cases*, providing instructors with an opportunity to introduce students to the relevance of academic research to the auditing profession.

Examples of Selected Cases by Chapter include:

Longtop Financial Technologies (Ch. 1), Bentley’s Brisbane Partnership (Ch. 1), Wells Fargo (Ch. 2), Weatherford International (Ch. 2), Lime Energy (Ch. 2), U.S. Department of Defense (Ch. 3), Diamond Foods (Ch. 3), Chesapeake Petroleum and Supply (Ch. 3), Florida Department of Financial Services (Ch. 4), Toshiba (Ch. 4), Boeing (Ch. 5), ContinuityXSolutions, Inc. (Ch. 7), Ag Feed Industries (Ch. 9), China Media Express Holdings (Ch. 9), Monsanto Corporation (Ch. 9), Agricultural Bank of China (Ch. 10), MagnaChip (Ch. 11), Miller Energy Resources (Ch. 12), Soyo Group (Ch. 13), Logitech (Ch. 13), 2GO (Ch. 14), Chelsea Logistics Holding Corp. (Ch. 14), Suiss Finance (Ch. 14), ImmunoGen, Inc. (Ch. 15), Rolls Royce (Ch. 15), and Westmoreland Coal Company (Ch. 15).

Expanded View of “Users.” In prior versions, our user-emphasis was on shareholders, bondholders, regulators, and standards-setters as primary actors. While of course critical, we now incorporate discussion of the role that analysts play (e.g., in incentivizing managers, and therefore affecting the judgments and decisions of users), along with stock market reactions to both financial accounting and auditing information disclosures. As an illustration of one such view, we include the following discussion in *Chapter 9* (the revenue cycle), embedded in a *Why It Matters* feature.

The Incentive for Managers to Commit Fraud in the Revenue Cycle: The Role of Stock Analysts and Consensus Earnings Calculations

This feature provides insight into the role that stock analyst following and consensus analyst earnings per share calculations play in affecting managements' incentives to commit fraud.

Stock analysts follow companies and issue earnings per share and revenue forecasts they anticipate for the companies they follow.

To understand this concept better, see the analysts' forecast report for Ford Motor Company as of June 2017, which we reproduce below.



This report shows that 16 analysts together, that is, by consensus predict Q1 2017 earnings per share of \$0.35 per share, and that the actual results were better than that at \$0.39 per share. It also shows that the annual earnings per share for 2016 was \$1.76; analysts

make predictions about both quarterly and annual earnings per share. Managers do not want to "disappoint" the market by having their earnings results come in "under forecast," which creates the incentive for earnings manipulation.



This report shows that 15 analysts together, that is, by consensus predict Q1 2017 revenues at \$34.59 billion, while the actual revenue that Ford reported exceeded that estimate, coming in at \$36.48 billion. Managers do not want to “disappoint” the market by having their revenue results come in “under forecast,” which creates the incentive for fraudulently overstated revenue amounts.

What does the term “analyst consensus forecast” mean?

It means the average earnings per share or revenue based on all the analysts that are following the company. If a company is at or near its consensus forecast and the auditor proposes a material, income decreasing audit adjustment, client management may

resist because they do not want to report a negative earnings surprise.

What is a negative earnings surprise or a negative revenue surprise?

It is a negative departure from the consensus analyst earnings forecast or the revenue forecast, for example, lower actual earnings per share amount compared to the consensus or lower revenue compared to the consensus expectation.

For further details, see

<https://markets.ft.com/data/equities/tearsheet/forecasts?s=F:NYQ>

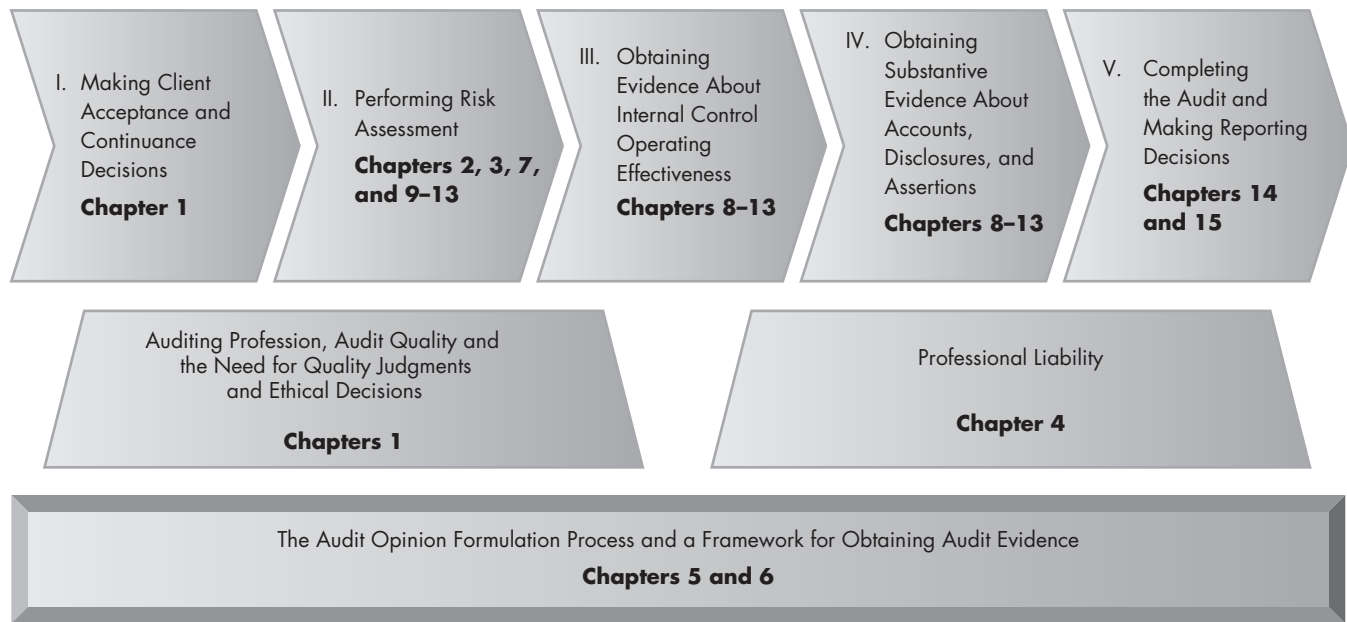
Hallmark Pedagogical Features

Articulating an audit opinion formulation process to help organize students’ acquisition of the technical material in each chapter. A chapter-opening figure helps students identify the major phases in the audit process and see how the steps within that process relate to specific chapters. The textbook describes how auditors go through a structured judgment process to issue an audit opinion. We refer to this process as the *Audit Opinion Formulation Process*, and it serves as the foundation for this textbook.

The process consists of five phases. Phase I concerns client acceptance and continuance. Once a client is accepted (or the audit firm decides to continue to provide services to a client), the auditor needs to perform risk assessment procedures to thoroughly understand the client’s business (or update prior knowledge in the case of a continuing client), its industry, its competition, and its management and governance processes (including internal controls) to determine the likelihood that financial accounts might be materially misstated (Phase II). In some audits, the auditor also obtains evidence about internal control operating effectiveness through testing those controls (Phase III). Much of what most people think of as auditing, obtaining substantive evidence about accounts, disclosures, and assertions, occurs in Phase IV. The information gathered in Phases I through III greatly influences the amount of testing auditors perform in Phase IV. Finally, in Phase V, the auditor completes the audit and makes a decision about what type of audit report to issue.

Also fundamental to students’ understanding is the framework’s inclusion of the auditing profession, audit quality, quality judgments, ethical decisions, and professional liability. Further fundamentals highlighted in the *Audit Opinion Formulation Process* include discussion of a framework for obtaining audit evidence, as depicted below.

Recognizing that professional judgment, sufficient appropriate evidence, and quality decisions are critical to conducting a quality financial statement audit. In addition to the focus on professional judgment throughout the text, numerous exercises emphasize this key auditing skill, including examples and end-of-chapter materials based on the business press, PCAOB enforcement actions, SEC filings, and company proxy statements. Further, the end-of-chapter materials help ensure that students understand the link between mandatory financial reporting and auditing, risk assessment, transaction cycles, and analytical procedures.



Emphasizing that professional skepticism, which can be challenging to maintain, is at the heart of auditor judgments. This emphasis provides students with the tools to learn how to apply the concept of professional skepticism. We include conceptual discussion of this topic in *Chapter 1*, with substantial reinforcement through the remaining chapters in the text, as well as in end-of-chapter materials (highlighted with an identifying icon for ease of identification). This emphasis helps students see the practical application of professional skepticism, as well as provides practical insights as to downside risks when auditors fail to maintain appropriate levels of skepticism.

Using data analytics tools and analytical procedures to improve the effectiveness and efficiency of the audit. The text contains a new focus on data analytics around “big data” that will become an evolving hallmark pedagogical feature over subsequent editions. The text covers planning, substantive, and review-related analytical procedures, and provides ways in which auditors can use data analytics tools to perform these procedures. *Chapter 6* and *Chapter 7* outline the theory of analytical procedures, and discuss appropriate processes and best practices. Various end-of-chapter problems provide examples of using analytical procedures. *Chapters 9, 11, and 13* contain an extensive practice case (set in the pharmaceutical industry, complete with data based on three real companies) that would be ideal for a semester team project to enforce concepts around analytical procedures.

Employing specific learning objectives, which we introduce at the outset of each chapter in a “What You Will Learn” feature and summarize at the end of each Chapter with a “Let’s Review” feature. We reinforce these objectives throughout the chapter materials, along with linking the objectives to specific end-of-chapter materials, including links to academic research cases to enhance students’ appreciation for the theoretical underpinnings of the learning objectives. These learning objectives help to shape students’ cognitive architecture as they integrate their preliminary understanding of chapter topics with the theory, examples, and accompanying discussion that follow.

Providing and applying professional decision-making and ethical decision-making frameworks. Decision-making frameworks, introduced in *Chapter 1*, require students to think about real-life professional and ethical decisions associated in each chapter. End-of-chapter materials continue the use of these professional and ethical decision-making frameworks to help students

address contemporary issues. Further, we identify these problems as part of the last learning objective in each chapter.

Acquiring hands-on experience through a practice-oriented audit case. On the CengageNOW website, you will find a tool that allows students to engage in a practice-oriented audit case. Brony's Bikes is an auditing case that encompasses a complete auditing scenario spanning from Performing Risk Assessment (Phase II of the Audit Opinion Formulation Process) to making reporting decisions (Phase V of the Audit Opinion Formulation Process). The case includes 13 modules that address specific activities included in the Audit Opinion Formulation Process. The authors have structured these 13 modules so that each can be undertaken independently of the other modules. For example, Module I, *Assessment of Inherent Risk*, takes the students through the audit planning process based on AU-C 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, AU-C 300 *Planning an Audit*, and AU 315-C *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Module I can be assigned on a stand-alone basis or along with any or all of the other modules at the instructor's discretion.

Students gain experience with auditing documentation including many working papers. Analytical procedures are performed in Excel worksheets requiring conclusions and recommendations.

Other Resources

MindTap: Empower Your Students

MindTap is a platform that propels students from memorization to mastery. It gives you complete control of your course, so you can provide engaging content, challenge every learner, and build student confidence. Customize interactive syllabi to emphasize priority topics, then add your own material or notes to the eBook as desired. This outcomes-driven application gives you the tools needed to empower students and boost both understanding and performance.

Access Everything You Need in One Place

Cut down on prep with the preloaded and organized MindTap course materials. Teach more efficiently with interactive multimedia, assignments, quizzes, and more. Give your students the power to read, listen, and study on their phones, so they can learn on their terms.

Empower Students to Reach their Potential

Twelve distinct metrics give you actionable insights into student engagement. Identify topics troubling your entire class and instantly communicate with those struggling. Students can track their scores to stay motivated toward their goals. Together, you can be unstoppable.

Control Your Course—and Your Content

Get the flexibility to reorder textbook chapters, add your own notes, and embed a variety of content including Open Educational Resources (OER). Personalize course content to your students' needs. Students can even read your notes, add their own notes, and highlight key text to aid their learning.

Get a Dedicated Team, Whenever You Need Them

MindTap isn't just a tool; it's backed by a personalized team eager to support you. We can help set up your course and tailor it to your specific objectives, so you'll be ready to make an impact from day one. Know we'll be standing by to help you and your students until the final day of the term.

Becker CPA Exam Questions

To help students prepare for taking the CPA exam, for each chapter, students have access to four or five representative multiple-choice questions from the Becker test bank, tailored to each chapter's most critical learning objectives.

ACL analytics and audit software with updated cases.

This edition integrates ACL software into end-of-chapter materials. An ACL Appendix and tutorial is located at the end of the text. The ACL Appendix contains an overview of the basic functions of ACL followed by a brief, illustrated tutorial to help students learn how to use the basic features of the ACL Analytics. Access to the software can be provided by Instructors who are enrolled in the ACL Academic Network program.

ACL cases include the following:

1. *Pell Grants*, a fraud investigation case related to this student grant program. (*Chapter 6*)
2. *Husky Accounts Receivable*, which includes exercises in which students identify unpaid invoices and sales made over credit limits, perform cutoff analyses, conduct aging analyses, and identify procedures to be performed based upon their results. (*Chapter 9*)
3. *FloorMart Sales and Inventory*, which requires students to identify store locations in which data appear to indicate potential inaccuracies, and to identify procedures to gather additional evidence. (*Chapter 9*)
4. *Husky Inventory*, which includes exercises in which students identify potentially obsolete inventory, calculate inventory turnover, consider possible write-downs, and prepare a report based on their results. (*Chapter 11*)
5. *Benford's Law Case*, a fraud case dealing with employee expense reimbursements and the application of Benford's Law of numbers. (*Chapter 14*)

Organization of the Eleventh Edition

The demand for quality auditing: Chapter 1.

Chapter 1 provides the foundation for students to understand the economic context in which financial statement auditing exists. The chapter defines the objective of financial statement auditing and describes its role in meeting society's demands for reliable financial and internal control information. *Chapter 1* introduces the Financial Reporting Council's *Audit Quality Framework*, and identifies professional conduct requirements that help auditors achieve high quality. This chapter also provides frameworks for professional and ethical decision making. *Chapter 1* also describes the process by which audit firms make client acceptance and continuance decisions, and recognizes that this process is important to achieving audit quality.

Risk assessment with a focus on fraud and internal controls over financial reporting: Chapters 2 and 3.

Chapter 2 defines fraud, describes the fraud triangle, and provides examples of recent financial reporting frauds. The chapter discusses users' expectations of auditors' fraud-related responsibilities, explains how various requirements of the Sarbanes-Oxley Act of 2002 help prevent fraud, and discusses the importance of corporate governance in relation to quality auditing.

Chapter 3 articulates the importance of internal control over financial reporting, defines internal control, identifies and describes the components

and principles of internal control, and describes management's responsibility related to internal control. *Chapter 3* also explains how to distinguish between material weaknesses, significant deficiencies, and control deficiencies in internal control over financial reporting.

Important elements of the professional environment and the audit opinion formulation process: Chapters 4, 5, and 6.

Chapter 4 discusses the liability environment in which auditors operate, explores the effects of lawsuits on audit firms, identifies laws from which auditor liability is derived, and describes possible remedies, sanctions, and auditor defenses.

Chapter 5 identifies and compares auditing standards that provide audit guidance on the audit opinion formulation process, and discusses the foundational principles underlying these standards. The chapter lists the phases and related activities in the audit opinion formulation process, explains the concept of accounting cycles, describes the assertions that are inherent to financial statements, defines audit evidence and the purpose and types of audit procedures used to obtain audit evidence, and discusses the importance of audit documentation.

Chapter 6 discusses the importance of evidence sufficiency and appropriateness, illustrates professional judgments about the type and timing of audit procedures, discusses the use and application of substantive analytical procedures, identifies issues relating to audit evidence needed for accounts involving management estimates, and discusses evidence issues involving specialists and related party transactions. *Chapter 6* also describes the characteristics of quality audit documentation and explains the nature, design, and purposes of audit programs.

Planning the audit and employing appropriate audit tools: Chapters 7 and 8.

Chapter 7 defines the concept of material misstatement and discusses the importance of materiality judgments in the audit context. The chapter also identifies the risks of material misstatement and describes how they relate to audit risk and detection risk. *Chapter 7* illustrates how auditors respond to assessed risks of material misstatement.

In planning how to respond to assessed risk of material misstatements, auditors need to determine which of the available specialized tools they will use. *Chapter 8* describes how auditors can use sampling techniques and data analytics tools to gather and evaluate sufficient appropriate audit evidence. The chapter explains the objectives of sampling for testing controls and account balances, compares and contrasts nonstatistical and statistical sampling, describes attributes sampling, describes the sampling process used to gather evidence about misstatements in account balances and assertions, describes monetary unit sampling, and explains how to use data analytics tools to obtain and evaluate audit evidence.

Performing Audits Using the Transaction Cycle Approach: Chapters 9, 10, 11, 12, and 13.

These five chapters focus on the application of concepts developed earlier for assessing risk, identifying and testing controls designed to address those risks, and using substantive approaches to testing account balances. Each chapter:

- identifies significant accounts, disclosures, and relevant assertions
- explains the process of identifying and assessing inherent risks, fraud risks, and control risks

- describes planning analytical procedures that the auditor can use to identify potential material misstatement
- articulates appropriate responses to identified risks of material misstatement, including appropriate tests of controls and considering results of tests of controls
- and identifies how to apply substantive audit procedures.

Completing a quality audit and issuing the audit report: Chapters 14 and 15.

Chapter 14 discusses the procedures that auditors conduct while completing the audit. These procedures include reviewing activities relating to detected misstatements, loss contingencies, disclosure adequacy, non-compliance with laws or regulations, review analytical procedures, going-concern matters, and subsequent events. The chapter also distinguishes between a management representation letter and a management letter, identifies procedures that are part of an engagement quality review, and identifies issues the auditor should communicate to the audit committee and management.

Once these activities are completed, the auditor makes a reporting decision, which is described in *Chapter 15*. This chapter identifies the principles underlying audit reporting on financial statements, describes the information that is included in an unqualified/unmodified audit report, and describes financial statement audits resulting in an unqualified/unmodified audit opinion with report modifications. The chapter describes financial statement audits resulting in a qualified opinion, an adverse opinion, or a disclaimer of opinion. *Chapter 15* describes the emerging critical audit matters (PCAOB) and key audit matters (IAASB) disclosures that auditors will, or already are, including in the auditor's report. The chapter also describes the information that is included in a standard unqualified audit report on internal control over financial reporting and identifies the appropriate audit report modifications for situations requiring other than an unqualified report on internal control over financial reporting. *Chapter 15* concludes with a discussion of how auditors should respond to situations in which omitted procedures come to light after the audit report has been issued.

Supplements

Companion Site: Instructors and students can find most of the textbook's support materials online at login.cengage.com., including the solutions manual, PowerPoint slides, ACL data spreadsheet files, and other resources.

Solutions Manual: The solutions manual contains the solutions to all end-of-chapter assignments. It is available on the instructor's page at www.cengagebrain.com.

PowerPoint Slides: Instructors can bring their lectures to life with engaging PowerPoint slides that are interesting, visually stimulating, and paced for student comprehension. These slides are ideal as lecture tools and provide a clear guide for student study and note-taking. We have purposely provided *more* slides rather than *less*! We encourage instructors to tailor down the slides to meet their own, individual instructional preferences.

Test Bank: Cengage Learning Testing Powered by Cognero is a flexible, online system that allows you to:

- author, edit, and manage test bank content from multiple Cengage Learning solutions,
- create multiple test versions in an instant,
- deliver tests from your LMS, your classroom, or wherever you want. The test bank is also available in Microsoft Word.

The eleventh edition integrates the use of ACL software into both homework and cases. An appendix and tutorial located at the end of the textbook provide guidance for students unfamiliar with the software. Access to the software can be provided by instructors who are enrolled in the ACL Academic Network program.

Access to the software for qualified instructors and their students can be arranged with ACL through the Academic Network program: <http://info.acl.com/Academic-Network-for-Professors.html> and http://info.acl.com/Academic-Network-Program_Professor-Sign-up.html. The signup process may take a few weeks to process so first-time instructors should sign-up for the program in advance of their teaching semester.

Once instructors join the Academic Network, they will have access to:

- ACL GRC - a cloud-based platform for audit management (including electronic workpapers)
- ACL Analytics
- ACL Launchpad - the single access point for ACL GRC, ACL Analytics, as well as support, ScriptHub, and ACL Academy
- Analytical Procedures: A Case in the Context of the Pharmaceutical Industry (*Chapters 9, 11, and 13*): The case contains online Excel files that students download and analyze. The case enables students to practice developing and conducting planning and substantive analytical procedures. We developed the case using the published financial statements of three prominent companies in this industry, with adaptations to make the case suitable for classroom use. Students will access an Excel file on the companion site at login.cengage.com. The Excel file contains financial data and information from footnote disclosures. We view these exercises as one type of data analytic technique – one that individual instructors may be more comfortable using than emerging data analytics such as Tableau or other similar platforms.

Acknowledgments

We are grateful to members of the staff at Cengage for their help in developing the eleventh edition: Matt Filimonov, Senior Product Manager; Emily Lehmann, Associate Content Developer; Sangeetha Vijay, Content Project Manager at SPi Global; and Emily McLellan, Marketing Manager.

Karla M. Johnstone
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Karla M. Johnstone

Karla M. Johnstone, Ph.D., CPA, is the Ernst & Young (EY) Professor of Accounting and Information Systems at the University of Wisconsin–Madison, School of Business. She teaches auditing, and her research investigates a broad range of auditing topics, including: curriculum enhancements in auditing, along with auditor decision making; client acceptance and continuance decisions; how fraud risk and fraud brainstorming affect audit planning and audit fees; client–auditor negotiation; competitive bidding; audit budget-setting processes; and governance responses to various negative corporate events such as fraud or internal control material weakness disclosures. Professor Johnstone serves on the editorial boards of numerous academic journals and is active in the Auditing Section of the American Accounting Association (AAA). She recently completed a term as the President of the Auditing Section. Before beginning her coursework for her Ph.D., Karla worked as a corporate accountant and as a staff auditor and was a doctoral fellow in residence at Coopers & Lybrand. Importantly, Karla’s research and interactions with practice—both in the U.S., and abroad (e.g., the Foundation for Audit Research in the Netherlands)—demonstrate a significant commitment to the theory and practice of auditing, along with associated regulatory and standards-setting activities.

Audrey A. Gramling

Audrey A. Gramling, Ph.D., CPA, CIA is the Accounting Department Chair and Professor at Colorado State University. Previously, she held the Treece Endowed Chair and was Accounting Department Professor and Chair at Bellarmine University. She has been on the accounting faculty at Kennesaw State University, Georgia State University, Wake Forest University, and University of Illinois at Urbana-Champaign. Audrey’s research investigates both internal and external auditing issues, with a focus on decision behavior of auditors, external auditor independence, internal control reporting, and other factors affecting the market for audit and assurance services. Prior to earning her Ph.D. at the University of Arizona, Audrey worked as an external auditor at a predecessor firm of Deloitte and as an internal auditor at Georgia Institute of Technology. She has also served a one-year appointment as an Academic Accounting Fellow in the Office of the Chief Accountant at the U.S. Securities and Exchange Commission. She is a past-President of the Auditing Section of the American Accounting Association and has served in an advisory role to the Committee of Sponsoring Organizations (COSO). In February 2018 she began serving as a member of the AICPA’s Auditing Standards Board. For over three decades, in recognition of the valuable role of auditing as a key component of corporate governance, Audrey has been committed to both the practice and theory of quality auditing.

Larry E. Rittenberg

Larry E. Rittenberg, Ph.D., CPA, CIA, is Professor Emeritus, Department of Accounting and Information Systems, at the University of Wisconsin–Madison, where he taught courses in auditing, risk management, and corporate governance. He is also Chair Emeritus of the COSO of the Treadway Commission, where he provided oversight of the development of the COSO Enterprise Risk Management Framework, the COSO Guidance for Smaller Businesses, and was instrumental in developing the Framework for COSO 2013. He has served as Vice-Chair of Professional Practices for the Institute of Internal Auditors (IIA) and President of the IIA Research Foundation, and has been a member of the Auditing Standards Committee of the AAA Auditing Section, the NACD Blue Ribbon Commission on Audit Committees, the IIA's Professional Practices Committee, and Vice-President and Treasurer of the AAA. He recently retired as audit committee chair and board member of Woodward Governor, a publicly traded company, and has consulted on audit committee, risk, and control issues with Petro China – the largest public company in China. Professor Rittenberg served as a staff auditor for Ernst & Young and has co-authored five books and monographs and numerous research articles.

Recommendations from Instructors Who Have Used Our Textbook Previously

Professor Tim Bell, University of North Florida. I have used [this] text for seven years now and it has been an outstanding resource for teaching my students the fundamentals of contemporary auditing. Text discussions and end-of-chapter applications help me to develop students' critical analysis and judgment skills, sensitivity and responses to ethical dilemmas, and understanding and appreciation of the essential role of professional skepticism in auditing.... My impression based on use of successive editions of the text is that the authors have worked very hard to ensure it is up-to-date as auditing standards and related guidance evolve and audit-relevant events occur in the rapidly-changing business environment. Without reservation, I highly recommend this text.

Professor Veena L. Brown, University of Wisconsin-Milwaukee. This textbook is ideal for my students as it presents a good mix of theory and practice using the integrated audit approach. The authors do a great job portraying the auditing concepts in a deceptively simple manner. The Exhibits and the Professional Judgment in Context presented in each chapter helps students better grasp the sometimes-elusive auditing concepts. I have successfully used this textbook for the past six years and look forward to exploring the next edition with my students.

Professor Barry J. Bryan, Southern Methodist University. I selected this textbook because I believe that it presents a realistic approach to the integrated audit. Having worked with several of the Big Four firms, it is evident to me that the authors have been diligent in writing a book that mirrors the risk-based approach to the audit. In addition, my students have enjoyed outstanding success on the AUD Exam having used this text as their primary study resource.

Professor Sean Dennis, University of Kentucky. I use this book because it has it all... detailed (yet intuitive!) explanations, challenging review questions for students, and detailed cases that are both timely and relevant. The authors have organized the material in a way that helps students build an understanding of risk and the audit process from the ground up. The questions and cases at the end of the chapters also help create engaging discussions among students that

lead to productive critical thinking. In fact, my favorite thing about this book is that the authors continually update the cases at the end of the chapters. This has really helped my students relate to the course material – and I use these cases in class as much as I can!

Professor Denise Hanes Downey, Villanova University. The beauty of this textbook is that it facilitates an appreciation for the many nuances and complexities of auditing without overwhelming students. The authors appropriately balance necessary details with illustrations and *recent* examples to guide students' understanding. As a result, students come into class ready to engage in higher level discussions – having mastered the fundamentals on their own. From a course design perspective, I appreciate how the chapters stand-alone allowing professors to select chapters they find to be of particular importance without requiring additional chapters be added to the syllabus for clarity.

Professor Kim Westermann, California Polytechnic State University. As a former auditor and current audit professor, I find the book very easy to follow and well written. The content is organized in a similar fashion to the audit process itself, which I think is essential for students' understanding. The authors also include topics that I have not found in any other auditing textbook (e.g., an entire chapter on corporate governance, sections on upcoming changes or changes soon to be integrated into the profession). This textbook simply feels more up to date about current events in auditing.

How Can You Learn by Leveraging the Features of this Textbook?

Follow these ten steps:

1. Before you even begin, go online to MindTap via login.cengage.com and complete the first **Becker CPA Exam Pre-test**, which the authors have personally tailored to the chapters and learning objectives in this textbook. There is a 25-question Pre-test relating to Chapters 1–8, and another 25-question Pre-test relating to Chapters 9–15. In addition, these same tests are available online as **Becker CPA Exam Post-tests**, so that you can track your knowledge progress both within this course, as well as relating to the upcoming CPA exam.
2. For each chapter, start by viewing the **Audit Opinion Formulation Process** diagram at the outset of the chapter. Relevant chapter topics are highlighted for your reference so that you can track your progress through learning about all of the phases of conducting a quality audit.
3. Take a few minutes to read the **What's Covered** feature in the chapter, which briefly describes the main themes of the chapter. Then, review the **Learning Objectives**. Just as you begin to read the chapter, quickly read the **What You Will Learn** questions. Engaging in these simple and quick actions will help you know what to expect out of each chapter, which research shows will help you organize your knowledge and recall it later (during exams!).
4. To help set the practical application for each chapter, read the **Why It Matters** feature at the outset of each chapter. This feature will help you see beyond the factual insights provided in the chapters. Elements include for example, extensions based on in-the-news examples that illustrate fundamental features and applications of text facts, professional standards in foreign jurisdictions, and interesting points that may be tangential to the text facts, but that should facilitate your deep engagement with the chapter. In addition, we highlight some of these features as relating to an **International Focus**.

(Continues)

Continued

5. The 15 chapters are split into a variety of clearly articulated learning objectives, each containing its own important insights. Within these objectives, you will encounter the following helpful learning take-aways that we intend to engage your critical thinking about the conceptual contents of each chapter:

“Prompt for Critical Thinking—It’s Your Turn!” feature. This feature encourages you to engage in critical thinking as you acquire knowledge relevant to each chapter. This feature is intentionally creative in form and substance, and varies widely in structure based upon the learning objective to which it is related. We also provide potential answers to these prompts at the end of the chapter so that you can compare your thoughts about these prompts to those that the authors provide.

“What Do You Think?—For Classroom Discussion” feature. This feature provides an avenue by which you can expect that the will use to facilitate preparation for class, encourage cognitive engagement, and facilitate critical thinking through discussions with other students. You have the opportunity to learn by preparing for these discussions, and engaging with the instructor and your classmates.

Your employers and their clients will take as a given that you are proficient in your technical knowledge; what will set you apart from other young professionals is to express clearly articulated perspectives on the matters at hand; use these features as practice in rising to this challenge!

6. At the conclusion of each learning objective, complete the **Check Your Basic Knowledge** feature, which contains two true-false questions and two multiple-choice questions. Your instructor will provide you with answers to these questions, so you can compare your existing knowledge with the correct facts as you expand your understanding of textbook materials.
 7. Fraud prevention and detection is one of the most important roles that auditors play in providing assurance with respect to financial reporting. Carefully read and be prepared to discuss in class the examples of auditors’ roles in this regard in the **Focus on Fraud** feature.
 8. Attend to the Exhibits and Figures! These lists and diagrams will be very helpful to you as you organize your knowledge in preparation for both the exams in this class, as well as the CPA exam.
 9. Examine the **Let’s Review** feature at the end of each chapter to ensure that you have a solid understanding of the basic concepts of the chapter. Review the **Significant Terms** list and use it as a way to review your understanding of the material that you have read about within the chapter. As you do this review, develop a set of questions for any topics whereby you lack understanding. Impress your instructor by drafting some formative questions whereby you can challenge the in-class lecture on these topics.
 10. Complete the **End-of-Chapter Review Questions, Cases, and Application Activities** that your instructor requires, and view them not as a burden, but rather as an opportunity for you to thoughtfully engage these topics. Doing so will enable you to properly categorize these ideas for later retrieval and use, both in the CPA exam and in your professional job.
-

Quality Auditing: Why It Matters

I. Making Client
Acceptance and
Continuance
Decisions

Chapter 1

II. Performing Risk
Assessment

**Chapters 2, 3, 7,
and 9–13**

III. Obtaining
Evidence About
Internal Control
Operating
Effectiveness

Chapters 8–13

IV. Obtaining
Substantive
Evidence About
Accounts,
Disclosures, and
Assertions

Chapters 8–13

V. Completing
the Audit and
Making Reporting
Decisions

**Chapters 14
and 15**

Quality Auditing and the Need for
Quality Auditor Judgments
and Ethical Decisions

Chapter 1

Professional Liability

Chapter 4

The Audit Opinion Formulation Process and a Framework for Obtaining Audit Evidence

Chapters 5 and 6

Decision makers need reliable information to make many types of decisions, including investing and lending decisions. If these decision makers receive unreliable information, they may lose confidence in the information,

make poor decisions, and lose money. External auditors help enhance the reliability of the information used by these decision makers by performing a quality financial statement audit.

Learning Objectives

- LO 1** Describe decision makers' needs for reliable financial and internal control information, and discuss how a financial statement audit helps meet those needs.
- LO 2** Define audit quality and list drivers of audit quality provided in the Financial Reporting Council's *Audit Quality Framework*.
- LO 3** Identify professional conduct requirements that help auditors achieve audit quality.
- LO 4** Describe and apply frameworks for professional and ethical decision making.
- LO 5** Describe factors considered by audit firms making client acceptance and continuance decisions.

The Importance of Conducting a Quality Audit and Complying with Professional Requirements

This feature highlights that audit quality is an international issue.

In March 2017, the Public Company Accounting Oversight Board (PCAOB) announced sanctions against a former partner of PricewaterhouseCoopers Auditores Independentes in Brazil for audit failures and violations of PCAOB rules and standards.

Wander Rodrigues Teles was the lead partner for PwC-Brazil's audit work in connection with the audits of Sara Lee's FYE 2007 through FYE 2011 consolidated financial statements. U.S.-based PricewaterhouseCoopers LLP ("PwC-US") prepared and issued the audit reports on Sara Lee's consolidated financial statements, which were filed with the U.S. Securities and Exchange Commission. In 2012, Sara Lee restated its 2010 and 2011 financial results, citing accounting irregularities in its Brazil operations, including the overstatement of accounts receivable.

The PCAOB found that Teles failed to adequately respond to indications that one of Sara Lee's subsidiaries may have overstated its accounts receivable. When conducting the audit, Teles knew

that a material amount of the subsidiary's accounts receivable was overdue and disputed by customers. He was also aware that the subsidiary was extending the due dates of overdue receivables. The re-aging of receivables in this manner could cause overdue receivables to appear current. The PCAOB found that Teles failed to adequately respond to these risks with

and , and failed to obtain sufficient evidence to support his audit conclusions.

In the settled disciplinary order, Teles was censured, fined \$10,000, and barred for two years from associating with a registered public accounting firm.

In discussing this case, PCAOB Chairman James R. Doty noted, "Audit quality is a global issue. As this order demonstrates, the Board is committed to investigating and disciplining auditors who present risks to investors in the U.S. markets, regardless of where the audit is conducted."

For further details, see PCAOB Release No. 105-2017-007.

- What is a financial statement audit, and how does it provide financial statement users with enhanced information reliability? (LO 1)
- What skills and knowledge do auditors need? (LO 1)
- What is audit quality, and why is it vital to perform an audit in a quality manner? (LO 2)
- What professional conduct requirements aid auditors in conducting a quality audit? (LO 3)
- What frameworks can auditors use to make professional and ethical decisions? (LO 4)
- Why are client acceptance and continuance decisions important to audit quality? (LO 5)

LO 1

Describe decision makers' needs for reliable financial and internal control information, and discuss how a financial statement audit helps meet those needs.

An Overview of External Auditing

Decision Makers' Need for Reliable Information and the Role of a Financial Statement Audit

External auditors perform an important task. While managers within organizations produce financial statements and design internal control systems, external auditors performing a **financial statement audit** provide independent assurance on the reliability of the financial statements and, as part of an **integrated audit**, provide independent assurance on internal control effectiveness.

Decision makers need information that is transparent and unbiased—information that does not favor one user over another. However, the interests of the various users can conflict. Current shareholders might want management to use accounting principles that result in higher levels of reported income, while lending institutions might prefer management to use a conservative approach to valuation and income recognition. *Exhibit 1.1* identifies potential financial statement users and the decisions they make based on financial and internal control information.

Why do financial statement users need independent assurance on reliability of information provided by management? Shouldn't users expect management

Exhibit 1.1

Users of Audited Financial Statements

User	Types of Decisions
Management	Review performance, make operational decisions, and report results to capital markets
Stockholders	Buy or sell stock
Bondholders	Buy or sell bonds
Financial institutions	Evaluate loan decisions, considering interest rates, terms, and risk
Taxing authorities	Determine taxable income and tax due
Regulatory agencies	Develop regulations and monitor compliance
Labor unions	Make collective bargaining decisions
Court system	Assess the financial position of a company in litigation
Vendors	Assess credit risk
Retired employees	Protect employees from surprises concerning pensions and other post-retirement benefits

to provide reliable information? The need for independent assurance arises from several factors:

- *Potential bias*—Management might have incentives to bias financial information to convey a better impression of the financial data than circumstances would merit. For example, when management's compensation is tied to profitability or stock price, managers may be tempted to "bend" generally accepted accounting principles (GAAP) to make the organization's performance look better.
- *Remoteness*—An organization and the users of its financial information are often remote from each other, both in terms of geographic distance and the extent of information available to the both parties. Most users cannot interview management, tour a company's plant, or review its financial records; instead, they must rely on financial statements to communicate the results of management's performance. These factors can tempt management to keep information from users or bend GAAP so the organization looks better.
- *Complexity*—Transactions, information, and processing systems are often very complex, so it can be difficult to determine their proper presentation. This factor provides an opportunity for management to mislead users.
- *Consequences*—When financial information is not reliable, investors and other users lose a significant source of information that they need to make decisions that have important consequences. Without reliable financial information, users may invest in securities or may lend money to a company that is committing a fraud, and once the fraud is revealed users are in a position of losing significant amounts of money.

Financial statement audits help increase the confidence that users can place on management-prepared information. Users of audited information need to have confidence in the objectivity and accuracy of the opinions provided by external auditors. Thus, external auditors need to be independent when performing a financial statement audit. Independence, often referred to as the *cornerstone* of the auditing profession, requires objectivity and freedom from bias. Without independence, audits lack value.

Auditors must not only be independent *in fact*, but they must act in a manner that ensures that they are independent *in appearance*. For example, if an audit partner's uncle was the CEO at the partner's client company, users could reasonably worry about a conflict of interest. It is entirely possible that the audit partner has, in fact, an independent mental attitude. However, the audit partner would not appear to be independent in this scenario. Further complicating

Auditors Must Be Mindful of their Role as Guardians of the Capital Markets

This feature makes the point an auditor should make decisions in the public interest rather than in the interest of management.

Auditors are hired by their clients, so in some sense they owe an allegiance to clients' interests. However, the most critical role that auditors play is providing independent assurance to investors,

lenders, workers, and others who make decisions based on the client's financial and internal control information. Auditors, therefore, need the highest level of technical competence, freedom from bias, and concern for the integrity of the financial reporting process.

Does Owning Stock in an Audit Client Affect Auditor Independence?

This feature provides an interesting example of an audit senior violating auditor independence rules.

In 2005, Susan Birkert was an audit senior working for KPMG on the audit engagement of Comtech Corporation. One of Susan's friends asked her whether she thought that Comtech stock was a good investment. She responded that, indeed, it was a good investment. At that point, her friend asked if she would like him to purchase Comtech stock on her behalf. She agreed and gave her friend \$5,000 to make the purchase under his name rather than hers. She did so because she was aware that owning stock in one's audit client is not allowed because of independence concerns. If auditors own stock in their audit clients, they are not independent of their clients because they are part owners. Therefore, rather than acting in an unbiased manner during the

conduct of the audit, they might make judgments that favor the client company rather than external users of the financial statements. Even if the auditor does not actually behave in a biased manner and is independent in fact, external users may *perceive* an independence conflict—the auditor would not be independent in appearance.

Susan continued working on the Comtech engagement well into 2006, and she lied when she responded to KPMG's yearly written requirements to comply with the firm's independence policies. Prompted by an anonymous tip later in 2006, KPMG launched an internal investigation into the matter and terminated her employment. The PCAOB barred her from serving as an external auditor for a period of at least one year.

For further details, see PCAOB Release No. 105-2007-003.

matters, management and the audit committee expect cost-effective audits. Auditors face many pressures—keeping fees low, making careful decisions regarding independence, and conducting a quality audit.

What Is a Financial Statement Audit?

A financial statement audit is a

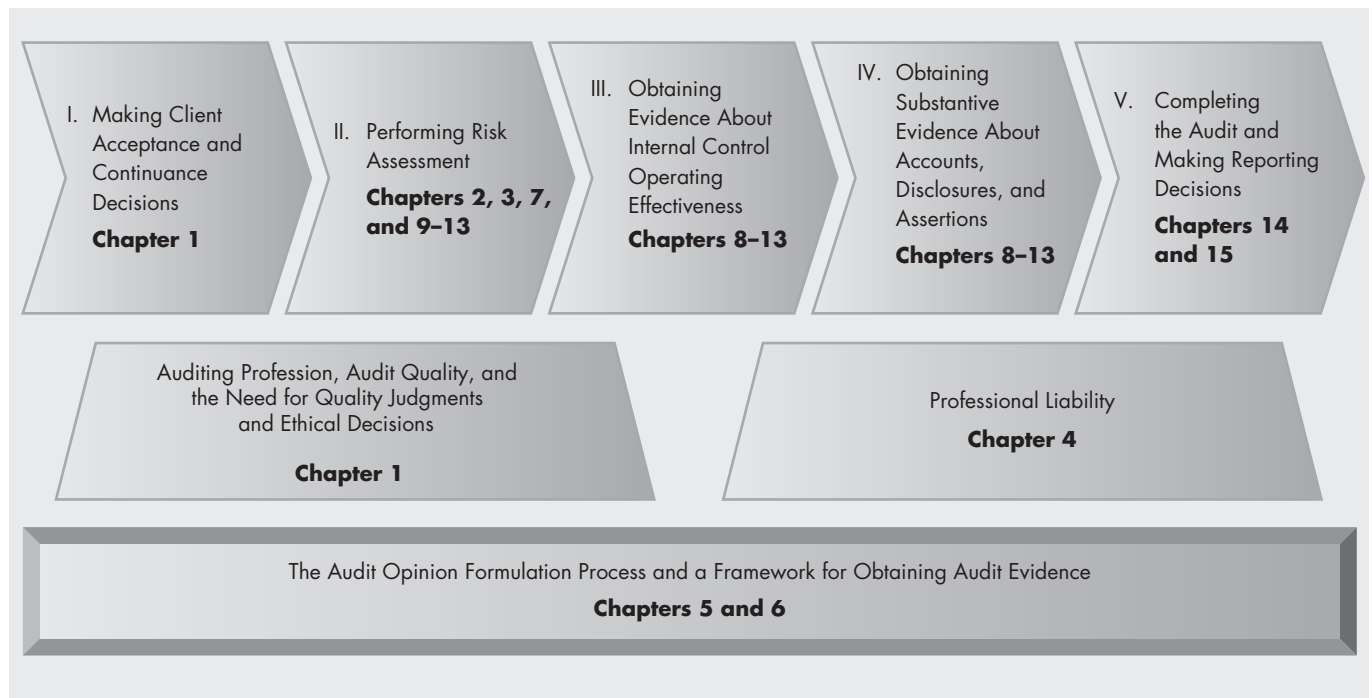
systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria; and communicating the results to interested users.¹

The overall objective of an audit is to obtain reasonable assurance about whether the financial statements are free from material misstatement and to report on the financial statements based on the auditor's findings. To accomplish these objectives, the auditor:

- Complies with relevant ethical and professional conduct requirements
- Conducts the audit in accordance with professional auditing standards
- Exercises professional judgment, professional skepticism, and critical thinking
- Obtains sufficient appropriate evidence, via a structured process, on which to base the auditor's opinion

We refer to the structured process used by auditors to accomplish their objectives as the *audit opinion formulation process*. *Exhibit 1.2* presents that process.

Phase I addresses client acceptance and continuance decisions. Auditors are not required to perform audits for any organization that asks; *auditors* choose whether to perform each individual audit. Audit firms have procedures to help them ensure that they are not associated with clients where management integrity is in question or where a company might otherwise present the audit firm with unnecessarily high risk (such as client financial failure or regulatory action against the client).

Exhibit 1.2**The Audit Opinion Formulation Process**

Next, in Phase II the auditor performs risk assessment procedures to thoroughly understand the client's business (or update prior knowledge in the case of a continuing client), its industry, its competition, and its management and governance processes (including internal controls) to determine the likelihood that financial accounts might be in error. These assessments also include the risk of fraud. In some audits, the auditor also obtains evidence about internal control operating effectiveness through testing those controls (Phase III).

In Phase IV, the auditor obtains substantive evidence about accounts, disclosures, and assertions. The information gathered in Phases I through III greatly influences the amount of testing performed in Phase IV. Finally, in Phase V the auditor will complete the audit and make a decision about what type of audit report to issue.

Exhibit 1.2 notes that the five phases occur in an environment where auditors conducting a quality audit need to make quality judgments and ethical decisions, and are subject to legal liability. The foundation for the audit opinion formulation process relies on obtaining audit evidence to support the audit opinion.

When the auditor has no objections about management's financial statements or internal controls, the auditor issues an **unqualified audit report**. *Exhibit 1.3* provides an example of this type of report. *Exhibit 1.3* indicates that the audit firm, PricewaterhouseCoopers, has provided two opinions. One opinion states that the audit firm has confidence that the financial statements of Ford are fairly stated. The other opinion states that PricewaterhouseCoopers has confidence that Ford's internal control over financial reporting was effective as of Ford's year-end, December 31, 2016.

PricewaterhouseCoopers provided these opinions after going through a systematic process of objectively obtaining and evaluating sufficient appropriate

Exhibit 1.3

Integrated Audit Report

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Ford Motor Company

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, comprehensive income, equity and cash flows present fairly, in all material respects, the financial position of Ford Motor Company and its subsidiaries at December 31, 2016 and December 31, 2015, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2016 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and the financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Detroit, Michigan
February 9, 2017

Source: <http://shareholder.ford.com/~media/Files/F/Ford-IR/annual-report/2016-annual-report.pdf>.

NOTE: The format of this report for public companies will be different effective for fiscal years ending on or after December 15, 2017. We discuss the new report formats in Chapter 15.

evidence. If the auditor had objections about the fair presentation of the financial statements, the audit report would be modified to explain the nature of the auditor's objections (for further details, see *Chapter 15*). If the auditor had reservations about the effectiveness of the client's internal controls, the auditor would issue an **adverse opinion** on internal controls.

Parties Involved in Preparing and Auditing Financial Statements

Various parties are involved in preparing and auditing financial statements and related disclosures; *Exhibit 1.4* describes these parties and their roles. Management has responsibilities for: (a) preparing and presenting financial statements in accordance with the applicable financial reporting framework; (b) designing, implementing, and maintaining internal control over financial reporting; and (c) providing auditors with information relevant to the financial statements and internal controls.

The internal audit function provides management and the audit committee with assurance on internal controls and reports. The audit committee, a subcommittee of the organization's board of directors, oversees both management and the internal auditors; they also hire and oversee the external auditor.

The external auditor's job is to obtain reasonable assurance about whether management's statements are materially accurate and to provide a publicly available report. External auditors conduct their procedures and make judgments in accordance with professional standards (for further details, see *Chapter 5*). Those who have an interest in the organization will use the audited financial statements for various purposes.

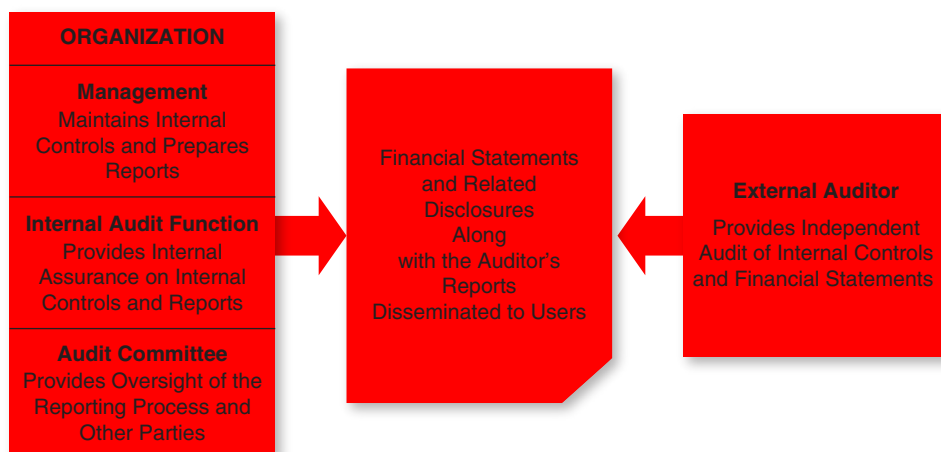
Providers of External Auditing Services

The external auditing profession includes sole-practitioner firms, local and regional firms, and large multinational professional services firms such as the Big 4. The Big 4 firms are KPMG, Deloitte Touche Tohmatsu (Deloitte in the United States), PricewaterhouseCoopers (PwC), and EY. The organizational structure of these firms is quite complex. For example, each of the Big 4 firms is a network of member firms. Each of the member firms enters into agreements to share a common name, brand, and quality standards. In most cases, member firms organize as a partnership or limited liability corporation within each country.

Some smaller firms also practice internationally through an affiliation with a network of firms. For example, a number of regional or local firms belong to an

Exhibit 1.4

Parties Involved in Preparing and Auditing Financial Statements



affiliation of such firms under the name of Moore Stephens, and another group operates under the name of Baker Tilly.

Many public accounting firms have also organized their practices along industry lines. Common industry lines include financial services, retailing, not-for-profit, manufacturing, and government.

The organizational hierarchy of audit firms is structured with partners (or owners) at the top level; these individuals are responsible for the overall conduct of each audit. Next in the hierarchy are managers, who review the audit work performed by seniors and staff personnel. Seniors are responsible for overseeing the day-to-day activities on a specific audit, and they oversee staff auditors and interns who perform many of the basic auditing procedures. Partners and managers are simultaneously responsible for many audit engagements, whereas seniors and staff are usually assigned to fewer audits at one time.

Skills and Knowledge Needed by External Auditors

The requirements for external auditors are demanding. Auditors complete tasks requiring considerable technical knowledge and expertise; auditors must understand accounting and auditing authoritative literature, develop industry and client-specific knowledge, develop and apply computer skills, evaluate internal controls, and assess and respond to fraud risk.

In addition to having appropriate technical knowledge, auditors need well-developed skills in leadership, teamwork, communication, decision-making, **critical thinking**, and general professionalism.

In terms of general professionalism, auditors make presentations to management and audit committee members, exercise logical reasoning, communicate decisions to users, manage and supervise others by providing meaningful feedback, act with integrity and ethics, interact in a team environment, collaborate with others, and maintain a professional presence.

A credential that auditors use to let the public know that they have the appropriate knowledge and skills to conduct an audit is the CPA license. A **CPA** is a certified public accountant who is licensed by a state board of accountancy. A CPA license is the profession's highest standard of competence, a symbol of achievement and assurance of quality. A CPA license holds its owner to a high standard of ethical conduct, no matter where the individual is in his or her career. To earn a CPA license, you are required to demonstrate knowledge and competence by meeting high educational standards, passing the CPA exam, and completing a specific amount of general accounting experience.

The Need for Critical Thinking

This feature emphasizes the need for auditors to be critical thinkers throughout the audit opinion formulation process.

Critical thinking is a rational response to questions that cannot be answered definitively and for which all the relevant information may not be available. Critical thinking is an investigation whose purpose is to: (1) analyze a problem, (2) arrive at a conclusion that

integrates all available information, and (3) justify that conclusion convincingly to others.

Auditors make many decisions throughout the audit that require critical thinking. These decisions include assessing the risk associated with a client, determining the appropriate audit procedures to perform, evaluating the sufficiency of evidence collected, and resolving detected misstatements in the client's financial statements.

- 1-1 When the auditor has no reservations about management's financial statements or internal controls, the auditor will issue an unqualified audit opinion. (T/F)
- 1-2 The sole responsibility of management with regard to financial reporting involves preparing and presenting financial statements in accordance with the applicable financial reporting framework. (T/F)
- 1-3 Which of the following are the responsibilities of the external auditor in auditing financial statements?
 - a. Maintaining internal controls and preparing financial reports.
 - b. Providing internal assurance on internal control and financial reports.
 - c. Providing internal oversight of the reporting process.
 - d. Providing independent assurance on the financial statements.
- 1-4 Which of the following factors does not create a demand for external audit services?
 - a. Potential bias by management in providing information.
 - b. Requirements of the state boards of accountancy.
 - c. Complexity of the accounting processing systems.
 - d. Remoteness between a user and the organization.

For Classroom Discussion

External auditing is a “special function” as described by Chief Justice Warren Burger in a 1984 Supreme Court decision:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate

allegiance to the corporation's creditors and stockholders, as well as to the investing public. This “public watchdog” function demands . . . complete fidelity to the public trust.²

Auditors serve a number of parties. Which party is the most important? Do you agree with Chief Justice Burger's characterization of the auditor as a public watchdog?

LO 2

Define audit quality and list drivers of audit quality provided in the Financial Reporting Council's *Audit Quality Framework*.

Achieving Audit Quality

Financial statement users expect a quality audit. What is a **quality audit**? One definition describes a quality audit as one performed “in accordance with **generally accepted auditing standards** (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are (1) presented in accordance with GAAP and (2) are not materially misstated whether due to errors or fraud.”³

The Financial Reporting Council's *Audit Quality Framework* identifies five primary drivers of audit quality, including (1) audit firm culture, (2) the skills and personal qualities of audit partners and staff, (3) the effectiveness of the audit process, (4) the reliability and usefulness of audit reporting, and (5) factors outside the control of auditors that affect audit quality. *Exhibit 1.5* contains an overview of the FRC's *Audit Quality Framework* that recognizes effective audit processes, by themselves, are not sufficient to achieve audit quality. Rather, a combination of five factors influences audit quality.

FRC

The Financial Reporting Council (<https://www.frc.org.uk/>) is the United Kingdom's independent regulator responsible for promoting investment in securities through good corporate governance

and financial reporting. The FRC sets standards for corporate reporting and audit practice. It monitors and enforces accounting and auditing standards.

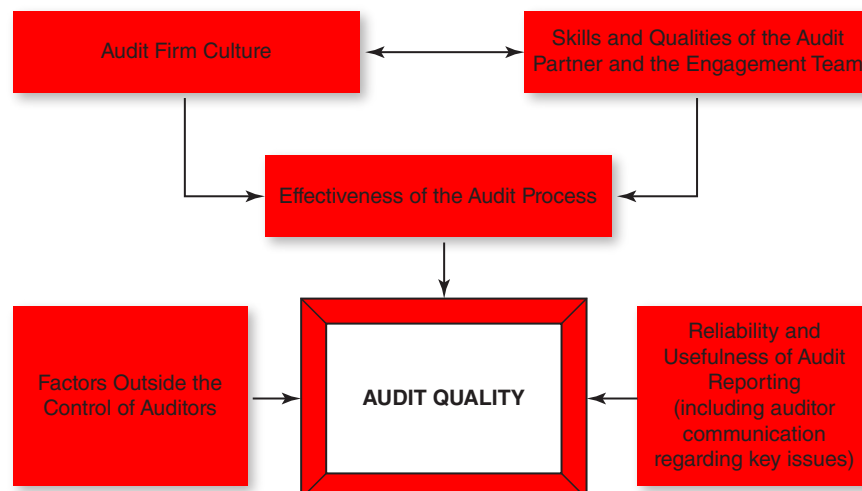
Audit Firm Culture

Audit firm culture contributes positively to audit quality when the leadership of the audit firm:

- Creates a work culture where audit quality is valued and rewarded
- Emphasizes that “doing the right thing” is appropriate from a public interest perspective, and that doing the right thing helps develop and maintain both individual and audit firm reputation
- Ensures that audit firm employees have enough time and resources to address difficult issues that may arise
- Ensures that monetary considerations do not adversely affect audit quality
- Promotes the benefits of having audit partners seek guidance on difficult issues and supporting their professional judgment
- Ensures that the audit firm has quality systems in place for making client acceptance and continuation decisions
- Fosters evaluation and compensation practices that promote personal characteristics important to quality auditing
- Ensures that audit quality is monitored within the audit firm and that appropriate consequences are taken when audit quality is found to be lacking

Exhibit 1.5

Drivers of Audit Quality



Disclosing the Name of the Audit Partner and Participants in the Audit

This feature highlights a recent disclosure requirement for auditing firms.

The skills and qualities of the engagement team are important to audit quality. Beginning in 2017, the PCAOB requires disclosure of the names of engagement partners for all public company audits. Further, many audit engagements are conducted with the assistance of other audit firms. Information about other audit firms

participating in an audit must also be disclosed for all public company audits. These disclosures appear in PCAOB Form AP.

These disclosures recognize that one important way investors can assess the quality of an audit is to know who conducted that audit. If you are interested in learning the engagement partners and audit firms participating in an audit, you can find a searchable public database with this information at <https://pcaobus.org/Pages/AuditorSearch.aspx>

Skills and Qualities of the Engagement Team

Auditors positively contribute to audit quality when they:

- Understand the client's business and adhere to auditing and ethical standards
- Exhibit professional skepticism and address issues identified during the audit
- Ensure that staff performing audit work have appropriate levels of experience and that they are properly supervised by their superiors
- Ensure that partners and managers provide lower-level staff with mentoring and on-the-job training opportunities
- Participate in training intended to aid in understanding audit, accounting, and industry specialist issues

Effectiveness of the Audit Process

The audit process contributes in a positive way to audit quality when:

- The audit methodology is well structured and:
 - Encourages partners and managers to work diligently in planning the audit
 - Provides a framework and the procedures to obtain sufficient appropriate audit evidence in an effective and efficient manner
 - Requires appropriate audit documentation
 - Provides for complying with auditing standards but does not inhibit professional judgment
 - Ensures that audit work is effectively reviewed
 - Includes audit quality-control procedures that are effective, understood, and applied
- Quality technical support is available when auditors encounter unfamiliar situations requiring assistance or guidance.
- Ethical standards are communicated and achieved, thereby aiding auditors' integrity, objectivity, and independence.
- Auditors' evidence collection is not constrained by financial pressures.

Reliability and Usefulness of Audit Reporting

Audit reporting contributes positively to audit quality when:

- Audit reports are written in a way that clearly and unambiguously conveys the auditor's opinion on the financial statements and addresses the needs of users of financial statements

- Auditors appropriately conclude as to the truth and fairness of the financial statements (e.g., in the United States, concluding that the financial statements are fairly presented in accordance with GAAP)
- The auditor communicates with the audit committee about:
 - Audit scope (in other words, what the auditor is engaged to accomplish)
 - Threats to auditor objectivity
 - Important risks identified and judgments that were made in reaching the audit opinion
 - Qualitative aspects of the client's accounting and reporting and possible ways of improving financial reporting

Factors Outside the Control of Auditors

The FRC recognizes that some factors affecting audit quality are outside of the direct control of the external auditor, such as client corporate governance. Good corporate governance includes audit committees that are robust in dealing with

For Classroom Discussion

The Financial Reporting Council's *Audit Quality Framework* is one of many frameworks of audit quality. The profession worldwide is committed to providing quality audits.

The Center for Audit Quality (CAQ) has published *Approach to Audit Quality Indicators*, which lays out perspectives regarding which indicators of audit quality may be most relevant and how and to whom they should be communicated. The indicators represent four thematic elements of audit quality: firm leadership and tone at the top; engagement team knowledge, experience, and workload; monitoring; and auditor reporting. You can find this publication at <http://www.thecaq.org/caq-approach-audit-quality-indicators>

The International Auditing and Assurance Standards Board (IAASB) has published *A Framework for Audit Quality: Key Elements*

that Create an Environment for Audit Quality. This *Framework* describes the different input, process, and output factors relevant to audit quality at the engagement, firm, and national levels. Further, the *Framework* demonstrates the importance of various contextual factors, such as laws and regulations, the litigation environment, corporate governance, and the financial reporting framework to audit quality. You can find this publication at <https://www.ifac.org/publications-resources/framework-audit-quality-key-elements-create-environment-audit-quality>

Review these two frameworks. Compare and contrast them with the FRC's framework. Which framework do you think might be most helpful to an auditor who wants to conduct a quality audit?

CAQ and IAASB

Center for Audit Quality

(CAQ, <http://www.thecaq.org/about-us>) is a public policy organization based in Washington, DC. The CAQ is dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ engages in many activities including providing thought leadership on proposed rules and standards, as well as webcasts, events, and tools for the profession and other members of the financial reporting supply chain. While conducting its own research, the CAQ works closely with the academic community to facilitate independent research relevant to the auditing profession.

International Auditing and Assurance Standards Board

(IAASB, www.ifac.org/iaasb) is a part of the International Federation of Accountants (IFAC), a global organization for the accounting profession. The IAASB sets International Standards on Auditing (ISAs) and facilitates the convergence of national and international auditing standards.

- 1-5 Audit quality is achieved when the audit is performed in accordance with GAAS and when it provides reasonable assurance that the financial statements have been presented in accordance with GAAP and are not materially misstated due to errors or fraud. (T/F)
- 1-6 One of the key drivers of audit quality is the gross margin achieved by the audit firm and the ability of the engagement partner to maintain those margins over the duration of the audit engagement. (T/F)
- 1-7 Audit quality involves which of the following?
- Performing an audit in accordance with GAAS to provide reasonable assurance that the audited financial statements and related disclosures are presented in accordance with GAAP and providing assurance that those financial statements are not materially misstated whether due to errors or fraud.
 - Performing an audit in accordance with GAAP to provide reasonable assurance that the audited financial statements and related disclosures are presented in accordance with GAAS and providing assurance that those financial statements are not materially misstated whether due to errors or fraud.
 - Performing an audit in accordance with GAAS to provide absolute assurance that the audited financial statements and related disclosures are presented in accordance with GAAP and providing assurance that those financial statements are not materially misstated whether due to errors or fraud.
 - Performing an audit in accordance with GAAS to provide reasonable assurance that the audited financial statements and related disclosures are presented in accordance with GAAP and providing assurance that those financial statements contain no misstatements due to errors or fraud.
- 1-8 Which of the following factors is not a driver of audit quality as discussed by the FRC?
- Audit firm culture.
 - Skills and personal qualities of client management.
 - Reliability and usefulness of audit reporting.
 - Factors outside the control of auditors.

issues and a greater emphasis by the client on getting things right as opposed to getting done by a particular date (for further discussion, see *Chapter 2*).

LO 3

Identify professional conduct requirements that help auditors achieve audit quality.

Professional Conduct Requirements that Help Auditors Achieve Audit Quality

To achieve audit quality, auditors should adhere to relevant codes of professional conduct and related guidance on professional responsibilities. Organizations providing such guidance for U.S. auditors include the AICPA SEC, and PCAOB.

AICPA, SEC, and the PCAOB

American Institute of Certified Public Accountants

The (AICPA, www.aicpa.org) has long served as the primary governing organization of the public accounting profession. That role changed with the establishment of the PCAOB as the body for setting auditing standards for the audits of public companies. However, the AICPA

continues to develop standards for audits of nonpublic companies. The AICPA is responsible for a peer review program in which registered firms are subject to periodic peer review of their nonpublic audits. The AICPA also provides continuing education programs, and through its Board of Examiners, prepares and administers the Uniform CPA Examination.

Securities and Exchange Commission

The Securities and Exchange Commission (SEC, www.sec.gov) was established by Congress in 1934 to regulate the capital market system. The SEC has oversight responsibilities for the PCAOB and for all public companies that are traded on U.S. stock exchanges. The SEC has the authority to establish GAAP for companies whose stock is publicly traded, although it has generally delegated this authority to the Financial Accounting Standards Board (FASB).

Actions by the SEC have important implications for public company auditors. For example, the SEC has a responsibility to prosecute public companies and their auditors for violating SEC laws, including fraudulent accounting. In recent years, the SEC has brought actions against companies and auditors including: (a) Dell for failing to disclose material information and for improper accounting related to the use of “cookie jar” reserves, (b) Lucent for inappropriate revenue recognition, (c) a former Deloitte & Touche partner for a lack of independence, (d) Ernst & Young for allowing premature revenue recognition and improper deferral of costs in its audits of Bally Total Fitness Holding Corporation, and (e) a former KPMG partner for insider trading.

Public Company Accounting Oversight Board

The Public Company Accounting Oversight Board (PCAOB, www.pcaobus.org) is a private sector, nonprofit organization that oversees auditors of public companies. The overall goal of the PCAOB is to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

The PCAOB has four primary responsibilities related to auditors of public companies: (1) registering audit firms that audit public companies; (2) periodically inspecting registered audit firms; (3) establishing auditing and related standards for registered audit firms; and (4) investigating and disciplining registered audit firms for violations of relevant laws or professional standards. Firms that provide audits of U.S. public companies must register with the PCAOB.

The PCAOB is comprised of five board members. No more than two board members may be Certified Public Accountants (CPAs); this requirement helps ensure that members of the external auditing profession do not dominate the Board. This helps assure users of audited financial statements that the PCAOB is representing the broad interests of users, not just serving the preferences of the external auditing profession.

AICPA Requirements: Code of Professional Conduct

The AICPA has a code of professional conduct to aid auditors in conducting a quality audit. The *Code* applies to professional services performed by AICPA members. Compliance with the *Code* depends primarily on the voluntary cooperation of AICPA members and secondarily on public opinion, reinforcement by peers, and ultimately, on disciplinary proceedings. Disciplinary proceedings are initiated by complaints received by the AICPA’s Professional Ethics Division. A disciplinary proceeding may result in the suspension or revocation of an auditor’s CPA license by the state board of accountancy. Without that license, one is legally prohibited from issuing an audit report on financial statements. The state board may also require additional continuing education to retain or reinstate the CPA certificate.

The AICPA’s *Code of Professional Conduct* consists of a set of **principles of professional conduct** which we summarize in *Exhibit 1.6*. These principles apply to all members of the AICPA.

The *Code* also includes a conceptual framework for members in public practice. This framework incorporates a “threats and safeguards” approach to help auditors analyze relationships and circumstances that the *Code* does not specifically address. *Exhibit 1.7* provides a flowchart of the steps in the conceptual framework.

Threats are circumstances that could result in an auditor lacking independence in fact or in appearance. Threats to independence include:

1. *Self-review threat*—occurs when the audit firm also provides nonaudit work for the client, such as preparing source documents used to generate the client’s financial statements. Self-review threatens independence because it may appear that the auditor is reviewing his or her own work.
2. *Advocacy threat*—occurs when the auditor acts to promote the client’s interests, such as representing the client in tax court. Advocacy threatens

Exhibit 1.6**AICPA Principles of Professional Conduct**

Responsibilities In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

Public interest Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

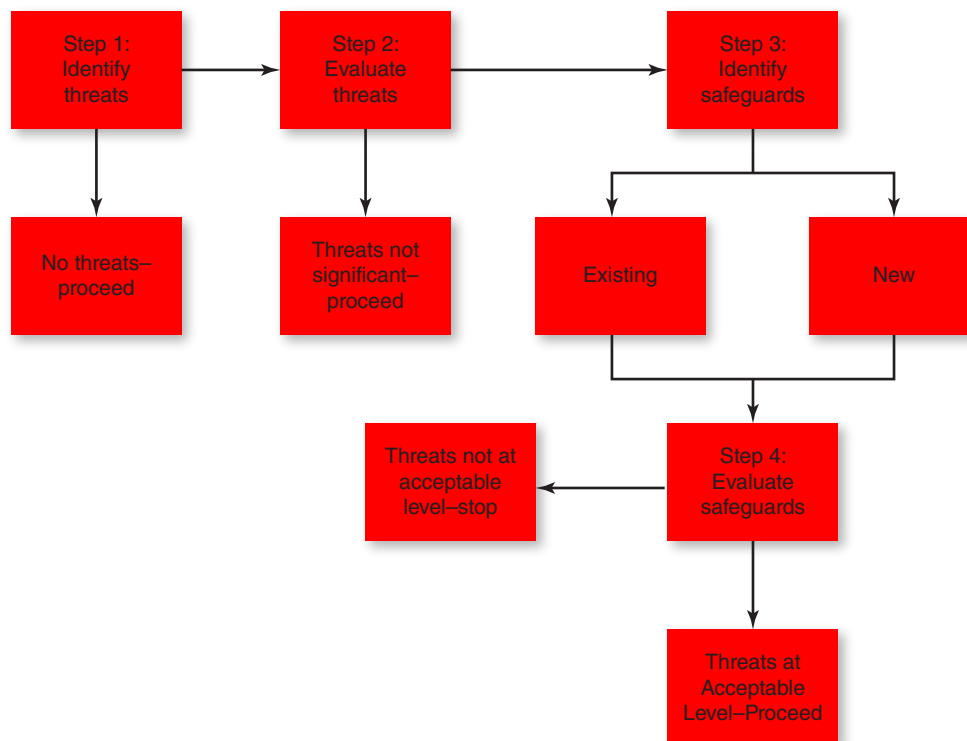
Integrity To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

Objectivity and independence A member should maintain objectivity and be free of conflicts in discharging professional responsibilities. A member in public practice should be independent both in fact and in appearance when providing auditing and other attestation services. A member not in public practice does not need to maintain independence.

Due care A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability.

Scope and nature of services A member in public practice should observe the principles of the *Code* in determining the scope and nature of services to be provided.

Source: <http://www.aicpa.org/Research/Standards/CodeofConduct/DownloadableDocuments/2014December15ContentAsOf2016August31CodeofConduct.pdf>

Exhibit 1.7**Steps of the Conceptual Framework**

Source: www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/DownloadableDocuments/ToolkitsandAids/ConceptualFrameworkToolkitForMembersInPublicPractice.docm

independence because it may appear that the auditor cares more about the client than external users of the financial statements.

3. *Adverse interest threat*—occurs when the auditor and the client are in opposition to each other, such as when either party has initiated litigation against the other. Adverse interest threatens independence because the auditor may take actions that are intended to weaken the client's chances in the litigation and may appear to care more about the audit firm and its interests rather than those of the company or external users of the financial statements.
4. *Familiarity threat*—occurs when the auditor has some long-standing relationship with an important person associated with the client. Examples include:
 - The audit partner's close relative is employed in a key position at the client.
 - The audit partner has been assigned to the client for a long period of time and has developed very close personal relationships with top management.
 - A member of the audit team has a close personal friend who is employed in a key position at the client.
 - A member of the audit team was recently a director or officer at the client.

In each of these examples, familiarity threatens independence because the auditor may act in a way that favors the client or individual employed at the client rather than external users of the financial statements.

5. *Undue influence threat*—occurs when client management attempts to coerce or provide excessive influence over the auditor. Examples include:
 - Top management threatens to replace the auditor or the audit firm because of a disagreement over an accounting issue.
 - Top management pressures the auditor to reduce the amount of work he or she does on the audit in order to achieve lower audit fees.
 - An employee of the client gives the auditor a gift that is clearly significant or economically important to the auditor.

In each of these examples, undue influence threatens independence because the auditor may act in a way that favors the client or individual employed at the client rather than external users of the financial statements.

6. *Self-interest threat*—occurs when the auditor has a direct financial relationship with the client, such as owning stock in the client company, owing money to the client company, or when the audit client makes up the vast majority of the audit firm's total revenue. Self-interest threatens independence because the auditor's judgment may be unduly influenced by their own financial interests rather than acting in the best interests of external users of the financial statements.
7. *Management participation threat*—occurs when the auditor takes on the role of management or completes functions that management should reasonably complete, such as establishing internal controls or hiring/firing client employees. Management participation threatens independence because the auditor is acting as management; therefore, the auditor would, in essence, be reviewing his or her own work.

Safeguards are actions or other measures that may eliminate a threat or reduce a threat to an **acceptable level**. These safeguards include:

1. *Safeguards created by the profession, legislation, or regulation*. Examples include:
 - Education, continuing education, and training requirements
 - Professional standards and disciplinary punishments

- External review of audit firms' quality-control systems
 - Legislation concerning independence requirements
 - Audit partner rotation requirements for publicly traded companies, which include mandatory partner rotation after five years of service
 - Nonaudit (e.g., consulting) work not allowed for companies for which the auditor provides external audit work
2. *Safeguards implemented by the audit client.* Examples include:
- Client personnel with expertise to adequately complete necessary management and accounting tasks without the involvement or advice of the auditor
 - Appropriate tone at the top of the client
 - Policies and procedures to ensure accurate financial reporting
 - Policies and procedures to ensure appropriate relationships with the audit firm
3. *Safeguards implemented by the audit firm.* Examples include:
- Audit firm leadership that stresses the importance of independence
 - Audit firm quality-control policies and procedures
 - Audit firm monitoring processes to detect instances of possible independence violations
 - Disciplinary mechanisms to promote compliance with independence policies and procedures
 - Rotation of senior engagement personnel

The *Code* also consists of specific rules of conduct. The rules and related interpretations address many situations; however, they cannot address all relationships or circumstances that may arise. In the absence of a rule or interpretation addressing a particular relationship or circumstance, auditors evaluate whether that relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant information to conclude that there is a threat to compliance with the rules that is not at an acceptable level. When making that evaluation, auditors should apply the conceptual framework approach discussed earlier and highlighted in *Exhibit 1.7*.

The evaluation includes identification of threats to compliance with the rules, evaluation of the significance of the threats, and identification and application to safeguards. When an auditor identifies threats, the auditor must demonstrate that safeguards were applied that eliminated or reduced significant threats to an acceptable level.

One of the critical rules is the Independence Rule, which we discuss below. We summarize rules applicable to members in public practice in *Exhibit 1.8*.

Independence Rule

The Independence Rule requires that a member in public practice be independent in the performance of professional services as required by standards promulgated by bodies designated by the AICPA.

Covered Member An important point concerning the Independence Rule is that it only applies to a **covered member**. A covered member includes:

- a. An individual on the engagement team
- b. An individual in a position to influence the engagement
- c. A partner, partner equivalent, or manager who provides more than 10 hours of nonattest services to the audit client within any fiscal year
- d. A partner or partner equivalent in the office in which the lead engagement partner or partner equivalent primarily practices in connection with the engagement

Exhibit 1.8
AICPA Rules of Conduct for Members in Public Practice

Rule Section Number and Topic	Guidance	What You Should Know
100 Integrity and objectivity	In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.	<p>You are required to act with integrity and objectivity when performing all services.</p> <p>If you offer a gift to a client or accept gifts or entertainment from a client that is not reasonable, <i>self-interest, familiarity, or undue influence threats</i> to your compliance with this rule may exist.</p> <p>A conflict of interest creates <i>adverse interest and self-interest threats</i> to your compliance with this rule.</p> <p><i>Self-interest, familiarity, and undue influence threats</i> to your compliance with this rule may exist when you and your supervisor or any other person within your organization have a difference of opinion relating to the application of accounting principles; auditing standards; or other relevant professional standards, including standards applicable to tax and consulting services or applicable laws or regulations.</p> <p>An <i>advocacy threat</i> to compliance with this rule may exist when a you or your firm is engaged to perform nonattest services, such as tax and consulting services, that involve acting as an advocate for the <i>client</i> or to support a <i>client's</i> position on accounting or financial reporting issues.</p> <p>The existence of unpaid audit fees for professional services previously rendered to an audit client may create self-interest, undue influence, or advocacy threats to the covered member's compliance with this rule.</p> <p>In some circumstances, no safeguards can reduce an independence threat to an acceptable level. For example, as discussed earlier, the <i>Code</i> specifies that a covered member may not own even an immaterial direct financial interest in an audit client because there is no safeguard to reduce the <i>self-interest threat</i> to an acceptable level. As another example, threats to the covered member's compliance with this rule could not be reduced to an acceptable level by the application of safeguards if the unpaid fees are for any previously rendered professional service provided more than one year prior to the date of the current-year report. Accordingly, independence would be impaired.</p>
200 Independence	A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.	

300 General Standards

A member shall comply with the following standards and with any interpretations thereof by bodies designated by Council.

Professional Competence. Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.

Due Professional Care. Exercise due professional care in the performance of professional services.

Planning and Supervision. Adequately plan and supervise the performance of professional services.

Sufficient Relevant Data. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

This rule requires you to comply with general standards and interpretations by standards setters such as the FASB, the PCAOB, and the AICPA.

310 Compliance with Standards

A member who performs auditing, review, compilation, consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council.

This rule requires you to comply with general standards and interpretations by standards setters such as the FASB, the PCAOB, and the AICPA.

320 Accounting Principles

A member shall not (1) express an opinion that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

A member shall not commit an act discreditable to the profession.

This rule requires you to comply with general standards and interpretations by standards setters such as the FASB, the PCAOB, and the AICPA.

400 Acts Discreditable

Examples of discreditable acts include violation of an antidiscrimination law, failure to file a tax return, the preparation and presentation of false information in financial statements due to negligence, and failure to follow the accountancy laws, rules, and regulations on use of the CPA credential in any of the jurisdictions in which the CPA practices.

As a student, you may be interested to learn that solicitation or knowing disclosure of CPA exam questions or answers is a discreditable act.

(Continues)

Exhibit 1.8 *Continued*

Rule Section Number and Topic	Guidance	What You Should Know
510 Contingent Fees	<p>A member in public practice shall not: (1) perform for a contingent fee any professional services for, or receive such a fee from a client for whom the member or the member's firm also performs:</p> <ul style="list-style-type: none"> (a) an audit or review of a financial statement, or (b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not describe a lack of independence, or (c) an examination of prospective financial information, or <p>(2) prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client. This prohibition applies during the period in which the member or the member's firm is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in any such listed services.</p>	<p>A contingent fee is a fee established for the performance of any service in which a fee will not be collected unless a specified finding or result is attained, or in which the amount of the fee depends on the finding or results of such services.</p> <p>An example of a contingent fee is a consulting firm agreeing to perform an information systems project for a fee of 50% of the defined cost savings attributable to the system for a period of three years.</p> <p>Contingent fees are prohibited from any client for whom the auditor performs audit services. However, an auditor's fees may vary, depending on the complexity of services rendered or the time taken to perform the services. Contingent fees have not been prohibited for services provided to nonaudit clients; however, the auditor must still be sure that the use of such fees does not impair the auditor's objectivity or ability to uphold the public trust.</p>
520 Commissions and Referral Fees	<p><u>Prohibited Commissions.</u> A member in public practice shall not for a commission recommend or refer to a client any product or service, or for a commission recommend or refer any product or service to be supplied by a client, or receive a commission, when the member or the member's firm also performs (attestation services referred to in Rule 302) for the client.</p> <p>This prohibition applies to the period covered by the attestation service and the related historical financial statements.</p> <p><u>Disclosure of Permitted Commissions.</u> A member in public practice who is not prohibited by this rule from performing services for or receiving a commission and who is paid or expects to be paid a commission shall disclose that fact to any person or entity to whom the member recommends or refers a product or service to which the commission relates.</p> <p><u>Referral Fees.</u> Any member who accepts a referral fee for recommending or referring any service of a CPA to any person or entity or who pays a referral fee to obtain a client shall disclose such acceptance or payment to the client.</p>	<p>Many types of commissions are prohibited. For permitted commissions, appropriate disclosures must be made.</p> <p>Referral fees, which are distinct from commissions, are permitted, but must be disclosed.</p>

600 Advertising and Other Forms of Solicitation

A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, overreaching, or harassing conduct is prohibited.

This rule prohibits false, misleading, or deceptive advertising. Examples include:

- Creating false expectations about outcomes
- Suggesting the ability to influence relevant parties
- Providing representations that would cause one to be deceived

During the course of an audit, the auditor develops a complete understanding of the client and obtains confidential information, such as its operating strengths, weaknesses, and plans for financing or expanding into new markets. To assure a free flow and sharing of information between the client and the auditor, the client must be assured that the auditor will not communicate confidential information to outside parties.

700 Confidential Client Information

A member in public practice shall not disclose any confidential client information without the specific consent of the client.

The exceptions to this general rule are that auditors are not precluded from communicating information for any of the following purposes:

- To assure the adequacy of accounting disclosures required by GAAP
 - To comply with a validly issued and enforceable subpoena or summons or to comply with applicable laws and government regulations
 - To provide relevant information for an outside quality review of the firm's practice under PCAOB, AICPA, or state board of accountancy authorization
 - To initiate a complaint with, or respond to an inquiry made by the AICPA's professional ethics division or by the trial board or investigative or disciplinary body of a state CPA society or board of accountancy
- An audit firm name should not be misleading. If the firm name contains any representation that would be likely to cause a reasonable person to misunderstand, or be confused about, what the legal form of the firm is or who the owners or members of the firm are, the firm name would be misleading.

Firms within a network sometimes share the use of a common brand or share common initials as part of the firm name. The sharing of a common brand name or common initials of a network as part of the member's firm name would not be considered misleading, provided the firm is a network firm.

800 Form of Organization and Name

A member may practice public accounting only in a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council.

A member shall not practice public accounting under a firm name that is misleading.

Names of one or more past owners may be included in the firm name of a successor organization.

A firm may not designate itself as "Members of the American Institute of Certified Public Accountants" unless all of its CPA owners are members of the Institute.

- e. The firm, including the firm's employee benefit plans
- f. An entity whose operating, financial, or accounting policies can be controlled by any of the individuals or entities described in items a–e or two or more such individuals or entities if they act together

Financial Interests Auditors and their immediate family should not have any direct or material indirect financial interest in that client. A **direct financial interest** is a financial interest owned directly by, or under the control of, an individual or entity or beneficially owned through an investment vehicle, estate, or trust when the beneficiary controls the intermediary or has the authority to supervise or participate in the intermediary's investment decisions. For example, a covered member may not own bonds of a client.

An **indirect financial interest** occurs when the beneficiary neither controls the intermediary nor has the authority to supervise or participate in the intermediary's investment decisions. The concept is that a covered member may have some limited financial interests in clients as long as the interests are not direct and not material (to either the member or the client). For example, suppose an auditor has an investment in a mutual fund that has an investment in an audit client. The auditor does not make the decisions to buy or sell the security held by the mutual fund. Ownership of mutual fund shares is a direct financial interest. The underlying investments of a mutual fund are indirect financial interests. If the mutual fund is diversified, a covered member's ownership of 5% or less of the outstanding shares of the mutual fund would not be considered to constitute a material indirect financial interest in the underlying investments. For purposes of determining materiality, the financial interests of the covered member and immediate family should be aggregated.

Independence would be considered impaired in the following situations involving financial interests:

- A covered member has a material joint, closely held investment with a client. For example, the member cannot own a vacation home or time share with a key office or principal shareholder of a client.
- A partner or professional employee of an audit firm owns more than 5% of client.
- One or more partners or professional employees have a relationship with a client as an officer, director, manager, employee, etc.

Employment of Family Members A covered member's independence would be impaired if an immediate family member was employed by an audit client in a key position in which he or she can exercise influence over the contents of the financial statements. Key positions typically include the CEO, CFO, chief accountant, member of the board of directors, chief internal audit executive, or treasurer. Independence is impaired if a covered member has a close relative who has a key position with the client or has a material financial interest in the client of which the CPA has knowledge. An immediate family member may be employed by the client in a position that is not key to the organization.

Loans There are limits on the types and amounts of loans covered members may obtain from a financial institution that is also an audit client. Essentially, auditors cannot obtain large loans, or loans for investment purposes, from a client. However, auditors may obtain loans through normal lending procedures if they are at standard terms, such as automobile loans.

Performing Other Nonaudit Services Independence may be impaired if auditors provide certain *nonaudit* services to an audit client. In particular, independence is impaired when an auditor assumes management responsibilities for an audit client.