PART ONE

Introduction to Assurance and Financial Statement Auditing

CHAPTER 1

LEARNING OBJECTIVES

Upon completion of this chapter you will

1-1 Understand why studying auditing can be valuable to you whether or not you plan to become an auditor, and why it is different from studying accounting.

1-2 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

1-3 Understand the relationships among auditing, attestation, and assurance services.

1-4 Know the basic definition of a financial statement audit.

1-5 Understand three fundamental concepts that underlie financial statement auditing.

1-6 Be able to explain why on most audit engagements an auditor tests only a sample of transactions that occurred.

1-7 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.

1-8 Know what an audit report is and understand the nature of an unqualified report.

1-9 Understand why auditing demands logic, reasoning, and resourcefulness.

RELEVANT ACCOUNTING AND AUDITING PRONOUNCEMENTS*

AU 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with GAAS
AU 210, Terms of Engagement
AU 450, Evaluation of Misstatements Identified During an Audit
AU 700, Forming an Opinion and Reporting on Financial Statements
AU 705, Modifications to the Opinion in the Independent Auditor's Report
AU 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
PCAOB Auditing Standard No. 1, References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board
PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements
PCAOB Auditing Standard No. 8, Audit Risk
PCAOB Auditing Standard No. 9, Audit Planning (AU 300)
PCAOB Auditing Standard No. 10, Supervision of the Audit Engagement
PCAOB Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit (AU 320)
PCAOB Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (AU 315)
PCAOB Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement (AU 330)
PCAOB Auditing Standard No. 15, Audit Evidence (AU 500)

*References to AU sections have been updated to reflect the new codification of ASB standards. PCAOB standards are referenced by standard number. Where the ASB has a standard that is similar to a PCAOB standard, the AU reference is included in parentheses after the PCAOB standard.

An Introduction to Assurance and Financial Statement Auditing

You will learn in this chapter that auditing consists of a set of practical conceptual tools that help accounting professionals to find, organize, and evaluate evidence about the assertions of another party. The demand for capable accountants and auditors of high integrity has never been greater. Opportunities for auditors are plentiful and rewarding and can lead to attractive career opportunities in other areas. Those who practice as auditors often later go into financial management, becoming controllers, chief financial officers (CFOs), and even chief executive officers (CEOs). But even those who do not plan to become an auditor can benefit greatly from an understanding of financial statement auditing and its underlying concepts. Learning these tools is valuable to any business decision maker.

The past decade has been challenging for the auditing profession. In the early 2000s, a series of high-profile accounting frauds began to cause investors to doubt the integrity of the nation's financial reporting system, including the role of the external auditor. To restore investor confidence, Congress passed the *Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act* in July 2002—the most significant legislation related to financial statement audits of public companies since the Securities Acts of 1933 and 1934. The implications of the Sarbanes-Oxley Act are discussed throughout the text in appropriate places. While the public scrutiny, government reforms, and establishment of a regulated process for creating auditing standards for public companies have been challenging for accountants and auditors, the events of the last several years have also served as powerful reminders of just how critical the roles of accounting and auditing are in our society.

We live in a time when the amount of information available for decision makers via electronic databases, the Internet, and other sources is rapidly expanding, and there is a great need for the information to be reliable, credible, relevant, and timely. High-quality information is necessary if managers, investors, creditors, and regulatory agencies are to make informed decisions. Auditing and assurance services play an important role in ensuring the reliability, credibility, and relevance of business information.

The following examples present situations that illustrate how auditing increases the reliability and credibility of an entity's financial statements:

> Sara Thompson, a local community activist, has been operating a not-for-profit center that provides assistance to abused women and their children. She has financed most of her operations from private contributions. Ms. Thompson applied to the State Health and Human Services Department requesting a large grant to expand her two shelters to accommodate more women. In completing the grant application, Ms. Thompson discovered that the state's laws for government grants require that recipients be audited to ensure that existing funds are being used appropriately. Ms. Thompson hired a CPA to audit the center's financial statements. Based on the center's activities, the intended use of the funds, and the auditor's clean report, the grant was approved.

Conway Computer Company is a wholesaler of computer products. The company was started by George and Jimmy Steinbuker five years ago. Two years ago, a venture capital firm acquired 40 percent of the company and thus provided capital for expansion. Conway Computer's revenues and profits increased by 25 percent in each of the last two years, and the Steinbuker brothers and the venture capital firm decided to take the company public through a stock sale. However, they knew that the company's financial statements needed to be audited by a reputable public accounting firm before a registration statement could be filed with the Securities and Exchange Commission and in order for investors to trust the stock offering. The company hired a major public accounting firm to perform its audits and the company successfully sold stock to the public.

These situations show the importance of auditing to both private and public enterprise. By adding an audit to each situation, the users of the financial statements have additional assurance that the financial statements report honestly and accurately, and they will be more willing to rely on those statements. Auditors can also provide valuable assurance for operating information, information systems reliability and security, and the effectiveness of an entity's internal control. Consider the following example:

EarthWear Clothiers is a successful mail-order retailer of high-quality clothing for outdoor sports. Over the last few years the company has expanded sales through its Internet site. EarthWear's common stock is listed and traded on NASDAQ. Securities laws require company officials to certify that they have properly designed, implemented, and tested internal control over their accounting and reporting information systems. EarthWear's public accounting firm, Willis & Adams, examines the design and documentation of EarthWear's internal control on a yearly basis and conducts independent tests to verify that EarthWear's controls are operating effectively. Willis & Adams issues a report to the public expressing its opinion as to whether EarthWear's internal control is well designed and operating effectively. Thus, stockholders, creditors, and other stakeholders can have greater confidence in the financial reports issued by EarthWear's management.

Most readers of an introductory auditing text initially have little understanding of what auditing and assurance services entail. Thus, we start by helping you understand in general terms why there is a demand for auditing and assurance services. We then compare auditing to other well-known forms of assurance to provide an intuitive understanding of the economic role auditing plays. Finally, we define auditing, attestation, and assurance services, and give you an overview of the financial statement auditing process.

Tips for Learning Auditing

LO 1-1

You will find that the study of auditing is different from any of the other accounting courses you have taken in college, and for good reason. Most accounting courses focus on learning the rules, techniques, and computations required to prepare and analyze financial information. Auditing, on the other hand, focuses on learning the analytical and logical skills necessary to evaluate the relevance and reliability of financial information as well as of the systems and processes responsible for recording and summarizing that information. As such, you will find the study of auditing to be much more conceptual in nature than your other accounting courses. This is simply due to the nature of auditing. Thus, we will periodically prompt you to "stop and think" about the concepts being discussed throughout the book. Seeking to thoroughly understand and apply principles as you read them will greatly improve your success in studying auditing.

Learning auditing essentially helps you understand how to gather and assess evidence so you can evaluate assertions (or claims) made by others. This text is filled with the tools and techniques used by financial statement auditors in practice. You'll find that the "tool kit" used by auditors consists of a coherent, logical framework, together with techniques useful for analyzing financial data and gathering evidence about others' assertions. Acquiring this conceptual tool kit can be valuable in a variety of settings, including practicing as an auditor, running a small business, providing consulting services, and even making executive business decisions. An important implication is that learning this framework makes the study of auditing valuable to future accountants and business decision makers, whether or not they plan to become auditors.

While the concepts and techniques you will learn in this book will be useful to you regardless of your career path, our experience is that students frequently fall into the trap of defining auditing in terms of memorized lists of rules, tools, and techniques. The study of auditing and the related concepts and techniques will make a lot more sense if you build up your intuition of why audits are needed, if you understand the necessary characteristics of audits and auditors, and if you focus on what an auditor does, and *why*. Don't fall into the trap of attempting to study auditing through rote memorization! Instead, pause frequently to be sure you understand both "what?" and "why?" as you study the concepts and techniques of auditing.

Reliable information is important for managers, investors, creditors, and regulatory agencies to make informed decisions. Auditing helps ensure that information is reliable, credible, and relevant. In fact, the assurance provided by auditing is vital to the proper functioning of our economic system.

The Demand for Auditing and Assurance

LO 1-2 Why would an entity decide to spend money on an audit? In view of the fact that many of the largest companies spend millions of dollars each year for their annual audit, this is an important question.[1] Some might answer that audits are required by law. While true in certain circumstances, this answer is far too simplistic. Audits are often utilized in situations where they are not required by law, and audits were in demand long before securities laws required them. In fact, evidence shows that some forms of accounting and auditing existed in Greece as early as 500 BC.[2] However, the development of the corporate form of business and the expanding world economy over the last 200 years have given rise to an explosion in the demand for the assurance provided by auditors. In 1926, several years prior to the Securities Acts of 1933 and 1934, which required audits for publicly traded companies in the United States, 82 percent of the companies on the New York Stock Exchange were audited by independent auditors.[3]

Principals and Agents

The demand for auditing can be understood through the need for accountability when business owners hire others to manage their businesses, as is typical in modern corporations. Until the late 18th and early 19th centuries, most organizations were relatively small and were owned and operated as sole proprietorships or partnerships. Because businesses were generally run by their owners, accountability to outside parties was limited. The birth of modern accounting and auditing occurred during the industrial revolution, when companies became larger and

[1] See G. L. Sundem, R. E. Dukes, and J. A. Elliott, *The Value of Information and Audits* (New York: Coopers & Lybrand, 1996), for a more detailed discussion of the demand for accounting information and auditing.

[2] G. J. Costouros, "Auditing in the Athenian State of the Golden Age (500–300 BC)," *The Accounting Historian Journal* (Spring 1978), pp. 41–50.

[3] G. J. Benston, "The Value of the SEC's Accounting Disclosure Requirements," *The Accounting Review* (July 1969), pp. 515–32.

needed to raise capital to finance expansion.[4] Over time, capital markets developed, enabling companies to raise the investment capital necessary to expand to new markets, finance expensive research, and fund the buildings, technology, and equipment needed to deliver products to market. A capital market allows a public company to sell small pieces of ownership (i.e., stocks) or to borrow money in the form of thousands of small loans (i.e., bonds) so that vast amounts of capital can be raised from a wide variety of investors and creditors. A *public company* is a company that sells its stocks or bonds to the public, giving the public a valid interest in the proper use of the company's resources. Thus, the growth of the modern corporation led to diverse groups of owners who are not directly involved in running the business (stockholders) and the use of professional managers hired by the owners to run the corporation on a day-to-day basis. In this setting, the managers serve as *agents* for the owners (sometimes referred to as *principals*) and fulfill a *stewardship* function by managing the corporation's assets.

Accounting and auditing play important roles in this principal–agent relationship. We first explain the roles of accounting and auditing from a conceptual perspective. Then we'll use an analogy involving a house inspector to illustrate the concepts. First, it is important to understand that the relationship between an owner and manager often results in information asymmetry between the two parties. *Information asymmetry* means that the manager generally has more information about the "true" financial position and results of operations of the entity than does the absentee owner.

Stop and Think: What negative consequences could this information asymmetry have for the absentee owner? How do the perspectives and motives of the manager and absentee owner differ?

Because their goals may not coincide, there is a natural *conflict of interest* between the manager and the absentee owner. If both parties seek to maximize their self-interest, the manager may not always act in the best interest of the owner. For example, the risk exists that a manager may follow the example of Tyco Inc.'s former CEO Dennis Kozlowski, who spent Tyco funds on excessive personal benefits such as $6,000 shower curtains, or Andrew Fastow, the former CFO of Enron, who pleaded guilty to manipulating the reported earnings of Enron in order to inflate the price of the company's stock so that he could earn larger bonuses and sell his stock holdings at artificially high prices. The owner can attempt to protect him or herself against the possibility of improper use of resources by reducing the manager's compensation by the amount of company resources that the owner expects the manager to consume. But rather than accept reduced compensation, the manager may agree to some type of monitoring provisions in his or her employment contract, providing assurance to the owner that he or she will not misuse resources. For example, the two parties may agree that the manager will periodically report on how well he or she has managed the owner's assets. Of course, a set of criteria is needed to govern the form and content of the manager's reports. In other words, the reporting of this financial information to the owner must follow some set of agreed-upon accounting principles. As you can see, one primary role of accounting information is to hold the manager accountable to the owner—hence the word *accounting*.

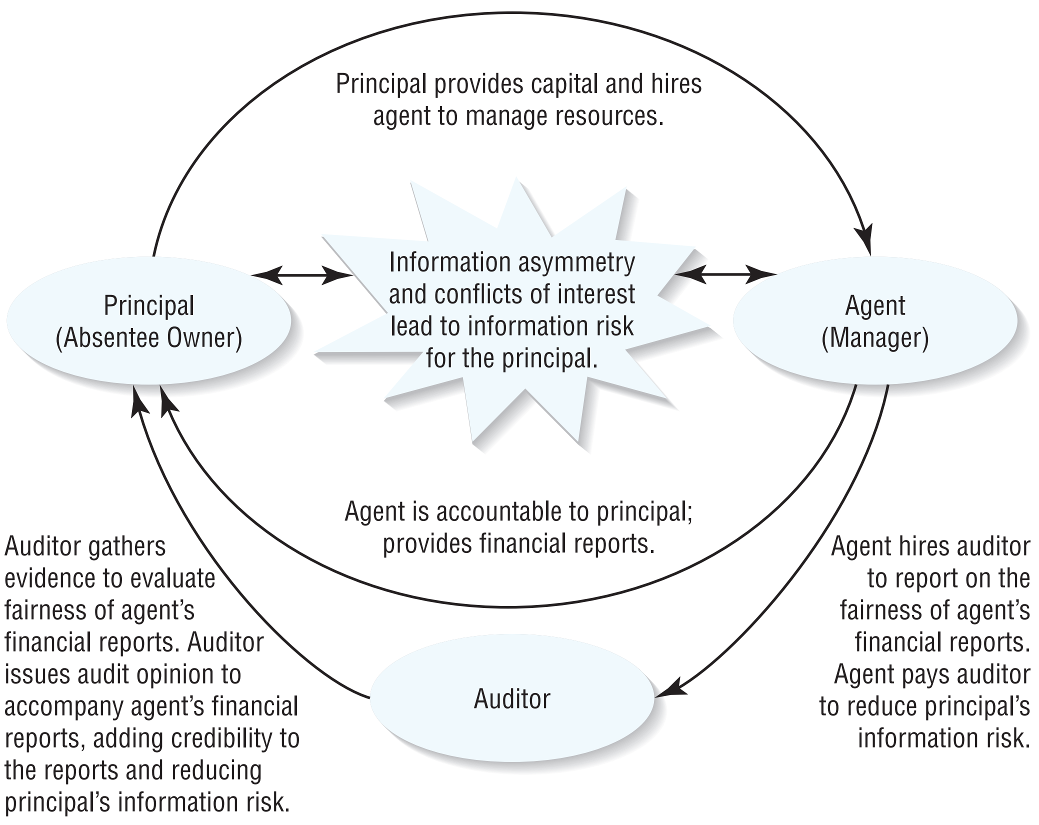
[4]Also see M. Chatfield, *A History of Accounting Thought* (Hinsdale, IL: Dryden Press, 1974), for a discussion of the historical development of accounting and auditing. See D. L. Flesher, G. J. Previts, and W. D. Samson, "Auditing in the United States: A Historical Perspective," *ABACUS* (2005), pp. 21–39, for a discussion of the development of auditing in the United States.

The Role of Auditing

Of course, reporting in accordance with an agreed-upon set of accounting principles doesn't solve the problem by itself. Because the manager is responsible for reporting on the results of his or her own actions, which the absentee owner cannot directly observe, the manager is in a position to manipulate the reports. Again, the owner adjusts for this possibility by assuming that the manager *will* manipulate the reports to his or her benefit and by reducing the manager's compensation accordingly. It is at this point that the demand for auditing arises. If the manager is honest, it may very well be in the manager's self-interest to hire an auditor to monitor and report to the owner on his or her activities. The owner likely will be willing to invest more in the business and to pay the manager more if the manager can be held accountable for how he or she uses the owner's invested resources. As the amount of capital involved and the number of potential owners increase, the potential impact of accountability also increases. The auditor's role is to determine whether the reports prepared by the manager conform to the contract's provisions. Thus, the auditor's verification of the financial information adds credibility to the report and reduces *information risk*, or the risk that information circulated by a company's management will be false or misleading. Reducing information risk potentially benefits both the owner and the manager. Figure 1–1 provides an overview of this agency relationship.

While the setting we've outlined is very simple, understanding the basics of the owner–manager relationship is helpful in understanding the demand for auditing.

FIGURE 1–1 **Overview of the Principal–Agent Relationship Leading to the Demand for Auditing**



The principal–agent model is a powerful conceptual tool that can be extrapolated to much more complex employment and other contractual arrangements. For example, how can a lender prevent management from taking the borrowed funds and using them inappropriately? One way is to place restrictive covenants in the debt agreement with which the entity and its management must comply. Again, this arrangement gives rise to a demand for the auditing of information reported by management to the lender.

Practice INSIGHT

At the heart of a capital-market economy is the free flow of reliable information, which investors, creditors, and regulators use to make informed decisions. Chief Justice Warren Burger opined on the significance of the audit function 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.

More than 30 years later, the message is the same—users of financial statements rely on the external auditor to act with honor and integrity in protecting the public interest.

In summary, auditing is demanded because it plays a valuable role in monitoring the contractual relationships between the entity and its stockholders, managers, employees, and debt holders. Certified public accountants have been charged with providing audit services because of their traditional reputation of competence, independence, objectivity, and concern for the public interest. As a result, they are able to add credibility to information produced and reported by management to outside parties. The role of the Certified Public Accountant is discussed in more detail in Chapter 2.

An Assurance Analogy: The Case of the House Inspector

LO 1-2 Before we discuss financial statement auditors further, let's illustrate the concepts we've just covered using an analogy: buying an older home. In the purchase of an existing house, *information asymmetry* usually is present because the seller typically has more information about the house than does the buyer. There is also a natural *conflict of interest* between the buyer and the seller. Sellers generally prefer a higher selling price and may be motivated to overstate the positive characteristics and understate or remain silent about the negative characteristics of the property they have for sale. In other words, there is *information risk* to the buyer.

Seller Assertions, Information Asymmetry, and Inspector Characteristics

To support the asking price, sellers typically make *assertions* about their property. For instance, the seller of an older home might declare that the roof is watertight, that the foundation is sound, that there is no rot or pest damage, and that the plumbing and electrical systems are in good working order. Fortunately, many sellers are honest and forthcoming, but this is not always the case. The problem is that the buyer often does not know if she or he is dealing with an honest seller or if the seller has the necessary expertise to evaluate all the structural or mechanical aspects of the property. Lacking the necessary expertise to validate the seller's assertions, the buyer can logically reduce information risk by hiring a house inspector.

Stop and Think: Imagine for a moment that you are buying a house and are wisely considering hiring an inspector. Test your intuition—what characteristics would you like your inspector to possess?

Desired Characteristics of the House Inspection Service

Now that you have identified some of the characteristics of a good inspector, consider the key characteristics of the service he or she will provide. Are some of the seller's assertions more important than others? For instance, you are probably not equally concerned with the assertions that there is no structural rot and that the lightbulbs in the master bathroom are working. Depending on what you are willing to pay, the inspection could theoretically range from the extremes of driving past the house to taking the home entirely apart, board by board. How thorough do you want the inspector to be? Do you want the inspector to issue a "pass-fail" grade based on a quick walk-through or would you like more details, such as careful examination of the furnace and air conditioner? As you can see, there are many factors to take into account in deciding on the nature and extent of the assurance service you want to buy. In Table 1–1 we have listed what we think are desirable characteristics of a house inspector and of the service provided by an inspector.

The concepts contained in Table 1–1 are in fact fundamental to most forms of inspection (and all financial statement audits). Certainly home inspections and other assurance services must focus on the assertions that are most important, and they must be conducted in a timely and cost-effective manner. Some assertions are more important than others because of their potential risk or cost. For example, a house inspector should recognize the signs that indicate an increased risk for a leaky roof. If those signs are present, he or she should investigate further, because damage caused by a leaky roof can be very expensive to repair. At the same time, just because the seller asserts that he or she recently lubricated all the door and window hinges doesn't mean it would be wise to pay the inspector to validate this assertion.

Stop and Think: How might a house inspection be similar to a financial statement audit?

TABLE 1–1 Important Characteristics of House Inspectors and Inspections

Desirable Characteristics of House *Inspectors*

- Competent—they possess the required training, expertise, and experience to evaluate the property for sale.
- Objective—they have no reason to side with the seller; they are independent of the seller's influence.
- Honest—they will conduct themselves with integrity, and they will share all of their findings with the buyer.
- Skeptical—they will not simply take the seller's assertions at face value; they will conduct their own analysis and testing.
- Responsible and/or liable—they should stand behind their assessment with a guarantee and/or be subject to litigation if they fail to act with due care.

Desirable Characteristics of a House Inspection *Service*

- Timely—the results of the service are reported in time to benefit the decision maker.
- Reasonably priced—the costs of the services must not exceed the benefits. For this to occur the service provider will likely need to focus attention on the most important and risky assertions and likely can't provide absolute assurance.
- Complete—the service addresses all of the most important and risky assertions made by the seller.
- Effective—the service provides some degree of certainty that it will uncover significant risks or problems.
- Systematic and reliable—the service is based on a systematic process, and the conclusions are based on reliable evidence. In other words, another comparable inspector would likely find similar things and come to similar conclusions.
- Informative—the service provides a sense for how likely mechanical or structural failure is in the near future and provides an estimate of the cost to repair known defects or failures.

Relating the House Inspection Analogy to Financial Statement Auditing

Now that we have discussed some of the basic characteristics of house inspectors and their services, let's consider how these relate to financial statement auditors. As noted previously, the demand for the assurance provided by a house inspector comes from information asymmetry and conflicts of interest between the buyer and the seller. Information asymmetry and conflicts of interest also exist between managers of companies and potential investors. For example, if managers are overly optimistic or if they wish to inflate their bonus compensation, they may unintentionally or intentionally overstate the company's earnings and assets (e.g., by understating the allowance for doubtful accounts or by claiming to have more cash than they really have). One important difference between our house inspector example and financial statement auditing is that the buyer of a home typically hires the inspector. In other words, the buyer identifies and hires the inspector rather than hiring someone that the seller recommends—presumably because by hiring an inspector directly, they increase the likelihood that the inspector will be objective and independent.

However, as was discussed previously, the companies selling stocks or bonds to the public typically hire and pay the auditor, rather than the other way around. To raise capital in the marketplace, companies often sell many small parcels of stocks and bonds to a large number of investors. Suppose a financial statement audit of a given company would cost $500,000. Under such circumstances, it obviously doesn't make sense for each individual investor to pay for an audit. Instead, the company hires and pays for the auditor because a reputable independent auditor's opinion can provide assurance to thousands of potential investors. In addition, recall from our previous discussion that the initial demand for auditing comes not from the principal but from the agent. By purchasing the assurance provided by an audit, the company can sell its stocks and bonds to prospective owners and creditors at more favorable prices, significantly reducing the cost of capital. In fact, studies indicate that audits save companies billions of dollars in costs of obtaining capital.

Given that the seller of stocks and bonds typically hires the auditor, consider just how crucial a strong reputation is to an independent auditor. Four large, international accounting firms dominate the audits of large publicly traded companies, auditing over 95 percent of the revenue produced by all such companies in the United States. One reason these firms dominate the audits of large companies is because they have well-known names and strong reputations. Entities who buy assurance from these firms know that potential investors and creditors will recognize the auditing firm's name and reputation and feel assured that they therefore face reduced information risk.

The fact that the entity being audited typically hires and pays the auditor also highlights just how important auditor objectivity and independence are to the investing public. In fact, Arthur Andersen, the once highly regarded member of the former "Big 5" international accounting firms, failed in 2002 at least in part because the firm lost its reputation as a high-quality, objective auditor whose opinion could be relied upon by investors and creditors. Later in the book we will discuss some changes enacted over the past several years to strengthen the independence of financial statement auditors, including prohibiting auditors from providing many kinds of consulting services to their public audit clients.

Management Assertions and Financial Statements

We've seen that home sellers make a number of different assertions about which a home buyer might want independent assurance. What assertions does a company that is selling its stocks or bonds make? Some of the most important assertions entities make to investors are implicit in the entities' financial statements. Immediately after this chapter you will find a set of financial statements for EarthWear, a hypothetical seller of high-quality outdoor clothing. We'll use EarthWear examples and exercises throughout the book to illustrate important audit concepts and techniques. Let's consider what assertions EarthWear makes to potential investors when it publishes its financial statements. For example, EarthWear lists the asset account "Cash" on its balance sheet and indicates that the account's year-end balance was $48.9 million.

Stop and Think: Consider for a moment what assertions the company is making about cash.

An obvious answer is that EarthWear's management is asserting that the cash is really there—that it "exists." They are also implicitly asserting that all the cash that the company owns is included in the records—in other words, the financial records are "complete" with respect to the company's cash. Finally, management is asserting that the cash amount is fairly and accurately recorded, and that no other parties have valid claims to the cash. Such assertions are implicit for each account in the financial statements.

Financial statement assertions are management's expressed or implied claims about information reflected in the financial statements. Assertions are central to auditing because they are the focus of the auditor's evidence collection efforts. In other words, much of what auditors do revolves around collecting and evaluating evidence about management's financial statement assertions.

One of the main tasks of the auditor is to collect sufficient appropriate evidence that management's assertions regarding the financial statements are correct. If you were to audit EarthWear, how would you go about collecting evidence for the cash account? The process is really quite logical and intuitive. First, you would carefully consider the most important assertions the company is making about the account, and then you would decide what evidence you would need to substantiate the truthfulness of each important assertion. For example, to ensure the cash exists, you might call the bank, examine bank statements, or send a letter to the bank requesting confirmation of the balance. To ensure the cash hasn't been pledged or restricted, you might review the minutes of key management meetings to look for discussions or agreements on this issue.

We will discuss management assertions in greater depth in Chapter 5, but for now take a look at Table 1–2, which lists all of the management assertions that auditors focus on in an audit. This presentation divides management assertions into three aspects of information reflected in the financial statements: transactions, account balances, and presentation and disclosure. For example, EarthWear's management asserts, among other things, that ***transactions*** relating to inventory actually *occurred*, that they are *complete* (i.e., no valid transactions were left out), that they are *classified* properly (e.g., as an asset rather than an expense), and that they are recorded *accurately* and in the *correct period*. Similarly, management asserts that the inventory represented in the inventory ***account balance*** *exists*, that the entity *owns* the inventory, that the balance is *complete*, and that the inventory is properly *valued*. Finally, management asserts that the financial statements properly ***present*** the inventory (e.g., inventory is appropriately listed as a current asset on the balance sheet) and that all required ***disclosures*** having to do with inventory (e.g., a footnote indicating that the company uses the FIFO inventory method) are *complete*, *accurate*, and *understandable*. Understanding the assertions in terms of transactions, account balances, and presentation and disclosure is helpful because the three categories help the auditor focus on the different types of audit procedures needed to test the assertions in the three different categories. Chapter 5 discusses the types of procedures available to the auditor in more detail.

TABLE 1–2 **Summary of Management Assertions by Category**

Assertions about classes of transactions and events for the period under audit:

- **Occurrence**—transactions and events that have been recorded have occurred and pertain to the entity.
- **Completeness**—all transactions and events that should have been recorded have been recorded.
- **Authorization**—all transactions and events have been properly authorized.*
- **Accuracy**—amounts and other data relating to recorded transactions and events have been recorded appropriately.
- **Cutoff**—transactions and events have been recorded in the correct accounting period.
- **Classification**—transactions and events have been recorded in the proper accounts.

Assertions about account balances at the period end:

- **Existence**—assets, liabilities, and equity interests exist.
- **Rights and obligations**—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- **Completeness**—all assets, liabilities, and equity interests that should have been recorded have been recorded.
- **Valuation and allocation**—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Assertions about presentation and disclosure:

- **Occurrence and rights and obligations**—disclosed events, transactions, and other matters have occurred and pertain to the entity.
- **Completeness**—all disclosures that should have been included in the financial statements have been included.
- **Classification and understandability**—financial information is appropriately presented and described, and disclosures are clearly expressed.
- **Accuracy and valuation**—financial and other information are disclosed fairly and at appropriate amounts.

*International and AICPA auditing standards consider Authorization to be a subset of the Occurrence assertion and thus do not list it separately. We list Authorization as a separate assertion about classes of transactions and events for instructional clarity.

Once you have finished auditing the important assertions relating to each account included in the company's financial statements, you will need to report your findings to the company's shareholders and to the investing public because EarthWear is publicly traded.

Now, instead of EarthWear's auditor, imagine you are a prospective investor in EarthWear. As an investor, would the reputation of the company's auditor matter to you? Would you want to know that the audit firm used a well-recognized audit approach to gather sufficient, appropriate evidence? What form of report would you expect? What if the lead partner on the audit were a close relative of EarthWear's president? Considering these questions makes it easy to see that the desired characteristics of auditors and audit services are similar to those relating to house inspectors and house inspection services.

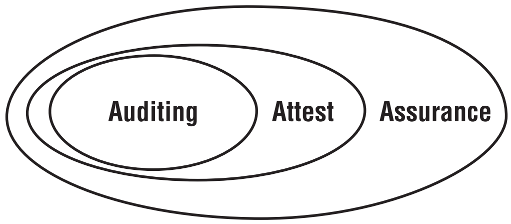
We hope the analogy of house inspectors and auditors as assurance providers has helped you understand the basic intuition behind the necessary characteristics of auditors and auditing and why auditing is in demand, even when it is not required by law. We will refer back to this analogy occasionally throughout the book to remind you of this basic intuition. As you study this book, we encourage you to keep in mind how what you are learning relates to important characteristics of auditors and home inspectors and the services they offer. Keep the big picture in mind!

Auditing, Attest, and Assurance Services Defined

LO 1-3

Accounting professionals provide three overlapping categories of services that are intended to provide assurance about information provided by one party to another: auditing, attest, and assurance services. Many times these terms are used interchangeably because they are related, and, at a general level, they encompass the same process: *the evaluation of evidence to determine whether information has been recorded and presented in accordance with a predetermined set of criteria, together with the issuance of a report that indicates the degree of correspondence.*

FIGURE 1–2 The Relationship among Auditing, Attest, and Assurance Services



As Figure 1–2 indicates, the broadest category is that of assurance services. Attest services are a subset of the broader set of assurance services, and, in turn, auditing services are a specialized type of attest service. In other words, a financial statement audit is one particular type of attest service and an attest service is a particular type of assurance service. We'll discuss each category in turn, from narrowest to broadest.

Auditing

LO 1-4 Consider the following definition of auditing:

> **Auditing** 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.[5]

A number of phrases in this definition deserve attention. The phrase "systematic process" implies that there should be a well-planned and thorough approach for conducting an audit. This approach entails "objectively obtaining and evaluating evidence." In other words, the auditor must *objectively search for* and *evaluate* the relevance and validity of evidence. The type, quantity, and reliability of evidence will vary between audits, but the process of obtaining and evaluating evidence makes up most of the auditor's activities on any audit.

As our analogy between house inspection and auditing illustrates, the evidence gathered by the auditor must relate to "assertions about economic actions and events." The auditor compares the evidence gathered to management's financial statement assertions in order to assess "the degree of correspondence between those assertions and established criteria." While different types of "criteria" might be available in various settings, generally accepted accounting principles usually serve as the basis for evaluating management's assertions in the context of a financial statement audit.

The last important phrase in the definition, "communicating the results to interested users," relates to the report the auditor provides to the intended users of the reported information. The communication will vary depending on the type and purpose of the audit, and the nature of the auditor's findings. In the case of financial statement audits, very specific types of reports are prescribed by auditing standards to communicate the auditor's findings. We briefly introduce audit reports later in this chapter.

Attestation

Auditors have a reputation for independence and objectivity. As a result, it was common for various parties to request that auditors attest to information beyond

[5]American Accounting Association, Committee on Basic Auditing Concepts, "A Statement of Basic Auditing Concepts" (Sarasota, FL: AAA, 1973).

historical financial information. However, professional standards did not allow for such services until the profession established a separate set of attestation standards in 1986. These standards provide the following definition for attest services:

> **Attest services** occur when a practitioner is engaged to issue . . . a report on subject matter, or an assertion about subject matter, that is the responsibility of another party.

This definition is broader than the one previously discussed for auditing because it is not limited to economic events or actions. The subject matter of attest services can take many forms, including prospective information, analyses, systems and processes, and even the actions of specified parties. Note that financial statement auditing is a specialized form of an attest service.

Assurance

In the late 1990s, the accounting profession expanded the potential breadth of auditors' activities beyond auditing and attest services to include *assurance services.* Extending auditors' activities to assurance services allows reporting not only on the reliability and credibility of information but also on the *relevance* and *timeliness* of that information. Assurance services are defined as follows:

> **Assurance services** are independent professional services that improve the quality of information, or its context, for decision makers.

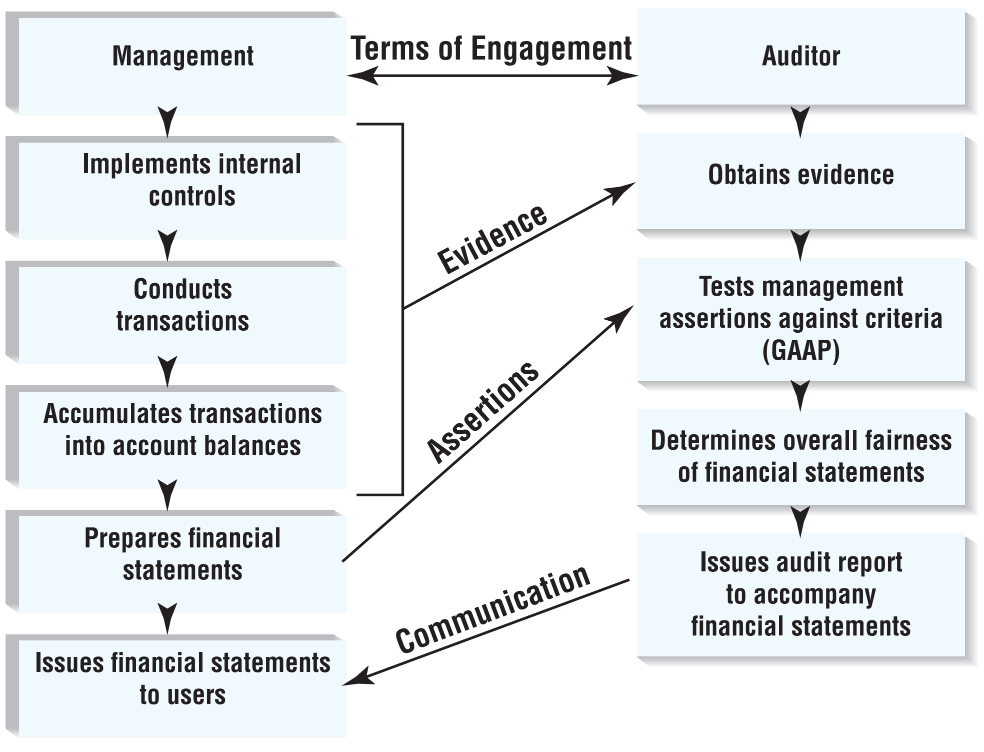
This definition captures a number of important concepts. First, the definition focuses on decision making. Making good decisions requires quality information, which, in the context of the broad set of assurances services, can be financial or nonfinancial. Second, it relates to improving the quality of information or its context. An assurance service engagement can improve quality through increasing confidence in the information's reliability and relevance. Context can be improved by clarifying the format and background with which the information is presented. Third, the definition includes independence, which relates to the objectivity of the service provider. Last, the definition includes the phrase "*professional services,*" which implies the application of professional judgment and due care by the provider. To summarize, assurance services can include almost any service provided by accounting professionals that involves capturing information, improving its quality, or enhancing its usefulness for decision makers.

This text focuses primarily on financial statement auditing because it represents the major type of assurance service offered by most public accounting firms. In addition, in many instances, the approach, concepts, methods, and techniques used for financial statement audits also apply to other attest and assurance service engagements. While this text focuses primarily on financial statement auditing, Chapters 2 and 21 describe various examples of audit, attest, and assurance services commonly offered by auditors, including *internal auditors* who are often directly employed by the company for which they provide services.

Fundamental Concepts in Conducting a Financial Statement Audit

LO 1-5 Figure 1–3 presents a simplified overview of the process for a financial statement audit. Take a moment to think through the steps in this figure. The auditor gathers evidence about the business transactions that have occurred and about the account balances into which the transactions have been accumulated. The auditor uses this evidence to compare the assertions contained in the financial statements to the criteria used by management in preparing them (i.e., GAAP). The auditor's report

FIGURE 1–3 An Overview of the Financial Statement Audit Process



communicates to the user the degree of correspondence between the assertions and the criteria. Be sure you understand Figure 1–3 before you continue reading! Understanding these concepts at an intuitive level will help you understand the fundamental concepts underlying a financial statement audit.

The conceptual and procedural details of a financial statement audit build on three fundamental concepts: materiality, audit risk, and evidence relating to management's financial statement assertions. The auditor's assessments of audit risk and materiality influence the nature, timing, and extent of the audit evidence to be gathered. This section briefly discusses the concepts of materiality, audit risk, and audit evidence. Chapters 3 through 5 cover each of these concepts in greater depth, but your study of those chapters will be easier and more effective if you take the time now to understand materiality, audit risk, and audit evidence at a general level.

Materiality

Materiality refers to the amount by which a set of financial statements could be misstated without affecting the judgment of reasonable people. For example, suppose a company's earnings per share (EPS) is $4.50 but due to an unintentional error the company mistakenly reports EPS of $4.52. This very small difference is unlikely to affect an investor's decisions in any significant way—in other words, the auditor will likely consider the difference to be *immaterial*.

One of the auditor's first tasks in planning an audit is to make a judgment about just how big a misstatement would have to be before it would significantly affect users' judgments. The concept of materiality is important because it just isn't practical or cost beneficial for auditors to ensure that financial statements are completely free of small misstatements.

The Financial Accounting Standards Board has provided the following definition of materiality:

> Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity.[6]

The focus of this definition is on the users of the financial statements. In planning the engagement, the auditor assesses the magnitude of a misstatement that may affect the users' decisions. This assessment helps the auditor determine the nature, timing, and extent of audit procedures. Let's relate the concept of materiality to our house inspector analogy—we would not be willing to pay a house inspector to validate the remaining life on lightbulbs or thoroughly test every cabinet hinge. These items are not critical to the buyer's decision.

While other factors must be considered in determining materiality, a common rule of thumb is that total (aggregated) misstatements of more than about 3 to 5 percent of income before tax would cause the financial statements to be materially misstated. Suppose the auditor decides that the financial statements of a client would be materially misstated if total misstatements exceed $400,000. The auditor would design audit procedures precise enough to detect misstatements that, either by themselves or in combination with other misstatements, might exceed the materiality threshold of $400,000. When testing is complete for all accounts, the auditor will evaluate the audit results and ask the company to adjust its financial records for identified misstatements. The auditor will issue a clean audit opinion if the unadjusted misstatements in all the accounts add up to less than overall materiality of $400,000. Thus, a clean audit report expresses the auditor's opinion that the financial statements are not *materially* misstated.

As we shall see later in this chapter, the wording of the standard auditor's report indicates that the financial statements "present fairly *in all material respects . . .*" This is the manner in which the auditor communicates the notion of materiality to the users of the auditor's report. As we will explain in connection with the concept of audit risk, there can be no guarantee that the auditor will uncover *all* material misstatements. In fact, the auditor provides no assurance that *immaterial* misstatements will be detected.

Audit Risk

The second major concept involved in auditing is *audit risk*, which is the risk that the auditor may unknowingly give a "clean" opinion on financial statements that are materially misstated.

> **Audit risk** is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.[7]

The auditor's standard report states that the audit provides only reasonable assurance that the financial statements do not contain material misstatements. The phrase "*reasonable assurance*" implies some risk that a material misstatement could be present in the financial statements and the auditor will fail to detect it. The auditor plans and conducts the audit to achieve an acceptably low level of audit risk. The auditor controls the level of audit risk through the effectiveness and extent of the audit work conducted. The more effective and extensive the audit work, the lower the risk that a misstatement will go undetected and that the auditor will issue an inappropriate report. However, the concept of reasonable assurance means that an auditor could conduct an audit in accordance with professional auditing standards and issue a clean

[6]Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 8, Chapter 3: "Qualitative Characteristics of Useful Accounting Information."

[7]AU 320, Materiality in Planning and Performing an Audit.

opinion, and the financial statements might still contain material misstatements. A house inspector cannot absolutely guarantee the absence of problems without taking apart a house board by board, which of course is highly impractical. Similarly, due to cost considerations and the sheer impossibility of investigating every item reflected in an entity's financial statements, the risk that an auditor will mistakenly issue a clean opinion on financial statements that are materially misstated cannot be driven to zero. Even careful and competent auditors can only offer reasonable, rather than absolute, assurance.

Audit Evidence Regarding Management Assertions

The third major concept involved in auditing is *evidence regarding management's assertions*, or, more simply, *audit evidence*. Most of the auditor's work in arriving at an opinion on the financial statements consists of obtaining and evaluating audit evidence relating to management's assertions. Audit evidence consists of the underlying accounting data and any additional information available to the auditor, whether originating from the client or externally.

As illustrated earlier in our discussion about EarthWear, management's assertions are used as a framework to guide the collection of audit evidence. The assertions, in conjunction with the assessment of materiality and audit risk, are used by the auditor to determine the nature, timing, and extent of evidence to be gathered. Once the auditor has obtained sufficient appropriate evidence that the management assertions can be relied upon for each significant account and disclosure, the auditor has reasonable assurance that the financial statements are fairly presented. Note the two key descriptors of audit evidence: *sufficient* and *appropriate*.

The *sufficiency* of audit evidence simply refers to the quantity of evidence the auditor obtains—does the auditor have enough evidence to justify a conclusion as to whether management's assertions are fairly stated? The *appropriateness* of audit evidence refers to whether the evidence is relevant and reliable. *Relevance* refers to whether the evidence relates to the specific management assertion being tested. *Reliability* refers to the diagnosticity of the evidence. In other words, can a particular type of evidence be relied upon to signal the true state of the account balance or assertion being examined? Using the house inspection example, inspecting the foundation of a house would not give us relevant evidence about whether the roof leaks. Likewise, the seller's opinion of the home's roof would not be as reliable as that of the inspector, because the seller has an incentive to deceive the buyer.

While the auditor has a professional responsibility to obtain "sufficient appropriate evidence," the auditor seldom has the luxury of obtaining completely convincing evidence about the true state of a particular management assertion. In most situations, the auditor is able to obtain only persuasive evidence that the assertion is fairly stated.

Sampling: Inferences Based on Limited Observations

LO 1-6

You might ask why the auditor relies on concepts such as materiality and audit risk in designing an audit. Why not test all transactions that occurred during the period so that audit risk can be driven to zero, even for immaterial misstatements? The main reason is the cost and feasibility of such an audit. In a very small business, the auditor might be able to examine all transactions that occurred during the period and all the accounts that exist at the end of the period and still issue the audit report in a reasonable amount of time. However, it is unlikely that the owner of the business could afford to pay for such an extensive audit. For a large organization, the sheer volume of transactions, which might well reach into the millions, prevents the auditor from examining every transaction. Similarly, ending account balances can reflect millions of individual items (e.g., individual inventory items making up the ending inventory account). Thus, just as with a house inspection, there is a trade-off between the exactness or precision of the audit and its cost.

To deal with the problem of not being able to examine every transaction and account, the auditor selects a subset of transactions and accounts to examine. Many times the auditor, based on previous audits, understanding of the client's internal control system, or knowledge of the client's industry, is aware of items in an account balance that are more likely to contain misstatements. For example, the auditor's prior knowledge may indicate that individual accounts receivable involving certain types of customers are more likely to contain misstatements. The auditor can use this knowledge to specifically select those particular accounts receivable for examination. When the auditor has no special knowledge about which particular transactions or items may be misstated, he or she uses random sampling procedures that increase the likelihood of obtaining a sample that is *representative* of the population of transactions or account items. In such cases, the auditor uses the laws of probability to make inferences about potential misstatements based on examining a sample of transactions or items.

The size of the subset of items the auditor examines is primarily a function of materiality and the desired level of assurance for the account or assertion being examined. There is an *inverse* relation between sample size and materiality, and a direct relation between sample size and desired level of assurance. For example, if an auditor assesses materiality for an account to be a small amount, a larger sample will be needed than if materiality were a larger amount. This occurs because the auditor must gather more evidence (a larger sample) to have a reasonable likelihood of detecting smaller errors. You can think of materiality as the "fineness of the auditor's filter." A lower materiality amount requires the auditor to use a finer filter in order to detect smaller errors, and it takes more work to create a finer filter. Similarly, as the desired level of assurance increases for a given materiality amount, the sample size necessary to test an assertion becomes greater.

The Audit Process

LO 1-7 Now that we have explained some of the fundamental concepts of auditing, this section provides an overview of the logical thought processes underlying a financial statement audit and then presents the major phases of an audit. A thorough understanding of this section will be a great help to you in understanding subsequent chapters!

Overview of the Financial Statement Auditing Process

Consider the auditor's task from a logical perspective. The end product of a financial statement auditor's work is an audit opinion indicating whether or not the client's financial statements are free of material misstatement. What might an auditor do to obtain the information needed to develop and support that opinion? The auditor must first obtain a thorough understanding of the client, its business, and its industry. The auditor must understand the risks the client faces, how it deals with those risks, and what remaining risks are most likely to result in a material misstatement in the financial statements. Armed with this understanding, the auditor plans procedures that will produce evidence helpful in developing and supporting his or her opinion on the financial statements.

To understand this process intuitively, consider what financial statements are made of. From your financial accounting courses, you know that accounting systems capture, record, and summarize individual transactions. Entities must design and implement controls to ensure that those transactions are initiated, captured, recorded, and summarized appropriately. These individual transactions are grouped and summarized into various account balances, and finally, financial statements are formed by organizing meaningful collections of those account balances. We have just identified three stages in the accounting process that take place in the preparation of financial statements: *internal controls* are implemented to ensure appropriate capturing and recording of *individual transactions,* which are then collected into ending *account balances*. This summary might seem like an oversimplification, but it will help you understand the stages of a client's accounting process on which auditors focus to collect evidence.

Keep in mind that the auditor's job ultimately is to express an opinion on *whether the financial statements are fairly stated*. It makes sense, then, that the auditor can design procedures to collect *direct* information about the ending account balances that make up the financial statements. For example, an auditor might confirm the ending balance of the cash account by contacting the client's bank, or the auditor might verify the ending balance of the inventory account by physically examining individual inventory items that make up the ending balance. But remember—account balances are made up of *transactions* that occurred over the past year (or earlier). If the auditor designs procedures to test whether the transactions were captured and handled properly, the auditor can obtain *indirect* information about whether the ending account balances are likely to be fairly stated. This information is clearly one step removed from the ending account balances themselves. But we can even back up one more step. If the auditor designs procedures to test whether the entity's *internal control* over financial transactions is effective, the auditor can obtain additional indirect information regarding whether the account balances are fairly stated.

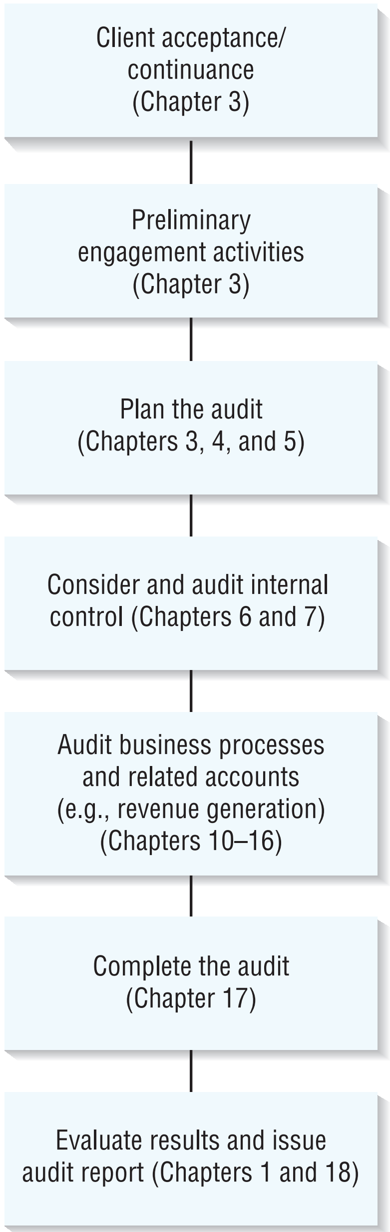
Carefully think through the logic in this last step: if controls are effective, then the transactions will probably be captured and summarized properly, which means in turn that the account balances are likely to be free of material misstatement. Thus, information about internal control is even more indirect than information about transactions, but it is useful information nonetheless! In fact, while it is indirect, evidence about internal control is often a relatively cost-effective form of audit evidence.

To summarize, the auditor can collect evidence in each of three different stages in a client's accounting system to help determine whether the financial statements are fairly stated: (1) the *internal control* put in place by the client to ensure proper handling of transactions (e.g., evaluate and test the controls); (2) the *transactions* that affect each account balance (e.g., examine a sample of the transactions that happened during the period); and (3) the ending *account balances* themselves (e.g., examine a sample of the items that make up an ending account balance at year-end). Evidence that relates directly to ending account balances is usually the highest quality, but also the costliest, evidence. Thus, an auditor will usually rely on a combination of evidence from all three stages in forming an audit opinion regarding the fairness of the financial statements. On which of these three areas it is best to focus depends on the circumstances, and this is generally left to the auditor's discretion. Chapters 3 and 5 address the types of procedures and types of evidence available to the auditor in more detail.

Major Phases of the Audit

The audit process can be broken down into a number of audit phases (see Figure 1–4). While the figure suggests that these phases are sequential, they are actually quite iterative and interrelated in nature. Phases often include audit procedures designed for one purpose that provide evidence for other purposes, and sometimes audit procedures accomplish purposes in more than one phase. Figure 1–4 shows the specific chapters where each of these phases is discussed in detail.

FIGURE 1–4 Major Phases of an Audit



Client Acceptance/Continuance Professional standards require that public accounting firms establish policies and procedures for deciding whether to accept new clients and to retain current clients. The purpose of such policies is to minimize the likelihood that an auditor will be associated with clients who lack integrity. If an auditor is associated with a client who lacks integrity, the risk increases that material misstatements may exist and not be detected by the auditor. For a prospective new client, the auditor is required to confer with the predecessor auditor and the auditor frequently conducts background checks on top management. The knowledge that the auditor gathers during the acceptance/continuance process provides valuable understanding of the entity and its environment, thus helping the auditor assess risk and plan the audit.

Preliminary Engagement Activities There are generally three preliminary engagement activities: (1) determine the audit engagement team requirements; (2) ensure the independence of the audit team and audit firm; and (3) establish an understanding with the client regarding the services to be performed and the other terms of the engagement.

Once the decision has been made to accept an audit engagement, the auditor begins preliminary engagement activies by updating his or her understanding of the entity and its environment. This understanding includes the nature of the entity and the industry in which it operates, how it measures its own performance, and the quality of its internal control. The auditor's understanding of the entity and its environment helps in assessing the risk of material misstatement and in setting the scope of the audit.

The engagement partner or manager forms an audit team composed of members who have the appropriate audit and industry experience for the engagement, determines whether specialists (e.g., tax specialists) are needed, and makes sure that the audit firm and individual team members are free from prohibited relationships that might threaten the auditor's objectivity.

Finally, the auditor establishes an understanding with the client regarding the services to be performed and the terms of the engagement, including such considerations as timing of the audit and expected audit fees. Chapter 3 addresses the preliminary engagement activities of the audit process in more detail.

Plan the Audit Proper planning is important to ensure that the audit is conducted in an effective and efficient manner. In order to plan the audit properly, the audit team must make a preliminary assessment of the client's business risks and determine materiality. The audit team relies on these judgments to then assess risk relating to the likelihood of material misstatements in the financial statements. Audit planning should take into account the auditor's understanding of the entity's internal control system (discussed next). This assessment of internal control will be in greater depth if the client is a public company, because for public companies the auditor is required to report on both the company's internal control over financial reporting and the company's financial statements. The outcome of the auditor's planning process is a written audit plan that sets forth the nature, extent, and timing of the audit work. Chapters 3, 4, and 5 cover the issues that are involved in this phase of the audit.

Consider and Audit Internal Control A company's system of internal control is put in place by the company's board of directors and management to help the company achieve reliable financial reporting, effective and efficient operations, and consistent compliance with applicable laws and regulations. The quality of a company's internal control over financial reporting is of direct relevance to auditors. As part of obtaining an understanding of the entity and its environment, the auditor obtains an understanding of internal control to help the auditor assess risk and identify areas where financial statements might be misstated. Chapter 6 covers the role of internal control in a financial statement audit, and Chapter 7 specifically addresses the audit of internal control for public companies. Later chapters apply the process of considering and auditing internal control in the context of various business processes.

Audit Business Processes and Related Accounts Auditors usually organize audits by grouping financial statement accounts according to the business processes that primarily affect those accounts. For example, sales revenue and accounts receivable are both part of a company's sales and collection process and are audited together. The auditor applies audit procedures to the accounts in order to obtain audit evidence about management's assertions relating to each account and reduce the risk of undetected material misstatement to an appropriately low level. On most engagements, actually conducting the planned audit tests comprises most of the time spent on a financial statement audit or an audit of internal control over financial reporting. For public company clients, the audit of internal control is done in an integrated way with the financial statement audit. This topic is addressed in Chapter 7 and throughout the book where appropriate.

Complete the Audit The auditor must obtain sufficient appropriate evidence in order to reach and justify a conclusion on the fairness of the financial statements. After the auditor has finished gathering reliable evidence relating to management's financial statement assertions, the auditor assesses the sufficiency of the evidence and obtains additional evidence where deemed necessary. In this phase, the auditor also addresses a number of issues, including the possibility of undisclosed contingent liabilities, such as lawsuits, and searches for any events subsequent to the balance sheet date that may impact the financial statements. Chapter 17 discusses the completion phase of the audit in detail.

LO 1-8

Evaluate Results and Issue Audit Report The final phase in the audit process is to evaluate results and choose the appropriate audit report to issue. The auditor's report, also known as the audit opinion, is the main product or output of the audit. Just as the report of a house inspector communicates the inspector's findings to a prospective buyer, the audit report communicates the auditor's findings to the users of the financial statements.

After completion of the audit work, the auditor determines if the preliminary assessments of risks were appropriate in light of the evidence collected and whether sufficient evidence was obtained. The auditor then aggregates the total uncorrected misstatements that were detected and determines if they cause the financial statements to be materially misstated. If the uncorrected misstatements are judged to be material, the auditor will request that the client correct the misstatements. If the client refuses, the auditor issues an opinion that clearly indicates that the financial statements are materially misstated and explains the nature of the misstatement. If the uncorrected misstatements are insignificant enough that they do not cause the financial statements to be materially misstated, or if the client is willing to correct the misstatements, the auditor issues an unqualified (i.e., "clean") report.

The Unqualified/Unmodified Audit Report

The unqualified audit report is by far the most common type of report issued.[8] In this context, *unqualified* means that, because the financial statements are free of material misstatements, the auditor does not find it necessary to *qualify* his or her opinion about the fairness of the financial statements. While it is fairly common for the auditor to find misstatements needing correction, audit clients are almost always willing to make the adjustments necessary to receive a clean opinion. Exhibit 1–1 presents an audit report issued on EarthWear Clothier's financial statements. This report covers financial statements that include balance sheets for two years and statements of income, stockholders' equity, and cash flows for three years. The audit report presented in Exhibit 1–1 is the standard type of unqualified audit opinion issued for publicly traded companies.

Take a moment to read through the report. You will see that the title refers to the "Independent Registered Public Accounting Firm" issuing the audit report. The report is addressed to the individual or group that is the intended recipient of the report. The body of the report begins with an introductory paragraph indicating which financial statements are covered by the report, that the statements are the responsibility of management, and that the auditor has a responsibility to express an opinion.

[8]A "clean" audit report is referred to as "unqualifed" by PCAOB auditing standards and as "unmodified" by AICPA and international auditing standards. See Chapters 2 and 18.

EXHIBIT 1–1 The Auditor's Standard Unqualified Report—Comparative Financial Statements (with explanatory paragraph)

Title:	REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
Addressee:	*To the Stockholders of EarthWear Clothiers*
Introductory paragraph:	We have audited the consolidated balance sheets of EarthWear Clothiers as of December 31, 2013 and 2012, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2013. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.
Scope paragraph:	We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
Opinion paragraph:	In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2013 and 2012, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles.
Explanatory paragraph referring to the audit of internal control:	We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of EarthWear Clothiers' internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 15, 2014, expressed an unqualified opinion that EarthWear Clothiers maintained, in all material respects, effective internal control over financial reporting.
Name of auditor:	*Willis & Adams* *Boise, Idaho*
Date of report:	*February 15, 2014*

The second, or scope, paragraph communicates to the users, in very general terms, what an audit entails. In addition to indicating that the audit was conducted in accordance with applicable auditing standards, it emphasizes the fact that the audit provides only reasonable assurance that the financial statements contain no material misstatements. The scope paragraph also discloses that an audit involves an examination of evidence on a *test basis* (i.e., using samples rather than examining entire populations), an assessment of accounting principles used and significant estimates, and an overall evaluation of financial statement presentation. Finally, the scope paragraph expresses the auditor's judgment that the audit provides a reasonable basis for the opinion to be expressed in the report.

The third paragraph contains the auditor's opinion concerning the fairness of the financial statements based on the audit evidence. Note two important phrases contained in this paragraph. First, the phrase "present fairly . . . in conformity with U.S. generally accepted accounting principles" indicates the criteria against which the auditor assesses management assertions. Second, the opinion paragraph contains the phrase "in all material respects," emphasizing the concept of materiality. Note that the scope paragraph indicates *how the audit was conducted*—in accordance with the standards of the PCAOB because EarthWear is a publicly traded company.

Audit reports for nonpublic companies refer instead to "generally accepted auditing standards."

The fourth paragraph contains explanatory language. As shown in Exhibit 1–1, when the auditor's opinion on a public company's financial statements is presented separately from the auditor's report on the client's internal control over financial reporting, as is the case here, the report must refer to the audit of internal control in an explanatory paragraph.

The financial statement audit report concludes with the manual or printed signature of the CPA firm providing the audit and with the date of the report. The audit report date indicates the last day of the auditor's responsibility for the review of significant events that have occurred after the date of the financial statements.

Other Types of Audit Reports

For an audit report to be unqualified, the audit must be done in accordance with applicable standards (e.g., the standards of the PCAOB), the auditor must be independent, there must be no significant limitations imposed on the auditor's procedures, and the client's financial statements must be free of material departures from GAAP. If any one of these conditions is not met, the auditor issues a report that appropriately conveys to the reader the nature of the report and the reasons why the report is not unqualified.

For example, suppose a client's financial statements contain a misstatement that the auditor considers material and the client refuses to correct the misstatement. The auditor will likely *qualify* the report, explaining that the financial statements are fairly stated *except for* the misstatement identified by the auditor. If the misstatement is considered so material that it pervasively affects the interpretation of the financial statements, the auditor will issue an *adverse* opinion, indicating that the financial statements are not fairly stated and should not be relied upon. Other types of reports are available to the auditor as well, depending on the circumstances. While it is important for you to be familiar with the basic components of the audit report as part of understanding an overview of the audit process, we cover the different types of financial statement audit reports in detail in Chapter 18. Our experience is that students find it more intuitive to learn the fundamental concepts of auditing and how an audit is conducted before being immersed in the details of audit reporting.

The audit report represents the culmination of the audit process and is the way the auditor communicates his or her opinion about a client's financial statements with outside parties. An example of an unqualified audit report is included in this chapter to give you a basic idea of what the most common type of audit report for a public company looks like and how auditors report their opinion to the public.

Conclusion

LO 1-9 You can see from this chapter that a good financial statement auditor needs to understand not only accounting but also the concepts and techniques of gathering and evaluating evidence to assess management's financial statement assertions. In addition, an auditor needs a deep understanding of business in general as well as of the specific industries in which his or her clients operate. This is why professionals with auditing experience frequently have attractive opportunities to move into other areas of business and management. Chief executive officers, business owners, chief financial officers, consultants, and controllers are often former auditors.

This chapter is designed to help you develop an intuitive understanding of basic auditing concepts. As you study auditing, you will need to commit some details to memory. But we can't emphasize this enough: *you will understand and appreciate the details of the auditing process much more fully if you make a serious effort to understand at an intuitive, common sense level why financial statement auditing is in demand, the fundamental concepts and logic underlying an audit, and the basic process by which it is carried out.*

Keep in mind that auditing is a fundamentally logical process of thinking and reasoning—don't be hesitant to exercise your common sense and reasoning skills! You will benefit much more from your reading of this text (and likely do better on exams) if you study it with a reasoning, inquisitive approach, rather than merely attempting to memorize details. As you learn new auditing concepts, take some time to understand the underlying logic and how the concepts interrelate with other concepts. As you learn about auditing procedures, ask yourself how and why the procedure might yield relevant evidence, and think of other ways you might obtain useful evidence. Rote memorization alone is not a good way to study auditing!

Being a good auditor sometimes requires imagination and innovation. For example, a few years back an auditor was faced with figuring out how to verify a client's assertion regarding the existence of inventory. The problem was that the "inventory" consisted of thousands of head of cattle on a ranch covering dozens of square miles. There was no standard procedure manual for the auditor to refer to—he simply had to figure out an effective and efficient way to obtain persuasive evidence that the cattle existed in the numbers asserted by the ranch's management.

In the end, the auditor decided to charter a small airplane to fly over the ranch and systematically take photos—one per fifty square acres. The auditor was able to obtain a count of the cattle from the photos. He also evaluated veterinary records to see if the number of required annual vaccinations approximated the number of cattle counted in the photos. Finally, he did some calculations based on average bovine birth and death rates, taking into account recorded purchases and sales of livestock during the year. Using this combination of procedures, the auditor was able to obtain persuasive evidence supporting management's assertion regarding inventory (and got an airplane ride in the process).

We hope this example helps illustrate why you will need to approach the study of auditing differently from that of most other accounting courses, and how learning auditing concepts can benefit you even if you do not plan to become a financial statement auditor. We can promise you this—in learning the concepts and techniques of auditing, you will not only acquire the tools to become an effective financial statement auditor, you will also learn new ways of reasoning and analyzing that will be highly useful to you in many different contexts and settings.

KEY TERMS

Assurance services. Independent professional services that improve the quality of information, or its context, for decision makers. Encompasses attest services and financial statement audits.

Attest. A service when a practitioner is engaged to issue or does issue a report on subject matter, or an assertion about subject matter, that is the responsibility of another party. Encompasses financial statement audits.

Audit evidence. All the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence includes the information contained in the accounting records underlying the financial statements, as well as other information.

Audit risk. The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Auditing. A systematic process of (1) 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 (2) communicating the results to interested users.

Financial statement assertions. Expressed or implied representations by management that are reflected in the financial statement components.

Information asymmetry. The concept that the manager generally has more information about the true financial position and results of operations of the entity than the absentee owner does.

Materiality. The maximum amount by which the auditor believes the financial statements could be misstated and still not affect the decisions of users.

Misstatement. An instance where a financial statement assertion is not in accordance with the criteria against which it is audited (e.g., GAAP). Misstatements may be classified as fraud (intentional), other illegal acts such as noncompliance with laws and regulations (intentional or unintentional), and errors (unintentional).

Reasonable assurance. The concept that an audit done in accordance with auditing standards may fail to detect a material misstatement in a client's financial statements. In an auditing context this term has been defined to mean a high but not absolute level of assurance.

Reporting. The end product of the auditor's work, indicating the auditing standards followed and expressing an opinion as to whether an entity's financial statements are fairly presented in accordance with agreed-upon criteria (e.g., GAAP).

Risk of material misstatement. The preaudit risk that the entity's financial statements contain a material misstatement whether caused by error or fraud.

Unqualified/unmodified audit report. A "clean" audit report, indicating the auditor's opinion that a client's financial statements are fairly presented in accordance with agreed-upon criteria (e.g., GAAP).

www.mhhe.com/messier9e	Visit the book's Online Learning Center for a multiple-choice quiz that will allow you to assess your understanding of chapter concepts.

REVIEW QUESTIONS

LO 1-1 1-1 Why is studying auditing different from studying other accounting topics? How might understanding auditing concepts prove useful for consultants, business managers, and other business decision makers?

LO 1-2 1-2 Discuss why there is a demand for auditing services in a free-market economy. What evidence suggests that auditing would be demanded even if it were not required by government regulation?

LO 1-2 1-3 What is meant by the statement "The agency relationship between absentee owners and managers produces a natural conflict of interest"?

LO 1-2 1-4 Why is independence such an important requirement for auditors? How does independence relate to the agency relationship between owners and managers?

LO 1-3, 1-4 1-5 Define *auditing*, *attest*, and *assurance services.*

LO 1-4 1-6 The Committee on Basic Auditing Concepts has provided a widely cited definition of auditing. What does the phrase "systematic process" mean in this definition?

LO 1-5 1-7 Define *audit risk* and *materiality*. How are these concepts reflected in the auditor's report?

LO 1-6 1-8 Briefly describe why on most audit engagements an auditor tests only a sample of transactions that occurred.

LO 1-7 1-9 What are the major phases of an audit?

LO 1-7 1-10 What are the primary elements involved in the planning phase of an audit?

LO 1-8 1-11 Identify the four paragraphs of the auditor's standard unqualified report for a public company client.

LO 1-9 1-12 Briefly discuss why auditors must often exercise creativity and innovation in auditing financial statements. Give an example different from the one offered in the text.

MULTIPLE-CHOICE QUESTIONS

All applicable questions are available with McGraw-Hill's *Connect® Accounting*.

LO 1-2, 1-4 1-13 An independent audit aids in the communication of economic data because the audit
a. Confirms the exact accuracy of management's financial representations.
b. Lends credibility to the financial statements.
c. Guarantees that financial data are fairly presented.
d. Assures the readers of financial statements that any fraudulent activity has been corrected.

LO 1-2, 1-4 1-14 Which of the following best describes the reason why an independent auditor is often retained to report on financial statements?
a. Management fraud may exist, and it is more likely to be detected by independent auditors than by internal auditors.
b. Different interests may exist between the entity preparing the statements and the persons using the statements, and thus outside assurance is needed to enhance the credibility of the statements.
c. A misstatement of account balances may exist, and all misstatements are generally corrected as a result of the independent auditor's work.
d. An entity may have a poorly designed internal control system.

LO 1-3 1-15 Which of the following best describes relationships among auditing, attest, and assurance services?
a. Attest is a type of auditing service.
b. Auditing and attest services represent two distinctly different types of services—there is no overlap.
c. Auditing is a type of assurance service.
d. Assurance is a type of attest service.

LO 1-3 1-16 Which of the following statements relating to attest and assurance services is not correct?
a. Independence is an important attribute of assurance service providers.
b. Assurance services can be performed to improve the quality or context of information for decision makers.
c. Financial statement auditing is a form of attest service but it is not an assurance service.
d. In performing an attest service, the CPA determines the correspondence of the subject matter (or an assertion about the subject matter) against criteria that are suitable and available to users.

LO 1-5, 1-7 1-17 For what primary purpose does the auditor obtain an understanding of the entity and its environment?
a. To determine the audit fee.
b. To decide which facts about the entity to include in the audit report.
c. To plan the audit and determine the nature, timing, and extent of audit procedures to be performed.
d. To limit audit risk to an appropriately high level.

LO 1-5 1-18 Which of the following statements best describes the role of materiality in a financial statement audit?
- a. *Materiality* refers to the "material" from which audit evidence is developed.
- b. The higher the level at which the auditor assesses materiality, the greater the amount of evidence the auditor must gather.
- c. The lower the level at which the auditor assesses materiality, the greater the amount of evidence the auditor must gather.
- d. The level of materiality has no bearing on the amount of evidence the auditor must gather.

LO 1-7 1-19 Which of the following is the most important reason for an auditor to gain an understanding of an audit client's system of internal control over financial reporting?
- a. Understanding a client's system of internal control can help the auditor assess risk and identify areas where financial statement misstatements might be more likely.
- b. Understanding a client's system of internal control can help the auditor make valuable recommendations to management at the end of the engagement.
- c. Understanding a client's system of internal control can help the auditor sell consulting services to the client.
- d. Understanding a client's system of internal control is not a required part of the audit process.

LO 1-7 1-20 Preliminary engagement activities include
- a. Understanding the client and the client's industry.
- b. Determining audit engagement team requirements.
- c. Ensuring the independence of the audit team and audit firm.
- d. All of the above.

LO 1-8 1-21 Which of the following statements best describes what is meant by an unqualified audit opinion?
- a. Issuance of an unqualified auditor's report indicates that in the auditor's opinion the client's financial statements are not fairly enough presented in accordance with agreed-upon criteria to qualify for a clean opinion.
- b. Issuance of an unqualified auditor's report indicates that the auditor is not qualified to express an opinion that the client's financial statements are fairly presented in accordance with agreed-upon criteria.
- c. Issuance of an unqualified auditor's report indicates that the auditor is expressing different opinions on each of the basic financial statements regarding whether the client's financial statements are fairly presented in accordance with agreed-upon criteria.
- d. Issuance of a standard unqualified auditor's report indicates that in the auditor's opinion the client's financial statements are fairly presented in accordance with agreed-upon criteria, with no need for the inclusion of qualifying phrases.

LO 1-8 1-22 The auditing standards used to guide the conduct of the audit are
- a. Implicitly referred to in the opening paragraph of the auditor's standard report.
- b. Explicitly referred to in the opening paragraph of the auditor's standard report.
- c. Implicitly referred to in the scope paragraph of the auditor's standard report.
- d. Explicitly referred to in the scope paragraph of the auditor's standard report.

e. Implicitly referred to in the opinion paragraph of the auditor's standard report.
f. Explicitly referred to in the opinion paragraph of the auditor's standard report.

LO 1-8 1-23 A client has used an inappropriate method of accounting for its pension liability on the balance sheet. The resulting misstatement is material, but the auditor does not consider it to be pervasive. The auditor is unable to convince the client to alter its accounting treatment. The rest of the financial statements are fairly stated in the auditor's opinion. Which kind of audit report would an auditor most likely issue under these circumstances?
a. Standard unqualified opinion.
b. Qualified opinion due to departure from GAAP.
c. Adverse opinion.
d. No opinion at all.

PROBLEMS

All applicable problems are available with McGraw-Hill's *Connect*® *Accounting*.

connect ACCOUNTING

LO 1-1, 1-2 1-24 You recently attended your five-year college reunion. At the main reception, you encountered an old friend, Lee Beagle, who recently graduated from law school and is now practicing with a large law firm in town. When you told him that you are a CPA and employed by a regional CPA firm, he made the following statement: "You know, if the securities acts had not been passed by Congress in the 1930s, no one would be interested in having an audit performed."

Required:
Draft a memo that highlights your thoughts about Lee's statement that audits only take place because they are required by law.

LO 1-2 1-25 Greenbloom Garden Centers is a small, privately held corporation that has two stores in Orlando, Florida. The Greenbloom family owns 100 percent of the company's stock, and family members manage the operations. Sales at the company's stores have been growing rapidly, and there appears to be a market for the company's sales concept—providing bulk garden equipment and supplies at low prices. The controller prepares the company's financial statements, which are not audited. The company has no debt but is considering expanding to other cities in Florida. Such expansion may require long-term borrowings and is likely to reduce the family's day-to-day control of the operations. The family does not intend to sell stock in the company.

Required:
Discuss the factors that may make an audit necessary and potentially valuable for the company. Be sure to consider the concept of information risk.

LO 1-2, 1-4, 1-5 1-26 You were recently hired by the CPA firm of Honson & Hansen. Within two weeks, you were sent to the first-year staff training course. The instructor asks you to prepare answers for the following questions:
a. How is audit evidence defined?
b. How does audit evidence relate to assertions and to the audit report?
c. What characteristics of evidence should an auditor be concerned with when searching for and evaluating audit evidence?

LO 1-7 1-27 John Josephs, an audit manager for Tip, Acanoe & Tylerto, was asked to speak at a dinner meeting of the local Small Business Administration Association. The president of the association has suggested that he talk about the various phases of the audit process. John has asked you, his trusted assistant, to prepare an outline for his speech. He suggests that you answer the following:

a. List and describe the various phases of an audit.
b. Describe how audit procedures designed for one purpose might provide evidence for other purposes. Give an example.
c. One of the phases involves understanding an entity's internal control. Why might the members of the association be particularly interested in the work conducted by auditors in this phase of the audit?

LO 1-8 1-28 Many companies post their financial statements and auditor's report on their home pages, generally under a heading labeled "investor relations." Use one of the Internet search engines to do the following:

a. Visit Intel's (www.intel.com) and Microsoft's (www.microsoft.com) home pages and review their financial statements, including their auditors' reports.
b. Search the web for the home page of a non-U.S. company and review its financial statements, including its auditor's report. For example, BMW's home page (www.bmwgroup.com, under Investor Relations) allows a visitor to download the financial statements as a .pdf file. Identify the auditing standards followed by the company's auditors.
c. Compare the standard U.S. audit report with the audit report for the non-U.S. company (e.g., BMW). Note that in some cases, non-U.S.-based companies' reports use a U.S. audit report.
d. Visit the SEC's website (www.sec.gov), and find the link for EdgarScan. Find, download, and print the auditor's report for a U.S. company of your choice. Identify whether or not the audit report is an unqualified, or "clean," opinion and explain how you could tell.

LO 1-8 1-29 Using the audit report included in Chapter 1, identify and record the phrases or words that indicate to the users that the financial statements are not necessarily an "exact" representation of the results of operations and financial position of a company.

DISCUSSION CASE

LO 1-1, 1-2, 1-4, 1-5, 1-8, 1-9 1-30 The Government Accountability Office (GAO) gave the following results in a report based on an examination of 39 failed banks:[9]

> The early warning system provided by bank call reports* is seriously flawed. The 39 failed banks' call reports did not provide the regulators with advance warning of the true magnitude of the deterioration in the banks' financial condition. As a result of the asset valuations FDIC prepared after these banks failed, loss reserves increased from $2.1 billion to $9.4 billion. A major portion of the $7.3 billion deterioration in asset values was not previously reported because deficiencies in GAAP allowed bank management to unduly delay the recognition of losses and mask the need for early regulatory intervention that could have minimized losses to the Bank Insurance Fund.

[9]U.S. Government Accountability Office, *Failed Banks: Accounting and Auditing Reforms Urgently Needed* (GAO/AFMD-91-43) (April 1991).

*A call report is a Quarterly Consolidated Report of Condition and Income submitted by management to bank regulators. It consists of unaudited financial information that is required to be prepared in accordance with federal regulatory requirements, which are generally consistent with GAAP.

The key to successful bank regulation is knowing what banks are really worth. The 39 bank failures are expected to cost the fund $8.9 billion. Large banks present a major threat to the solvency of the Bank Insurance Fund and need closer scrutiny.

The corporate governance system upon which successful regulation depends is seriously flawed. Of the 39 banks, 33 had serious internal control problems that regulators cited as contributing significantly to their failure. Had these problems been corrected, the banks might not have failed or their failure could have been less expensive to the fund.

Many of the 39 failed banks did not obtain an independent audit in their last year prior to failure. Without an audit, a troubled institution's management can more easily conceal its financial difficulties.

Audits would enhance both the corporate governance and regulatory functions. In addition, the roles of both management and the auditors would be strengthened if they were required to assume responsibility for assessing and reporting on the condition of internal control, a significant cause of bank failures.

Required:
Describe in one or two concise, informative paragraphs how audits by external auditors could have prevented or limited the losses incurred by the Bank Insurance Fund.

INTERNET ASSIGNMENT

LO 1-1, 1-9 1-31 Using an Internet browser, identify five Internet sites that contain accounting or auditing resources. For each site identified, prepare a brief summary of the types of information that are available. For example, the PCAOB's home page (www.pcaobus.org) contains extensive information on the organization's activities (you may use the PCAOB site as one of the five). Your five summaries should not exceed a total of one typed page.

HANDS-ON CASES

EarthWear Online	**EarthWear Introduction** In this activity you will become further acquainted with EarthWear Clothiers and their auditors Willis and Adams. This introductory activity also provides an opportunity to become familiar with the structure and format of the EarthWear Online cases. *Visit the book's Online Learning Center at www.mhhe.com/messier9e to find a detailed description of the case and to download required materials.*

ACL

www.mhhe.com/messier9e	Visit the book's Online Learning Center for problem material to be completed using the *ACL* software packaged with your new text.