## CONTENTS

### Course Approach Suggestions

<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-Quarter Schedule</td>
<td>v</td>
</tr>
<tr>
<td>One-Semester Schedule</td>
<td>vi</td>
</tr>
<tr>
<td>One-Quarter Assignment Schedule</td>
<td>vii</td>
</tr>
<tr>
<td>One-Semester Assignment Schedule</td>
<td>viii</td>
</tr>
<tr>
<td>Assignment of Computer-Related Problems</td>
<td>x</td>
</tr>
<tr>
<td>Companion Website</td>
<td>xii</td>
</tr>
<tr>
<td>Chapter Opening Vignettes — Lessons from Practice</td>
<td>xiii</td>
</tr>
<tr>
<td>Use of ACL Software</td>
<td>xiii</td>
</tr>
<tr>
<td>Use of Systems Understanding Aid</td>
<td>xiii</td>
</tr>
<tr>
<td>Use of Integrated Audit Practice Case</td>
<td>xiv</td>
</tr>
<tr>
<td>Use of Auditing Cases</td>
<td>xiv</td>
</tr>
<tr>
<td>Suggested Term Projects</td>
<td>xiv</td>
</tr>
<tr>
<td>Summary of Additional, Changed, and Deleted Problem Material</td>
<td>xxiii</td>
</tr>
</tbody>
</table>

### CHAPTERS

#### I. THE AUDITING PROFESSION

1. The Demand for Audit and Other Assurance Services | 1-1
2. The CPA Profession | 2-1
3. Audit Reports | 3-1
4. Professional Ethics | 4-1
5. Legal Liability | 5-1

#### II. THE AUDIT PROCESS

6. Audit Responsibilities and Objectives | 6-1
7. Audit Evidence | 7-1
8. Audit Planning and Analytical Procedures | 8-1
9. Materiality and Risk | 9-1
10. Section 404 Audits of Internal Control and Control Risk | 10-1
11. Fraud Auditing | 11-1
12. The Impact of Information Technology on the Audit Process | 12-1
13. Overall Audit Plan and Audit Program | 13-1

#### III. APPLICATION OF THE AUDIT PROCESS TO THE SALES AND COLLECTION CYCLE

15. Auditing Sampling for Tests of Controls and Substantive Tests of Transactions | 15-1
16. Completing the Tests in the Sales and Collection Cycle: Accounts Receivable | 16-1
17. Audit Sampling for Tests of Details of Balances | 17-1

#### IV. APPLICATION OF THE AUDIT PROCESS TO OTHER CYCLES

18. Audit of the Acquisition and Payment Cycle: Tests of Controls, Substantive Tests of Transactions, and Accounts Payable | 18-1
19. Completing the Tests in the Acquisition and Payment Cycle: Verification of Selected Accounts | 19-1
20. Audit of the Payroll and Personnel Cycle | 20-1
21. Audit of the Inventory and Warehousing Cycle | 21-1
22. Audit of the Capital Acquisition and Repayment Cycle | 22-1
23. Audit of Cash Balances | 23-1

#### V. COMPLETING THE AUDIT

24. Completing the Audit | 24-1

#### VI. OTHER ASSURANCE AND NONASSURANCE SERVICES

25. Other Assurance Services | 25-1
26. Internal and Governmental Financial Auditing and Operational Auditing | 26-1
To download more slides, ebook, solutions and test bank, visit http://downloadslide.blogspot.com
Course Approach Suggestions

The purpose of the Instructor's Resource Manual is to help you teach auditing and other assurance services courses more efficiently. Naturally, we do not want to interfere with your present approach or imply that our suggestions are the only good alternatives.

This resource manual has several parts:

- Illustrative schedules for one-quarter and one-semester courses.
- Term projects we have successfully used.
- Chapter-by-chapter suggestions for teaching the content in each chapter.

The suggestions for each chapter include the following:

- Ideas we find useful in teaching introductory auditing.
- Homework problems we use most often.
- A matrix illustrating how learning objectives correlate with chapter problem material. The matrix for each chapter is designed to provide a one-page summary of this information in order to assist you in assigning problem material.
- Transparency masters containing ideas we like to emphasize in class. These are labeled with a "T" in the teaching notes for each chapter. The transparency masters are located in the back of this book and can also be downloaded from the Companion Website (www.pearsonhighered.com/aren).

Note that the Electronic Art Log on the Companion Website contains every table, graph, and piece of art from the textbook. You can use the items in the art log to create PowerPoint presentations or overhead transparencies of key figures, tables, and other art from the textbook.

The chapters are designed so that their arrangement and selection provides maximum flexibility in course design.

Suggested Syllabi

In this section, we provide a possible schedule for use in a one-quarter course and in a one-semester course. We also provide suggested problem assignments that could easily be presented in your syllabus.

Following these sample syllabi, we briefly overview other teaching materials that you might find helpful as you develop your plan for coverage of the course content.
### One-Quarter Schedule (assumes two seventy-five minute sessions per week)

<table>
<thead>
<tr>
<th>WEEK NO.</th>
<th>CONTENTS</th>
<th>CORRESPONDING CHAPTER IN TEXT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Introduction&lt;br&gt;The demand for audit and other assurance services&lt;br&gt;The CPA profession and global standards-setting&lt;br&gt;Overview of reporting</td>
<td>Chapter 1&lt;br&gt;Chapter 2&lt;br&gt;Chapter 3</td>
</tr>
<tr>
<td>2</td>
<td>Audit responsibilities and objectives&lt;br&gt;Audit evidence</td>
<td>Chapter 6&lt;br&gt;Chapter 7</td>
</tr>
<tr>
<td>3</td>
<td>Audit planning and analytical procedures&lt;br&gt;Materiality and risk</td>
<td>Chapter 8&lt;br&gt;Chapter 9</td>
</tr>
<tr>
<td>4</td>
<td>Sec. 404 audits of internal control and control risk&lt;br&gt;Fraud auditing</td>
<td>Chapter 10&lt;br&gt;Chapter 11</td>
</tr>
<tr>
<td>5</td>
<td>The impact of information technology on the audit process&lt;br&gt;Midterm examination</td>
<td>Chapter 12&lt;br&gt;Midterm</td>
</tr>
<tr>
<td>6</td>
<td>Overall audit plan and audit program&lt;br&gt;Audit of the sales and collection cycle: tests of controls and substantive tests of transactions</td>
<td>Chapter 13&lt;br&gt;Chapter 14</td>
</tr>
<tr>
<td>7</td>
<td>Accounts receivable: tests of details of balances&lt;br&gt;Audit sampling for tests of controls and substantive tests of transactions</td>
<td>Chapter 16&lt;br&gt;Chapter 15</td>
</tr>
<tr>
<td>8</td>
<td>Audit sampling for tests of controls and substantive tests of transactions (cont.)&lt;br&gt;Completing the audit</td>
<td>Chapter 15&lt;br&gt;Chapter 24</td>
</tr>
<tr>
<td>9</td>
<td>Audit reporting—other assurance reports&lt;br&gt;Professional ethics</td>
<td>Chapter 25&lt;br&gt;Chapter 4</td>
</tr>
<tr>
<td>10</td>
<td>Legal liability&lt;br&gt;Internal and governmental financial auditing and operational auditing</td>
<td>Chapter 5&lt;br&gt;Chapter 26</td>
</tr>
<tr>
<td>WEEK NO.</td>
<td>CONTENTS</td>
<td>CORRESPONDING CHAPTER IN TEXT</td>
</tr>
<tr>
<td>---------</td>
<td>--------------------------------------------------------------------------</td>
<td>-------------------------------</td>
</tr>
<tr>
<td>1</td>
<td>Introduction&lt;br&gt;The demand for audit and other assurance services&lt;br&gt;The CPA profession and global standards-setting&lt;br&gt;Overview of reporting</td>
<td>Chapter 1&lt;br&gt;Chapter 2&lt;br&gt;Chapter 3</td>
</tr>
<tr>
<td>2</td>
<td>Professional ethics&lt;br&gt;Legal liability</td>
<td>Chapter 4&lt;br&gt;Chapter 5</td>
</tr>
<tr>
<td>3</td>
<td>Audit responsibilities and objectives&lt;br&gt;Audit evidence</td>
<td>Chapter 6&lt;br&gt;Chapter 7</td>
</tr>
<tr>
<td>4</td>
<td>Audit planning and analytical procedures&lt;br&gt;Materiality and risk</td>
<td>Chapter 8&lt;br&gt;Chapter 9</td>
</tr>
<tr>
<td>5</td>
<td>Materiality and risk (cont.)&lt;br&gt;Midterm examination #1</td>
<td>Chapter 9&lt;br&gt;Midterm #1</td>
</tr>
<tr>
<td>6</td>
<td>Sec. 404 audits of internal control and control risk&lt;br&gt;Fraud auditing</td>
<td>Chapter 10&lt;br&gt;Chapter 11</td>
</tr>
<tr>
<td>7</td>
<td>The impact of information technology on the audit process&lt;br&gt;Overall audit plan and audit program</td>
<td>Chapter 12&lt;br&gt;Chapter 13</td>
</tr>
<tr>
<td>8</td>
<td>Audit of the sales and collection cycle: tests of controls and substantive tests of transactions&lt;br&gt;Accounts receivable: tests of details of balances</td>
<td>Chapter 14&lt;br&gt;Chapter 16</td>
</tr>
<tr>
<td>9</td>
<td>Audit sampling for tests of controls and substantive tests of transactions&lt;br&gt;Audit sampling for tests of details of balances</td>
<td>Chapter 15&lt;br&gt;Chapter 17</td>
</tr>
<tr>
<td>10</td>
<td>Audit sampling for tests of details of balances (cont.)&lt;br&gt;Midterm examination #2</td>
<td>Chapter 17&lt;br&gt;Midterm #2</td>
</tr>
<tr>
<td>11</td>
<td>Audit of the acquisition and payment cycle</td>
<td>Chapter 18&lt;br&gt;Chapter 19</td>
</tr>
<tr>
<td>12</td>
<td>Audit of cash balances&lt;br&gt;Completing the audit</td>
<td>Chapter 23&lt;br&gt;Chapter 24</td>
</tr>
<tr>
<td>13</td>
<td>Audit reporting-completion and other assurance services reports</td>
<td>Chapter 3&lt;br&gt;Chapter 25</td>
</tr>
<tr>
<td>14</td>
<td>Internal and governmental financial auditing and operational auditing</td>
<td>Chapter 26</td>
</tr>
</tbody>
</table>
## One-Quarter Assignment Schedule

<table>
<thead>
<tr>
<th>SESSION</th>
<th>SUBJECT</th>
<th>READING ASSIGNMENT (CHAPTER)</th>
<th>PROBLEM ASSIGNMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Introduction, audit and assurance services, and the CPA profession</td>
<td>1 and 2</td>
<td>1-17, 1-18, 2-22, Internet 2-1</td>
</tr>
<tr>
<td>2</td>
<td>Overview of reporting</td>
<td>3</td>
<td>3-29, 3-30, 3-33</td>
</tr>
<tr>
<td>3</td>
<td>Audit responsibilities and objectives</td>
<td>6</td>
<td>6-22, 6-24, 6-27, 6-30</td>
</tr>
<tr>
<td>4</td>
<td>Audit evidence</td>
<td>7</td>
<td>7-27, 7-28, 7-33, 7-40</td>
</tr>
<tr>
<td>5</td>
<td>Audit planning and analytical procedures</td>
<td>8</td>
<td>8-26, 8-32, 8-37, 8-39, 8-40, 8-41</td>
</tr>
<tr>
<td>6</td>
<td>Materiality and risk</td>
<td>9</td>
<td>9-25, 9-31, 9-34, 9-26, 9-36, 9-37</td>
</tr>
<tr>
<td>7</td>
<td>Sec. 404 audits of Internal control and control risk</td>
<td>10</td>
<td>10-36, 10-40, 10-43</td>
</tr>
<tr>
<td>8</td>
<td>Fraud auditing</td>
<td>11</td>
<td>11-23, 11-24, 11-28, 11-34</td>
</tr>
<tr>
<td>9</td>
<td>The impact of information technology on the audit process</td>
<td>12</td>
<td>12-21, 12-24, 12-29, 12-30, 12-31</td>
</tr>
<tr>
<td>10</td>
<td>Midterm</td>
<td>Midterm</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Overall audit plan and audit program</td>
<td>13</td>
<td>13-26, 13-30, 13-31, 13-32, 13-36</td>
</tr>
<tr>
<td>12</td>
<td>Audit of the sales and collection cycle: tests of controls and substantive tests of transactions</td>
<td>14</td>
<td>14-25, 14-32, 14-34, 14-35</td>
</tr>
<tr>
<td>13</td>
<td>Accounts receivable: tests of details of balances</td>
<td>16</td>
<td>16-23, 16-26, 16-27, 16-29, 16-35, 16-36</td>
</tr>
<tr>
<td>14</td>
<td>Audit sampling for tests of controls and substantive tests of transactions</td>
<td>15</td>
<td>15-28, 15-29, 15-34</td>
</tr>
<tr>
<td>15</td>
<td>Audit sampling for tests of controls and substantive tests of transactions (cont.)</td>
<td>15</td>
<td>15-35</td>
</tr>
<tr>
<td>16</td>
<td>Completing the audit</td>
<td>24</td>
<td>24-27, 24-28, 24-33</td>
</tr>
<tr>
<td>17</td>
<td>Audit reporting-completion</td>
<td>25</td>
<td>25-25, 25-26, 25-28</td>
</tr>
<tr>
<td>18</td>
<td>Professional ethics</td>
<td>4</td>
<td>4-21, 4-25, 4-26, 4-28</td>
</tr>
<tr>
<td>19</td>
<td>Legal liability</td>
<td>5</td>
<td>5-20, 5-24, 5-28</td>
</tr>
<tr>
<td>20</td>
<td>Internal and governmental financial auditing and operational auditing</td>
<td>26</td>
<td>26-23, 26-26</td>
</tr>
</tbody>
</table>
### One-Semester Assignment Schedule

<table>
<thead>
<tr>
<th>SESSION</th>
<th>SUBJECT</th>
<th>READING ASSIGNMENT (CHAPTER)</th>
<th>PROBLEM ASSIGNMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Introduction, audit and assurance services, and the CPA profession</td>
<td>1 and 2</td>
<td>1-17, 1-18, 2-22, 2-28, Internet 2-1</td>
</tr>
<tr>
<td>2</td>
<td>Overview of reporting</td>
<td>3</td>
<td>3-29, 3-30, 3-33</td>
</tr>
<tr>
<td>3</td>
<td>Professional ethics</td>
<td>4</td>
<td>4-21, 4-25, 4-26, 4-28</td>
</tr>
<tr>
<td>4</td>
<td>Legal liability</td>
<td>5</td>
<td>5-20, 5-24, 5-28</td>
</tr>
<tr>
<td>5</td>
<td>Audit responsibilities and objectives</td>
<td>6</td>
<td>6-22, 6-24, 6-27, 6-30</td>
</tr>
<tr>
<td>6</td>
<td>Audit evidence</td>
<td>7</td>
<td>7-27, 7-28, 7-33, 7-40</td>
</tr>
<tr>
<td>7</td>
<td>Audit planning and analytical procedures</td>
<td>8</td>
<td>8-26, 8-32, 8-37, 8-39, 8-40, 8-41</td>
</tr>
<tr>
<td>8</td>
<td>Materiality and risk</td>
<td>9</td>
<td>9-25, 9-31, 9-34</td>
</tr>
<tr>
<td>9</td>
<td>Materiality and risk (cont.)</td>
<td>9</td>
<td>9-26, 9-36, 9-37</td>
</tr>
<tr>
<td>10</td>
<td>Midterm #1</td>
<td>Midterm #1</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Sec. 404 audits of internal control and control risk</td>
<td>10</td>
<td>10-36, 10-40, 10-43</td>
</tr>
<tr>
<td>12</td>
<td>Fraud auditing</td>
<td>11</td>
<td>11-23, 11-24, 11-28, 11-34</td>
</tr>
<tr>
<td>13</td>
<td>The impact of information technology on the audit process</td>
<td>12</td>
<td>12-21, 12-24, 12-29, 12-30, 12-31</td>
</tr>
<tr>
<td>14</td>
<td>Overall audit plan and audit program</td>
<td>13</td>
<td>13-26, 13-30, 13-31, 13-32, 13-36</td>
</tr>
<tr>
<td>15</td>
<td>Audit of the sales and collection cycle: tests of controls and substantive tests of transactions</td>
<td>14</td>
<td>14-25, 14-32, 14-34, 14-35</td>
</tr>
<tr>
<td>16</td>
<td>Accounts receivable: tests of details of balances</td>
<td>16</td>
<td>16-23, 16-26, 16-27, 16-29, 16-35, 16-36</td>
</tr>
<tr>
<td>17</td>
<td>Audit sampling for tests of controls and substantive tests of transactions</td>
<td>15</td>
<td>15-28, 15-29, 15-34, 15-35</td>
</tr>
<tr>
<td>18</td>
<td>Audit sampling for tests of details of balances</td>
<td>17</td>
<td>17-28, 17-29, 17-30</td>
</tr>
<tr>
<td>19</td>
<td>Audit sampling for tests of details of balances (cont.)</td>
<td>17</td>
<td>17-31, 17-33</td>
</tr>
<tr>
<td>20</td>
<td>Midterm #2</td>
<td>Midterm #2</td>
<td></td>
</tr>
</tbody>
</table>
### Chapter Opening Vignettes – Lessons from Practice

Each chapter begins with a short vignette that is based on a realistic situation that auditors might expect to face in practice. In addition, each chapter contains several mid-chapter vignettes that highlight other real-world issues that relate to the chapter content, including recent events, news articles, fraud cases, or related thought papers and articles. Many of these opening and mid-chapter vignettes summarize actual company issues, while others highlight realistic judgments faced by auditors in practice.

We have used these vignettes in our own classrooms over the years. We have also shared them with others. One of our colleagues has used them as a "Lesson for the Day" for students. Each vignette illustrates the point implied by its title. Thus, they can be used by the instructor as pre-reading for discussion of a particular point or as short cases on a stand-alone basis. In any event, we believe they are interesting and add a flavor that does not otherwise exist in the traditional academic study of auditing, unless significant time is spent on longer case studies.

We suggest you review all 26 opening vignettes plus the shaded mid-chapter vignettes at the beginning of the course and decide which ones to use and how they can be used in your auditing class. A brief discussion of many of the vignettes appears in each chapter’s material in this resource guide. Several of them emphasize international issues.
End of Chapter Cases and Internet Problems

Internet-based case/homework assignments are included in the end of chapter material for each of the 26 chapters. These assignments require students to use the Internet to research relevant auditing issues and they expose students to real-world events, such as actual SEC enforcement actions related to a fraud investigations, actual audit committee charters that outline the audit committee’s role in the oversight of the external auditor selection process, and management reports on internal control filed with the SEC. We believe these assignments provide opportunities for students to engage in research activities outside traditional homework problems to learn about issues affecting the audit process. Some of these can be assigned as individual assignments while others could be assigned to groups for in-class presentation and discussion.

In addition to the Internet Problems, most chapters include Cases that challenge students beyond what is required in other end of chapter problems. They are generally more complex than other homework problems. Thus, we sometimes assign these as group assignments that can be worked outside of class or we assign them as in-class assignments whereby students work together to develop a group solution to the case for subsequent class discussion.

Pinnacle Manufacturing Integrated Case

For instructors who are interested in providing a more complex case that students can work across multiple chapters, we have included the Pinnacle Manufacturing Integrated Case. This seven-part case has been revised and expanded to give students a hands-on experience that begins in Chapter 8 and concludes in Chapter 16. The case can be worked individually or in small teams.

Use of ACL Software

Students receive a full working version of ACL Software with the textbook. Students use this software, which includes several hypothetical databases, to complete several ACL-based homework problems in selected chapters. The problems that use ACL software are 7-40, 8-41, 11-35, 12-31, 14-35, 16-36, and 17-38. These problems are designated by the ACL logo in the margin next to the problem.

Instructors who want to provide more detailed coverage of ACL software can use Computerized Auditing Using ACL, Second Edition (2008) by Alvin A. Arens. This resource is designed for use as a supplement in either an undergraduate or advanced auditing course and contains Version 9.0 software, along with data sets for eight companies. Students work through this 25-35 hour project outside of class time, but the project also provides great flexibility for you to cover important concepts in class. After completing Computerized Auditing Using ACL, students will have an in-depth understanding of how audit software is used in practice for both data analysis and audit testing.
Assignment of Computer-Related Problems in the Textbook

In the chapter problem materials, there are problems that can be solved using Excel. You may assign these problems to be done manually, with the computer, or both, at your discretion. In the solutions manual, we offer solutions on both bases. In addition, we offer the solution templates and relevant data files on the Companion Website.

The list below notes the problems that can be assigned for solving with computer assistance through the use of Excel software, along with the related file names on the Website.

<table>
<thead>
<tr>
<th>PROBLEM NUMBER</th>
<th>EXCEL FILE NAME</th>
</tr>
</thead>
<tbody>
<tr>
<td>7-37</td>
<td>P737.xls</td>
</tr>
<tr>
<td>8-39</td>
<td>P839.xls</td>
</tr>
<tr>
<td>8-40</td>
<td>P840.xls</td>
</tr>
<tr>
<td>9-36</td>
<td>P936a.xls</td>
</tr>
<tr>
<td></td>
<td>P936b.xls</td>
</tr>
<tr>
<td>10-43</td>
<td>P1043a.xls</td>
</tr>
<tr>
<td></td>
<td>P1043b.xls</td>
</tr>
<tr>
<td>14-34</td>
<td>P1434a.xls</td>
</tr>
<tr>
<td></td>
<td>P1434b.xls</td>
</tr>
<tr>
<td>15-25</td>
<td>P1525.xls</td>
</tr>
<tr>
<td>15-26</td>
<td>P1526.xls</td>
</tr>
<tr>
<td>15-35</td>
<td>P1535.xls</td>
</tr>
<tr>
<td>16-35</td>
<td>P1635.xls</td>
</tr>
<tr>
<td>17-30</td>
<td>P1730.xls</td>
</tr>
<tr>
<td>17-34</td>
<td>P1734.xls</td>
</tr>
<tr>
<td>17-36</td>
<td>P1736.xls</td>
</tr>
<tr>
<td>17-37</td>
<td>P1737.xls</td>
</tr>
<tr>
<td>18-32</td>
<td>P1832.xls</td>
</tr>
<tr>
<td>21-29</td>
<td>P2129.xls</td>
</tr>
<tr>
<td>21-33</td>
<td>P2133.xls</td>
</tr>
</tbody>
</table>

The files listed above are available on the Companion Website.

Companion Website

The Arens/Elder/Beasley Companion Website (www.pearsonhighered.com/arens) includes a wide variety of resources, including current event articles, relevant Internet links for each chapter, Internet-based case/homework assignments for every chapter, and free online quizzes for students. If needed, periodic updates of major professional developments may be posted on the Companion Website for instructor downloading and review.
Other Resources That We Use

In addition to the many features included in this 14th edition of Auditing and Assurance Services: An Integrated Approach, there are several other resources that we find useful as complimentary materials and assignments. These are briefly highlighted next.

Use of Systems Understanding Aid

We find the use of the publication, Systems Understanding Aid, Alvin A. Arens and D. Dewey Ward, Armond Dalton Publishers, Inc., (2008) to be extremely useful. The aid is a self-study document that has students work through a simple accounting system, including application of internal controls. It is typically assigned to be done outside of class during the first four weeks, prior to the study of internal control. The aid will give students an adequate familiarity with documents and records to increase their understanding of internal control.

Use of Integrated Audit Practice Case

The Integrated Audit Practice Case, David S. Kerr, Randal J. Elder, and Alvin A. Arens, Armond Dalton Publishers, Inc., (2011) can be used to give students hands-on experience making audit judgments and completing audit documentation. The case can be completed individually or in groups, and includes 10 assignments that can be assigned throughout the semester. The assignments take students through the planning phase, evaluation of internal control and performance of tests of transactions, substantive tests of balances, and completing the audit. The case includes a CD that allows students to complete selected assignments in Excel.

Use of Auditing Cases

Auditing Cases: An Interactive Learning Approach, Fourth Edition (2011) by Beasley, Buckless, Glover, and Prawitt is an excellent supplement to the textbook. This collection of over 40 auditing cases addresses most major activities performed during the conduct of an audit, from client acceptance to issuance of an audit report. Many of the cases are based on actual companies, some of which were engaged in financial reporting fraud. Several cases involve students working with realistic audit evidence and preparing and evaluating audit documentation Auditing Cases: An Interactive Learning Approach provides instructors an easy opportunity to introduce short active learning exercises to promote in-class discussions of real-world audit issues throughout the introductory auditing course.

Suggested Term Projects

1. Have students obtain a public company’s recent Form 10-K filing with the SEC and, using a team approach, prepare an analysis of business risks affecting the financial reporting process and develop an audit plan (overview level) for the company selected.
2. Have students go through the audit process for the acquisition and payment cycle of a small manufacturing company from flowcharting the system to designing the audit program.

3. Have students evaluate the sampling approach used by an auditor for sales and cash receipts for a small business. The case can be used conveniently with nonstatistical sampling, difference estimation, or monetary unit sampling. The requirements should be modified depending on the alternative you select.

Syllabus excerpts for each project follow.
TERM PROJECT 1

Analysis and Audit Plan

The objectives of this project are as follows:

1. To acquaint students with the Form 10-K of a publicly held company audited by a CPA firm.
2. To provide data for the practical application of certain steps in the audit process.
3. To allow students to experience working in teams, as is done in actual auditing.

Detailed Instructions

1. Form a group of four persons. Discuss how you will organize (assign responsibilities) to complete this project in a suitable format.

2. Visit the SEC’s website (www.sec.gov) to obtain a copy of a recent Form 10-K filing by a publicly held company with stock actively traded on the New York, NASDAQ or other over-the-counter exchanges. Answer the following questions:

   a. What is the company's industry?
   b. What are its primary products?
   c. What raw materials does the company use?
   d. How large is the company:
      ■ sales
      ■ assets
      ■ employees
   e. Where is the company located?
   f. What other people/companies are closely associated with this company?
   g. Look at the Form 10-K:
      ■ What information is included in Item 1 and Item 1A of the Form 10-K?
      ■ How might that information be useful to the audit during audit planning?

3. Obtain outside information about the company and its industry. Answer the following questions:

   a. What are the key economic factors about the industry?
   b. Where is the company in its life cycle?
   c. What are the five or six most important factors for success in this business?
   d. How does this company stand with respect to these factors?
   e. Describe four or five key business risks related to the client’s business and industry.
f. What notable accounting considerations are there for companies in this industry?

4. Analyze the company's financial strength:
   a. Assess the financial strength of the company?
   b. How is the financial strength likely to change in the next year or so?
   c. What are its sources of capital and what is the value of the company's capital?
   d. How have capital markets responded to the company in the last year?
   e. What is the quality of earnings?
   f. How does the company compare with others in the industry?

5. Prepare a broad audit plan:
   a. What material types of transactions and transaction cycles are involved?
   b. What are the high-risk areas?
   c. What are the low-risk areas?
   d. If management faced tremendous pressure regarding the entity’s financial performance, what opportunities might exist for them to engage in fraudulent financial reporting?
   e. To what extent do you believe it will be appropriate to reduce assessed control risk?
   f. How will audit effort be allocated among geographical areas?
   g. What form of auditors’ report do you expect will be issued; what does it mean?

6. Indicate as an appendix to the report how the project team was organized and how it functioned on the project.

   This project accomplishes several purposes. First, it relates the course content to a real (although broadly presented) situation. The students get the idea of auditing the business, not just the books. Students are confronted — some for the first time — with having to obtain, study, and understand content in a Form 10-K. They have to think about such things as business risk and allocation of scarce resources as a decision maker.
Having the project done by teams is an important part of the approach. Audits are done by teams and auditors must learn to operate successfully in this mode. The team’s report determines the grade for each member of the team, regardless of how the team allocated effort. In grading the report, 20 percent of the grade is based on communication quality. This includes organization, style, grammar, neatness, etc. Since effective communication is so essential in practice, this skill receives emphasis in many ways throughout the course.

**Schedule for Completing Term Project:**

- **Week 1**  –  Form group.
- **Week 2**  –  Hold organizational meeting.
- **Week 3**  –  Obtain and the 10-K report.
- **Week 10**  –  Complete and hand in project.
You are provided with the following description of the accounting system and internal controls for materials purchases by the Johnson Machinery Company, a medium-sized firm that builds special machinery to order.

Materials purchase requisitions are first approved by the plant foreman, who then sends them to the purchasing department. Purchasing department employees enter the purchase requisition information into the computer, which automatically generates a purchase order in sequential order. The system automatically generates a paper copy of the purchase order, which is sent by purchasing department employees to the vendor. The receiving department electronically accesses a copy of the purchase order, which is printed to serve as a receiving report.

Delivered materials are immediately sent to the storeroom. The completed receiving report, which is a printed copy of the purchase order, is sent to the purchasing department. A copy of the receiving report is sent to the storeroom. Materials are issued to factory employees subsequent to the verbal request by one of the foremen.

When the mailroom clerk receives vendors' invoices, he or she forwards them to the purchasing department employee who placed the order. The invoice is compared with the electronic copy of the purchase order for price and terms by the employee. The invoice quantity is compared with the receiving department's report. After checking footings, extensions, and discounts on the vendor invoice, the employee indicates approval for payment by initialing the invoice. The invoice is then forwarded to the accounting department (voucher section) where it is coded for account distribution, assigned a voucher number, and entered into the accounting system for recording in the voucher register. The system tracks invoices due by payment date due. The purchase order and receiving report are filed in the purchasing department.

On payment dates, the system automatically generates a request for payment. The system automatically prepares checks and a transaction list for preparation of a cash disbursements journal, updates the accounts payable master file, and indicates the payment date for the voucher register. Prenumbered checks are sent to the cashier, who puts them through the check-signing machine. The checks are then sent to the voucher section that makes sure that the checks were correctly prepared. The checks are placed in envelopes and sent to the mailroom. The vouchers are subsequently filed in numerical order. At the end of each month, a computer listing of voucher and cash disbursement transactions, and an outstanding accounts payable list is prepared.
Required:

1. Prepare a flowchart for the acquisition and the payment cycle for Johnson Machinery Company.
2. List the controls in existence for each of the six transaction-related audit objectives for acquisitions.
3. For each control in part 2, list one test of control procedure for verifying its effectiveness.
4. List the most important deficiencies in the acquisition and payment cycle.
5. Identify the most likely error or fraud that could result from each of the deficiencies listed in part 4.
6. Suggest a system alteration for JMC that would correct each of the deficiencies identified in part 4. Be sure to keep cost/benefit in mind.
7. Design an audit program to test internal control. The program should include, but not be limited to, tests of controls from part 3 and procedures to compensate for the deficiencies in part 4.
TERM PROJECT 3

Audit Sampling Case

Hip E. Dude, CPA, is doing the audit of Baggum Gun and Rack Shop, a national wholesaler of rifles and related equipment and supplies. He is surprised at the results found so far in the testing of sales and sales returns. There are large numbers of misstatements in the sales tests, which were done using a nonstatistical sample. There are a variety of misstatements, including pricing, extensions, footings, failure to record, and duplicate recording in sales returns and postings to the accounts receivable master file. The confirmation of accounts receivable also indicates numerous misstatements. Upon analysis of the misstatements, he concludes that the problem is extremely sloppy accounting, rather than intentional misstatements.

When Dude informs management of the problem, he is told that they are not too surprised. Customers have been complaining about their bills in recent months, and the company accountant has been having personal problems. He has now been discharged, and the company is in the process of hiring a new accountant. The owner states that she does not feel that the problem is serious from a financial statement point of view, because the misstatements mostly offset each other.

Dude is not convinced that the problem of overall financial statement misstatements is as minor as the owner states. He decides that additional confirmation of accounts receivable is required under the circumstances. Further thought leads him to conclude that there are two problems: the positive confirmation response has been only approximately 25% to 30% in the past, and it is now 45 days after the balance sheet date. After considerable deliberation, Dude decides to select a combined sample of sales and sales returns and determine the effect of the misstatements on net sales and earnings. He has concluded that a misposting of a sale or return to the wrong customer is not a misstatement, because gross sales are correctly stated. The owner assures Dude that failure to bill a customer even for a period of several months is not likely to make the receivable uncollectible.

Total recorded sales amount to $15,356,686 and recorded sales returns are $1,492,797. Dude concludes that a misstatement of $210,000 affecting net earnings would be material. He decides to use an ARIA of 10% and an ARIR of 25%. He has no basis for estimating the standard deviation or a point estimate. He decides to randomly select 100 items to calculate these two items.

The sales invoices for the year started with 15,424 and ended with 28,841. They are recorded in the sales journal in the order of issue rather than sequentially. Sales returns and allowances, which are sequentially recorded in the sales returns and allowances journal, start with 1351 and end with 4,301.

Based upon the sample size of 100 items, of which 26 were sales returns and allowances, the following misstatement information was noted. The value of the 67 items in the sample that have no misstatements is $77,280.
<table>
<thead>
<tr>
<th>TYPE OF MISSTATEMENT</th>
<th>RECORDED VALUE</th>
<th>AUDIT VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SALES:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pricing</td>
<td>$ 98.50</td>
<td>$ 95.50</td>
</tr>
<tr>
<td></td>
<td>333.00</td>
<td>310.00</td>
</tr>
<tr>
<td></td>
<td>25.30</td>
<td>25.10</td>
</tr>
<tr>
<td></td>
<td>1,147.40</td>
<td>1,117.04</td>
</tr>
<tr>
<td></td>
<td>789.10</td>
<td>758.90</td>
</tr>
<tr>
<td></td>
<td>615.00</td>
<td>605.00</td>
</tr>
<tr>
<td></td>
<td>542.25</td>
<td>539.25</td>
</tr>
<tr>
<td></td>
<td>2,040.40</td>
<td>2,000.00</td>
</tr>
<tr>
<td></td>
<td>998.00</td>
<td>948.00</td>
</tr>
<tr>
<td></td>
<td>478.50</td>
<td>432.50</td>
</tr>
<tr>
<td></td>
<td>13.12</td>
<td>131.20</td>
</tr>
<tr>
<td></td>
<td>883.20</td>
<td>890.20</td>
</tr>
<tr>
<td></td>
<td>629.50</td>
<td>653.40</td>
</tr>
<tr>
<td></td>
<td>174.39</td>
<td>194.39</td>
</tr>
<tr>
<td>Extensions and footings</td>
<td>921.00</td>
<td>901.00</td>
</tr>
<tr>
<td></td>
<td>292.80</td>
<td>278.50</td>
</tr>
<tr>
<td></td>
<td>448.50</td>
<td>430.50</td>
</tr>
<tr>
<td></td>
<td>168.20</td>
<td>155.00</td>
</tr>
<tr>
<td></td>
<td>1,515.15</td>
<td>1,499.00</td>
</tr>
<tr>
<td></td>
<td>2,750.50</td>
<td>2,570.50</td>
</tr>
<tr>
<td></td>
<td>7,137.00</td>
<td>7,173.00</td>
</tr>
<tr>
<td></td>
<td>111.10</td>
<td>125.10</td>
</tr>
<tr>
<td></td>
<td>727.20</td>
<td>772.20</td>
</tr>
<tr>
<td></td>
<td>10.00</td>
<td>100.00</td>
</tr>
<tr>
<td><strong>SALES RETURNS:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Posting to accounts receivable master file</td>
<td>(510.00)</td>
<td>(810.00)</td>
</tr>
<tr>
<td></td>
<td>(890.90)</td>
<td>(590.90)</td>
</tr>
<tr>
<td></td>
<td>(152.00)</td>
<td>(1.52)</td>
</tr>
<tr>
<td>Failure to record sales returns</td>
<td>- 0 -</td>
<td>(725.00)</td>
</tr>
<tr>
<td></td>
<td>- 0 -</td>
<td>(700.00)</td>
</tr>
<tr>
<td></td>
<td>- 0 -</td>
<td>(515.00)</td>
</tr>
<tr>
<td></td>
<td>- 0 -</td>
<td>(1,219.50)</td>
</tr>
<tr>
<td></td>
<td>- 0 -</td>
<td>(353.00)</td>
</tr>
<tr>
<td></td>
<td>- 0 -</td>
<td>(777.00)</td>
</tr>
</tbody>
</table>
Required:

1. Evaluate the reasonableness of the sampling approach Dude is taking.
2. Explain how he should select the random numbers using computer generation of random numbers.
3. Calculate the confidence limits for the population of sales and sales returns combined using difference estimation. Show all intermediate steps.
4. Evaluate the sufficiency of the sample size Dude used in establishing the confidence limits. How large would the sample need to be to meet Dude's confidence limit requirements?
5. At what level of ARIA would Dude be able to accept the recorded value of "net sales" as being fairly stated within acceptable materiality? Show justification for your answer.
6. What would the confidence limits be for the sales population alone? Why is the difference between your answers in 3 and 6 so large?
7. Suggest a strategy for Dude to follow at this point.
8. Be sure that the documentation of your answers is adequate for inclusion in the audit files.
Summary of Additional, Changed, and Deleted Problem Material

We have added new end-of-chapter homework problems and revised others in this 14th edition of Auditing and Assurance Services: An Integrated Approach. If you have previously used the 13th edition of our book, you may want to visit the Companion Website for our book to see a list of new, revised, or deleted homework problems in the 14th edition relative to problems you may have used in the 13th edition.

<table>
<thead>
<tr>
<th>Question/Problem/Case # in 13/e</th>
<th>Question/Problem/Case # in 14/e</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CHAPTER 1</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1-14 d</td>
<td>1-14d</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>1-17</td>
<td>1-17</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>1-19</td>
<td>1-19</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>1-22</td>
<td>1-22</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>Internet Problem 1-1</td>
<td>Internet Problem 1-1</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 2</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2-11</td>
<td>2-11</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>2-16a</td>
<td>2-16a</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>2-17d</td>
<td>2-17d</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>2-20</td>
<td>2-20</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>2-22</td>
<td>2-22</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>Internet Problem 2-1</td>
<td>Internet Problem 2-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 3</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3-20</td>
<td></td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td>3-21</td>
<td>3-20</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>3-25</td>
<td>3-25</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>3-27</td>
<td>3-27</td>
<td>Modified for 14/e (names)</td>
</tr>
<tr>
<td>3-30</td>
<td>3-30</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>Internet Problem 3-1</td>
<td>Internet Problem 3-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 4</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4-17</td>
<td>4-5</td>
<td>Modified and replaced for 14/e</td>
</tr>
<tr>
<td>4-5 through 4-16</td>
<td>4-6 through 4-17</td>
<td>Shifted numbers, same problems</td>
</tr>
<tr>
<td>4-22</td>
<td>4-22</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>Internet Problem 4-1</td>
<td>Internet Problem 4-1</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 5</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5-16d</td>
<td></td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td>5-17d</td>
<td></td>
<td>New for 14/e</td>
</tr>
<tr>
<td>5-18</td>
<td></td>
<td>New for 14/e</td>
</tr>
<tr>
<td>5-18 through 5-23</td>
<td>5-19 through 5-24</td>
<td>Shifted numbers, same problems</td>
</tr>
<tr>
<td>5-24</td>
<td></td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td>Internet Problem 5-1</td>
<td>Internet Problem 5-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>Question/Problem/Case # in 13/e</td>
<td>Question/Problem/Case # in 14/e</td>
<td>Comments</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>---------------------------------</td>
<td>---------------------------------</td>
</tr>
<tr>
<td><strong>CHAPTER 6</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6-19b</td>
<td>6-19b</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>6-21</td>
<td>6-22</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>6-23</td>
<td>6-24</td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td>6-30</td>
<td>6-30</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>6-31</td>
<td>6-32</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>Internet Problem 6-1</td>
<td>Internet Problem 6-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 7</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7-5</td>
<td>7-6 through 7-16</td>
<td>Shifted numbers, same problems</td>
</tr>
<tr>
<td>7-17</td>
<td>7-18 through 7-33</td>
<td>Shifted numbers, same problems</td>
</tr>
<tr>
<td>7-27b</td>
<td>7-30</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>7-31</td>
<td>7-34 through 7-41</td>
<td>Shifted numbers, same problems</td>
</tr>
<tr>
<td>Internet Problem 7-1</td>
<td>Internet Problem 7-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 8</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8-25d</td>
<td>8-29</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>8-30</td>
<td>8-31</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>8-32</td>
<td>8-37d</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>8-37d</td>
<td>8-37e</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>8-40</td>
<td>8-40</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>Internet Problem 8-1</td>
<td>Internet Problem 8-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 9</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9-22b</td>
<td>9-23a and b</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>9-24a and 9-24b</td>
<td>9-25</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>9-28</td>
<td>9-28</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>9-30</td>
<td>9-31</td>
<td>Modified for 14/e</td>
</tr>
</tbody>
</table>

To download more slides, ebook, solutions and test bank, visit [http://downloadslide.blogspot.com](http://downloadslide.blogspot.com)
<table>
<thead>
<tr>
<th>Question/Problem/Case # in 13/e</th>
<th>Question/Problem/Case # in 14/e</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>9-32c</td>
<td>9-32c</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>9-34</td>
<td>9-34</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>9-37</td>
<td>9-37</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>Internet Problem 9-1</td>
<td>Internet Problem 9-1</td>
<td>Modified for 14/e</td>
</tr>
</tbody>
</table>

**CHAPTER 10**

| 10-20                          | 10-20                          | Replaced for 14/e |
| 10-25                          | 10-25                          | Replaced for 14/e |
| 10-30b and 10-30c              | 10-30b and 10-30c              | Replaced for 14/e |
| 10-31a                         | 10-31a                         | Replaced for 14/e |
| 10-32a                         | 10-32a                         | Replaced for 14/e |
| 10-33                          | 10-33                          | New for 14/e |
| 10-33 through 10-35            | 10-34 through 10-36            | Shifted numbers, same problems |
| 10-36                          | 10-43                          | Deleted for 14/e |
| Internet Problem 10-1          | Internet Problem 10-1          | Modified for 14/e |

**CHAPTER 11**

| 11-21a                         | 11-21a                         | New for 14/e |
| 11-23                          | 11-23                          | Modified for 14/e |
| 11-26                          | 11-26                          | Modified for 14/e |
| 11-31                          | 11-31                          | New for 14/e |
| 11-31 and 11-32                | 11-32 and 11-33                | Shifted numbers, same problems |
| 11-34                          | 11-34                          | New for 14/e |
| Internet Problem 11-1          | Internet Problem 11-1          | Modified for 14/e |

**CHAPTER 12**

| 12-16                          | 12-16                          | Replaced for 14/e |
| 12-17a and 12-17b              | 12-17a and 12-17b              | Replaced for 14/e |
| 12-18 b and 12-18c             | 12-18b and 12-18c              | Replaced for 14/e |
| 12-22                          | 12-22                          | Replaced for 14/e |
| Internet Problem 12-1          | Internet Problem 12-1          | Modified for 14/e |

**CHAPTER 13**

| 13-22b                         | 13-22b                         | Replaced for 14/e |
| 13-25                          | 13-25                          | New for 14/e |
| 13-26                          | 13-26                          | Shifted number, same problem |
| 13-26                          | 13-26                          | Deleted for 14/e |
| 13-28                          | 13-28                          | Modified for 14/e |
| 13-34a                         | 13-34a                         | New for 14/e |
| 13-34a and 13-34b              | 13-34b and 13-34c              | Shifted numbers, same problems |
| 13-36a                         | 13-36a                         | Modified for 14/e |
| Internet Problem 13-1          | Internet Problem 13-1          | Modified for 14/e |

Internet Problem 9-1

Internet Problem 10-1

Internet Problem 11-1

Internet Problem 12-1

Internet Problem 13-1

To download more slides, ebook, solutions and test bank, visit http://downloadslide.blogspot.com
<table>
<thead>
<tr>
<th>Question/Problem/Case # in 13/e</th>
<th>Question/Problem/Case # in 14/e</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CHAPTER 14</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14-21a and 14-21c</td>
<td>14-21a and 14-21b</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td></td>
<td>14-21c</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>14-21b</td>
<td>14-21d</td>
<td>Shift number, same problem</td>
</tr>
<tr>
<td>14-22d</td>
<td>14-22d</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>14-24</td>
<td>14-24</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>14-29</td>
<td>14-29</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>Internet Problem 14-1</td>
<td>Internet Problem 14-1</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 15</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15-5</td>
<td>15-5</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>15-14</td>
<td>15-14</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>15-17</td>
<td>15-17</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>15-22a and 15-22b</td>
<td>15-22a and 15-22b</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>15-22c and 15-22d</td>
<td>15-22c and 15-22d</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>15-23a</td>
<td>15-23a</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>15-23b</td>
<td>15-23b</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>15-25</td>
<td>15-25</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>15-26</td>
<td>15-26</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>15-27</td>
<td>15-27</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>15-29</td>
<td>15-29</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>15-30</td>
<td>15-30</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>15-33</td>
<td>15-33</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>15-35</td>
<td>15-35</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>Internet Problem 15-1</td>
<td>Internet Problem 15-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 16</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16-13</td>
<td>16-13</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>16-13 through 6-18</td>
<td>16-14 through 16-19</td>
<td>Shifted numbers, same problems</td>
</tr>
<tr>
<td>16-19</td>
<td>16-19</td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td></td>
<td>16-22c</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>16-24</td>
<td>16-24</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>16-25</td>
<td>16-25</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>16-27</td>
<td>16-27</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>16-30c</td>
<td>16-30c</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>16-31</td>
<td>16-31</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>16-32</td>
<td>16-32</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>16-35</td>
<td>16-35</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 17</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17-25a</td>
<td>17-25a</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>17-26 all</td>
<td>17-26 all</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td></td>
<td>17-27</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>17-27 through 17-36</td>
<td>17-28 through 17-37</td>
<td>Shifted numbers, same problems</td>
</tr>
<tr>
<td>Question/Problem/Case # in 13/e</td>
<td>Question/Problem/Case # in 14/e</td>
<td>Comments</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>-------------------------------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td>17-28</td>
<td>17-29</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>17-34f</td>
<td></td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td>Internet Problem 17-1</td>
<td>Internet Problem 17-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>17-38</td>
<td></td>
<td>New for 14/e</td>
</tr>
<tr>
<td>Internet Problem 17-1</td>
<td>Internet Problem 17-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 18 (Chapter 19 for 12/e)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18-18d</td>
<td></td>
<td>New for 14/e</td>
</tr>
<tr>
<td>18-19c</td>
<td>18-20b</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>18-20a</td>
<td>18-20a</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>18-20 through 18-25</td>
<td>18-21 through 18-26</td>
<td>Shifted numbers, same problems</td>
</tr>
<tr>
<td>18-24</td>
<td>18-25</td>
<td>Modified table for 14/e</td>
</tr>
<tr>
<td>18-26</td>
<td></td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td>18-27</td>
<td>18-27</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>18-27 and 18-28</td>
<td>18-28 and 18-29</td>
<td>Shifted numbers, same problems</td>
</tr>
<tr>
<td>18-29</td>
<td></td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td>Internet Problem 18-1</td>
<td>Internet Problem 18-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 19 (Chapter 20 for 12/e)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19-17a</td>
<td>19-17a</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>19-17c</td>
<td>19-17c</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>19-18c</td>
<td>19-18c</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>19-20a</td>
<td>19-20a</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>19-24</td>
<td>19-24</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>Internet Problem 19-1</td>
<td>Internet Problem 19-1</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 20 (Chapter 18 for 12/e)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20-17b</td>
<td>20-17-b</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>20-19</td>
<td>20-19</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>20-22</td>
<td>20-22</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>20-26</td>
<td>20-26</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>Internet Problem 20-1</td>
<td>Internet Problem 20-1</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 21</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21-17a</td>
<td>21-17a</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>21-18c</td>
<td>21-18c</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>21-19a</td>
<td>21-19a</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>21-26</td>
<td>21-26</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>Internet Problem 21-1</td>
<td>Internet Problem 21-1</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td><strong>CHAPTER 22</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>22-20c</td>
<td>22-20c</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>22-20d</td>
<td></td>
<td>New for 14/e</td>
</tr>
<tr>
<td>22-21c</td>
<td>22-21c</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>22-21d</td>
<td>22-21d</td>
<td>New for 14/e</td>
</tr>
<tr>
<td>22-24</td>
<td>22-24</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>Internet Problem 22-1</td>
<td>Internet Problem 22-1</td>
<td>Replaced for 14/e</td>
</tr>
</tbody>
</table>

To download more slides, ebook, solutions and test bank, visit http://downloadslide.blogspot.com
<table>
<thead>
<tr>
<th>Question/Problem/Case # in 13/e</th>
<th>Question/Problem/Case # in 14/e</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>CHAPTER 23</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23-19b</td>
<td>23-19b</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>23-24</td>
<td></td>
<td>New for 14/e</td>
</tr>
<tr>
<td>23-24 and 23-25</td>
<td>23-25 and 23-26</td>
<td>Shifted numbers, same problems</td>
</tr>
<tr>
<td>Internet Problem 23-1</td>
<td>Internet Problem 23-1</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>CHAPTER 24</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24-22b</td>
<td>24-22b</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>24-23c</td>
<td>24-23c</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>24-23d</td>
<td></td>
<td>New for 14/d</td>
</tr>
<tr>
<td>24-24c</td>
<td>24-24c</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>24-25a</td>
<td>24-25a</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>24-25c</td>
<td>24-25c</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>24-29</td>
<td></td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td>24-34</td>
<td>24-28</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>24-32</td>
<td>24-29</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>24-28</td>
<td>24-30</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>24-30</td>
<td>24-31</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>24-35</td>
<td>24-32</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>24-33</td>
<td></td>
<td>New for 14/e</td>
</tr>
<tr>
<td>24-31</td>
<td>24-34</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>24-36</td>
<td>24-35</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>Internet Problem 24-1</td>
<td>Internet Problem 24-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>CHAPTER 25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25-14</td>
<td></td>
<td>New for 14/e</td>
</tr>
<tr>
<td>25-14</td>
<td>25-15</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>25-15</td>
<td></td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td>25-18d</td>
<td></td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td>25-19b</td>
<td></td>
<td>New for 14/e</td>
</tr>
<tr>
<td>25-19b</td>
<td>25-19c</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>25-22</td>
<td></td>
<td>Deleted for 14/e</td>
</tr>
<tr>
<td>25-23</td>
<td>25-22</td>
<td>Shifted number, same problem</td>
</tr>
<tr>
<td>25-23</td>
<td></td>
<td>New for 14/e</td>
</tr>
<tr>
<td>25-24</td>
<td>25-24</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>Internet Problem 25-1</td>
<td>Internet Problem 25-1</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>CHAPTER 26</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26-20c</td>
<td>26-20c</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>26-21a</td>
<td>26-21a</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>26-23a</td>
<td>26-23a</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>26-23b</td>
<td>26-23b</td>
<td>Replaced for 14/e</td>
</tr>
<tr>
<td>26-26</td>
<td>26-26</td>
<td>Modified for 14/e</td>
</tr>
<tr>
<td>Internet Problem 26-1</td>
<td>Internet Problem 26-1</td>
<td>Replaced for 14/e</td>
</tr>
</tbody>
</table>
Chapter 1

The Demand for Audit and Other Assurance Services

Usually students will not have read Chapter 1 before the material is covered. As a policy, we always give students the entire scheduled time on the first day of class. In addition to getting a seating chart set up (which we always use), and handling the course procedures, we attempt to cover the following major topics in the chapter:

Chapter Opening Vignette — “Auditors Have a Great Responsibility”

We use this vignette about Cynthia Cooper and WorldCom to highlight the important role that internal and external auditors play in preventing fraud. We describe how WorldCom followed immediately after the Enron fraud, and resulted in the passage of the Sarbanes–Oxley Act and new regulation of public companies and their auditors. We do not discuss the audit failures that preceded the enactment of the Sarbanes–Oxley Act. We prefer to emphasize the responsibility of auditors, and the positive role that auditors play in providing assurance on financial statements.

Nature of Auditing (page 4)

Start by asking students to tell you what auditing is. A student’s own definition is written on the overhead. Other students are asked to discuss it until there is a reasonably usable definition. The three things that should be stressed are:

a. Evidence (define the term)
b. Information
c. Determining degree of correspondence

Students tend to think of auditing as auditing financial statements by CPA firms in accordance with GAAS or other auditing standards. We therefore use Figure 1-1 (page 5) to discuss the definition.

(See Figure 1-1)

We also like to set up the matrix on T-1-1 on the overhead and go through it with the students. As a part of this, students are briefly introduced to IRS auditors, CPAs, and internal auditors. None of this is usually lecture.

(See T-1-1)

After you have gone over this information, refer students to the definition of auditing. Briefly talk about the importance of:

■ Competence and independence of auditor (Chapter 4)
■ Need to report on findings (Chapters 3, 24, and 25)
Distinction Between Auditing and Accounting (page 6)

We spend little time on the distinction between accounting and auditing, but it is at least desirable to point out the differences and relationship between the two. Then ask why auditors need to have knowledge of accounting to be effective auditors. See Review Question 1-7.

Economic Demand for Auditing (page 6)

We like to spend a few minutes discussing the economic role of auditors in society in Chapter 1. Refer back to this material again in Chapter 5 (legal liability) and Chapter 9 (materiality and risk).

First, go over the three elements of interest, with emphasis on information risk. Use T-1-2 to summarize the material in the text. It is useful to discuss the effect on earnings of reducing an organization's interest rate by 1 or 2%. Problem 1-17 is useful for demonstrating the level of assurance associated with audits and reviews, and the effect of these services on information risk and borrowing costs.

(See T-1-2)

Assurance Services (page 8)

We start by asking students to describe assurance services. The term will be unfamiliar to most students, but some may recognize the concept. We use Figure 1-3 (page 12) as a framework for discussing the following services:

- Assurance services
- Attestation services
- Audits of historical financial statements
- Attestation on internal control over financial reporting
- Management consulting and other nonassurance services

(See Figure 1-3)

We then cover Problem 1-16 in class to help students distinguish assurance, attestation, and audit services.

Ask students to suggest other types of information on which users may desire assurance and the most likely provider of the assurance. T-1-3 can be used to list their responses. To start the discussion, we often name one or two types of assurance that aren't provided by CPAs, such as gas pump inspections and Arbitron radio ratings. Ask students to suggest reasons why the demand for assurance is increasing. Table 1-1 (page 11) is helpful for identifying other types of assurance services that may be provided by CPAs.

(See T-1-3)

(See Table 1-1)
Problem 1-18 can be covered in class to give students a perspective on the similarity between assurance services offered by CPAs, and the role played by organizations such as Consumers Union.

**Types of Audits and Auditors** (page 12, page 15)

Most students at our universities know little of the types of auditors and the nature of CPA firms. In a brief lecture, we tell the students:

- The nature of financial, operational, and compliance audits
- The primary differences between independent CPAs, government auditors, internal revenue agents, and internal auditors

*T-1-1 or Table 1-2* (page 13) can be used as part of this discussion. Problem 1-20 is a good one to use in class as part of a discussion about careers in accounting. Problem 1-21 can also be used to help distinguish the types of audits, and the auditor most likely to perform the audit.

(See T-1-1)

(See Table 1-2)

**Certified Public Accountant** (page 17)

We talk briefly about why some people want to be a CPA. We also tell them briefly about the exam requirements and the format of the computerized exam.

We then review the CPA Exam eligibility requirements in our state. We encourage students to visit the CPA Examination portion of the AICPA website (www.aicpa.org) to learn more about the exam and obtain the *CPA Candidate Bulletin*. We find students appreciate this information and it saves us a lot of time in the office telling them the same thing individually.
## Cross-Reference of Learning Objectives and Problem Material

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Discussion Questions and Problems</th>
<th>Multiple Choice Questions</th>
<th>Review Questions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-1</td>
<td>Describe auditing.</td>
<td>1-1</td>
<td>1-5, 1-6</td>
</tr>
<tr>
<td>1-2</td>
<td>Distinguish between auditing and accounting.</td>
<td>1-7</td>
<td>1-7</td>
</tr>
<tr>
<td>1-3</td>
<td>Explain the importance of auditing and reducing information risk.</td>
<td>1-2, 1-3</td>
<td>1-4</td>
</tr>
<tr>
<td>1-4</td>
<td>List the causes of information risk, and explain how this risk may be reduced.</td>
<td>1-4</td>
<td>1-4</td>
</tr>
<tr>
<td>1-5</td>
<td>Describe assurance services and distinguish audit services from other assurance and nonassurance services provided by CPAs.</td>
<td>1-1, 1-10, 1-13</td>
<td>1-4</td>
</tr>
<tr>
<td>1-6</td>
<td>Differentiate the three main types of audits.</td>
<td>1-1, 1-10, 1-13</td>
<td>1-4</td>
</tr>
<tr>
<td>1-7</td>
<td>Identify the primary types of auditors.</td>
<td>1-5</td>
<td>1-4</td>
</tr>
<tr>
<td>1-8</td>
<td>Describe the requirements for becoming a CPA.</td>
<td>1-12</td>
<td>1-4</td>
</tr>
</tbody>
</table>
# INFORMATION BEING AUDITED, TYPE OF AUDITOR, CRITERIA, AND NATURE OF EVIDENCE

<table>
<thead>
<tr>
<th>Information Being Audited</th>
<th>Who Performs the Audit</th>
<th>Criteria to Determine Correspondence</th>
<th>Nature of Evidence Used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Return of an Individual</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial Statements of a Corporation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Efficiency and Effectiveness of a Computer Installation</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
ECONOMIC DEMAND FOR AUDITING

Factors Determining Interest Rate

Risk Free Interest Rate + Business Risk + Information Risk

INFORMATION RISK

CAUSES

- Remoteness of Information
- Biases and Motives of Provider
- Voluminous Data
- Complex Exchange Transactions

WAYS TO REDUCE

- User Verifies Information
- User Shares Information Risk with Management
- Information is Audited
# INFORMATION AND SOURCE OF ASSURANCE

<table>
<thead>
<tr>
<th>INFORMATION</th>
<th>ASSURER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example:</td>
<td></td>
</tr>
<tr>
<td>Number of radio listeners</td>
<td>Arbitron</td>
</tr>
</tbody>
</table>

To download more slides, ebook, solutions and test bank, visit [http://downloadslide.blogspot.com](http://downloadslide.blogspot.com)
Chapter 2

The CPA Profession

In Chapter 1, students learned about the demand for assurance services and the different types of audits. Chapter 2 describes the CPA profession, and the standards that govern audit performance.

Chapter Opening Vignette – “Good Auditing Includes Good Client Service”

This vignette demonstrates that auditors are expected to provide value-added services to clients. The vignette also challenges preconceived notions about the role of auditors, and illustrates that students will be in a position to assist clients immediately upon entering the profession. We use this as an opportunity to discuss the performance expected of new auditors, and that students need to be familiar with real-world activities by reading such sources as the *Journal of Accountancy* and *The Wall Street Journal*.

Certified Public Accounting Firms and their Activities (page 26, page 27)

Many students will be familiar with the “Big 4” and the activities of these firms, but many will not. Most students will have little knowledge of other CPA firms. In a brief lecture, we tell students:

- The four categories of CPA firms
- The names of the Big 4, plus several major firms in the other categories that recruit at our universities
- Changes occurring in each category of firms

We then ask students for their perceptions about why there have been changes among the Big 4 and National firms. We use this as an opportunity to discuss the forces affecting the profession. We are careful not to offer opinions about the desirability of these changes, or preferences for one firm or category of firm versus another.

We briefly mention the major activities of the firms (audit and assurance services, taxes, and consulting). We also note that consulting and other services are once again growing in importance at the Big 4, although they are restricted from providing many services to public company audit clients. *Table 2-1* (page 26) is helpful in describing the relative size of firms in each category, and the relative importance of each activity. We encourage students to learn more about the major CPA firms by visiting their web sites.

(See Table 2-1)

Structure of CPA Firms (page 28)

We briefly describe the six organizational structures of CPA firms. We emphasize the use of limited liability corporations and partnerships. We ask students to evaluate the desirability of these organizational forms as a potential new entrant into the profession, from the perspective of a partner, and the perspective of an investor.
We use Table 2-2 (page 29) to describe the typical positions in a CPA firm, the responsibilities of the position, and how long a person stays in each category. We emphasize that technology has increased the responsibility given new staff, and that advancement is fairly rapid.

(See Table 2-2)

Sarbanes–Oxley Act and PCAOB (page 30)

We discuss the origins of the Sarbanes–Oxley Act and the significant changes it has brought to financial reporting and the accounting profession. We then discuss the role of the PCAOB in establishing auditing and quality control standards for registered firms with public company audit clients. We clarify that the PCAOB oversight is limited to public company audits. We also note that the PCAOB adopted GAAS as interim auditing standards, and that the PCAOB is establishing new auditing standards for public company audits. Problem 2-18 is good for discussing the costs and benefits of the Sarbanes–Oxley Act.

Securities and Exchange Commission (SEC) (page 30)

The four most important things to explain to students about the SEC are:

1. Role of the SEC in general and as it relates to auditors.
2. What companies are required to report to the SEC.
3. Differences between the AICPA and SEC and relation between the PCAOB and SEC.
4. How the SEC influences auditing.

AICPA (page 31)

We talk briefly of the role of the AICPA, with emphasis on its responsibility for the CPA exam and establishing standards and rules. We also hand out student affiliate membership forms which we obtain from the AICPA website. We encourage students to join and receive subscriptions to the Journal of Accountancy.

International and U.S. Auditing Standards (page 32)

We discuss the role of auditing standards and introduce the International Auditing and Assurance Standards Board. We note that globalization has increased the need for uniform international accounting and auditing standards. We discuss convergence and that new U.S. standards issued by Auditing Standards Board and PCAOB are based on the international standards.

We use Figure 2-1 (page 33) to indicate when each international, U.S. GAAS and PCAOB standards apply. Homework problem 2-22 is also useful to cover this concept. We emphasize the similarity of the standards.

(See Figure 2-1)
Generally Accepted Auditing Standards (page 34)

First, it is useful to introduce generally accepted auditing standards by using Review Question 2-8. Students are told they are required to know the ten standards (not word for word), and which standards are general, field work, and reporting.

At that point, it is helpful to set up a summary to aid in discussing GAAS. The summary is on T-2-1. (As an alternative use Figure 2-2, page 34.) We highlight the change to the second standard of fieldwork requiring the auditor to understand the entity and its environment.

(See T-2-1)

(See Figure 2-2)

Problem 2-21 is a good one to help students understand the application of GAAS to practice.

Statements on Auditing Standards (page 36)

We briefly explain the role of Statements on Auditing Standards. We explain the classification systems used to allow students to refer to SASs when necessary. We also note that significant changes in the classification system will occur when the Auditing Standards Board completes its clarity and convergence project.

Quality Control (page 37)

With the increased emphasis on quality control in the profession, we discuss both quality control and peer review briefly. Emphasize the purposes, benefits, and costs of both. Problem 2-19 is useful for defining the elements of quality control.

Students often have difficulty understanding the relation between quality control and peer review. A useful analogy is to describe peer review as an audit of the firm’s quality control system. Figure 2-3 (page 39) is helpful in describing the relation between audit standards, quality control, peer review, and the AICPA practice and quality centers. We clarify that PCAOB inspections relate to public company audits, and peer review relates to other areas of a firm’s assurance practice.

(See Figure 2-3)

Summary

After covering Chapters 1 and 2, students have an understanding of the value of audit and assurance services, and some of the factors that affect auditor performance. Figure 2-4 (page 40) provides a useful summary of these factors, and can be used to introduce the concepts of professional ethics and legal liability covered in Chapters 4 and 5.

(See Figure 2-4)
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>2-1</td>
<td>2-1, 2-2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Describe the nature of CPA firms, what they do, and their structure.</td>
<td>2-1, 2-2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2-2</td>
<td>2-3, 2-7</td>
<td>2-18, 2-20</td>
<td>2-20</td>
<td></td>
</tr>
<tr>
<td>Understand the role of the Public Company Accounting Oversight Board and the effects of the Sarbanes-Oxley Act on the CPA profession.</td>
<td>2-3, 2-7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2-3</td>
<td>2-4</td>
<td>2-20</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Summarize the role of the Securities and Exchange Commission in accounting and auditing.</td>
<td>2-4</td>
<td></td>
<td></td>
<td>2-22</td>
</tr>
<tr>
<td>2-4</td>
<td>2-5, 2-6, 2-7</td>
<td>2-20</td>
<td></td>
<td>2-16</td>
</tr>
<tr>
<td>Describe the key functions performed by the AICPA.</td>
<td>2-5, 2-6, 2-7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2-5</td>
<td>2-7, 2-11</td>
<td>2-20, 2-21</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Understand the role of international auditing standards and their relation to U.S. auditing standards.</td>
<td>2-7, 2-11</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2-6</td>
<td>2-8, 2-9, 2-10</td>
<td>2-16</td>
<td></td>
<td>2-17</td>
</tr>
<tr>
<td>Use U.S. auditing standards as a basis for further study.</td>
<td>2-8, 2-9, 2-10</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2-7</td>
<td>2-12, 2-13, 2-14</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Identify quality control standards and practices within the accounting profession.</td>
<td>2-12, 2-13, 2-14</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2-17</td>
<td>2-18, 2-19</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
GENERALLY ACCEPTED
AUDITING STANDARDS

GENERAL

● Adequate technical training and proficiency
● Independence
● Due professional care

FIELD WORK

● Adequate planning and supervision
● Sufficient understanding of the entity and its environment, including its internal control
● Sufficient appropriate evidence

REPORTING

● Generally accepted accounting principles
● Consistency
● Informative disclosures
● Opinion regarding the financial statements taken as a whole
Chapter 3

Audit Reports

Audit reports can be covered at any time during the course. Some professors prefer to overview audit reports early, whereas others teach it near the end of the course. Either option is great. There will be no problem if you prefer to teach reports later or to split it into two segments as shown in the one-quarter syllabus. We find that students are able to comprehend the primary reporting issues early in the term and that it helps for them to see the end product of an audit. We therefore cover it early so that we can refer to reporting concepts throughout the term as we address various other topics.

The way we teach audit reporting is less conceptual and more rule-oriented than any other part of the course. The following are the topics we cover:

- Chapter opening vignette
- Overview
- Parts of the audit report
- Categories of audit reports
- Separate report on internal control over financial reporting
- Unqualified audit report with explanatory paragraph or modified wording
- Conditions requiring a departure
- Audit reports other than unqualified
- Other issues

Chapter Opening Vignette - “The Audit Report Was Timely, But at What Cost?”

This vignette highlights several important issues. The first, and overriding issue, is the importance of knowing that the audit has been completely and properly performed before the audit report is issued. The case shows the severe penalty that can result from one poor judgment on the part of the auditor.

The second issue is the effect of conflicting responsibilities that can occur in public accounting. Here, the partner’s participation in the engagement is essential, yet he was unable to give this audit sufficient attention until the last day of field work.

Third, is the problem of time pressure to complete an audit by a deadline. This is especially common when filing a registration statement. The problem is that this is also a situation where risk is great. So the auditor is “caught between a rock and a hard place.”

Fourth, is the notion of risk. The company is going public, which will provide management with great financial rewards. Audit risk is high because management, who has extensive control, is strongly motivated to overstate earnings. Business risk is also high because of the market aspects.

Fifth, there are evidence issues involving management’s representations, representations by the Company’s attorney, and the weakness of a fax confirmation.

Finally, there is the matter of the client’s behavior and how the auditor reacts to it. A difficult aspect of auditing or any other business is how to deal with negative or threatening behavior.
Overview

For the class period dealing with audit reporting, we post materials on our course web page that includes selected portions of annual reports or copies of the auditor’s report downloaded from Form 10-Ks filed with the SEC (www.sec.gov) from different companies. We ask students to bring these materials to class so that we can review them together in class that day. We make sure there are a few explanatory paragraphs, and if possible, a few qualifications and modified wording opinions included in the annual reports. At the start of class, each student is asked to review the auditor's report. With the annual report as a frame of reference, we cover the following general concepts:

- Purpose of auditors' reports
- Distinction between the auditor's and management's responsibility
- Which financial statements and other information are covered by the auditor's report
- Auditor's responsibility for "other information" in the annual report, including specific examples from students' annual reports

If you do not have a web page for the course, you can take copies to class. As an alternative to providing report examples, prior to this class session you can assign students responsibility for searching for audit report examples from company web sites or SEC filings on EDGAR.

Parts of the Audit Report (page 46)

We start by showing a transparency (or we create a powerpoint slide) of the parts of the audit report, including the title.

(See T-3-1)

Report Title - Ask students to state titles included in their reports other than "Independent Auditor's Report."

Address - Ask students to state any report address other than "The Stockholders of the Company."

Introductory Paragraph - The purpose of the introductory paragraph is discussed along with the standard wording. Ask each student to compare titles on the financial statements with those on the auditor's report. Then, put the standard wording of the introductory paragraph on the overhead (Figure 3-1, on page 47). Students are then asked to identify any reports with wording other than standard wording. Discuss any modified wording, such as for a shared audit report.

(See Figure 3-1)

Scope Paragraph - As for the introductory paragraph, the purpose of the scope paragraph is discussed along with the standard wording. Again, put the standard wording of the scope paragraph on the overhead (Figure 3-1, on page 47). Students are then asked to identify any reports with wording other than standard wording.
Opinion Paragraph - Go through the same routine with the opinion paragraph as for the introductory and scope paragraphs. Discuss any reports other than standard wording.

Explanatory Paragraph - Any explanatory paragraphs in the report are identified and briefly described by the students.

Name of CPA Firm - Ask why the name is included, whether all names are in script and whether any audits have been done by firms other than the "Big Four." Also highlight the mid-chapter vignette at the top of page 48 noting that the EU requires audit partner’s to personally sign the audit report.

Audit Report Date - The purpose of the date is explained. Ask students to calculate the number of days between the balance sheet date and the date of the auditor’s report. The least and most number of days are identified and possible reasons for the differences are briefly discussed.

Also ask students how many of the annual reports have a "Statement of Management's Responsibilities." That is a good basis for discussing management's versus auditor's responsibilities.

Categories of Audit Reports (page 49)

The next topic we cover is the four categories of audit reports, including Figure 3-2 on page 49. We emphasize the increasing severity of the departures from a standard unqualified report, as depicted in Figure 3-2.

(See Figure 3-2)

Report on Internal Control Over Financial Reporting Required Under Section 404 of the Sarbanes–Oxley Act (page 49)

We display the wording of a separate report on internal control over financial reporting (Figure 3-3, on page 50). We discuss why reporting on internal control is required for accelerated filer public companies under the Sarbanes–Oxley Act, and the effect this has on the amount of audit testing and audit fees. We discuss the additional paragraphs for the definition of internal control and inherent limitations of internal control. Finally, we highlight the differences in the introductory, scope and opinion paragraphs from the standard audit report on the financial statements, and we highlight the framework used for internal control and that internal control is evaluated as of the end of the most recent fiscal year. We also note that because the audit report is for a public company, it refers to practice standards established by the PCAOB. Note: An example combined report on financial statements and internal control over financial reporting is included in the glossy Hillsburg Hardware Annual Report inserted in the text and issues surrounding the nature of the auditor’s opinion on internal control are addressed in Chapter 10.

(See Figure 3-3)
Unqualified Audit Report with Explanatory Paragraph or Modified Wording (page 51)

Next we cover the five causes of an unqualified report with an explanatory paragraph or modified wording. We put most of the emphasis on reports involving the going concern situations, the use of other auditors, and consistency exceptions, because they are the most common ones in practice. We show illustrations from practice. For a summary of unqualified audit reports with an explanatory paragraph or modified wording, we use T-3-2.

(See T-3-2)

When we plan to discuss the use of other auditors more extensively, we also use T-3-5.

Conditions Requiring a Departure from Unqualified Opinion (page 55)

At this point go over, in some detail, each of the three conditions, the type of opinion that is appropriate for each condition, and examples. We then refer students to Table 3-2 (page 63) and try to make sure students understand everything on that page. T-3-3 is also useful in covering the conditions and type of report.

(See T-3-3)

(See Table 3-2)

It is important that students be given practice at this point. The following problems are useful for that. (Keep Table 3-2 projected on the screen throughout all of the problems you have time to cover.)

3-25 - Multiple choice questions.
3-28 - Type of opinion. After students answer the question for each situation, we often change the situation slightly.
3-29 - Type of opinion.

At this point it is useful to go over several illustrative audit reports included in the text to make sure students understand which conditions exist, the type of report issued, and the nature of the wording.

Audit Reports Other Than Unqualified (page 55)

Next, we go over the types of qualified auditors' reports (qualified, adverse, and disclaimer), with emphasis on materiality. You may wish to bring up the use of the auditor's report as a "signal" here, i.e., three paragraphs generally signal that things are okay, whereas more than three paragraphs signal something is unusual or abnormal and demands the reader's special attention. We remind students that these reports are on the financial statements only to distinguish them from the separate report on internal control over financial reporting.
The number of paragraphs for each type of report is summarized in Table 3-3 (page 64). You may also find the matrix in Table 3-4 useful:

(See T-3-4)

(See Table 3-3)

Homework problem 3-30 can be used to help students link the type of opinion with the format of the auditor’s report.

You might also call attention to the mid-chapter vignette on page 65 that notes how the Auditing Standards Board has commissioned research to study the communication effectiveness of the current auditor’s report.

**International Accounting and Auditing Standards** (page 65)

With the continual move towards the embrace of both international accounting and auditing standards, we expose students to the SEC’s proposed roadmap that may lead to the embrace of international accounting standards for U.S. public companies by 2015. This provides an excellent opportunity to help students connect topics from their financial accounting courses to the audit course. We then discuss how auditor reports would be modified when they conduct the audit in accordance with International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB) that was introduced in Chapter 2. Homework Problem 3-33 can be used to highlight key differences in an audit report issued under U.S. GAAS and an audit report issued under the ISAs.

**Other Issues**

To the extent we have time, we do the following:

- Expand discussion of materiality and related issues
- Consistency versus comparability (See Problem 3-31)
- Negative assurances
- Problem 3-27 or Problem 3-32 – Deficiencies in the audit report
- U.S. Securities and Exchange Commission’s (SEC’s) EDGAR Database, and other sources of audited financial statements.
## CHAPTER 3
CROSS-REFERENCE OF LEARNING OBJECTIVES AND PROBLEM MATERIAL

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-1 Describe the parts of the standard unqualified audit report.</td>
<td>3-1, 3-2, 3-3, 3-4, 3-5</td>
<td>3-23</td>
<td>3-26, 3-27, 3-32, 3-33</td>
<td></td>
</tr>
<tr>
<td>3-2 Specify the conditions required to issue the standard unqualified audit report.</td>
<td>3-6</td>
<td>3-23</td>
<td>3-27, 3-32</td>
<td></td>
</tr>
<tr>
<td>3-3 Understand reporting on financial statements and internal control over financial reporting under Section 404 of the Sarbanes–Oxley Act.</td>
<td>3-7</td>
<td>3-23</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3-4 Describe the five circumstances when an unqualified report with an explanatory paragraph or modified wording is appropriate.</td>
<td>3-8, 3-9, 3-10, 3-11, 3-12</td>
<td>3-23, 3-24</td>
<td>3-27, 3-28, 3-29, 3-30, 3-31, 3-32</td>
<td></td>
</tr>
<tr>
<td>3-5 Identify the types of audit reports that can be issued when an unqualified opinion is not justified.</td>
<td>3-9, 3-13, 3-14, 3-18</td>
<td>3-25</td>
<td>3-28, 3-29, 3-30</td>
<td></td>
</tr>
<tr>
<td>3-6 Explain how materiality affects audit reporting decisions.</td>
<td>3-15, 3-16, 3-19</td>
<td></td>
<td>3-27, 3-28, 3-29</td>
<td></td>
</tr>
<tr>
<td>3-7 Draft appropriately modified audit reports under a variety of circumstances.</td>
<td>3-8, 3-17, 3-19</td>
<td>3-25</td>
<td>3-27, 3-28, 3-29, 3-30</td>
<td></td>
</tr>
<tr>
<td>3-8 Determine the appropriate audit report for a given audit situation.</td>
<td>3-20</td>
<td>3-23, 3-24, 3-25</td>
<td>3-28, 3-29, 3-30</td>
<td></td>
</tr>
<tr>
<td>3-9 Understand proposed use of international accounting and auditing standards.</td>
<td>3-21, 3-22</td>
<td></td>
<td>3-33</td>
<td></td>
</tr>
</tbody>
</table>
PARTS OF AUDIT REPORT

1. Report Title
2. Address
3. Introductory Paragraph
4. Scope Paragraph
5. Opinion Paragraph
6. Name of CPA Firm
7. Audit Report Date
## UNQUALIFIED AUDIT REPORT WITH EXPLANATORY PARAGRAPH OR MODIFIED WORDING

<table>
<thead>
<tr>
<th>Causes of Modified Wording or Explanatory Paragraph</th>
<th>Example</th>
<th>Type of Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consistency Exception</td>
<td>Change from LIFO to FIFO inventory</td>
<td>Unqualified with explanatory paragraph</td>
</tr>
<tr>
<td>Substantial Doubt About Going Concern</td>
<td>Significant recurring losses</td>
<td>Unqualified with explanatory paragraph</td>
</tr>
<tr>
<td>Auditor Agrees with a Departure from GAAP</td>
<td>Federal legislation requires the use of a new method of accounting for the automotive industry</td>
<td>Unqualified with explanatory paragraph</td>
</tr>
<tr>
<td>Emphasis of a Matter</td>
<td>A merger with a large company occurred after the balance sheet date</td>
<td>Unqualified with explanatory paragraph</td>
</tr>
<tr>
<td>Reports Involving Other Auditors</td>
<td>A chartered accounting firm audited a subsidiary operating in Canada</td>
<td>Unqualified with modified wording</td>
</tr>
</tbody>
</table>
### TYPES OF AUDIT REPORTS

<table>
<thead>
<tr>
<th>Materiality Level</th>
<th>(GAAP Departure) Auditor Has Knowledge</th>
<th>(Limitation of Scope) Auditor Lacks Knowledge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immaterial</td>
<td>Unqualified</td>
<td>Unqualified</td>
</tr>
<tr>
<td>Material</td>
<td>Qualified (opinion only)</td>
<td>Qualified (scope and opinion)</td>
</tr>
<tr>
<td>Highly Material</td>
<td>Adverse</td>
<td>Disclaimer</td>
</tr>
</tbody>
</table>
### CONDITIONS REQUIRING A DEPARTURE

<table>
<thead>
<tr>
<th>Conditions</th>
<th>Example</th>
<th>Types of Opinions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scope Restricted: By Client</strong></td>
<td>Client refuses to allow CPA to examine minutes</td>
<td>● Unqualified</td>
</tr>
<tr>
<td><strong>Scope Restricted: By Conditions</strong></td>
<td>Engagement begins after year-end</td>
<td>● Qualified (scope and opinion)</td>
</tr>
<tr>
<td><strong>Failure to Follow GAAP</strong></td>
<td>Client uses replacement cost for inventory</td>
<td>● Unqualified</td>
</tr>
<tr>
<td><strong>Auditor Lacks Independence</strong></td>
<td>Ownership of stock in client by partner</td>
<td>● Disclaimer</td>
</tr>
</tbody>
</table>
## USE OF OTHER AUDITORS

<table>
<thead>
<tr>
<th></th>
<th>Unqualified-Standard Wording</th>
<th>Modified Wording</th>
<th>Qualified</th>
</tr>
</thead>
<tbody>
<tr>
<td>Willing to take full responsibility</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Willing to share responsibility</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Not willing to take responsibility</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>or</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other auditor's report includes a</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>material qualification</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
To download more slides, ebook, solutions and test bank, visit http://downloadslide.blogspot.com
Chapter 4

Professional Ethics

The ethical conduct of all business people has become an increasing concern in business, accounting, and auditing education in recent years. The first part of the chapter deals with general ethical issues facing business people.

A useful way to deal with ethical conduct issues is to assign a case for discussion. Any of the cases 4-28 to 4-30 at the end of the chapter will do nicely. Each case can be used for a discussion of many issues in ethical conduct including the following:

1. The importance of ethical conduct.
2. How acting ethically at an early stage of one's career is likely to impact lifelong behavior.
3. The Josephson Institute ethical principles.
4. Ethical dilemmas and how to resolve them.
5. Special need for ethics by CPAs.

Chapter Opening Vignette - “The Value of the Audit Depends on Auditor Independence”

This vignette addresses the importance of auditor independence. It can be used as an introduction to general ethical issues by emphasizing the need for auditors to maintain the highest ethical standards. The vignette can also be used as an introduction to the topic of independence. Ask students why independence is so important for auditors, and whether it is reasonable to prohibit comparatively small investments in audit clients.

Mid-chapter Vignette – “Some Ethical Violations are More Severe than Others” (page 82)

We use the ethical dilemma involving Bryan Longview and the supervisor’s request that he work hours and not record the time (page 80) as an opportunity to discuss the competitive pressures in the audit environment. After applying the six-step approach to resolving this ethical dilemma, students appreciate that many people are potentially affected by the decision not to record time. We ask students how they would handle this type of request from a supervisor, and why not recording time may be against firm policy. The mid-chapter vignette involving Tom Holton (page 82) signing off on uncompleted procedures is a good follow-up to this discussion, and indicates that some responses to time pressure are never appropriate.

Code of Professional Conduct (page 84)

A useful way to discuss the Code of Professional Conduct is with a question: What is the difference between ethics in the philosophical sense and the Code of Professional Conduct for CPAs or other professional groups? The answer is that the latter is based
on the former, but the CPA's Code is much more specific. Ethics in general involves the set of moral standards for right or wrong that a person, group, or a society develops. The Code of Professional Conduct concerns right and wrong behavior for CPAs. Given the focus on the move towards international standards, we also highlight the Code of Ethics for Professional Accountants that is issued by the International Ethics Standards Board for Accountancy (IESBA), which is described in the mid-chapter vignette on page 87. You may want to assign Internet Problem 4-1 which directs students to explore similarities and differences between the AIPCA's and IESBA's Codes.

Next, ask why CPAs need a code of professional conduct. Review Question 4-3 is a good way to ask the question. We emphasize the need and desire to control the actions and behavior of the members for the good of the profession and society. This is a good place to discuss various ways our society encourages CPAs to conduct themselves appropriately. Figure 4-2 (page 83) is helpful to discuss the ways other than the Code.

(See Figure 4-2)

Before getting into the Code, ask about the costs and benefits to society and the profession of an over- or under-restrictive code. The most important things we emphasize are protection of society's needs, rights of individuals in a "free country," and the need to let professionals make some judgments rather than only following rules.

Four Parts of the Code (page 84)

We expect students to know the differences between the four parts of the Code and the reasons for the differences. The text material on the four parts should be summarized. We make sure to give them specific examples, usually ones from later in the chapter. In discussing the four parts, project Figure 4-3 (page 84) on the screen.

(See Figure 4-3)

Other points we emphasize are:

1. The positiveness of the principles (should do this, and should do that) and the negativeness of the rules of conduct (shall not, cannot).
2. The enforceability of the rules of conduct and interpretations and the unenforceability of the principles.
3. The principles portion of the Code represents ideal activities and performance by CPAs and the rules of conduct and interpretations represent minimum performance. Show this on the overhead by using Figure 4-4 (page 86).

(See Figure 4-4)

Then explain how there should be a penalty on those who fall below the minimum. Hopefully, most engage in actions well above the minimum, but some practitioners will stay as close to the line as possible.

4. Ethical Rulings. Project examples of ethical rulings on the overhead to let students see how specific they often are.

(See T-4-1)
We encourage students to visit the AICPA web site to learn more about the Code and recent ethics interpretations.

**Independence** (page 87)

First ask students to explain why independence is so important for auditors. Then ask students to offer suggestions as to why concerns about auditor independence may have increased during the period leading up to the Sarbanes–Oxley Act. We do not to take a position as to whether independence weakened, but relate the concerns about independence to changes in the profession, including competition and the increased importance of consulting.

We also talk about the difference between having “independence of mind” and “independence in appearance” and highlight the importance of both. We also note that the phrase “independence of mind” is new, but relates to the long-standing requirement for members to be “independent in fact”.

**Sarbanes–Oxley Act and SEC Independence Provisions** (page 88)

We then discuss the SEC’s independence rules, including restrictions on consulting and other nonaudit services arising from the Sarbanes–Oxley Act, why these changes were considered necessary, and the important role of the audit committee in evaluating auditor independence. We also talk about whether nonaudit fees comprise independence.

**Other Influences on Auditor Independence**

Another frequent question we use is, "Other than the Code of Professional Conduct, what other motivation does the CPA have to remain independent?" Answer: Professionalism and legal liability.

Somewhere in the discussion on independence, we will have mentioned or added a comment about each of the following as aids in independence:

1. Rules of conduct and interpretations
2. Legal liability
3. Auditing standards requirements related to predecessor–successor auditor communications and issues related to opinion shopping (e.g., SAS 50 engagements).
4. Audit committees—we emphasize recent changes that improve the qualifications and independence of audit committee members, including Sarbanes–Oxley Act requirements that the audit committee be responsible for appointment and compensation of the auditor, including evaluation of auditor independence.
5. SEC reporting requirements for change of auditor, and disputes between management and auditors

Assign and go over Problem 4-24. In Problem 4-24, ask students how the auditors can have independent of mind and not independence in appearance, and vice-versa. Also try to get them to agree that prohibition of each of items e (1)-(7) would likely increase auditors’ independence. Then raise the costs and benefits question of the importance of having strict rules for each of e (1)-(7).
Independence Rule of Conduct and Interpretations (page 90)

In covering Rule 101 - Independence, we focus on the rules for financial interests. Explain the concept of “covered member,” emphasizing why ownership interests are restricted for covered members, and the distinction between direct and indirect financial interests. We also discuss the three steps in the independence conceptual framework (see pages 94-95) to help students develop a thought process for evaluating potential independence concerns.

We also discuss the rules related to bookkeeping, consulting and other nonaudit services, and why these restrictions are considered necessary. We make sure the students understand the distinction between rules applicable to private companies and rules applicable for public companies arising from the PCAOB, SEC, and Sarbanes–Oxley Act. Problem 4-20 is a good problem to distinguish allowable and prohibited nonaudit services.

Practice in "Which of the Following are Violations?"

Discussion Questions 4-21 and/or 4-22 are useful to test students' knowledge of the Code and interpretations and give them practice. We try to emphasize the reason each rule exists. Frequently, we go over one problem in class and collect the other for grading. It is helpful to refer to Table 4-1 on page 103 when answering these questions.

(See Table 4-1)

Case 4-27 is useful for more subjective questions about violations of the Code of Professional Conduct. This case works best by discussing alternative interpretations of what the case means.

Specific Rules and Interpretations

Normally, we cover this material as a part of Discussion Questions 4-21 and/or 4-22. We do try to spend a little time on certain rules that students are likely to misunderstand. The emphasis is on the meaning of the rule and why it exists.

- Rule 301 - Confidentiality
- Rules 302 and 503 - Contingent fees, commissions and referrals (including when there is no violation of these rules)
- Rule 501 - Acts discreditable
- Rule 502 - Advertising and solicitation
- Rule 505 - Form of organization and name

Desirability of Changes in the Code

We explain the reasons for provisions in the Code of Professional Conduct related to contingent fees, commissions, and advertising. We ask students to state the positive and negative effects on society and the profession of these provisions. After the discussion, ask for a "straw vote" as to how the students, as young people entering the profession, feel about the changes. There is usually significant disagreement.
We also like to discuss the changes in the ownership requirements for CPA firms, and relate these changes to other changes in the profession. We also discuss the recent emergence of alternative practice structures and corporate ownership of CPA firms.

**Enforcement** (page 103)

This is a good place to emphasize three organizations and their relationships:

1. **AICPA** — Organization supporting the profession. Membership is voluntary.
2. **State Society of CPAs** — Organization supporting the profession. Membership is voluntary.
3. **State Board of Accountancy**

   - Grants the license to practice in individual states.
   - Typically adopt the AICPA rules of conduct or a set of similar ones.
   - Note that the rules include requirements about auditing standards (Rule 201 and Rule 202) and accounting principles (Rule 203) along with all others.
   - A state Board of Accountancy can take away the license to practice.

The investigation and sanction by the AICPA and state society is much stronger and more effective than most students think. Pride along with a desire to maintain a professional reputation and peer pressure works.

We also find it useful to express our personal opinions, based on observations, that high quality work and following the *Code* results in a more successful practice in the long run, both in profits and personal satisfaction.

Students are interested in whether CPAs are sanctioned and if so, why. The students laugh when we tell them the two most common reasons for AICPA sanction are:

1. Failure to file a personal tax return
2. Bribing an internal revenue agent on behalf of a client

We often show them, on the overhead, an example of selections from the Disciplinary Actions sections of the AICPA’s Web site.

*(See T-4-2)*

We also note that auditors can also be sanctioned by the SEC and PCAOB.
# Chapter 4
## Cross-Reference of Learning Objectives and Problem Material

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>4-1 Distinguish ethical from unethical behavior in personal and professional contexts.</td>
<td>4-1</td>
<td></td>
<td></td>
<td>4-29</td>
</tr>
<tr>
<td>4-2 Resolve ethical dilemmas using an ethical framework.</td>
<td>4-2</td>
<td></td>
<td></td>
<td>4-28, 4-29, 4-30</td>
</tr>
<tr>
<td>4-3 Explain the importance of ethical conduct for the accounting profession.</td>
<td>4-3</td>
<td></td>
<td></td>
<td>4-29</td>
</tr>
<tr>
<td>4-4 Describe the purpose and content of the AICPA Code of Professional Conduct.</td>
<td>4-4, 4-5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4-5 Understand Sarbanes–Oxley Act and other SEC and PCAOB independence requirements and additional factors that influence auditor independence.</td>
<td>4-6, 4-7, 4-8, 4-10</td>
<td>4-20, 4-23, 4-24</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4-6 Apply the AICPA Code rules and interpretations on independence and explain their importance.</td>
<td>4-9</td>
<td>4-18</td>
<td>4-20, 4-21, 4-22, 4-24, 4-25, 4-26</td>
<td>4-27</td>
</tr>
<tr>
<td>4-7 Understand the requirements of other rules under the AICPA Code.</td>
<td>4-11, 4-12, 4-13, 4-14, 4-15, 4-16, 4-17</td>
<td>4-19</td>
<td>4-21, 4-22</td>
<td>4-27, 4-28</td>
</tr>
<tr>
<td>4-8 Describe the enforcement mechanisms for the rules of conduct.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
ILLUSTRATIVE ETHICAL RULINGS

EXAMPLE 1

A CPA's ownership of shares in a mutual investment fund which owns stock in the CPA's clients normally would not impair independence.

EXAMPLE 2

A CPA who is in partnership with non-CPAs may sign the report with the firm name, his own name, and indicate "Certified Public Accountant."

EXAMPLE 3

If the relationship of a member who is not an owner of a firm is terminated, he or she may not take or retain originals or copies from the firm’s client files or proprietary information without the firm’s permission, except where permitted by contractual arrangement.
EXAMPLES OF SUSPENSIONS FROM AICPA
(Names Changed)

EXAMPLE 1

James J. Shame of Newark, NJ, was notified by the secretary on January 22, 2011, that his institute membership was terminated. The termination followed receipt of a judgment of conviction in a U.S. District Court on the member's plea of guilty to charges of wire fraud and failure to pay employee withholding and FICA taxes to the U.S. government.

EXAMPLE 2

John L. Rascal of Dallas, TX, was notified by the secretary on January 23, 2011, that his institute membership was terminated upon receipt of a judgment of conviction in a U.S. District Court on the member's plea of guilty of making a false statement to a governmental agency in violation of the U.S. code.

EXAMPLE 3

On November 13, 2010, a hearing panel of the Joint Trial Board Division's Regional Trial Board VI voted to suspend the AICPA membership of Harry Naughty of Bloomington, IL, until December 31, 2011, for having departed from generally accepted auditing standards and generally accepted accounting principles in violation of Rules 202 and 203 of the Code of Professional Conduct.

The hearing panel found that the member issued a substandard report on the financial statements of a client based on fieldwork performed by a non-CPA. The audit documentation for the report, as well as documentation for other reports, were found to be deficient and contained insufficient evidence to issue an unqualified opinion.
Chapter 5
Legal Liability

The legal liability section is difficult to teach. We want the students to have a flavor for the auditor's legal responsibility without overwhelming them with material to memorize that they are unlikely to remember. The legal environment is also significantly different for individuals, depending on their employment choice. Internal and governmental auditors have little, if any, concern, while those who work for national CPA firms are greatly affected by SEC law. Smaller CPA firm employees are more concerned with client and third party common law. We also don't want students to believe that legal liability is the dominant consideration in an auditor's life.

The following are the major things we try to cover:

- Chapter opening vignette
- The changed legal environment
- Distinction among business failure, audit failure, and audit risk
- Prudent person concept
- Review of definitions
- Liability to clients
- Liability to third parties under common law
- Civil liability - Securities Act of 1933
- Civil liability - Securities Exchange Act of 1934
- Criminal liability
- Profession's response to liability
- Summary of chapters 1, 2, 4, and 5

Chapter Opening Vignette - “It Takes the Net Profit from Many Audits to Offset the Cost of One Lawsuit”

This vignette is fairly straightforward. It shows that an auditor can get sued even when he or she does everything right. In addition, once the suit is filed, the cost of riding it out is immense. Once these realities are grasped, an auditor should be convinced and motivated to be extremely careful to avoid high-risk clients and to ensure that auditing standards are complied with.

The vignette raises an important economic issue as well: the relationship between risk and fees. If auditors are too willing to "low-bid" fees to get work, and their average fees across all clients are low, then their fee structure may not be sufficient to justify the risks they are taking.

The vignette can also be used to discuss the nonmonetary costs of litigation. It is important for students to get some feel for the stress that is placed on individuals and the practice as a whole by a lawsuit.
The Changed Legal Environment (page 114)

It is useful to show students T-5-1 related to the history of legal liability for CPA firms. It gives them a perspective that it is fairly recent that liability has been a problem for CPAs.

(See T-5-1)

Next we ask students to compare the liability of CPAs and other professionals such as physicians, attorneys, and automobile manufacturers. (They are not substantially different.) It might be helpful to bring a recent article from the newspaper or business journal about a huge judgment or settlement in some other field.

It is also useful to ask students to state their opinions of the costs and benefits to society of extensive liability of CPAs. Should there be no liability? Should CPAs be guarantors and insurers of the accuracy of financial statements? Is there now too much or too little liability?

Review Question 5-2 is a good one to discuss at this point. We want students to think about the need for CPAs to be responsible for their actions, the cost and benefit to society of extensive liability, the need to attract competent people to the CPA profession, and the difference of opinions held by different people depending on their values.

Distinguishing Business Failure, Audit Failure, and Audit Risk (page 115)

Students need to be able to distinguish between business failure and audit failure. We often give the students a couple of examples of both and then ask them to distinguish whether the example represents business failure or audit failure. The opening vignette is useful when pointing out that auditors are often penalized for business failures, even when there has not been an audit failure. We use this discussion to describe the expectation gap that exists between users and the accounting profession. This provides a good opportunity to discuss how that gap can be narrowed (e.g., educating users, changing auditor professional responsibilities, etc.).

This is a nice point to introduce the four major sources of legal liability for auditors that are summarized in Figure 5-1 (page 119).

(See Figure 5-1)

Prudent Person Concept (page 116)

It is useful to go over the prudent person concept emphasizing the items in T-5-2.

(See T-5-2)

It is relevant to dwell on the second item and ask students about their legal responsibility as new employees when they are assigned a task they do not feel qualified to do. Students tend to have an attitude of "The CPA firm is responsible to properly supervise me and review my work, and I am only an employee."
It is also relevant to ask or discuss how the prudent person concept is implemented in practice given that a "reasonable person concept" is nebulous. Discuss the use of expert witnesses and the pros and cons of having lay people sit on juries involving technical subjects.

Review of Definitions (page 117)

Our discussion of definitions is ordinarily limited to telling students, preferably during the class period preceding the discussion of liability, to know the definitions in the early part of the chapter. It is useful to briefly go over the legal terms in Table 5-1 (page 117). Problem 5-18 can be used to review terms related to auditor legal liability.

(See Table 5-1)

Liability to Clients (page 118)

It should be emphasized that there are more lawsuits by clients than any other source, but the suits are usually small, not reported to the press, frequently settled out of court, and usually have no significance in setting new precedents.

(See T-5-3)

We emphasize the plaintiff's need to establish the CPA's negligence and auditor's defenses. The auditor's primary defenses are included in T-5-4.

(See T-5-4)

An example using taxes, audits, or unaudited engagements can be used to illustrate the differences in the defenses.

You may want to briefly summarize 1136 Tenants case (page 120) because many students may not understand what unaudited means at this point. The impact on the profession is the most important part of that case.

Liability to Third Parties Under Common Law (page 121)

The two most important common law concepts for students to understand are:

- Known versus unknown third parties and the impact on liability
- The variation in different legal jurisdictions in their interpretations

The graph in T-5-5 depicts the environment of legal liability to third parties under common law.

(See T-5-5)

Each letter indicates a degree of negligence and a level of known and unknown users. For A, B, and C there is clear legal responsibility. For M, N, and O there is clear nonlegal responsibility. There is more legal responsibility for D than F, and D than J. There is no way to state whether there is more legal responsibility for F than J.

Problems 5-19, 5-20, 5-21, 5-22, 5-23 or 5-26 can be used at this point.
Civil Liability - Securities Act of 1933 (page 123)

Most students need to be told the meaning of a registration statement and how it differs from a 10-K. Review Question 5-12 is useful for this. Ask students whether they consider the 1933 Act equitable to auditors with regard to each of the three points discussed under the Securities Act of 1933. A favorite quote about the 1933 Act was made by George O. May (1936).

(See T-5-6)

The BarChris case (page 124) should be referred to or discussed in reference to understanding the client’s business, which is now required by the second standard of fieldwork, and AU 560 (Subsequent Events). The relationship between legal liability and auditing standards can be conveniently discussed at this point.

Civil Liability - Securities Exchange Act of 1934 (page 125)

Students need to understand that the 1934 Act applies to auditors each year for all publicly held companies. Start by going over Rule 10b-5 with the students and ask them to explain what it says. At that point spend some time on Hochfelder, especially the quote included in the summary of Hochfelder v. Ernst & Ernst (page 125). We then ask students:

1. How do you believe critics of the auditing profession feel about the Hochfelder case?
2. Do you believe the auditor should only be responsible when there is manipulation and deception, or should the auditor also be responsible for negligence?

The unsettled nature of the 1934 Act is then discussed along with other actions that can be used by the SEC. Case 5-27 is useful for this material. Problem 5-24 can be used to distinguish the requirements for legal liability under the 1933 and 1934 acts.

Students are often confused by the various terms and sources of auditor liability. Table 5-3 (page 128) is useful to review legal liability to clients, third parties under common law, and under the federal securities laws.

(See Table 5-3)

Criminal Liability (page 127)

We emphasize how critical criminal liability is because of the inability to insure for it, and the personal impact on partners and staff. We make the point that a person need not perceive himself as a criminal to find himself in a circumstance where he is found guilty of committing a crime.
Go over the United States v. Andersen (2002) case (page 129) and discuss the role the criminal conviction played in the demise of the Andersen firm. Many students are aware of the document shredding in the case and are surprised that it was not a source of the criminal conviction.

Problem 5-23, Part c, is useful at this point.

The Profession's Response to Liability (page 130)

It is useful to conclude the section by distinguishing between what three groups can do to reduce CPAs' liability: the profession, CPA firms, and relatively inexperienced staff. We discuss these using the material at the end of the chapter as a frame of reference. Go over the list of "individual responses" and ask students, "which of these can you do during your first two years as an auditor?"

Summary of Chapters 1, 2, 4, and 5

As an introduction or a summary, it is useful to relate auditing standards (including quality control standards), professional ethics, competition, and accountants' liability as forming a system for the control of the performance of audit services by CPAs at a high level. All four elements of this system are important.

(See T-5-7)
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Discussion Questions and Problems</th>
<th>Multiple Choice Questions</th>
<th>Review Questions</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>5-1 Understand the litigious environment in which CPAs practice.</td>
<td>5-1, 5-2, 5-6</td>
<td></td>
<td>5-1, 5-2, 5-6</td>
<td></td>
</tr>
<tr>
<td>5-2 Explain why the failure of financial statement users to differentiate among business failure, audit failure, and audit risk has resulted in lawsuits.</td>
<td>5-3</td>
<td>5-4, 5-5, 5-8</td>
<td>5-3</td>
<td>5-18, 5-21</td>
</tr>
<tr>
<td>5-3 Use the primary legal concepts and terms concerning accountants' liability as a basis for studying legal liability of auditors.</td>
<td>5-4, 5-8, 5-9, 5-10, 5-13</td>
<td>5-16</td>
<td>5-16</td>
<td>5-18, 5-19, 5-20</td>
</tr>
<tr>
<td>5-4 Describe accountants' liability to clients and related defenses.</td>
<td>5-5, 5-10, 5-11, 5-12, 5-13</td>
<td>5-17</td>
<td>5-17</td>
<td>5-18, 5-22, 5-24, 5-25</td>
</tr>
<tr>
<td>5-5 Describe accountants' liability to third parties under common law and related defenses.</td>
<td>5-6, 5-13, 5-14</td>
<td>5-18, 5-22, 5-24, 5-25</td>
<td>5-18, 5-22, 5-24, 5-25</td>
<td>5-27</td>
</tr>
<tr>
<td>5-6 Describe accountants' civil liability under the federal securities laws and related defenses.</td>
<td>5-7 Specify what constitutes criminal liability for accountants.</td>
<td>5-13</td>
<td>5-13</td>
<td>5-23</td>
</tr>
<tr>
<td>5-7 Specify what constitutes criminal liability for accountants.</td>
<td>5-8 Describe how the profession and individual CPAs can reduce the threat of litigation.</td>
<td>5-27</td>
<td>5-27</td>
<td>5-23</td>
</tr>
</tbody>
</table>
HISTORICAL PERSPECTIVE OF LEGAL LIABILITY

<table>
<thead>
<tr>
<th>Prior to 1930</th>
<th>1930 to 1945</th>
<th>1945 to 1966</th>
<th>1967 and Later</th>
</tr>
</thead>
<tbody>
<tr>
<td>Few major lawsuits</td>
<td>Several precedent setting</td>
<td>Few major lawsuits</td>
<td>Extensive lawsuits</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Ultramares
- McKesson & Robbins
- BarChris
- Hochfelder
- 1136 Tenants
PRUDENT PERSON CONCEPT

- Employment of skill with reasonable care and diligence

- If one offers his or her service, he or she must have the required skills

- He or she undertakes for good faith and integrity, but not for infallibility

- He or she is liable for acts resulting from negligence, bad faith or dishonesty, but not pure errors of judgment
MOST LIKELY CAUSES OF LAWSUITS BY CLIENTS

- Alleged failure to deliver financial statements or tax returns on a timely basis
- Alleged failure to discover a fraud in audits and unaudited engagements
- Alleged errors in preparing tax returns resulting in deficiency assessments
- Alleged errors in preparing financial statements resulting in the failure to get a loan
AUDITOR'S DEFENSES — SUITS BY CLIENTS

- Lack of duty to perform the service
- Nonnegligent performance (expert witness)
- Contributory negligence
- Absence of causal connection
LIABILITY TO 3RD PARTIES – RELATIONSHIP OF "KNOWN 3RD PARTY" AND "DEGREE OF NEGLIGENCE"
GEORGE O. MAY, 1936

OPINION OF LIABILITY UNDER THE 1933 ACT

I cannot believe that a law is just or can long be maintained in effect which deliberately contemplated the possibility that a purchaser may recover from a person from whom he has not bought, in respect of a statement which at the time of his purchase he had not read, contained in a document which he did not then know to exist, a sum which is not to be measured by injury resulting from falsity in such statement.
THE "SYSTEM" FOR CONTROL OF THE QUALITY OF AUDIT SERVICES BY CPAs

Professional Standards

Professional Ethics

Legal Liability

Competition
Chapter 6
Audit Responsibilities and Objectives

Chapter 6 is important because students have difficulty visualizing the relationship between giving an opinion on financial statements and determining specific audit objectives for each component of the statements. We believe this chapter is an essential one to help students understand the audit process.

In teaching this chapter, we cover the following topics:

Chapter Opening Vignette - “Where Were the Auditors?”

This is the infamous ZZZZ Best case. It is an excellent case for consideration of audit evidence and fraud, and illustrates how an extremely clever crook can fool the auditors through an elaborate scheme. A logical question raised by the case is whether the auditor’s work was sufficient. We think it was, and that the case illustrates the legitimate limitations of auditing.

Students are often interested in Barry Minkow’s current status. He served his term and now speaks and teaches about fraud. There are a number of references that discuss this case in great detail if you wish to investigate it further.

Objective of Conducting an Audit of Financial Statements (page 142)

We bring different annual reports or Form 10-Ks to class for each student and ask the students to state the objective of an audit as it relates to the annual report. Given the study of audit reports, this takes little time.

Management’s Responsibilities (page 143)

We don’t spend a lot of time on this section, except to briefly discuss the fact that management, and not the auditor, is responsible for adopting sound accounting policies, maintaining adequate internal control, and making fair representations in the financial statements. It may be useful to highlight the discussion by the management of International Business Machines Corporation (IBM) in their “Report of Management” in Figure 6-2 (page 143).

(See Figure 6-2)

Auditor’s Responsibilities (page 144)

We begin discussion of auditor’s responsibilities by referring to the excerpt from auditing standards on page 144. While the standards do not state that the auditor is responsible for finding all instances of material errors and fraud, it requires the auditor to plan and perform the audit to obtain reasonable assurance that material errors and fraud will be found. Problem 6-22 is useful for comparing the auditor’s responsibilities with management’s responsibilities, and Problem 6-22 can be used to discuss the concept of “reasonable assurance.”
Next, it is helpful to distinguish between errors and fraud. Review Question 6-3 can be used here. Transparency T-6-1 is also helpful.

(See T-6-1)

After introducing fraud, the two types of fraud can be discussed: fraudulent financial reporting and misappropriation of assets. Review Question 6-4 can be used to emphasis the likely significance of each type of fraud.

Finally, we briefly discuss the auditor’s responsibility for discovering illegal acts. We distinguish between direct-effect illegal acts and indirect-effect illegal acts, and discuss the auditor’s responsibility for discovering each.

Financial Statement Cycles (page 148)

We use the financial statements in the annual reports or Form 10-Ks students have in their possession for the session to discuss dividing the statements into manageable segments. Looking at the financials, it becomes obvious that it is difficult to audit without more detailed information.

The relationship between financial statements and the general ledger and the importance of the general ledger can be shown with T-6-2.

(See T-6-2)

Next, we spend some time defining the cycles and explaining their role in the audit process. We use T-6-3, Figure 6-3 (page 148), and Figure 6-5 (page 152) to discuss cycles.

(See T-6-3)

(See Figures 6-3 and 6-5)

We use Problem 6-24 to practice relating accounts to cycles.

Setting Audit Objectives (page 152)

We put considerable emphasis on transaction-related audit objectives and balance-related audit objectives, both in this chapter and subsequent chapters. A good way to introduce setting audit objectives is to review Figure 6-1 (page 142).

(See Figure 6-1)

Management Assertions (page 153)

We use Table 6-2 (page 154) to present the three categories of management assertions. Problem 6-25 is useful for students to identify the management assertions in each category of assertions.

(See Table 6-2)
Transaction-Related Audit Objectives (page 156)

It is useful to cover each general transaction-related audit objective in detail. We suggest using T-6-4 during this discussion. Table 6-3 (page 158) can be used to illustrate specific transaction-related audit objectives for each general transaction-related audit objective.

(See T-6-4)

(See Table 6-3)

Problem 6-27 is useful for students to relate general transaction-related audit objectives to management assertions and specific transaction-related audit objectives.

Balance-Related Audit Objectives (page 158)

Next, we discuss the general balance-related audit objectives, using T-6-5 as a frame of reference. Table 6-4 (page 160) can be used to illustrate specific balance-related audit objectives for each general balance-related audit objective.

(See T-6-5)

(See Table 6-4)

Problem 6-26 or Problem 6-29 can be used to address specific balance-related objectives.

Presentation and Disclosure-Related Audit Objectives (page 161)

Next, we discuss the presentation and disclosure-related audit objectives. Table 6-5 (page 161) can be used to illustrate specific presentation and disclosure-related audit objectives for each general presentation and disclosure-related audit objective.

(See Table 6-5)

Problem 6-30 is useful to relate specific audit objectives to general balance-related, transaction-related, and presentation and disclosure-related audit objectives.

How Audit Objectives are Met (page 161)

It is useful to finish the chapter by briefly discussing how audit objectives are met. Put a transparency of expanded Figure 6-7 (page 162) on the overhead and discuss it briefly. We refer back to Figure 6-7 in later chapters.

(See Figure 6-7)

Problem 6-30 can be used to related specific audit activities to phases of the audit process.
## CHAPTER 6
### CROSS-REFERENCE OF LEARNING OBJECTIVES AND PROBLEM MATERIAL

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>6-1 Explain the objective of conducting an audit of financial statements and an audit of internal controls.</td>
<td>6-1</td>
<td>6-19</td>
<td>6-23</td>
<td>6-32</td>
</tr>
<tr>
<td>6-2 Distinguish management’s responsibility for the financial statements and internal control from the auditor’s responsibility for verifying the financial statements and effectiveness of internal control.</td>
<td>6-2</td>
<td></td>
<td>6-22</td>
<td></td>
</tr>
<tr>
<td>6-3 Explain the auditor’s responsibility for discovering material misstatements.</td>
<td>6-2, 6-3, 6-4, 6-5, 6-6</td>
<td>6-20</td>
<td>6-22, 6-23</td>
<td>6-32</td>
</tr>
<tr>
<td>6-4 Classify transactions and account balances into financial statement cycles and identify benefits of a cycle approach to segmenting the audit.</td>
<td>6-7, 6-8, 6-9</td>
<td></td>
<td>6-24</td>
<td></td>
</tr>
<tr>
<td>6-5 Describe why the auditor obtains a combination of assurance by auditing classes of transactions and ending balances in accounts, including presentation and disclosure.</td>
<td>6-9, 6-11</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6-6 Distinguish among the three categories of management assertions about financial information.</td>
<td>6-10, 6-11, 6-15, 6-16, 6-17</td>
<td>6-21</td>
<td>6-25, 6-26, 6-27, 6-28</td>
<td></td>
</tr>
<tr>
<td>6-7 Link the six general transaction-related audit objectives to management assertions for classes of transactions.</td>
<td>6-12, 6-14</td>
<td></td>
<td>6-27</td>
<td></td>
</tr>
<tr>
<td>6-8 Link the eight general balance-related audit objectives to management assertions for account balances.</td>
<td>6-13, 6-14, 6-15, 6-16</td>
<td></td>
<td>6-26, 6-29, 6-30</td>
<td></td>
</tr>
<tr>
<td>6-9 Link the four presentation and disclosure-related audit objectives to management assertions for presentation and disclosure.</td>
<td>6-14, 6-17</td>
<td></td>
<td>6-28</td>
<td></td>
</tr>
<tr>
<td>6-10 Explain the relationship between audit objectives and the accumulation of audit evidence.</td>
<td>6-18</td>
<td></td>
<td>6-31</td>
<td></td>
</tr>
</tbody>
</table>
THREE EQUALLY MATERIAL ERRORS OR FRAUDS

1. Unintentional use of inventory method not in accordance with GAAP.

2. Employee does not record cash sales in cash register and keeps the cash.

3. Management withholds information from auditor about a lawsuit for a patent infringement and does not include it as a footnote.

● Which are errors and which are frauds?

● Should auditors have equal responsibilities for discovering each one?
RELATIONSHIP OF FINANCIAL STATEMENTS TO ACCOUNT BALANCES

Financial Statements ↔ General Ledger Trial Balance ↔ General Ledger
CYCLES USED IN TEXT

- Sales and collection
- Acquisition and payment
- Payroll and personnel
- Inventory and warehousing
- Capital acquisition and repayment
GENERAL TRANSACTION-RELATED AUDIT OBJECTIVES

Occurrence

Completeness

Accuracy

Posting and Summarization

Classification

Timing
GENERAL BALANCE-RELATED AUDIT OBJECTIVES

Existence
Completeness
Accuracy
Classification
Cutoff
Detail Tie-in
Realizable Value
Rights and Obligations
Chapter 7
Audit Evidence

The amount of time you spend on this chapter is mostly dependent on the emphasis you want to put on audit documentation. The topics to cover are:

- Chapter opening vignette
- Overview
- Audit evidence decisions
- Persuasiveness of evidence
- Types of evidence
- Terms used in audit procedures
- Audit documentation

Chapter Opening Vignette – “Sometimes the Most Important Evidence Is Not Found in the Accounting Records”

This vignette illustrates a common weakness that occurs among auditors: getting caught up in the mechanics of a situation without grasping its substance. Here, the auditor failed to gain an adequate understanding of his client’s business. He didn’t recognize that the value of the client’s assets was a function of a market that essentially looks at cash flows. As cash flows declined, so did value and the Company’s ability to remain solvent.

A class discussion of this vignette might be facilitated by presenting a simple economic model of an apartment building and asking students how they would value it.

Overview

It is useful to start by defining evidence and distinguishing among scientific, legal, and audit evidence. Table 7-1 (page 174) is useful to do that.

(See Table 7-1)

Audit Evidence Decisions (page 175)

The four audit evidence decisions are explained throughout the course. List them on the overhead, define and discuss them.

(See T-7-1)

Also define an audit procedure. For the audit procedure, obtain accounts receivable confirmations, ask students to tell how and under what circumstances sample size, items to select, and timing should vary. The purpose is to get students to think about decision making.
**Persuasiveness of Evidence** (page 176)

We spend a few minutes discussing what persuasiveness means and its distinction from certainty (and conclusive). We then cover the distinction between appropriateness and sufficiency. We also discuss the factors affecting reliability.

*(See T-7-2)*

It is also worthwhile to discuss the reliability of various types of evidence.

**Types of Audit Evidence** (page 179)

Define and distinguish between procedures, types of evidence, and generally accepted auditing standards using **Figure 7-1** (page 180).

*(See Figure 7-1)*

At that point, list on the overhead, ask questions, or make observations about each type of evidence:

*(See T-7-3)*

**Physical Examination** (page 180)

- Define
- Applies only to tangible assets
- Assets applicable to (cash, fixed assets, securities, etc.)
- Reliability
- For what purposes it is useful and not useful
- Provides an opportunity to have direct contact with business

With regard to the last point, a useful teaching technique is to select an industry (e.g., cement manufacturing) and describe how it works and what assets the auditor might examine. The goal is to get the students to realize how important knowledge of the business is to performing rudimentary audit procedures in a proper fashion.

**Confirmation** (page 180)

- Four characteristics -
  1. Receipt (Note negative confirmation of receivables as an exception.)
  2. Written – we also note that they may be received electronically
  3. From independent third party
  4. Information requested by auditor

- Type of information confirmed (**Table 7-3**, page 181)
- Reliability and cost
- Why it is not usually used for tests of controls and substantive tests of transactions

*(See Table 7-3)*
**Documentation** (page 182)

- Define
- Examples
- Distinguish from physical examination
- Internal versus external documents
  - Reliability
  - Examples
- Where it is likely to be used
- Electronic evidence

Problem 7-27 is useful at this point.

**Analytical Procedures** (page 183)

We believe analytical procedures are an essential part of auditing. Students are introduced to the purposes of analytical procedures in this chapter. More detailed coverage of ratios and the use of analytical procedures in understanding the client's business and assessing risk is included in the next chapter on audit planning. Analytical procedures for specific accounts are discussed throughout subsequent chapters.

- Define
- When they are used
- Purposes (T-7-4, T-7-6)
- Examples (T-7-5)
- Reliability

(See T-7-4, T-7-5 and T-7-6)

For T-7-6, the answers are:

1. A, D  
2. B  
3. C  
4. A, E  
5. C  
6. B  
7. A, D  
8. C  
9. A, D  
10. B

**Inquiries of the Client** (page 184)

- Define
- Oral and written
- Examples
- Reliability
- Define letter of representation (which will be discussed in Chapter 24)
- Why they are used
- Legal implications if corroborative evidence not added
- Tie into *BarChris* case in Chapter 5
Recalculation (page 184)

- Define
- Examples
- Reliability

Reperformance (page 184)

- Define
- Examples
- Reliability
- Need for other evidence to test details even if no misstatements

Observation (page 184)

- Define
- Distinguish from physical examination and documentation
- Reliability
- When it is used
- Define corroborative evidence and why needed

Problem 7-28 is one we always use to test students' knowledge of types of evidence. Problems 7-29, 7-30, and 7-34 are also good ones at this point. Problem 7-35 is especially useful to discuss reliability of evidence in different situations. If there is time, it is also useful to summarize this discussion by having the students develop a hierarchy of evidence in terms of its probable reliability. We suggest they should arrive at the three-level hierarchy shown in T-7-7.

(See T-7-7)

After discussing types of evidence, it is desirable to return to the appropriateness of each type of evidence. Table 7-4 (page 185) is useful for that.

(See Table 7-4)

If you have time, relate the types of evidence to balance-related audit objectives in Chapter 6. This can be done conveniently with Problem 7-33.

Terms Used in Audit Procedures (page 186)

We cover the terms for definitional purposes. First, go over the terms briefly. Problem 7-35 is useful to help students learn the correct use of terms.

Audit Documentation (page 188)

The end of the chapter vignette on page 194 – “Will it Stand Up in Court?” – is a good starting point for your discussion of audit documentation. The vignette is an excerpt from the deposition of an auditor who was in charge of an audit six years ago.
It illustrates what can happen when audit files do not adequately document the audit procedures performed.

We spend little time on audit documentation format because firms have their own techniques. Students often have difficulty understanding what each type of audit schedule means. Briefly cover the following:

- Purposes
- Relationship of audit documentation to financial statements
- Common characteristics of audit documentation
- Ownership of audit files
- Confidentiality of audit files

If you wish to assign problem material for audit documentation, Problem 7-37 is a good one.

We discuss how information technology has changed the nature of the evidence available to auditors, and the way audits are conducted and documented. We note that the term “audit documentation” is now used instead of the term “working papers”, although the latter term is still acceptable.

We like to give a few examples of how information technology has made the audit more efficient. If many of the students in your class have internship experience, you can ask them to give examples of how they documented their audit testing.

**Requirements for Retention of Audit Documentation (page 189)**

We briefly discuss the Sarbanes-Oxley requirements for auditors of public companies to prepare and retain audit working papers and other information related to any audit report for a period of seven years. This component of the Sarbanes-Oxley Act is largely in response to the alleged document shredding by Andersen employees related to the Enron audit. We like to discuss the different types of documentation that now must be maintained. Students find it interesting to learn that even email related documentation may be subject to the retention requirements.
## CHAPTER 7
CROSS-REFERENCE OF LEARNING OBJECTIVES AND PROBLEM MATERIAL

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>ACL Problem and Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>7-1</td>
<td></td>
<td>7-1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7-2, 7-3, 7-4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7-3</td>
<td>7-5, 7-6, 7-7</td>
<td>7-25</td>
<td>7-34</td>
<td></td>
</tr>
<tr>
<td>7-25, 7-27, 7-28, 7-29, 7-30, 7-31, 7-32, 7-33, 7-34, 7-35, 7-36</td>
<td>7-38, 7-40</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7-4</td>
<td>7-8, 7-9, 7-10, 7-11, 7-12, 7-13, 7-14</td>
<td>7-25</td>
<td>7-27, 7-28, 7-29, 7-30, 7-31, 7-32, 7-33, 7-34, 7-35, 7-36</td>
<td>7-38, 7-40</td>
</tr>
<tr>
<td>7-5</td>
<td>7-15, 7-16, 7-22</td>
<td>7-26</td>
<td>7-37</td>
<td>7-39</td>
</tr>
<tr>
<td>7-6</td>
<td>7-16, 7-17, 7-18, 7-19, 7-20, 7-21</td>
<td>7-26</td>
<td>7-37</td>
<td>7-39</td>
</tr>
<tr>
<td>7-7</td>
<td>7-23, 7-24</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
FOUR EVIDENCE DECISIONS

- Audit procedures
- Sample size for a given procedure
- Items to select from the population
- Timing
FACTORS AFFECTING RELIABILITY OF EVIDENCE

• Independence of provider
• Effectiveness of client's internal control
• Auditor's direct knowledge
• Qualifications of provider
• Objectivity
• Timeliness
TYPES OF EVIDENCE

- Physical examination
- Confirmation
- Documentation
- Analytical procedures
- Inquiries of the client
- Recalculation
- Reperformance
- Observation
PURPOSES OF
ANALYTICAL PROCEDURES

● Understand the client's business and industry

● Assess going concern

● Indicate possible misstatements (attention directing)

● Reduce detailed tests
USE OF INTERNAL RATIOS

Explain how each of the following analytical procedures can be useful to the auditor in determining evidence to accumulate. When would each one be most and least relevant?

1. Review (scan) the sales journal.

2. Calculate the ratio of bad debt expense to sales for the past four years.

3. Calculate interest income for the year by multiplying the prevailing interest rate times average interest-bearing receivables.

4. Compare the balance due each vendor for accounts payable with the balance in the previous year.

5. Compare the total balance in depreciation expense with the previous year.

6. Compare the budgeted amount of selling expense with the actual amount.
USE OF RATIO ANALYSIS

For each ratio:

- Indicate whether it is primarily (A) an indicator of financial failure, (B) an indicator of potential misstatements, or (C) both.
- For each "A" answer, is it primarily (D) short-term or (E) long-term?
- For each "B" and "C" answer, state the potential misstatement

1. Quick ratio
2. Sales commission / sales
3. Gross margin percentage
4. Debt / equity
5. Average days to collect receivables
6. Interest expense / average interest-bearing debt outstanding
7. Current ratio
8. Inventory turnover
9. Profit / tangible operating assets
10. Manufacturing repair and maintenance / manufacturing fixed assets

To download more slides, ebook, solutions and test bank, visit http://downloadslide.blogspot.com
HIERARCHY OF RELIABILITY OF EVIDENCE

LEVEL ONE
- Physical examination
- Confirmation
- External documentation
- Recalculation
- Reperformance

LEVEL TWO
- Internal documentation under good internal control
- Observation
- Analytical procedures with adequate data

LEVEL THREE
- Internal documentation where internal control is weak
- Inquiries of client
- Broad analytical procedures
Chapter 8
Audit Planning and Analytical Procedures

Chapter 8 emphasizes understanding the client’s business and industry and assessing client business risk, two concepts that are receiving increased emphasis in audit practice. This chapter highlights the importance for auditors to really understand the nature of their client’s business especially in light of its industry, the economy, and the impact of regulation on its business model. This chapter begins laying the foundation for the importance of a knowing your client to recognize how business risks may lead to increased risks of material misstatements that we’ll discuss in more depth in later chapters. This can be a fun chapter for students as it brings together many of the issues addressed in other business classes, such as their strategy or organizational behavior classes.

The following are the topics we cover:

- Chapter opening vignette
- Purpose and methodology of audit planning
- Client acceptance and continuance
- Obtain knowledge of client’s industry and business
- Assess client business risk
- Analytical procedures

Chapter Opening Vignette – “The Fall of Enron: Did Anyone Understand Their Business?”

The bankruptcy of Enron is used to illustrate how important understanding a client’s business is to conducting an adequate audit, which is now a required component of the second standard of fieldwork. Enron was involved in new markets as a result of deregulation and the development of new financial trading instruments. It also engaged in complex arrangements with related parties. Many argue that members of the board of directors, senior management, and the auditors, among others, had a poor understanding of the nature of the business and related business risks at Enron. You might ask students what they know about Enron, and how an auditor could evaluate the risks from new markets and related party transactions. We note that related parties have been present in many other significant legal cases involving auditors.

Purpose and Methodology of Audit Planning (page 210)

The effect of planning on audit efficiency and effectiveness is the major emphasis in discussing the purpose of planning.

Figure 8-1 (page 210) is the focal point for planning in Chapters 8 through 13 and we refer to it frequently. Only the first four sections are discussed in Chapter 8. We emphasize the items discussed in the following sections. Figure 8-5 (page 224) summarizes that discussion.

(See Figures 8-1 and 8-5)
Client Acceptance and Continuance (page 211)

We walk through students through some of the decisions that auditors need to make as outlined by auditing standards as they consider whether to accept a new audit client or continue serving as the auditor with existing clients.

- What are the requirements in auditing standards before the CPA accepts a new audit client that was previously audited by another CPA firm? Problem 8-26 is good to test students' knowledge of these requirements.
- How does the auditor assess industry risks and client business risks prior to client acceptance?
- How do the results of the assessment affect client acceptance and evidence accumulation?

Case 8-38 (part a) is useful for illustrating the importance of client acceptance.

Because the Sarbanes-Oxley Act defines the audit committee as “the client,” it is important to emphasize that auditors of public companies need to obtain an understanding of the engagement with the audit committee. This may include obtaining a signed engagement letter from the audit committee.

Obtain an Understanding with the Client (page 213)

We highlight auditing standards requirements that the auditor document his or her understanding with the client about the terms of the engagement in an engagement letter. We lead of discussion of the following questions:

- What is an engagement letter and what should be in it?
- When should it be obtained?

We have students look at the example of an engagement letter contained in Figure 8-2 as a way to debrief their answers.

(See Figure 8-2)

Understand the Client’s Business and Industry (page 215)

First we ask students to explain why it is important to understand the client’s business and how to do so. We remind students of the second fieldwork standard that requires the auditor to obtain a sufficient understanding of the entity and its environment, including its internal control. We refer back to the chapter-opening vignette or refer back to specific litigation cases or other real-world examples to emphasize that knowledge of the client’s industry is critical to providing an effective audit. We refer back to the chapter-opening vignette in Chapter 2 to note that knowledge of the client’s business is necessary to be able to provide valuable insights about client business processes.

Use Figure 8-3 (page 217) as a framework for discussing the types of knowledge that that auditor should obtain about the client’s business. It may also be useful to spend
some time tying the material at this point in the auditing course into concepts the students have studied in other courses.

(See Figure 8-3)

Internet Problem 8-1 can be used to give students experience in learning about the client’s business and identifying information useful for audit planning.

**Identify Related Parties** (page 218)

We discuss auditor responsibility for identifying related parties so that auditors can be alert for any undisclosed related party transactions. We talk about the importance of auditor consideration of related party transactions in light the reality that existence of related party transactions has been noted in many fraud cases. A simple example may be useful to demonstrate how a company can use related party transactions to manipulate their financial statements.

Auditing standards guidance can be difficult for students to understand. If you cover it, try to get students to have a general understanding of:

- Definitions of related parties and related party transactions
- Difference between illegal and related party transactions
- How to determine whether there are likely to be related parties
- How to determine if related party transactions have occurred
- Evaluating the substance of identified related party transactions
- Disclosure requirements for related party transactions

Problem 8-29 is useful at this point.

**Assess Client Business Risk** (page 220)

We use Figure 8-4 (page 221) to relate the understanding of the client’s business and industry to client business risks and the risk of material misstatements in the financial statements. Ask the students to suggest a company that they are familiar with. Then ask them to identify risks affecting that company, and how those risks might impact the financial statements and the auditor’s evidence accumulation.

(See Figure 8-4)

Recent corporate scandals have led to increasing calls for better management of risks affecting the enterprise. Boards of directors and senior executives are being called upon to develop processes and guidelines for the management of risks threatening the entity’s achievement of its objectives. The mid-chapter vignette on page 221 highlights growing focus by external parties, such as the NYSE and Standard & Poor’s, on an entity’s approach to managing risk across the enterprise. Be sure to point out that as companies implement more formal ERM practices, auditors can benefit by considering information about business risks identified and managed through the entity’s ERM.
processes. Given increasing expectations surrounding enterprise-wide risk management, it is important for students to be aware of this emerging risk management mindset.

Problem 8-37 is a good one to demonstrate the changing nature of business operations and relationships, and how those affect client business risk.

**Perform Preliminary Analytical Procedures** (page 222)

We briefly review the four purposes of performing analytical procedures that were first introduced in Chapter 7. **Figure 8-6** (page 225) is especially helpful for this purpose. **Table 8-1** (page 222) provides an example of the types of analytical procedures that might be performed during audit planning for a wholesaler like Hillsburg Hardware Company.

(See Figure 8-6)

(See Table 8-1)

Problem 8-35 or 8-36 can be used to give students experience in evaluating analytical procedures performed in planning.

**Analytical Procedures** (page 223)

Analytical procedures are an essential part of auditing, but we believe they are often under-emphasized. They receive more detailed coverage in this chapter after students have been introduced to their use in audit planning. The purposes, types (industry versus internal), timing, and impact on the audit should be stressed (see **Figure 8-6** on page 225).

(See Figure 8-6)

There are several problems we like in this area, especially 8-33 and 8-34. Case 8-39 is also a good one. If you are interested in exposing students to ACL software, consider problem 8-41.

The calculation of specific ratios beginning on page 230 can be used by faculty who want to emphasize analytical procedures, and the calculation of ratios.

**Seven-Part Integrated Case – Pinnacle Manufacturing**

If you are looking for an integrated case that you can use throughout the remaining of the course you may want to consider the Integrated Case Application – Pinnacle Manufacturing that is first introduced in this chapter in case 8-40. This seven-part case begins in chapter 8 and continues as part of the case component of the end-of-chapter materials in chapters 9, 10, 11, 14, 15, and 16. This case has been updated in this edition with revised financial statement information, revised student assignments, and a new part addressing auditor consideration of fraud in chapter 11.
## Cross-Reference of Learning Objectives and Problem Material

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>ACL Problem and Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>8-1</td>
<td>8-1, 8-2</td>
<td>8-3, 8-4, 8-5, 8-6, 8-7</td>
<td>8-8, 8-9, 8-10, 8-11, 8-12, 8-13, 8-14, 8-15, 8-16, 8-17</td>
<td>8-25, 8-26, 8-27, 8-28, 8-29, 8-30, 8-31, 8-32, 8-33, 8-34, 8-35, 8-36, 8-37, 8-38, 8-39, 8-40, 8-41, 8-42, 8-32, 8-33, 8-34, 8-36, 8-37, 8-38, 8-39, 8-40, 8-41, 8-42</td>
</tr>
<tr>
<td>8-2</td>
<td>8-3, 8-4, 8-5, 8-6, 8-7</td>
<td>8-25, 8-26, 8-27, 8-28, 8-29, 8-30, 8-31, 8-32, 8-33, 8-34, 8-35, 8-36, 8-37, 8-38, 8-39, 8-40, 8-41, 8-42, 8-32, 8-33, 8-34, 8-36, 8-37, 8-38, 8-39, 8-40, 8-41, 8-42</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8-3</td>
<td>8-6, 8-7</td>
<td>8-27</td>
<td>8-20</td>
<td>8-24</td>
</tr>
<tr>
<td>8-4</td>
<td>8-20</td>
<td>8-27</td>
<td>8-20</td>
<td>8-24</td>
</tr>
<tr>
<td>8-5</td>
<td>8-21</td>
<td>8-27</td>
<td>8-20</td>
<td>8-24</td>
</tr>
<tr>
<td>8-6</td>
<td>8-31</td>
<td>8-27</td>
<td>8-20</td>
<td>8-24</td>
</tr>
<tr>
<td>8-7</td>
<td>8-32, 8-33, 8-34, 8-36, 8-37, 8-38, 8-39, 8-40, 8-41</td>
<td>8-27</td>
<td>8-20, 8-21, 8-22, 8-23, 8-24, 8-25, 8-26, 8-27, 8-28, 8-29, 8-30, 8-31, 8-32, 8-33, 8-34, 8-35, 8-36, 8-37, 8-38, 8-39, 8-40, 8-41, 8-42, 8-32, 8-33, 8-34, 8-36, 8-37, 8-38, 8-39, 8-40, 8-41, 8-42</td>
<td></td>
</tr>
<tr>
<td>8-8</td>
<td>8-24</td>
<td>8-27</td>
<td>8-20</td>
<td>8-24</td>
</tr>
</tbody>
</table>

- **8-1** Discuss why adequate audit planning is essential.
- **8-2** Make client acceptance decisions and perform initial audit planning.
- **8-3** Gain an understanding of the client’s business and industry.
- **8-4** Assess client business risk.
- **8-5** Determine the purposes of analytical procedures and the timing of each purpose.
- **8-6** Select the most appropriate analytical procedure from among the five major types.
- **8-7** Compute common financial ratios.

To download more slides, ebook, solutions and test bank, visit [http://downloadslide.blogspot.com](http://downloadslide.blogspot.com)
Chapter 9

Materiality and Risk

This is an essential chapter because both materiality and risk are critical to the audit process and somewhat difficult to understand. The material in the chapter is closely tied to the risk assessment auditing standards. We consider risk a more essential topic than materiality, but both are important.

The following are emphasized in this chapter:

- Chapter opening vignette
- Set preliminary judgment about materiality
- Allocate preliminary judgment about materiality to segments (tolerable misstatement)
- Estimate misstatement and compare with preliminary judgment
- Audit risk model
- Planned detection risk
- Acceptable audit risk
- Inherent risk and control risk
- Relating the risk of fraud to the audit risk model
- Discussion of the audit risk model

Chapter Opening Vignette – “Explain to Me One More Time that You Did a Good Job, but the Company Went Broke”

This vignette dramatizes the positions of investors and auditors in three famous situations. The three situations are: Enron, WorldCom, and Adelphia. Many of the investors in these companies were retirees or retirement funds.

Although the risks may have seemed low on these investments, they were actually high. Unqualified audit opinions were issued by the auditors in all years prior to massive failure in which the investors suffered huge losses. The overriding messages of the case are that, (1) real people invest real money in client companies and rely greatly on the auditors to protect them, and (2) auditors must grasp the real nature of the risks their clients present and deal with them effectively.

Set Preliminary Judgment About Materiality (page 251)

Before discussing setting materiality, we refer to Figure 8-1 (page 211) to help integrate materiality as one factor affecting audit planning.

Next we cover the steps in applying materiality as shown in Figure 9-1 (page 251), with emphasis on the first step.

(See Figures 8-1 and 9-1)
Next we discuss how setting a preliminary judgment about materiality affects audit evidence.

Problems 9-25 and 9-27 a, are useful to discuss overall materiality. Either problem should bring out the essential points in setting a preliminary estimate.

Allocate Preliminary Judgment about Materiality to Segments (Tolerable Misstatement) (page 254)

Studying this topic is conceptually fairly easy, but difficult to demonstrate. **Figure 9-3** (page 255) should be helpful to illustrate the methodology and logic. Review Question 9-8 and Problem 9-25 b both show students how this is done. An important point to bring out is that the allocation is always arbitrary, and regardless of how it is done, the final audit results of all audit areas combined will have to support the auditor's opinion. It is important to explain why the total of tolerable misstatement exceeds the preliminary judgment about planning materiality.

(See Figure 9-3)

Part a of Case 9-36 can be used to give students practice in setting the preliminary judgment about materiality and allocating tolerable misstatement to accounts.

Estimate Misstatement and Compare with Preliminary Judgment (page 257)

We spend little time doing this, but believe it is essential to show students how the results of audit tests tie back to materiality. We find a brief discussion using Problem 9-25 d is sufficient. We return to the discussion of materiality when covering audit sampling for detailed tests of balances in Chapter 17 and completing the audit in Chapter 24. **Table 9-1** (page 257) is useful to discuss sampling error.

(See Table 9-1)

Audit Risk Model (page 259)

We consider the audit risk model one of the most important concepts in auditing. We refer to it throughout the course.

We go over the logic of its use and discuss the model when the auditor is determining planned detection risk. We briefly introduce each element of the audit risk model.

(See T-9-1)

It is important for students to be able to relate the audit risk model to the understanding of the client’s business and industry studied in Ch. 8. **Figure 9-4** (page 259) can be used for this purpose.

(See Figure 9-4)
Planned Detection Risk (page 261)

Students often have difficulty with detection risk. We find the key is for students to relate it to components of the financial statements, distinguish between achieved and planned detection risk, and remember that it is the inverse of evidence.

The use of Table 9-4 (page 270) and T-9-2 is helpful to discuss planned detection risk.

(See Table 9-4)

(See T-9-2)

It is also useful to relate achieved level of assurance to segments. T-9-3 is useful to do that.

(See T-9-3)

Assessing Acceptable Audit Risk (page 263)

This material is the beginning of the general area of "risk assessment." The auditor who is to be effective and efficient must recognize certain risks and modify evidence accordingly.

We find students have difficulty understanding the concept of audit risk. We go through a several-step process.

- Relate the concept of acceptable audit risk to information risk as it was discussed in Chapter 1.
- If auditors demand zero audit risk what does it mean? (They are willing to be insurers or guarantors.)
- What audit risk level do you believe auditors achieve in practice for publicly held companies? Students tend to say 5% because of their knowledge of statistics. That is an ideal time to explain the difference between audit risk and confidence level. You might give them a level of assurance such as 7% and then explain what it means.
- Why can't the level of audit risk be quantified as a specific number?
- Should auditors have different acceptable audit risk for different companies? If so, how can it be justified from an individual firm and a social point of view?
- What factors affect acceptable audit risk? What is the relationship between auditors' legal liability and acceptable audit risk?
- How does acceptable audit risk affect evidence accumulation? What is the relationship between tolerable misstatement and acceptable audit risk?
- How does acceptable audit risk affect the components of the audit?
This is a good place to discuss why the auditor may want to have different audit risks for different areas because of liens on certain assets or reliance on specific information by certain users.

- Distinguish between acceptable and achieved audit risk.
- What does the auditor do if the achieved audit risk is greater than the acceptable level?

It is useful to summarize acceptable audit risk, audit evidence and achieved audit risk by discussion of Review Questions 9-17 to 9-19. Problem 9-29 is a good one to use for this material.

(See also T-9-3)

**Inherent Risk and Control Risk** (pages 261-262 and 266-268)

It is important for students to understand the relationship between these two risks and audit risk. We go through several steps.

- Compare two situations where everything else is equal.
  a. The auditors uncovered considerable misstatements in the valuation of inventory in each of two previous years.
  b. The auditor uncovered no misstatements in the valuation of inventory in each of the two previous years.

There is no apparent change in circumstances. In which one would more evidence likely be accumulated for tests of inventory valuation? Why?

- What factors affect the likelihood of misstatements, and how should each impact the audit? (Students are asked to identify factors and explain logic for including them.)
- Distinguish between control risk and inherent risk.

**Relating Risk of Fraud to the Audit Risk Model** (page 268-269)

We review the auditor’s responsibility for the detection of material misstatements due to fraud introduced in Chapter 6, which includes a responsibility to assess fraud risk. While the responsibility to assess fraud risk is covered extensively in Chapter 11, it is important for students to relate the fraud risk assessment to the audit risk model. We emphasize that it is difficult in concept and practice to separate fraud risk factors into acceptable audit risk, inherent risk, and control risk. We point out that it is more important for the auditor to assess the risks and respond to them than it is to identify them as specific components of the audit risk model. This topic will be discussed more extensively in Chapter 11.
Discussion of the Audit Risk Model

There are several problems to illustrate application of the audit risk model: 9-30, 9-31, 9-32, 9-33, and 9-34. Case 9-35 is useful to apply audit risk concepts, either using the audit risk model or discussing the concept without use of the model. Parts b-d of Case 9-36 can also be used to illustrate parts of the audit risk model.

If there is adequate time, T-9-4 provides a good class exercise to summarize the relation of planning materiality and inherent risk to planned audit evidence.

(See T-9-4)

Using the columnar headings and the major accounts, discuss the contents of each column. The idea is to logically indicate the expected degree of audit effort for each account, relative to other accounts. This helps the students gain an appreciation of the concept that the purpose of assessing materiality and risk is to allocate audit effort to the accounts that are most likely to contain material misstatements. You can change assumptions about materiality and inherent risk and discuss the effect on audit effort.

Table 9-2 (page 260) and Figure 9-5 (page 269) are also helpful to summarize the effect of factors in the audit risk model on planned evidence.

Figure 9-6 (page 272) and Figure 9-7 (page 273) are helpful to help explain the relationships among the various risks and planned evidence.

(See Table 9-2, Figures 9-5, 9-6, and 9-7)
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>9-1</td>
<td>Apply the concept of materiality to the audit.</td>
<td>9-1, 9-2, 9-3, 9-9, 9-10</td>
<td>9-1, 9-2, 9-3, 9-4, 9-5, 9-6, 9-7, 9-10</td>
<td>9-36</td>
</tr>
<tr>
<td>9-2</td>
<td>Make a preliminary judgment about what amounts to consider material.</td>
<td>9-2, 9-5</td>
<td>9-6, 9-7, 9-10</td>
<td>9-26, 9-27, 9-28</td>
</tr>
<tr>
<td>9-3</td>
<td>Allocate preliminary materiality to segments of the audit during planning.</td>
<td>9-7, 9-8</td>
<td>9-8</td>
<td>9-25, 9-26, 9-27, 9-28</td>
</tr>
<tr>
<td>9-4</td>
<td>Use materiality to evaluate audit findings.</td>
<td>9-9</td>
<td>9-9</td>
<td>9-25, 9-26, 9-27, 9-28</td>
</tr>
<tr>
<td>9-5</td>
<td>Define risk in auditing.</td>
<td>9-11, 9-12, 9-13, 9-14, 9-15, 9-16, 9-17</td>
<td>9-11, 9-12, 9-13, 9-14, 9-15, 9-16, 9-17</td>
<td>9-23</td>
</tr>
<tr>
<td>9-6</td>
<td>Describe the audit risk model and its components.</td>
<td>9-17, 9-18, 9-19</td>
<td>9-17, 9-18, 9-19</td>
<td>9-23</td>
</tr>
<tr>
<td>9-7</td>
<td>Consider the impact of engagement risk on acceptable audit risk.</td>
<td>9-14, 9-15, 9-16, 9-17</td>
<td>9-14, 9-15, 9-16, 9-17</td>
<td>9-23</td>
</tr>
<tr>
<td>9-8</td>
<td>Consider the impact of several factors on the assessment of inherent risk.</td>
<td>9-18, 9-19, 9-20, 9-21</td>
<td>9-18, 9-19, 9-20, 9-21</td>
<td>9-23</td>
</tr>
</tbody>
</table>
AUDIT RISK MODEL

$$PDR = \frac{AAR}{IR \times CR}$$

Where:

- **AAR** = Acceptable Audit Risk
- **IR** = Inherent Risk
- **CR** = Control Risk
- **PDR** = Planned Detection Risk
PLANNED DETECTION RISK

Evidence was accumulated such that achieved detection risk for accounts receivable was 14%.

<table>
<thead>
<tr>
<th>WHAT WOULD ACHIEVED DETECTION RISK HAVE BEEN IF (TREAT EACH ONE INDEPENDENTLY):</th>
<th>ACHIEVED DETECTION RISK WOULD HAVE BEEN</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>HIGHER</td>
</tr>
<tr>
<td>1. Additional audit procedures for accounts receivable were performed</td>
<td></td>
</tr>
<tr>
<td>2. More accounts receivable had been confirmed</td>
<td></td>
</tr>
<tr>
<td>3. The client instructed the auditor not to confirm accounts receivable</td>
<td></td>
</tr>
<tr>
<td>4. The auditor contended that confirmations were not reliable due to the nature of the customers</td>
<td></td>
</tr>
<tr>
<td>5. Confirmations were sent at an interim date rather than at year-end</td>
<td></td>
</tr>
</tbody>
</table>

What are the answers to 1 through 5 if "Achieved Audit Risk" is substituted for "Achieved Detection Risk?"
ACHIEVED LEVEL OF ASSURANCE = 
98.6% FOR ALL SEGMENTS EXCEPT INVENTORY, WHICH IS MATERIAL

Question: 1. What is the overall achieved level of assurance?

2. What should the auditor do?
RELATIONSHIP OF MATERIALITY AND INHERENT RISK WITH PLANNED AUDIT EVIDENCE

<table>
<thead>
<tr>
<th>ACCOUNTS</th>
<th>SIGNIFICANCE OF AMOUNTS</th>
<th>INHERENT RISK</th>
<th>PLANNED AUDIT EVIDENCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Petty Cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid Insurance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Stock</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowance for Uncollectible Accounts</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

What is the effect on planned audit evidence if acceptable audit risk is reduced for the entire audit?
Chapter 10
Section 404 Audits of Internal Control and Control Risk

This chapter illustrates the auditor’s responsibilities related to internal control required by Section 404 of the Sarbanes–Oxley Act and PCAOB Standard 5. The requirements for an integrated audit of financial statements and an audit of internal control over financial reporting have had the most significant effect on the auditing profession as anything in several decades. This chapter outlines management’s and the auditor’s responsibilities related to documentation, assessment, and reporting on the operating effectiveness of internal control over financial reporting required by Section 404. We emphasize the permanent exemption from Section 404 (b) for non-accelerated filers after the passage of the federal financial reform legislation passed by Congress in 2010 (known as the Dodd-Frank Act).

This chapter also highlights the key components of COSO’s Internal Control – Integrated Framework, which is the framework used by public companies to assess the operating effectiveness of internal control. The chapter concludes by contrasting the auditor’s responsibilities related to internal control in audits of public and nonpublic companies.

We spend three to four hours on this important chapter. Our greatest concern is for students to understand the public company auditor’s testing and reporting responsibilities and to see the interrelationship of internal control with the rest of the integrated audit. It is also important for them to develop a strong understanding of key internal control concepts and to develop skills in identifying controls and deficiencies in internal control.

The following are the major topics we cover:

- Chapter opening vignette
- Relationship with the rest of the audit
- Internal control objectives
- Management’s responsibilities for internal control
- Auditor responsibilities for understanding, testing and reporting on internal control
- Transaction-related audit objectives
- COSO components of internal control
  - The control environment
  - Risk assessment
  - Control activities
  - Information and communication
  - Monitoring
- Obtain and document an understanding of internal control
- Assess control risk
- Identify controls and deficiencies
- Tests of controls
- Practical application
- Section 404 reporting on internal control
- Evaluating, reporting, and testing internal control for nonpublic companies
- Other homework problems
Chapter Opening Vignette – “Rogue Trader Circumvents Controls Causing $7 Billion in Losses”

Students are fascinated that one individual can cause such substantial losses as occurred at Société Générale. This demonstrates the importance of internal controls in all companies, but especially in financial institutions that engage in complex transactions involving billions of dollars.

The vignette contains several implications. First, past experience with controls do not necessarily indicate that problems will not occur in the future. Second, controls such as mandatory vacations that may not seem of great importance can be critical in preventing and detecting fraud. Finally, any client document or circumstance that looks at all inappropriate should be carefully investigated. Auditors won't have many chances to find a defalcation and must capitalize on any fraud indicators that appear unusual.

Relationship With the Rest of the Audit

Our starting point for this chapter is Figure 8-1 (page 210), so that students can see in general how internal control evaluation ties into the planning process and relates to designing audit programs.

(See Figure 8-1)

Next, we refer students to the second standard of field work and ask, "Why is obtaining an understanding of the entity and its environment, including internal control and assessing control risk so important in auditing?" Try to gain agreement that it is related to the concept of expectation of misstatements developed in Chapter 9.

We refer students to the audit risk model used for planning: PDR = AAR ÷ (IR x CR). It is important for students to understand that this chapter deals with control risk and how it relates to substantive tests (PDR). Use T-10-1 to show students two aspects: the importance of internal control in evidence determination for financial statement audit purposes, and the relationship of internal control to other factors.

(See T-10-1)

Internal Control Objectives (page 290)

We briefly identify and discuss the three broad objectives management has when designing an effective internal control system (reliable financial reporting, efficient and effective operations, and compliance with laws and regulations). We use this discussion to highlight that while management focuses on internal controls related to these broad objectives, the auditor’s focus is on those controls related to the reliability of financial reporting, which may include some controls related to operations and compliance that might also impact financial reporting. This is particularly important to emphasize since PCAOB Standard 5 specifically requires the auditor to report on internal controls over financial reporting. We use T-10-2 to illustrate these three objectives.

(See T-10-2)
Management’s Responsibilities for Internal Control (page 291)

We use this section of the chapter to emphasize that management and auditor responsibilities for internal control are different. We make sure students know that management is responsible for establishing and maintaining the entity’s internal controls. We then emphasize the specific Section 404 (a) responsibility for management to publicly report on the operating effectiveness of those controls. We contrast that with the auditor’s responsibility in Section 404 (b) to understand and test internal control over financial reporting to provide a basis to express an opinion on the operating effectiveness of those controls as required for accelerated filer public companies.

We briefly identify and discuss the two underlying concepts related to management’s design and implementation of internal control: reasonable assurance and inherent limitations. This discussion ties nicely to the auditor’s responsibility and an achieved level of assurance of less than 100%.

We then cover the Section 404 (a) requirement for management to issue an internal control report in its Form 10-K filed with the SEC. Be sure to emphasize the key elements required in management’s report:

1. A statement that management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting.
2. An assessment of the effectiveness on the internal control structure and procedures for financial reporting as of the end of the company’s fiscal year. That assessment consists of two key components:
   - Management must evaluate the design of internal control over financial reporting and
   - Management must test the operating effectiveness of those controls.

Figure 10-1 (page 292) provides an illustration of management’s report on internal control.

(See Figure 10-1)

Auditor Responsibilities for Understanding, Testing and Reporting on Internal Control (pages 292-294)

We contrast management’s responsibilities with the Section 404 (b) responsibility that auditors of accelerated filer public companies must issue an opinion on the effectiveness of internal control over financial reporting. We emphasize that to express the opinion on internal control as required by PCAOB Standard 5, the auditor obtains an understanding of and performs tests of controls related to all significant account balances, classes of transactions, and disclosures related to assertions in the financial statements. We emphasize that the required understanding and testing of all key controls is generally much more extensive than the amount of testing of internal controls required in the financial statement audit of a nonpublic company. This concept is illustrated by Figure 10-10 on page 320.

(See Figure 10-10)
You might want to engage the class in a discussion about the pros and cons of the decision by Congress in 2010 to permanently exempt non-accelerated filer public companies from the Section 404(a) requirements to provide an opinion on the operating effectiveness of internal control over financial reporting. The mid-chapter vignette on page 294 highlights some concerns about this exemption, in light of the fact that most SEC investigations of fraudulent financial reporting involve smaller public companies. This might make an interesting class discussion to debate the benefits and costs of this exemption.

Transaction-Related Audit Objectives (page 293)

Because PCAOB Standard 5 requires the auditor to test controls related to all significant account balances, classes of transactions, and disclosures related to assertions in the financial statements, we believe it is important to discuss the transaction-related audit objectives that were first covered in Chapter 6. It is important to identify the transaction-related audit objectives and explain why each is important to prevent specific types of misstatements.

A useful way to apply transaction-related audit objectives is by starting with Table 10-1 (page 293) and expanding on it as follows:

a. Examine each of the six objectives in Table 10-1.

b. Ask students to identify a specific misstatement that could occur for each objective related to payroll.

c. Ask students to identify a specific internal control that could prevent such a misstatement. The use of the components of internal control is helpful in doing this.

(See Table 10-1 and T-10-3)

A possible solution for T-10-3 is shown on the following page.

COSO Components of Internal Control (page 294)

It is essential that students become familiar with the five key components of COSO’s Internal Control-Integrated Framework, which is the most widely used framework among public companies for purposes of reporting in accordance with Section 404. We help students see how all of the five components of internal control are related. We try to talk about the differences and interrelationships of the five components before we get into the details. Figure 10-2 (page 295) is a useful summary of the components of internal control.

(See Figure 10-2)
The Control Environment (page 295)

The greatest difficulty we have in dealing with the subcomponents of the control environment is to avoid emphasizing memorization. A useful way to do that is to put the subcomponents on an overhead and have students discuss how each subcomponent might vary for a large company (we discuss a publicly held company students are familiar with) and an owner-managed company with 100 employees and $20 million in sales. To help with this discussion, we use T-10-4.

(See T-10-4)

Risk Assessment (page 297)

We discuss the comparison of management's risk assessment to the auditor's risk assessment. It is helpful to relate management's risk assessment to the design and operation of internal control. The mid-chapter vignette on page 297 highlights how organizations are striving to strengthen their overall enterprise risk oversight. The recent financial crisis has highlighted how for some organizations that amount of risk-taking on the part of management far exceeded key stakeholder’s risk appetite. You might have students discuss why it would be important for auditors to understand the organization’s approach to risk management and how that might be informative to the auditor.

Control Activities (page 298)

The instructor must decide how much time should be spent on control activities. We use T-10-5 to emphasize the following:

- Adequate separation of duties, especially between custody of assets and recordkeeping
- Proper authorization of transactions and activities
- Adequate documents and records, especially prenumbered documents that are properly accounted for
- Physical control over assets and records
- Independent checks on performance, especially the role of the internal auditor

(See T-10-5)

Problems are important to understand the material in this section. Use one or more of the following:

10-13 — review question
10-34 — controls to prevent misstatements
10-36 — division of duties
<table>
<thead>
<tr>
<th>OBJECTIVE</th>
<th>TYPE OF MISSTATEMENT</th>
<th>EXAMPLE OF INTERNAL CONTROL TO PREVENT MISSTATEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence</td>
<td>Former employee continues to be paid.</td>
<td>Completed time card approved by the foreman, required for preparation of paycheck (authorization and adequate documents and records).</td>
</tr>
<tr>
<td>Completeness</td>
<td>A time card is lost and an employee does not get paid.</td>
<td>Use prenumbered time cards and account for all cards (adequate documents and records and internal verification).</td>
</tr>
<tr>
<td>Accuracy</td>
<td>Employees are paid the wrong amount because of clerical errors in calculation.</td>
<td>Internal verification of calculations (internal verification).</td>
</tr>
<tr>
<td>Posting and summarization</td>
<td>An employee's wages are posted to the wrong employee earnings record.</td>
<td>Internal verification of postings (internal verification).</td>
</tr>
<tr>
<td>Classification</td>
<td>Sales salaries are charged for manufacturing wages.</td>
<td>An adequate chart of accounts is provided to the bookkeeper and this is used for internal verification (adequate documents and records and internal verification).</td>
</tr>
<tr>
<td>Timing</td>
<td>Paychecks for the month of May are recorded in June.</td>
<td>Policy requiring recording of checks on the date they are delivered (adequate documents and records).</td>
</tr>
</tbody>
</table>

**Information and Communication** (page 301)

We find it important to distinguish between the accounting information and communication system and the other components of internal control by emphasizing that all companies must have an effective accounting information system for recording transactions.
Monitoring (page 301)

In our coverage of monitoring, we emphasize that the focus of this component is on the assessment of the quality of performance of the other four components of internal control. We often tell students to think of this component as the “monitoring of controls” to emphasize that the focus is on the performance of other controls. We emphasize that the internal audit function is a great example of the monitoring component. It is also useful to discuss how an effective internal audit department can reduce the cost of external audits.

Problems 10-33, 10-34, and 10-35 are useful at this point. They can provide a basis for discussing potential monitoring activities that could be performed to ensure the underlying controls are operating effectively.

Obtain and Document Understanding of Internal Control (page 302)

We begin by showing Figure 10-3 (page 304) to highlight how considering internal controls affects the auditor’s substantive tests in an audit of the financial statements. We emphasize that the auditor’s understanding of internal control is required in every audit, both public and nonpublic companies. It is important for students to understand that the primary difference in the level of understanding in audits of public and nonpublic companies is that the level of understanding is greater for the audit of internal control over financial reporting required for larger public companies than an audit of the financial statements.

To emphasize the concept of the integrated audit required by PCAOB Standard 5, it is important to note that when the audit of internal control for a public company is completed, the auditor uses the results to decide planned detection risk and substantive tests for the audit of financial statements. We then go to Figure 10-11 (page 321) and go over that flowchart in detail. Our students must understand that overview completely.

(See Figures 10-3 and 10-11)

Use Review Questions 10-17, 10-18, 10-19 and 10-23 to talk about ways to gain an understanding. Also refer students to Figure 10-4 on page 306 (questionnaire) and Figure 10-13 on page 334 (flowchart).

It is essential to relate obtaining an understanding of the design and operation of internal control as a whole to how this is done for each of the five components of internal control.

(See Figures 10-4 and 10-13)

Assess Control Risk (page 307)

The assessment decisions discussed on pages 307-312 are essential, especially in setting assessed control risk. The audit risk model discussed in Chapter 9 is useful to reinforce the importance of this decision. You may want to emphasize the importance of starting with an assessment of entity-level controls first before assessing transaction specific controls. Also it is essential to discuss the three alternatives shown in the Phase 2 section of Figure 10-11 (page 321).

(See Figure 10-11)
Identify Controls and Deficiencies (pages 310-312)

We make a considerable effort to get students to understand the fundamental difference between controls and deficiencies, and the impact of each on the audit. And, we emphasize the important differences between control deficiencies, significant deficiencies, and material weaknesses. Figure 10-6 on page 310 is useful when discussing factors affecting the auditor’s evaluation of the significance of deficiencies.

(See Figure 10-6)

Tests of Controls (page 312)

We discuss the four types of procedures for tests of controls. We also find it helpful to explain the differences between tests of controls and substantive tests. We use T-10-6 and T-10-7 to explain the differences further. It is also useful to refer to Figure 10-11 (page 321) and Table 10-3 (page 315).

(See T-10-6 and T-10-7)

(See Figure 10-11 and Table 10-3)

Practical Application

Students have a great deal of difficulty visualizing how everything in Figure 10-11 is applied in practice. Pages 307 to 315 are intended to help accomplish that. We find it useful to relate Figure 10-11 to each of the steps in pages 307 to 315. The use of the control risk matrix (Figure 10-5, page 309) is essential in helping students understand assessing control risk on an objective by objective basis. Tests of controls can also be discussed again. This is also a good time to discuss communication of significant deficiencies in internal control to the audit committee.

(See Figure 10-5)

The relationship between obtaining an understanding of internal control and tests of controls can be shown nicely with T-10-8.

(See T-10-8)

Our comments about T-10-8 include the following:

- Audit A and B both used an assessed control risk of 40%, but in Audit A, more reduction occurred during the understanding. That implies more confidence and knowledge of internal control early in the audit.
- Audit C apparently has deficient internal control and the auditor has spent little time obtaining an understanding or testing controls. Audit C would not represent the audit of a public company.
In Audit D, the auditor did tests of all controls as a part of obtaining an understanding. The likely reason is that the auditor had considerable confidence the controls would be found effective.

In Audit E, the auditor initially believed, based on his or her understanding of internal controls, that they were effective, but tests of controls caused the auditor to conclude otherwise. If this was a public company, the auditor's report on internal control would be adverse.

Section 404 Reporting on Internal Control (page 315)

We discuss an accelerated filer's auditor responsibilities to report on internal control over financial reporting required by PCAOB Standard 5. Figure 3-3 (page 50) provides an illustration of a separate report on internal control over financial reporting.

(See Figure 3-3)

We also describe the specific PCAOB Standard 5 reporting options when the auditor's scope has been limited or when the auditor identifies material weaknesses in internal control. Problem 10-41 provides a useful illustration of the auditor's reporting requirements.

Evaluating, Reporting, and Testing Internal Control for Nonpublic Companies (page 317)

We spend time discussing differences in the auditor's responsibility for considering internal controls in an audit of financial statements from an integrated audit of financial statements and internal controls required for accelerated filers by PCAOB Standard 5. It is important for students to understand that most of the concepts discussed in this chapter apply equally to nonpublic company audits. The primary difference is in the extent of internal controls considered in a financial statement audit of a nonpublic company in contrast to the extent of internal controls considered in the audit of internal controls over financial reporting. Figure 10-10 (page 320) provides a useful visual depiction of the difference in extent of controls considered in these two types of audits.

(See Figure 10-10)

It might be helpful to use T-10-8 as the basis for discussion about relating evidence obtained in a financial statement audit to the audit of internal controls. For example, in Audits A and B, the auditor may have an adequate basis for providing assurance about internal control effectiveness. However, in Audit C the auditor would have no assurance about internal controls because no tests of controls have been conducted. Thus, Audit C could not represent the audit of a public company. Audit D may represent the audit of a public company, given the low initial and final assessments of control risks. In Audit E, the auditor would likely issue an adverse opinion about internal controls, given that the auditor's tests of controls identified deficiencies that required a revision in control risk from 40% to 100%.

(See T-10-8)
Other Homework Problems

A good problem for identifying deficiencies in internal control is Problem 10-38, descriptions 2 and 3. Problem 10-39 and Case 10-42 are also good, but they are longer. Case 10-43 is the third part of a seven-part case used in Chapters 8, 9, 10, 11, 14, 15, and 16. It is intended to help students tie together planning, control risk assessment, tests of controls and substantive tests of transactions, and tests of details of balances. We recommend the case be used only if you plan to use all seven parts.
### CHAPTER 10

CROSS-REFERENCE OF LEARNING OBJECTIVES AND PROBLEM MATERIAL

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>10-1</strong> Describe the three primary objectives of effective internal control.</td>
<td>10-1, 10-2</td>
<td>10-30</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>10-2</strong> Contrast management’s responsibilities for maintaining internal control with the auditor’s responsibilities for evaluating and reporting on internal control.</td>
<td>10-3, 10-4, 10-5, 10-6, 10-7, 10-8, 10-9</td>
<td>10-30</td>
<td>10-37</td>
<td></td>
</tr>
<tr>
<td><strong>10-3</strong> Explain the five components of the COSO internal control framework.</td>
<td>10-9, 10-10, 10-11, 10-12, 10-13, 10-14, 10-15, 10-16, 10-22</td>
<td></td>
<td>10-33, 10-34, 10-35, 10-36, 10-38</td>
<td></td>
</tr>
<tr>
<td><strong>10-4</strong> Obtain and document an understanding of internal control.</td>
<td>10-6, 10-17, 10-18, 10-19, 10-20</td>
<td></td>
<td>10-34, 10-35, 10-37</td>
<td></td>
</tr>
<tr>
<td><strong>10-5</strong> Assess control risk by linking key controls and control deficiencies to transaction-related audit objectives.</td>
<td>10-8, 10-21, 10-22, 10-23</td>
<td>10-31, 10-32</td>
<td>10-34, 10-35, 10-38, 10-39</td>
<td>10-42, 10-43</td>
</tr>
<tr>
<td><strong>10-6</strong> Describe the process of designing and performing tests of controls.</td>
<td>10-24, 10-25, 10-26, 10-27</td>
<td>10-32</td>
<td>10-34, 10-40</td>
<td></td>
</tr>
<tr>
<td><strong>10-7</strong> Understand Section 404 requirements for auditor reporting on internal control.</td>
<td>10-21, 10-28, 10-29</td>
<td>10-30, 10-31</td>
<td>10-41</td>
<td></td>
</tr>
<tr>
<td><strong>10-8</strong> Describe the differences in evaluating, reporting, and testing internal control for nonpublic companies.</td>
<td>10-6, 10-24</td>
<td>10-32</td>
<td>10-37</td>
<td></td>
</tr>
</tbody>
</table>
AUDIT RISK MODEL AND INTERNAL CONTROL

\[ PDR = \frac{AAR}{IR \times CR} \]

SITUATION 1

Assume: AAR = 5%
IR = 100%
CR = 100%

A. Calculate PDR and explain the meaning of the result.
B. What does IR of 100% mean?

SITUATION 2

Assume: AAR = 5%
IR = 50%
CR = 50%

A. Calculate PDR and explain the effect on the audit of the change from Situation 1 to 2.
B. What factors could cause the auditor to change from an IR of 100% to an IR of 50%?
CLIENT'S INTERNAL CONTROL CONCERNS

- Reliability of financial reporting
- Efficiency and effectiveness of operations
  - Accurate information for decision making
  - Safeguarding of assets
- Compliance with applicable laws and regulations
  - Civil Rights Laws
  - Federal Securities Laws

TRANSACTION-RELATED AUDIT OBJECTIVES APPLIED TO PAYROLL

<table>
<thead>
<tr>
<th>OBJECTIVE</th>
<th>TYPE OF MISSTATEMENT</th>
<th>EXAMPLE OF INTERNAL CONTROL TO PREVENT MISSTATEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Completeness</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

T-10-2
<table>
<thead>
<tr>
<th>Accuracy</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Posting and summarization</td>
<td></td>
</tr>
<tr>
<td>Classification</td>
<td></td>
</tr>
<tr>
<td>Timing</td>
<td></td>
</tr>
</tbody>
</table>
THE CONTROL ENVIRONMENT

- Integrity and ethical values
- Commitment to competence
- Board of directors or audit committee participation
- Management's philosophy and operating style
- Organizational structure
- Human resource policies and practices
CONTROL ACTIVITIES

- Adequate separation of duties
- Proper authorization of transactions and activities
- Adequate documents and records
- Physical control over assets and records
- Independent checks on performance
RELATIONSHIP OF DEFICIENCIES TO EVIDENCE

Deficiencies

Perform some analytical procedures

Identify likely misstatements due to deficiencies

Inform Those Charged with Governance

Perform expanded substantive tests to determine if likely misstatements actually exist

No tests of controls are performed for deficiencies
RELATIONSHIP OF CONTROLS TO EVIDENCE

Controls

Identify misstatements that are less likely to occur because of controls

Perform tests of controls to determine if controls are effective

Perform limited substantive tests to determine if misstatements exist

Perform extensive analytical procedures
REDUCING ASSESSED CONTROL RISK

<table>
<thead>
<tr>
<th>Audit</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control risk after obtaining an understanding of internal control</td>
<td>70%</td>
<td>90%</td>
<td>100%</td>
<td>50%</td>
<td>40%</td>
</tr>
<tr>
<td>Control risk after completing tests of controls</td>
<td>40%</td>
<td>40%</td>
<td>100%</td>
<td>50%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Required:

Explain how the auditor approached each of Audit A through E and the results.
Chapter 11

Fraud Auditing

Chapter 11 provides a focused discussion on the auditor’s responsibility for material misstatements due to fraud, which is critically important to the auditing profession. While auditors have always had a responsibility for the detection of fraud, recent examples of fraudulent financial reporting have greatly increased interest in the subject of fraud auditing. There is tremendous student interest in the subject, and it is important for students to understand the technical requirements of SAS 99, as well as the conditions for fraud and areas of specific fraud risk.

Chapter Opening Vignette – “Accounting Scandal Rocks Public Trust”

Students will have a general awareness of several recent high-profile examples of fraudulent financial reporting, but are generally unaware that there are many other earlier examples. The vignette makes two central points. First, fraudulent financial reporting is not just a recent occurrence. Second, major frauds are often followed by significant changes in the profession. In addition to the requirements for confirmation of receivables and observation of inventory following the fraud at McKesson-Robbins, subsequent waves of fraud later gave rise to peer review and the “expectation gap” auditing standards issued in the late 1980s. We find that this helps students understand the underlying reasons for the Sarbanes-Oxley Act and formation of the PCAOB, and it helps put the recent focus and criticism of the auditing profession into a larger context of events.

Types of Fraud (page 336)

The two types of fraud considered in the context of auditing financial statements were first introduced in Chapter 6, so we do not spend a significant amount of time on this issue. To help illustrate the differences, we ask students to provide specific examples of fraudulent financial reporting and misappropriation of assets for the revenue and collection cycle, acquisition and payment cycle, and inventory and warehousing cycle. We use T-11-1 to record their responses. Students will often be able to provide many examples of misappropriation of assets that they have personally observed, and it often leads to a lively discussion. As students identify numerous types of fraud possibilities, we emphasize that certain immaterial frauds (e.g., petty theft of supplies) fall below the scope of auditor responsibility. This helps illustrate the auditor’s responsibility is in the context of material misstatements in the financial statements. Review questions 11-1, 11-2, and 11-3 are also useful in distinguishing fraudulent financial reporting from misappropriation of assets and requiring students to provide examples of each. Problem 11-30 can be used for the same purpose. Problem 11-26 is good for distinguishing errors from fraud.

(See T-11-1)
Conditions for Fraud (page 337)

We emphasize the fraud triangle included in Figure 11-1 (page 338). We use Table 11-1 (page 338) and Table 11-2 (page 340) to describe each of the conditions for fraud for fraudulent financial reporting and misappropriation assets. We emphasize many of the reasons why fraud occurs as shown in Figure 11-2 (page 339). We then ask students to give more specific examples of incentives and opportunities. T-11-2 or Review Questions 11-5 and 11-6 can be used for this purpose. Problem 11-23 is also good for classifying fraud risk factors.

(See Figures 11-1 and 11-2)

(See Tables 11-1 and 11-2)

(See T-11-2)

Assessing the Risk of Fraud (page 341)

We emphasize the importance of professional skepticism, and sources of information to assess the risk of fraud in Figure 11-3 (page 343). We also mention the importance of communication among the audit team and the documentary requirements in SAS 99. The brainstorming among students about possible fraud techniques when completing T-11-1 or fraud risk factors when completing T-11-2 provides a nice illustration of how the communication among audit team members about an entity’s susceptibility to fraud risk might be useful in the audit planning process.

(See Figure 11-3)

Corporate Governance Oversight to Reduce Fraud Risks (page 345)

We use Figure 11-5 (page 348) to illustrate how organizational factors contribute to the risk of fraud. We use Review Question 11-12 to distinguish management’s responsibility for designing and implementing antifraud programs and controls, and the audit committee’s oversight responsibility.

We also emphasize that auditors of public companies must also evaluate the effectiveness of the audit committee when reporting on internal controls over financial reporting. PCAOB Standard 5 notes that ineffective oversight by the audit committee may be a strong indicator of a material weakness in internal control over financial reporting.

(See Figure 11-5)
Responding to the Risk of Fraud (page 349)

We emphasize the importance of the auditor responding to the risk of fraud. We use T-11-3 to discuss the various forms the response can take, and the required procedures to address management override of controls. We ask students to give examples of responses involving the overall conduct of the audit, and responses for specific examples of fraud risk. Review Question 11-13 can also be used for this purpose, and Review Question 11-14 can be used to cover the procedures to address management override of controls.

(See T-11-3)

Specific Fraud Risk Areas (page 351)

The amount of coverage of this topic depends upon the amount of time you wish to spend on fraud auditing, and the extent to which you discuss fraud risk areas in the cycle chapters that follow. We emphasize that because of materiality, auditors are specifically concerned with fraudulent financial reporting.

Because we believe that analytical procedures are an effective warning sign of fraud, we use Table 11-4 (page 353) and Table 11-5 (page 355) to illustrate the effect of fictitious receivables and inventory on financial ratios.

(See Tables 11-4 and 11-5)

Even though we always cover the sales and collection cycle, we discuss fraud risks related to revenue in Chapter 11 because SAS 99 requires that revenue recognition normally be considered a high fraud risk. Review Question 11-15 is a good one to review the three main ways in which revenue can be manipulated.

We usually review at least one other fraud risk area. We like to review risk of fraudulent financial reporting arising from inappropriately capitalized fixed assets because it is easy for students to understand, and was a central element in WorldCom and other recent fraud cases.

Problems 11-25, 11-27, 11-28, or 11-29 can be used to discuss fraud risks in specific accounting cycles. The ACL Problem 11-33 gives students hands-on experience in how audit software can be effective at identifying potential fraud conditions.

Responsibilities When Fraud is Suspected (page 356)

Figure 11-6 (page 357) is useful to indicate that most frauds are detected by tip, accident, internal controls, or internal audit. We emphasize the importance of considering the effect of fraud on the remainder of the audit.

(See Figure 11-6)
We generally do not spend too much time on inquiry techniques. The types of inquiries and verbal and non-verbal cues (Table 11-6, page 358, and Table 11-7, page 359) can be used for role playing exercises that students generally enjoy.

(See Tables 11-6 and 11-7)

It is also important to emphasize that the discovery of fraud has implications for public company auditors when auditing internal control over financial reporting. PCAOB Standard 5 states that fraud of any magnitude by senior management is at least a significant deficiency and may be a material weakness in internal control over financial reporting. We emphasize that such a discovery may lead to an adverse opinion on internal control over financial reporting.
## CHAPTER 11

### CROSS-REFERENCE OF LEARNING OBJECTIVES AND PROBLEM MATERIAL

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Discussion Questions and Problems</th>
<th>Multiple Choice Questions</th>
<th>ACL Problem and Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>11-1</td>
<td>11-1, 11-2, 11-3</td>
<td>11-24, 11-26, 11-30</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>Define fraud and distinguish between fraudulent financial reporting and misappropriation of assets.</td>
<td>11-4, 11-5, 11-6</td>
<td>11-23, 11-24, 11-25, 11-27, 11-26, 11-29</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>11-2</td>
<td>11-1, 11-2, 11-3</td>
<td>11-24, 11-26, 11-30</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>Describe the fraud triangle and identify conditions for fraud.</td>
<td>11-4, 11-5, 11-6</td>
<td>11-23, 11-24, 11-25, 11-27, 11-26, 11-29</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>11-3</td>
<td>11-1, 11-2, 11-3</td>
<td>11-24, 11-26, 11-30</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>Understand the auditor’s responsibility for assessing the risk of fraud and detecting material misstatements due to fraud.</td>
<td>11-4, 11-5, 11-6</td>
<td>11-23, 11-24, 11-25, 11-27, 11-26, 11-29</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>11-4</td>
<td>11-1, 11-2, 11-3</td>
<td>11-24, 11-26, 11-30</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>Identify corporate governance and other control environment factors that reduce fraud risks.</td>
<td>11-4, 11-5, 11-6</td>
<td>11-23, 11-24, 11-25, 11-27, 11-26, 11-29</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>11-5</td>
<td>11-1, 11-2, 11-3</td>
<td>11-24, 11-26, 11-30</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>Develop responses to identified fraud risks.</td>
<td>11-4, 11-5, 11-6</td>
<td>11-23, 11-24, 11-25, 11-27, 11-26, 11-29</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>11-6</td>
<td>11-1, 11-2, 11-3</td>
<td>11-24, 11-26, 11-30</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>Recognize specific fraud risk areas and develop procedures to detect fraud.</td>
<td>11-4, 11-5, 11-6</td>
<td>11-23, 11-24, 11-25, 11-27, 11-26, 11-29</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>11-7</td>
<td>11-1, 11-2, 11-3</td>
<td>11-24, 11-26, 11-30</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
<tr>
<td>Understand interview techniques and other activities after fraud is suspected.</td>
<td>11-4, 11-5, 11-6</td>
<td>11-23, 11-24, 11-25, 11-27, 11-26, 11-29</td>
<td>11-20</td>
<td>11-33, 11-34</td>
</tr>
</tbody>
</table>

**To download more slides, ebook, solutions and test bank, visit [http://downloadslide.blogspot.com](http://downloadslide.blogspot.com)**
EXAMPLES OF FRAUDULENT FINANCIAL REPORTING AND MISAPPROPRIATION OF ASSETS

<table>
<thead>
<tr>
<th></th>
<th>FRAUDULENT FINANCIAL REPORTING</th>
<th>MISAPPROPRIATION OF ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales and Collection Cycle</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquisition and Payment Cycle</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory and Warehousing Cycle</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## EXAMPLES OF FRAUD RISK FACTORS
FOR FRAUDULENT FINANCIAL REPORTING
AND MISAPPROPRIATION OF ASSETS

<table>
<thead>
<tr>
<th></th>
<th>FRAUDULENT FINANCIAL REPORTING</th>
<th>MISAPPROPRIATION OF ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Incentives</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Opportunities</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
RESPONDING TO THE RISK OF FRAUD

1. Change the overall conduct of the audit

2. Design audit procedures to address identified risks

3. Design procedures to address management override of controls
   - Examine journal entries and adjustments
   - Review accounting estimates for biases
   - Evaluate business rationale for unusual transactions
Chapter 12

The Impact of Information Technology on the Audit Process

Most companies rely on information technology (IT) to record and process business transactions. This chapter highlights how IT affects an audit client’s internal controls, which in turn affects the audit process. Because IT often significantly impacts internal control, this chapter builds upon the discussion of internal control in Chapter 10.

Due to the expanding role of IT in the financial reporting process, we believe that some discussion of the material in this chapter is useful in an introductory auditing course. In this chapter, we highlight several of the key issues related to the impact of IT on risks and have identified types of internal controls that are often implemented to reduce those risks. However, the complexities associated with the variety of IT-based systems in existence today and the ever-evolving nature of IT including e-commerce and the Internet can make this a difficult topic to cover. A full discussion of all the issues and details of related controls could easily turn into a full advanced auditing course on IT auditing. Thus, when we teach this chapter in an introductory auditing course, we try to keep in mind that our goal is to provide a brief overview of the IT issues and related IT controls to increase student awareness of the basic impact IT can have on the audit process. Discussion of this chapter should complement material presented throughout the remainder of the textbook that interweaves the impact of IT and e-commerce on various aspects of the audit. If an advanced auditing course is provided, this chapter could be deferred to that course.

The following topics are covered:

- Chapter opening vignette
- How information technologies improve internal control
- Assessing risks of IT
- Internal controls specific to IT
- General controls
- Application controls
- Impact of IT on the audit process
- Issues for different IT environments, including e-commerce systems

Chapter Opening Vignette – “Just Because the Computer Did the Work Doesn’t Mean It’s Right”

This vignette illustrates several important points concerning client IT-based accounting systems. First, students must realize the extent of computer processing of accounting information and how important it is for auditors to understand the technology used in the financial reporting process and how it affects internal controls and the audit. Second, as the title indicates, computer output looks good, but that doesn’t mean it’s correct. Computer output must be tested, and evidence must be obtained to support its reliability. In this case, students might be asked what different ways the aging could be tested.
This vignette also allows for a discussion of many of the audit software packages, such as ACL software highlighted in this edition, that are now available for purchase and use by auditors. These vendor developed software packages are capable of reading client data stored in a variety of formats and re-computing information, such as re-doing an aging of accounts receivable. The Windows based format of the software allows the auditor to easily perform numerous audit tasks requiring testing of client data presented in electronic form efficiently and effectively. If not already assigned, ACL problems in chapters 7, 8, and 11 could be used to illustrate the benefits of audit software tools as part of this chapter's discussions.

This chapter highlights that while IT reduces many of the risks associated with traditional manual accounting systems, new risks are introduced. We focus on those risks and then outline internal controls specific to IT that management can implement to address some of those risks.

**How Information Technologies Improve Internal Control** (page 372)

Most students already embrace the idea that IT provides tremendous benefits to businesses and that most businesses rely on IT to some extent to produce financial statement information. This section illustrates two primary benefits for internal control when IT is integrated into accounting systems:

- The replacement of manual controls with computer performed controls that apply checks and balances to each processed transaction thereby reducing the risk of human error, which can be scattered randomly throughout processing.
- The use of IT, if implemented correctly, typically provides management with more and higher quality information faster than most manual systems.

In this section, we emphasize how a well-controlled IT system can offer greater potential for reducing material misstatements because computers process information consistently. Once management and the auditor are reasonably assured that IT programs are properly designed and installed, they can benefit from the systematic nature of IT processing of transactions.

**Assessing Risks of IT** (page 372)

While students generally think of IT offering significant benefits to a client’s internal control, they often fail to recognize new risks that are introduced. In this section we highlight several key risks specific to IT environments to emphasize the impact on a client’s overall control risk. We believe this helps set the stage for the discussion of general and application controls, which follows. **T-12-1** summarizes these key risks.

(See T-12-1)
Internal Controls Specific to IT (page 374)

In this section, we illustrate how management can respond to many of the risks unique to IT by implementing internal controls specific to IT. We describe both general controls and application controls and highlight how they differ. We emphasize how general controls have an umbrella effect over all aspects of the IT function while application controls apply to the processing of individual transactions within a specific transaction cycle. We note that general controls are designed to protect each application software program and data from many of the risks noted earlier in this chapter. Figure 12-1 (page 375) provides a useful visual example of the difference between general and application controls.

(See Figure 12-1)

General Controls (page 374)

We highlight how the six categories of general controls have an overriding effect on all IT functions by briefly describing each category of control. Table 12-1 (page 375) provides a helpful summary of the six general controls along with an example of each. We particularly emphasize the importance of segregating key duties and the importance of a controlled systems development process.

(See Table 12-1)

- **Segregation of duties** – We refer back to the discussion in Chapter 10 about the importance of segregating the key duties of authorization, accounting, and custody of assets in a traditional accounting system (see pages 298-299). Then, we note how many of these duties traditionally handled in different parts of the organization are now centralized under the IT function. We highlight how companies address the risks of collapsing many of these duties under the IT function by segregating key duties within the IT function. We emphasize that ideally responsibilities for IT management, systems development, operations, and data control should be segregated. We briefly describe each of these functions. Figure 12-2 (page 376) provides a useful depiction of an ideal IT organizational chart. We also refer back to Chapter 10 (page 298) to note the importance of segregating IT duties from the duties of key users outside IT (for example, IT personnel should not have the ability to authorize changes to the employee master file – that should reside with the human resources function). Problem 12-22 provides a useful illustration of the importance of segregating key IT duties.

The use of Problem 12-20 provides a good way to emphasize the concepts related to this general control.

(See Figure 12-2)
Systems Development – We refer back to the discussion of how the use of IT to process transactions can lead to systematic error by noting that once errors are included in software programming the computer will process transactions incorrectly until those programs are changed. We describe how a well-designed process of selecting, designing, testing, and implementing application software using a team of both IT and non-IT personnel helps increase the likelihood that program design errors are properly addressed before the system is implemented and relied upon to produce financial statement information. We emphasize that an important aspect of systems development involves thorough testing of the system before implementation through the use of pilot and parallel testing.

In addition to discussing these general controls, we spend a brief amount of time defining the other types of general controls by stating their importance and providing an example of each.

Problems 12-25 and 12-27 provide students an opportunity to identify weaknesses in general controls. The Internet Problem also provides students an opportunity to consider emerging best-practices related to effective overall IT governance and how that affects the entity’s overall internal control.

Application Controls (page 378)

After discussing general controls, we then highlight the three types of application controls: input controls, processing controls, and output controls. We refer back to Table 12-1 (page 375) to highlight examples of each of these categories of application controls. T-12-2 also is useful to show the relationship of these categories of control.

(See Table-12-1)

(See T-12-2)

The emphasis in this section is on relating application controls to the transaction-related audit objectives developed in Chapters 6 and 10 and used in subsequent chapters. This approach shows the relationship between IT and IT-based systems. Problems 12-19 and 12-26 provide useful examples of how IT-based application controls link to transaction-related audit objectives.

Impact of IT on the Audit Process (page 380)

In this section we illustrate how the auditor’s understanding and testing of general controls affect the auditor’s testing of application controls. We note that most auditors evaluate the effectiveness of general controls before evaluating application controls, given the umbrella effect general controls have over application controls. We emphasize that when the auditor determines that general controls are strong, the likelihood that the auditor will rely on key application controls embedded in the system to reduce control risk increases. That, in turn, can lead to greater audit efficiencies because more expensive substantive tests are less necessary. However, as general controls are found to be less effective, the auditor may be concerned that underlying application software
programs or related master files are not reliable due to a deficient IT environment. For example, the lack of control surrounding program development and program changes increases the auditor’s concern that application programs are more likely to produce systematic error. **T-12-3** illustrates the typical flow of auditor testing of general controls and application controls. It is important to emphasize that the results of auditor testing of general and application controls should be considered by auditors of accelerated filer public companies when issuing reports on internal control over financial reporting.

This usually leads to a discussion of the terms “auditing around the computer” (where the auditor does not use computer performed controls to reduce control risk) and “auditing through the computer” (where the auditor tests computer-performed internal controls and account balances electronically because good general controls exist). When discussing this section, we illustrate the test data, parallel simulation, and the embedded audit module approaches to auditing through the computer. **T-12-4** provides a useful way to demonstrate how these three approaches differ. In addition, **Figures 12-3 and 12-4** (pages 384 and 385) illustrate the test data and parallel simulation approaches, respectively. Problems 12-23 and 12-24 help illustrate the uses of these audit approaches. The ACL Problem 12-31 provides hands-on experience in using audit software as an audit tool.

**(See T-12-3 and T-12-4)**

**(See Figures 12-3 and 12-4)**

**Issues for Different IT Environments** (page 386)

The material presented in earlier sections of this chapter addresses the effect of IT on the audit process for organizations that centralize the IT function. While all organizations need a strong general controls environment, some of those general control issues differ across various IT environments. In this section we highlight unique issues for network environments, database management systems, e-commerce systems and outsourced IT functions. Problem 12-28 provides a basis for illustrating risks unique to on-line sales systems.
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>ACL Problem and Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>12-1 Describe how IT improves internal control.</td>
<td>12-1</td>
<td>12-17</td>
<td>12-23</td>
<td></td>
</tr>
<tr>
<td>12-2 Identify risks to accounting systems specific to IT.</td>
<td>12-2, 12-3, 12-4, 12-5</td>
<td>12-18</td>
<td>12-19, 12-20, 12-21, 12-23, 12-25, 12-27</td>
<td>12-30</td>
</tr>
<tr>
<td>12-3 Explain how general controls and application controls reduce IT risks.</td>
<td>12-6, 12-7</td>
<td></td>
<td>12-19, 12-20, 12-21, 12-22, 12-23, 12-25, 12-27</td>
<td>12-30</td>
</tr>
<tr>
<td>12-4 Describe how general controls affect the auditor’s testing of application controls.</td>
<td>12-8, 12-9, 12-10</td>
<td>12-17, 12-18</td>
<td>12-21, 12-23, 12-26</td>
<td></td>
</tr>
<tr>
<td>12-5 Use test data, parallel simulation, and embedded audit module approaches to test automated controls.</td>
<td>12-11</td>
<td></td>
<td>12-21, 12-23, 12-24</td>
<td>12-31</td>
</tr>
<tr>
<td>12-6 Identify issues for e-commerce systems and other specialized IT systems.</td>
<td>12-12, 12-13, 12-14, 12-15, 12-16</td>
<td></td>
<td>12-28, 12-29</td>
<td></td>
</tr>
</tbody>
</table>
KEY RISKS SPECIFIC TO IT ENVIRONMENTS

- Reliance on functioning of hardware and software
- Lack of visible audit trail
- Reduced human involvement
- Systematic versus random errors
- Unauthorized access
- Loss of data
- Reduced segregation of duties
- Lack of traditional authorization
- Need for IT experience
# INPUT, PROCESSING, AND OUTPUT APPLICATION CONTROLS

<table>
<thead>
<tr>
<th>INPUT CONTROLS</th>
<th>PROCESSING CONTROLS</th>
<th>OUTPUT CONTROLS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Input →</td>
<td>IT Processing</td>
<td>→ Output</td>
</tr>
<tr>
<td>• Authorization</td>
<td>• Validation tests</td>
<td>• Review of output for reasonableness</td>
</tr>
<tr>
<td>• Preparation of source documents</td>
<td>• Sequence tests</td>
<td>• Reconciliation of output to input control totals</td>
</tr>
<tr>
<td>• Input screen controls</td>
<td>• Arithmetic accuracy tests</td>
<td>• Controls over distribution of output</td>
</tr>
<tr>
<td>• Validation of input</td>
<td>• Data reasonableness tests</td>
<td>• Review of error listings</td>
</tr>
<tr>
<td>• Control totals (batch, hash, record counts)</td>
<td>• Completeness tests</td>
<td></td>
</tr>
</tbody>
</table>

To download more slides, ebook, solutions and test bank, visit http://downloadslide.blogspot.com
SEQUENCE FOR EVALUATION – GENERAL AND APPLICATION CONTROLS

Test General Controls

Effective ?

Yes - Evaluate application controls

Effective ?

Yes - Perform tests of application controls and, if effective, reduce substantive tests

No - Do not rely on IT application controls to reduce control risk
## COMPARISON OF TEST DATA, PARALLEL SIMULATION AND EMBEDDED AUDIT MODULE APPROACHES

<table>
<thead>
<tr>
<th>BASIS FOR COMPARISON</th>
<th>TEST DATA</th>
<th>PARALLEL SIMULATION</th>
<th>EMBEDDED AUDIT MODULE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Objectives</strong></td>
<td>Test effectiveness of client’s internal controls</td>
<td>Generally to test output, but sometimes used to test internal controls</td>
<td>Test unusual transaction output</td>
</tr>
<tr>
<td><strong>Tests of controls versus substantive test</strong></td>
<td>Tests of controls</td>
<td>Generally substantive tests</td>
<td>Generally substantive tests</td>
</tr>
<tr>
<td><strong>Information being tested</strong></td>
<td>Client’s processes</td>
<td>Client’s output</td>
<td>Client’s output</td>
</tr>
<tr>
<td><strong>Computer program used</strong></td>
<td>Client’s</td>
<td>Auditor’s</td>
<td>Client’s modified by auditor</td>
</tr>
</tbody>
</table>
Chapter 13

Overall Audit Plan and Audit Program

Much of the material in Chapter 13 is review and integration. The audit methodology in Chapter 13 includes the requirements of the Risk Assessment SASs. The chapter helps students see the connection between risk assessment procedures and further audit procedures and the audit risk model introduced in Chapter 9. The integration portion of the material is especially important. The types of tests are also critical. This chapter is a major one to help students tie the audit process together.

The following are the areas we cover in the chapter:

- Chapter opening vignette
- Types of tests
- Impact of information technology on audit testing
- Evidence mix
- Design of the audit program
- Summary of key evidence-related terms
- Summary of the audit process

To provide a frame of reference for discussing the chapter, we first refer students to Figure 8-1 (page 210), with emphasis on the bottom rectangle and its relationship to the rest of the items in the figure.

(See Figure 8-1)

Chapter Opening Vignette – “How Much and What Kind of Testing Will Get the Job Done?”

This vignette presents a debate over the conflict between efficiency and effectiveness in doing audits. The auditor has an obligation to find material misstatements, but also to conduct the audit at the lowest possible cost. Clients want all misstatements found, especially fraud, but they also want the audit fee to be low. They can't have it both ways. Additionally, integrated audits of internal control over financial reporting and the financial statements required by PCAOB Standard 5 for larger public companies has significantly affected the mix of audit procedures that must be performed in audits of these companies. This vignette demonstrates that while tests of controls will be extensively performed in audits of most public companies, substantive tests will continue to be performed in all audits of financial statements.

Students can engage in this debate, and you can ask them how an auditor decides which procedures to do and which to forego. You can also discuss the tools auditors have to obtain both efficiency and effectiveness: e.g., audit risk model, statistical methods, computer processing, and computer models for assessing risk, developing programs, and accomplishing administrative tasks.
Types of Tests (page 404)

First we define the five types of tests and help students understand that only four of those five represent further audit procedures as defined by auditing standards. We remind students that risk assessment procedures are represented by the procedures auditors perform to assess inherent risk and control risk as described in Chapters 8 and 9. Auditors perform further audit procedures in response to the risks identified by the risk assessment procedures. We use Figure 13-1 (page 405) to help students see the connection between the four types of procedures that constitute further audit procedures to the components of the audit risk model. Notice that Problem 13-24 is a good test of students' understanding of the definitions and their relationship to material in earlier chapters.

(See Figure 13-1)

There are several other questions you might ask in this section.

1. What is the difference between a test of control and a substantive test of transactions? Review Question 13-4 is helpful.
2. What is the difference between a substantive test of transactions and a test of details of balances? (Review Question 13-9).
3. Review Question 13-6 – Performing substantive tests of transactions simultaneously with tests of controls.
4. What is the relationship between tests of controls and substantive tests? Figure 13-3 (page 411) is useful to discuss this.

(See Figure 13-3)

5. What are the relationships among tests of controls, substantive tests of transactions, analytical procedures, and tests of details of balances? We summarize this with T-13-1.

(See T-13-1)

6. What types of tests are required in a public company's audit of internal control over financial reporting? Review Question 13-1 is helpful for this emphasis.

For definitional purposes, several problems are excellent. These include 13-25, 13-26, 13-27, and 13-28. Each of these problems interrelate material from Chapters 6 through 13. Often we assign only two or three of the requirements for any given problem. To provide memory joggers, put T-13-2 on the overhead while discussing these problems. Also show Table 13-2 (page 408) to relate types of evidence to types of tests.

(See T-13-2)

(See Table 13-2)
Impact of Information Technology on Audit Testing (page 412)

Use T-13-1 as a framework to discuss how the client’s and the auditor’s use of information technology has changed the emphasis placed on each type of test. The existence of automated controls allows the auditor to rely on controls with a reduced level of testing. Audit software allows auditors to perform analytical procedures more effectively. As a result, auditors may be more likely to increase reliance on controls, and obtain greater assurance from analytical procedures. Auditor software, such as ACL as illustrated in this book, also allows many tests of details of balances to be completed more efficiently.

(See T-13-1)

Problem 13-29 can be used to illustrate the existence of automated controls, and to discuss the effect of automated controls on audit testing.

Evidence Mix (page 413)

Keep T-13-1 on the overhead and ask students to explain the difference between the three audits.

(See T-13-1)

Audits A and C were approached essentially the same except that a lower audit risk was acceptable for C. Refer to Chapter 9. Audits A and B achieved the same audit risk, but each audit was approached in a completely different manner. Audit A apparently had effective internal controls and analytical procedures results were good. In Audit B, the controls were apparently deficient and the results of analytical procedures must have indicated problem areas. Emphasize that Audit B could not represent an audit strategy for an integrated audit of a public company’s financial statements and internal control over financial reporting given that tests of controls must be performed in an integrated audit.

Another transparency we use to show the relationships among analytical procedures, tests of controls, substantive tests of transactions, and tests of details of balances is T-13-3.

(See T-13-3)

Next, we discuss the effect of a reduced assessed control risk and performing tests of controls and substantive tests of transactions on tests of details of balances. A return to Figure 10-11 (page 321) is useful to illustrate that concept and to integrate Chapters 10–13. We discuss the five types of tests and where they fit into Figure 10-11.

(See Figure 10-11)
Finally, we like to discuss the appropriate emphasis on different types of tests under differing circumstances. This is a discussion of the material in Table 13-3 (page 413).

T-13-3 shows a summary of the logic sequence that is appropriate to make the decision in the audit of the financial statements. Problems 13-31 and 13-32 are useful to illustrate this concept. Case 13-36 can also be used at this point. Be sure to point out that in the audit of internal controls over financial reporting the auditor’s basis for reporting comes from tests of controls and not substantive testing.

(See Table 13-3)

(See T-13-3)

Design of the Audit Program (page 414)

This material may be too conceptual for some students at this stage of the course, but an understanding of the audit process requires them to understand this material before the course is complete. We introduce the material in this part of the chapter, and return to it again in Chapter 16. There are several important things we like to accomplish in this section.

1. Compare the methodology for designing tests of controls, substantive tests of transactions, and tests of details of balances. Figure 13-4 (page 415) and Figure 13-6 (page 417) are useful to make that comparison.

(See Figures 13-4 and 13-6)

2. Show the factors that determine tests of details of balances. Figure 13-2 (page 406) and Figure 13-7 (page 419) show the progression from financial statements through tests of details of balances. If students understand Figure 13-2, they will likely understand the audit process.

(See Figures 13-2 and 13-7)

3. Show an output of the design of tests of balances, such as the audit program in Table 13-4 (page 421).

(See Table 13-4)

Summary of Key Evidence-Related Terms (page 423)

At this point, students have been exposed to many terms related to the phases of the audit process, audit objectives, types of tests, evidence decisions, and types of evidence. Use Table 13-6 (page 423) to summarize the relationship among these five key evidence-related terms.

(See Table 13-6)
Summary of the Audit Process (page 424)

At this point, we spend a few minutes going over Figure 13-9 (page 425). We like to use the transparency for this figure so that it can be discussed more effectively. This figure summarizes much of the material discussed in Chapters 6 through 13. We also refer back to Figure 13-9 in almost every other chapter in the course.

(See Figure 13-9)

If we have time, we like to list the major decisions made during Phase I (see T-13-4), and ask students to explain the primary basis on which the decisions are made. It is also useful to ask what can happen at a later date to change each decision.

(See T-13-4)
### CHAPTER 13
CROSS-REFERENCE OF LEARNING OBJECTIVES AND PROBLEM MATERIAL

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>13-2</strong> Select the appropriate types of audit tests.</td>
<td>13-7, 13-8, 13-12, 13-13, 13-14</td>
<td></td>
<td>13-24, 13-25, 13-26</td>
<td></td>
</tr>
<tr>
<td><strong>13-3</strong> Understand how information technology affects audit testing.</td>
<td>13-10</td>
<td></td>
<td></td>
<td>13-26, 13-29</td>
</tr>
<tr>
<td><strong>13-6</strong> Compare and contrast transaction-related audit objectives with balance-related and presentation and disclosure-related audit objectives.</td>
<td></td>
<td></td>
<td>13-26, 13-27, 13-28</td>
<td></td>
</tr>
<tr>
<td><strong>13-7</strong> Integrate the four phases of the audit process.</td>
<td>13-21</td>
<td>13-22</td>
<td>13-30, 13-34</td>
<td></td>
</tr>
</tbody>
</table>
## LEVEL OF ASSURANCE OBTAINED IN DIFFERENT WAYS (1 - AUDIT RISK)

<table>
<thead>
<tr>
<th></th>
<th>Achieved Level of Assurance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Audit A</td>
</tr>
<tr>
<td>Assessed Control Risk Including Tests of Controls</td>
<td>30%</td>
</tr>
<tr>
<td>Substantive Tests of Transactions</td>
<td>15%</td>
</tr>
<tr>
<td>Analytical Procedures</td>
<td>30%</td>
</tr>
<tr>
<td>Tests of Details of Balances</td>
<td>22%</td>
</tr>
<tr>
<td>Total</td>
<td>97%</td>
</tr>
</tbody>
</table>

| Achieved Audit Risk          | 3%      | 3%      | 1%      |

**Required:**
1. Explain the differences between Audit A and C.
2. Explain the differences between Audit A and B.
**TYPES OF EVIDENCE**

- Physical Examination
- Confirmation
- Documentation
- Observation
- Inquiries of the Client
- Reperformance
- Analytical Procedures
- Recalculation

<table>
<thead>
<tr>
<th>TRANSACTION-RELATED AUDIT OBJECTIVES</th>
<th>BALANCE-RELATED AUDIT OBJECTIVES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence</td>
<td>Existence</td>
</tr>
<tr>
<td>Completeness</td>
<td>Completeness</td>
</tr>
<tr>
<td>Accuracy</td>
<td>Accuracy</td>
</tr>
<tr>
<td>Posting &amp; summarization</td>
<td>Detail tie-in</td>
</tr>
<tr>
<td>Classification</td>
<td>Classification</td>
</tr>
<tr>
<td>Timing</td>
<td>Cutoff</td>
</tr>
<tr>
<td></td>
<td>Realizable value</td>
</tr>
<tr>
<td></td>
<td>Rights &amp; obligations</td>
</tr>
</tbody>
</table>

*Note: The auditor also uses a combination of the types of evidence to satisfy presentation and disclosure objectives*
RELATIONSHIPS AMONG ANALYTICAL PROCEDURES, TESTS OF CONTROLS, SUBSTANTIVE TESTS OF TRANSACTIONS, AND TESTS OF DETAILS OF BALANCES

Analytical Procedures
- Almost always heavy

T of C, S T of T, and Observations
- Independent of analytical procedures
- Extent of testing depends primarily upon intended reduction of assessed control risk
- Some substantive tests of transactions are normally performed

Tests of Details of Balances
- Dependent on analytical procedures, tests of controls, and substantive tests of transactions
- Some tests of details are normally always required

Assessed Control Risk, T of C, and S T of T

Good Results
- Analytical Procedures
  - Good Results
  - Minimal Tests of Details
  - Bad Results or Few Performed
  - Medium Tests of Details

Bad Results or Few Tests Performed
- Analytical Procedures
  - Good Results
  - Medium Tests of Details
  - Bad Results or Few Performed
  - Extensive Tests of Details
DECISIONS MADE IN PHASE I OF THE AUDIT

1. Accept or continue with client.

2. Understand client’s business and industry and assess client business risk.

3. Materiality, acceptable audit risk, inherent risk, and fraud risk.

4. Understand internal control and determine planned assessed control risk.

5. Planned extent of substantive tests in Phase II and III.

6. Timing of all audit procedures and intended completion date.

7. Size of audit team and allocation of work.

8. Extent of need for industry, statistical sampling, or IT specialists.

9. Degree of additional management and tax services to provide.
Chapter 14

Audit of the Sales and Collection Cycle: Tests of Controls and Substantive Tests of Transactions

This is an essential chapter because it is the first chapter to deal with specific evidence in an audit area. It is essential that the concepts of previous chapters be applied to the sales and collection cycle. The following are the primary areas covered:

- Chapter opening vignette
- Accounts and classes of transactions in the sales and collection cycle
- Accounting rules for the timing of recording transactions
- Factors affecting evidence accumulation
- Overview of the audit for the sales and collection cycle
- Types of audit tests applied to sales and cash receipts
- Methodology for designing tests of controls and substantive tests of transactions for sales
- Design and performance format audit procedures
- Methodology for designing tests of controls and substantive tests of transactions for cash receipts
- Effect of the results of tests of controls and substantive tests of transactions
- Suggested homework problems and cases

Chapter Opening Vignette – “The Choice Is Simple - Rely on Internal Control or Resign”

This vignette makes the point that some companies are so large and so complex that the only way they could possibly be audited is through reliance on internal controls. This presents a dilemma: what does an auditor do if he or she finds that a large client has poor controls? The problem is exacerbated by the demands for public companies to issue annual reports at an early date, and to file their Form 10-K with the SEC. We remind students that the Sarbanes–Oxley Act requires auditors to also report on internal control for accelerated filer public companies.

This case offers an opportunity to discuss the differences between auditing large and small companies, and auditing public and non-public companies. Students may be interested in the fact that even the largest firms have more small clients than large ones in absolute numbers. However, most audit hours are spent on the large ones.

Accounts and Classes of Transactions in the Sales and Collection Cycle (p. 442)

We like to start with a set of financial statements and remind students that the overall statements are being audited. Reference can also be made to the Hillsburg Hardware Company financial statements included in the glossy insert to the text. All sales and collection cycle accounts in the statements can be identified to show which areas are involved. Figure 14-1 (page 442) is helpful here.
Next, we find it useful to talk about the relationship between the financial statements, documents, and records. It is important that students thoroughly understand how the information gets into the financial statements, the nature and purpose of journals, master files, and documents affecting the cycle. It is difficult to teach the material without actually seeing documents and records. The amount of time you need to spend depends on the students' background in systems. We go through T-14-1 to help students understand the relationship in the audit of sales and cash receipts.

(See T-14-1)

At the same time documents and records are discussed, the business functions in the cycle can be reviewed (page 443). Ask students to explain how the transactions for each business function discussed in the early part of Chapter 14 affect the balances in the statements, and how they are recorded so that they are properly reflected. Table 14-1 (page 443) is an excellent summary of the classes of transactions, accounts, business functions, and related documents and records in the sales and collection cycle.

(See Table 14-1)

**Accounting Rules for the Timing of Recording Transactions**

It is important that students understand the "key point" for recording each type of transaction in the cycle. Consider assigning Internet Problem 14-1 that highlights the revenue recognition fraud at Bally Total Fitness.

(See T-14-2)

**Factors Affecting Evidence Accumulation**

We try to relate the material from early chapters to this cycle.

- Four audit evidence decisions that must be made in the cycle (Chapter 7).
- Acceptable audit risk (Chapter 9).
- Expectation of misstatements for each account (Chapter 9). We emphasize internal control, materiality of accounts receivable, sales returns and allowances, bad debts, and results of prior year tests as being especially significant.
- Understanding internal control and assessing control risk (Chapter 10).
- Scope restrictions by the client or conditions (Chapter 3).
- Reliability of confirmations (Chapter 7).

(See T-14-3)

**Overview of the Audit for the Sales and Collection Cycle**

Before we get into the details of the audit, we go over the approach in Figure 10-11 (page 321), applied to sales and cash receipts. We want students to understand that this approach must be applied to each cycle. Also refer students to Figure 14-2 (page 448) and make sure students understand the decision process.

(See Figures 10-11 and 14-2)
Types of Audit Tests Applied to Sales and Cash Receipts

It is worthwhile to review the types of audit tests used in conducting the audit and discuss them briefly for sales and cash receipts.

(See T-14-4)

Ask students to give examples of each type of tests for sales and cash receipts. It is useful to refer to Figure 13-1 (page 405) as this discussion takes place.

(See Figure 13-1)

Methodology for Designing Tests of Controls and Substantive Tests of Transactions for Sales (page 447)

We are now ready to review Table 14-2 (pages 452-453).

- Ask students why transaction-related audit objectives are used to develop the audit program.
- Discuss the need to, and how to convert the general transaction-related audit objectives to those used in column 1 of Table 14-2.
- Remind students that there are four audit evidence decisions. Only audit procedures are studied in this chapter.
- Select two transaction-related audit objectives and go over them in detail, covering columns 1-5. The important thing is to emphasize how the columns relate to each other (see top of next page).

1. Transaction-related audit objectives - all four other columns are tied to the objectives.
2. Key internal controls - relate to objectives.
3. Common tests of controls - relate to key controls.
4. Deficiencies - relate to objectives and indicate an absence of controls.
5. Common substantive tests of transactions - relate to objectives.

(See T-14-5)

- Ask students to explain the effect on tests of controls and substantive tests of eliminating certain specific controls in Table 14-2.
- Ask students to explain the difference between occurrence and completeness for sales. Figure 14-4 (page 455) is a helpful illustration here.

(See Figure 14-4)

- Ask students why certain procedures on Table 14-2 are included in more than one place.
- Go over Problem 14-25.

Design and Performance Format Audit Procedures (page 458)

Distinguish between a design and a performance format audit program, and explain why each is important. It is useful to combine several of the procedures in Table 14-2 to show how it should be done.
Refer students to Table 14-2 (pages 452-453), Table 14-3 (page 461), and Figure 14-6 (page 462) to illustrate going from a design to a performance format. We ask students to trace a procedure in each direction. Ask the students which format is done first by the auditor and which format is used by the auditor in the field.

(See Tables 14-2 and 14-3, Figure 14-6)

Methodology for Designing Tests of Controls and Substantive Tests of Transactions for Cash Receipts (page 459)

We spend little time covering cash receipts except to emphasize:

- The objectives and concepts are identical to those covered in sales.
- The potential for theft in cash receipts and the importance of the prelisting.
- The relationship of sales and cash receipts, and why they are a part of the same cycle.
- Certain objectives are more important for cash receipts than sales, and others are less important. It is useful to discuss which ones are important and why.
- Define and explain the meaning of a proof of cash receipts and its importance as an audit test.
- Define and explain lapping.

Effect of Results of Tests of Controls and Substantive Tests of Transactions (page 464)

It is important to remind students that only tests of controls and substantive tests of transactions audit procedures have been discussed, not sample size, or items to select. Also discuss, again, the relationship between tests of controls and substantive tests of transactions and the rest of the audit.

Figure 14-7 (page 465) provides a good summary of the chapter material. This figure summarizes the major accounts in the sales and collection cycle, how the types of audit tests are used to audit these accounts, and how the audit risk model relates to the audit of the sales and collection cycle.

(See Figure 14-7)

Suggested Homework Problems and Cases

To complete the coverage of the material in this chapter, we suggest assigning Problem 14-31 or Case 14-33. We suggest using Part V of the Pinnacle Manufacturing Integrated Case (Case 14-34) if you assigned Parts III and IV (Cases 10-43 and 11-34) earlier.
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Discussion Questions</th>
<th>Multiple Choice Questions</th>
<th>ACL Problem and Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>14-1 Identify the accounts and the classes of transactions in the sales and collection cycle.</td>
<td>14-1, 14-2, 14-3, 14-4</td>
<td>14-1-14, 14-2, 14-3, 14-4</td>
<td>14-23</td>
<td>14-24, 14-27</td>
</tr>
<tr>
<td>14-2 Describe the business functions and the related documents and records in the sales and collection cycle.</td>
<td>14-5, 14-6, 14-7, 14-8, 14-9, 14-10, 14-11, 14-12, 14-13, 14-14, 14-15, 14-16, 14-17, 14-18, 14-19, 14-20</td>
<td>14-21, 14-22, 14-23</td>
<td>14-24, 14-25, 14-26, 14-27, 14-28, 14-29, 14-30, 14-31</td>
<td>14-33, 14-34, 14-35</td>
</tr>
<tr>
<td>14-3 Understand internal control, and design and perform tests of controls and substantive tests of transactions for sales.</td>
<td>14-11</td>
<td>14-21, 14-22, 14-23</td>
<td>14-24, 14-25</td>
<td>14-21</td>
</tr>
<tr>
<td>14-4 Apply the methodology for controls over sales transactions to controls over sales returns and allowances.</td>
<td>14-17</td>
<td>14-12, 14-13, 14-14, 14-15, 14-16, 14-17, 14-18, 14-19</td>
<td>14-21</td>
<td></td>
</tr>
<tr>
<td>14-5 Understand internal control, and design and perform tests of controls and substantive tests of transactions for cash receipts.</td>
<td>14-17</td>
<td>14-12, 14-13, 14-14, 14-15, 14-16, 14-17, 14-18, 14-19</td>
<td>14-21</td>
<td></td>
</tr>
<tr>
<td>14-6 Apply the methodology for controls over the sales and collection cycle to write-offs of uncollectible accounts receivable.</td>
<td>14-17</td>
<td>14-12, 14-13, 14-14, 14-15, 14-16, 14-17, 14-18, 14-19</td>
<td>14-21</td>
<td></td>
</tr>
</tbody>
</table>
SOURCE OF INFORMATION FOR THE SALES AND COLLECTION CYCLE

<table>
<thead>
<tr>
<th>EXAMPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales and Collection Cycle Account Balances in the Financial Statements</td>
</tr>
<tr>
<td>Sales</td>
</tr>
<tr>
<td>Accts. Rec.</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Sales R &amp; A</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EXAMPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales and Collection Cycle Accounts in the General Ledger (Figure 14-1)</td>
</tr>
<tr>
<td>Sales Journal</td>
</tr>
<tr>
<td>Cash Receipts Journal</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EXAMPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Master File Affecting Accounts in the General Ledger</td>
</tr>
<tr>
<td>Journals Affecting Accounts in the General Ledger</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EXAMPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transactions Recorded in the Journals and Master Files</td>
</tr>
<tr>
<td>Cash Sales</td>
</tr>
<tr>
<td>Credit Sales</td>
</tr>
<tr>
<td>Sales Returns</td>
</tr>
<tr>
<td>Cash Receipts</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EXAMPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Documents Related to the Transactions</td>
</tr>
<tr>
<td>Sales Invoices</td>
</tr>
<tr>
<td>Ship. Documents</td>
</tr>
<tr>
<td>Remittance Advices</td>
</tr>
</tbody>
</table>
# KEY POINTS FOR RECOGNITION OF SALES AND COLLECTION CYCLE TRANSACTIONS

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales:</strong></td>
<td>Usually at the date of shipment; exception - earlier, when title passes before the date of shipment</td>
</tr>
<tr>
<td><strong>Cash Receipts:</strong></td>
<td>Date of receipt by the company</td>
</tr>
<tr>
<td><strong>Sales Returns and Allowances:</strong></td>
<td>In the same period as the period in which the sale is recorded</td>
</tr>
<tr>
<td><strong>Bad Debts:</strong></td>
<td>Periodically; usually as a percent of sales for the period with adjustment at year-end</td>
</tr>
<tr>
<td><strong>Write-Off of Uncollectibles:</strong></td>
<td>When the receivable is no longer considered to be collectible</td>
</tr>
</tbody>
</table>
FOUR AUDIT EVIDENCE DECISIONS

<table>
<thead>
<tr>
<th></th>
<th>SALES</th>
<th>CASH RECEIPTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Procedures</td>
<td>Table 14-2</td>
<td>Table 14-3</td>
</tr>
<tr>
<td>Sample Size</td>
<td>Chapter 15</td>
<td>Chapter 15</td>
</tr>
<tr>
<td>Items to Select</td>
<td>Chapter 15</td>
<td>Chapter 15</td>
</tr>
<tr>
<td>Timing</td>
<td>Chapters 6 &amp; 13</td>
<td>Chapters 6 &amp; 13</td>
</tr>
</tbody>
</table>
## TYPES OF AUDIT TESTS

<table>
<thead>
<tr>
<th>TYPES OF AUDIT TESTS</th>
<th>ACHIEVED LEVEL OF ASSURANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tests of Controls (including Procedures to Obtain an Understanding of I/C)</td>
<td></td>
</tr>
<tr>
<td>Substantive Tests of Transactions</td>
<td></td>
</tr>
<tr>
<td>Analytical Procedures</td>
<td></td>
</tr>
<tr>
<td>Tests of Details of Balances</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>
### RELATIONSHIPS IN TABLE 14-2

<table>
<thead>
<tr>
<th>Transaction-Related Audit Objectives</th>
<th>Key Internal Controls</th>
<th>Common Tests of Controls</th>
<th>Common Substantive Tests of Transactions</th>
</tr>
</thead>
</table>

Substantive procedures depend on key internal controls, deficiencies in internal control, materiality of sales, etc.
Chapter 15

Audit Sampling for Tests of Controls and Substantive Tests of Transactions

Both audit sampling chapters (Chapter 15 and 17) follow similar approaches to the topic. In response to suggestions from instructors and current trends in the use of sampling, nonstatistical sampling is covered early in each chapter, followed by a discussion of statistical sampling methods. Each chapter emphasizes the similarities between nonstatistical sampling and statistical sampling methods. We believe that the format of Chapter 15 will provide you with maximum flexibility in deciding how you wish to approach the topic of audit sampling for tests of controls and substantive tests of transactions. The chapter is built around the fourteen steps of audit sampling, which apply to both nonstatistical and attributes sampling. Each step is covered in detail during the discussion of nonstatistical sampling on pages 485-501. The discussion of attributes sampling on pages 501-507 uses these same fourteen steps, but focuses on the differences between how these steps are applied for nonstatistical and attributes sampling.

Before assigning Chapter 15, you must decide how you want to approach the topic of audit sampling. There are two suggested approaches for covering Chapter 15:

1. Cover nonstatistical sampling only
2. Cover nonstatistical sampling, followed by attributes sampling

Note that it is not feasible to cover attributes sampling only. You must cover the nonstatistical sampling portion of the chapter before discussing attributes sampling. This is because the attributes sampling portion of the chapter revolves around the fourteen steps outlined in the nonstatistical sampling section of the chapter.

The remainder of this outline assumes that you will follow approach (2) above – cover nonstatistical sampling, followed by attributes sampling. If you wish to use approach (1) above – cover nonstatistical sampling only – simply ignore the last section of this outline – Attributes Sampling.

The following are the primary topical areas that we suggest you cover:

- Chapter opening vignette
- Overview of audit sampling
- Representative samples
- Statistical versus nonstatistical sampling and probabilistic versus nonprobabilistic sample selection
- Nonprobabilistic sample selection methods
- Probabilistic sample selection methods, including random selection
- Sampling for exception rates
- Nonstatistical audit sampling
- Attributes sampling (ignore this section if teaching nonstatistical sampling only)
Chapter Opening Vignette – “If You are Not Going to Believe It, Don’t Use It”

An alternative title for this vignette would be: There is no such thing as an "isolated misstatement." A frequent occurrence in practice is for an auditor to find a misstatement in a sample item, to confront the client with it, and to be told it is unique and does not represent other similar items. It is easy to buy off on the client's argument, but very difficult to defend objectively. This vignette attempts to show this using some numbers that allow the students to think of accepting an "isolated misstatement" as a gamble where they are taking the risk.

The vignette also refers to the requirement to project misstatements from samples. You can discuss examples of how this is done.

Overview of Audit Sampling

We first summarize the process of assessing control risk and performing tests of controls and substantive tests of transactions (see T-15-1) to provide an overview of where audit sampling fits in the engagement.

(See T-15-1)

Next you should refer again to the four evidence decisions in Chapter 7.

(See T-15-2)

The only two decisions covered in this chapter are sample size and the items to select. Ask students the order in which the four decisions are likely to be made. (They are often interchangeable.)

1. Audit procedures
2. Sample size
3. Items to select
4. Timing

Representative Samples (page 478)

The concept of a representative sample is an important one. Review Question 15-1 can be used effectively here. During the discussion, we cover the two causes of a nonrepresentative sample: nonsampling risk and sampling risk. You should stress that nonsampling risk results from the auditor's failure. In contrast, sampling risk is an inherent part of audit sampling, which results from testing less than an entire population. Review Question 15-11 can be used during this discussion.

Statistical Versus Nonstatistical Sampling and Probabilistic Versus Nonprobabilistic Sample Selection (page 479)

We usually spend a few minutes discussing statistical versus nonstatistical sampling. We focus on the similarities between the two and stress that both methods are equally acceptable under professional standards as long as they are applied with due professional care.

We end this discussion with an introduction of nonprobabilistic and probabilistic samples. We stress that if a statistical sampling method is used, a probabilistic sample must be selected.
Nonprobabilistic Sample Selection Methods (page 480)

We briefly cover the three types of nonprobabilistic sample selection methods:

- Directed sample selection
- Block sample selection
- Haphazard sample selection

Probabilistic Sample Selection Methods, Including Random Selection (page 482)

We find it easy to overemphasize this area. We have found it effective to assign Problem 15-25, and generally have students select the samples using the computer and systematic selection. In discussing the problem in class, we first discuss the following:

- Establishing a numbering system when prenumbered documents are not available
- Replacement versus nonreplacement sampling
- Advantages, disadvantages, and problems in using systematic sampling computer selection

We end the discussion with:

- Advantages and disadvantages of probabilistic selection compared to nonprobabilistic
- Need for probabilistic selection if a statistical method is used

Sampling for Exception Rates (page 484)

We first discuss how audit sampling applies to tests of controls and substantive tests of transactions. We introduce the following concepts:

- Attribute (Review Question 15-12)
- Occurrence or exception rate
- Control deviations (tests of controls)
- Monetary misstatements in transactions (substantive tests of transactions)

Nonstatistical Audit Sampling (page 485)

During our discussion of nonstatistical sampling, we first introduce the fourteen steps of audit sampling for tests of controls and substantive tests of transactions. These steps are outlined on T-15-3, as well as Figure 15-7 on page 500.

(See T-15-3)

(See Figure 15-7)

Next, we use either T-15-3 or Figure 15-7 as a frame of reference to go through the fourteen steps of audit sampling for tests of controls and substantive tests of transactions. The following comments, beyond what the book discusses, are useful.

- State the objectives of the audit test (page 486). No additional comments.
- **Decide whether audit sampling applies** (page 486). We emphasize the importance of this step by referring students to **Figure 14-6** (page 462), which is an audit program for tests of controls and substantive tests of transactions for Hillsburg Hardware. We go through each procedure to ask students if audit sampling can be used. The purpose is to give students a perspective of when audit sampling is used and that it is not used for every audit procedure.

  (See Figure 14-6)

- **Define the attributes and exception conditions** (page 486). Review of Question 15-13 is helpful here. Problem 15-32 (part a) deals with exception conditions.

- **Define the population** (page 488). Here we emphasize the importance of establishing the completeness of the population. This can be done by discussing the difference between the theoretical population that the auditor believes he or she is testing (e.g., accounts receivable) and the physical representation of that population (e.g., the listing of detailed accounts), and how to specifically assure that they match. Related to this is the question of footing computer listings. We take the position that they should be footed (or test footed) or verified through reliance on IT-related controls, depending on the circumstances. We believe that some audit evidence must be obtained relative to this objective.

- **Define the sampling unit** (page 489). It is important to relate this back to Chapter 14. You might ask how many audit sampling applications could be used and are likely for the audit of sales transactions. Problem 14-27 is an excellent one to cover this point, relating it to direction of tests discussed in Chapter 14.

- **Specify the tolerable exception rate**, **specify the acceptable risk of assessing control risk too low** (page 491), and **estimate the population exception rate** (page 492). First we go over the terminology used in auditing standards in reasonable detail, using **Table 15-1** on page 485.

  (See Table 15-1)

  We also discuss how each of the above factors is determined by the auditor. We also cover **Table 15-4** (page 491) and **Table 15-5** (page 492).

  (See Tables 15-4 and 15-5)

- **Determine the initial sample size** (page 492). We emphasize the effect of the following four factors on the determination of initial sample size: population size, TER, ARACR, and EPER. **Table 15-6** on page 493 can be used to summarize how these four factors affect sample size.

  (See Table 15-6)
Review Question 15-16 and Multiple Choice Question 15-22 are especially helpful here. In addition, Problem 15-28 part a can be assigned to give students practice in deciding sample size using nonstatistical sampling. We also show students how a sampling data sheet might look at this point by referring them to Figure 15-2 (page 490).

(See Figure 15-2)

- **Select the sample** (page 493). You should refer students back to the nonprobabilistic and probabilistic methods discussed on pages 480-484.

- **Perform the audit procedures** (page 493). We discuss the assistant’s role in performing the audit procedures, as well as adequate documentation. Nonsampling error should also be discussed. We make the point that because we are sampling, the impact of any nonsampling error is magnified in terms of the population. Figure 15-3 (page 494) summarizes the results of performing procedures.

(See Figure 15-3)

- **Generalize from the sample to the population** (page 494). We discuss the need for this step and how to do it. We go over Problem 15-29 parts a and c at this point. In part c, the sensitivity of changing each factor on the CUER can also be discussed at this point. Problem 15-32 part c gives students practice calculating SER.

- **Analyze exceptions** (page 495). It is important for students to understand the need for exception analysis and that it does not replace comparing CUER to TER. Review Question 15-18 can be used effectively here. Figure 15-5 (page 498) illustrates documentation of exceptions.

(See Figure 15-5)

- **Decide the acceptability of the population** (page 495). We discuss subtracting SER from TER, which results in sampling error. We then discuss the need to evaluate the sufficiency of sampling error in deciding the acceptability of the population. Problem 15-32 part d illustrates this step. Finally, we go over the options when sampling error is too small.

After discussing all of the fourteen audit sampling steps, you can assign Case 15-35 using the nonstatistical approach. If you will also be covering attributes sampling, another option is to wait to assign this case after you discuss attributes sampling (see the next section of this outline).

**Statistical Audit Sampling** (page 501)

*Note: You should skip this section if you choose to only cover nonstatistical sampling.* First, we mention that attributes sampling is the most common statistical method of audit sampling for tests of controls and substantive tests of transactions. Next, we briefly discuss the concept of sampling distributions (see page 501). We typically do not spend a lot of time on sampling distributions. Finally, we emphasize that there are far more
similarities than differences between nonstatistical and attributes sampling. We suggest that you refer students back to either T-15-3 or Figure 15-7 (page 500) and use it as a frame of reference for focusing on the differences between how the fourteen steps of audit sampling are applied under attributes sampling versus nonstatistical sampling.

(See T-15-3 or Figure 15-7)

Next, we cover the fourteen steps. Following are the points that we emphasize:

- **State the objectives of the audit test.** Same for attributes and nonstatistical sampling.

- **Decide whether audit sampling applies.** Same for attributes and nonstatistical sampling. Problem 15-27 part a can be used to illustrate this step.

- **Define attributes and exception conditions.** Same for attributes and nonstatistical sampling. Problem 15-27 parts b and c can be used to illustrate this step.

- **Define the population.** Same for attributes and nonstatistical sampling.

- **Define the sampling unit.** Same for attributes and nonstatistical sampling.

- **Specify tolerable exception rate.** Same for attributes and nonstatistical sampling.

- **Specify acceptable risk of assessing control risk too low.** We discuss that under attributes sampling, auditors assign a specific amount (5%, 10%, etc.) versus the low, medium, or high assessment used in nonstatistical sampling.

- **Estimate the population exception rate.** Same for attributes and nonstatistical sampling.

- **Estimate the initial sample size.** At this point, we talk a little bit about statistical theory and relate it to the text material that all of the students studied when they had an introductory statistics course. Next we talk about why and how tables are used. We de-emphasize interpolation. Problem 15-27 part d and Problem 15-28 parts b and c are useful at this point.

- **Select the sample.** We stress that if attributes sampling is used, the sample must be a probabilistic one.

- **Perform the audit procedures.** Same for attributes and nonstatistical sampling.

- **Generalize from the sample to the population.** We discuss the need for this step and how to do it. It is useful to show students how the actual results are summarized on the data sheet in Figure 15-8 (page 506). We go over Problem 15-29 parts b and c at this point, with an emphasis on part c.

(See Figure 15-8)
- **Analyze exceptions.** Same for attributes and nonstatistical sampling.

- **Decide the acceptability of the population.** We go through the reasons for the need to compare CUER to TER for each attribute and then do it for Hillsburg Hardware. We then review the options when CUER exceeds TER.

After discussing all of the fourteen attributes sampling steps, you can assign Case 15-35 using an attributes sampling approach. If this case was already assigned during the nonstatistical sampling discussion, an alternative is Problem 15-30.
### CHAPTER 15
CROSS-REFERENCE OF LEARNING OBJECTIVES AND PROBLEM MATERIAL

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-1 Explain the concept of representative sampling.</td>
<td>15-1, 15-11</td>
<td>15-24</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15-2 Distinguish between statistical and nonstatistical sampling and between probabilistic and nonprobabilistic sample selection.</td>
<td>15-2, 15-7</td>
<td>15-24</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15-4 Define and describe audit sampling for exception rates.</td>
<td>15-6, 15-12, 15-13</td>
<td></td>
<td></td>
<td>15-34</td>
</tr>
<tr>
<td>15-6 Define and describe attributes sampling and a sampling distribution.</td>
<td></td>
<td></td>
<td>15-33</td>
<td></td>
</tr>
</tbody>
</table>
WHERE AUDIT SAMPLING FITS INTO THE ENGAGEMENT

1. Obtain a general understanding of the client and assess client business risk
2. Obtain an understanding of internal control
3. Initial assessment of control risk
4. Decide on a preliminary audit strategy - tests of controls, substantive tests of transactions, etc.
5. Develop a tests of controls and substantive tests of transactions audit program – design and performance format
6. Determine sample size and do tests using audit sampling
# FOUR AUDIT EVIDENCE DECISIONS

<table>
<thead>
<tr>
<th></th>
<th>SALES</th>
<th>CASH RECEIPTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Procedures</td>
<td>Table 14-2</td>
<td>Table 14-3</td>
</tr>
<tr>
<td>Sample Size</td>
<td>Chapter 15</td>
<td>Chapter 15</td>
</tr>
<tr>
<td>Items to Select</td>
<td>Chapter 15</td>
<td>Chapter 15</td>
</tr>
<tr>
<td>Timing</td>
<td>Chapters 6 &amp; 13</td>
<td>Chapters 6 &amp; 13</td>
</tr>
</tbody>
</table>
FOURTEEN STEPS OF AUDIT SAMPLING FOR TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS

1. State the objectives of the audit test
2. Decide whether audit sampling applies
3. Define attributes and exception conditions
4. Define the population
5. Define the sampling unit
6. Specify the tolerable exception rate
7. Specify the acceptable risk of assessing control risk too low
8. Estimate the population exception rate
9. Determine the initial sample size
10. Select the sample
11. Perform the audit procedures
12. Generalize from the sample to the population
13. Analyze exceptions
14. Decide the acceptability of the population
Chapter 16

Completing the Tests in the Sales and Collection Cycle: Accounts Receivable

Chapter 16 is a key chapter because it builds on Chapters 14 and 15. It is also the first chapter where tests of details of balances are applied.

The following are the topics we cover:

- Chapter opening vignette
- Methodology for designing tests of details of balances
- Designing tests of details of balances
- Confirmation of accounts receivable
- Developing tests of details audit program
- Review

Chapter Opening Vignette – “When More Isn’t Better”

This vignette makes one essential point: the quality of evidence is more important than the quantity of evidence. In fact, low quality cannot be compensated for by high quantity. Confirmations are used to illustrate this point and can be discussed here. Other types of evidence can also be discussed: e.g., internal vs. external documentation and the value of client representations.

Methodology for Designing Tests of Details of Balances (page 520)

Before covering the methodology for designing tests of details of balances, we spend quite a bit of time reviewing key concepts.

- Examine the summary of the audit process in Figure 13-9 (page 425) to review how tests of controls and substantive tests of transactions (Chapter 14) and audit sampling for tests of controls and substantive tests of transactions (Chapter 15) tie into Chapter 16. It is also useful to do the same with Figure 13-7 (page 419).

(See Figures 13-9 and 13-7)

- Review Figure 13-2 (page 406) to describe the role of analytical procedures and tests of details of balances in the audit of the sales and collection cycle.

(See Figure 13-2)

We cover the methodology for designing tests of details of balances by using Figure 16-1 (Page 520) as a frame of reference. We discuss the following steps:

(See Figure 16-1)
■ Identify client business risks
■ Set tolerable misstatement and assess inherent risk
■ Assess control risk – We use Figure 16-2 (page 523) to describe the relationship between transaction-related and balance related audit objectives for the sales and collection cycle

(See Figure 16-2)

■ Design and perform tests of controls and substantive test of transactions
■ Design and perform analytical procedures – Table 16-1 (page 524) can be used to illustrate analytical procedures for the sales and collection cycle. We also use Tables 16-2 and 16-3 (page 525) to highlight practical applications of analytical procedures for the sales and collection cycle using data for Hillsburg Hardware.

(See Tables 16-1, 16-2, and 16-3)

■ Design tests of details of balances

Designing Tests of Details of Balances (page 526)

We ask students to identify the physical starting point for performing tests of the year-end balance in accounts receivable and explain why the aged trial balance is the logical starting point. It is important that students know what an aged trial balance looks like (Figure 16-3, page 527), and where it comes from. T-14-1 is useful to show where the aged trial balance fits into the accounting system.

(See Figure 16-3)

(See T-14-1)

The balance-related audit objectives first developed in Chapter 6 should be reviewed at this point. Our emphasis is on why there are objectives (types of misstatements), why they are different from transaction-related audit objectives, and how they are used. T-16-1 summarizes balance-related audit objectives and T-16-2 compares balance-related audit objectives to transaction-related audit objectives.

(See T-16-1 and T-16-2)

Next, we require students to close their books and go over the balance-related audit objectives on T-16-3.

(See T-16-3)

We require students to do the following in class:

1. Convert the general objectives to specific objectives for accounts in the sales and collection cycle.
2. Identify procedures to satisfy the objectives.
3. Identify factors that would affect the procedures, sample size, and items to select.
Our experience is that they need a lot of guidance in doing this, and it is somewhat time-consuming, but productive. We believe that two objectives deserve special attention:

- **Realizable value** – We refer students to the analysis of the allowance for uncollectible accounts in Figure 16-4 (page 531). We first note that the analysis depends on an accurate aging, and note that the aged accounts receivable balances in Figure 16-4 come from the aged trial balance in Figure 16-3 (page 527). We then ask students to describe how an auditor should assess the appropriate loss percentage to apply to each aged accounts receivable category. We emphasize the need to consider recent trends in establishing loss percentages.

  *(See Figures 16-3 and 16-4)*

- **Cutoff** – Students in our classes have problems in this area. We emphasize cutoff for sales. We point out that cutoff misstatements are the most frequent type of misstatements that auditors will find. Problem 16-27 is a good one for this material. Often we make up our own example on T-16-4.

  *(See T-16-4)*

Problems 16-23, 16-24 and 16-26 are excellent reviews of accounts receivable balance-related audit objectives. Problem 16-25 is useful to help students distinguish among tests of controls, substantive tests of transactions, analytical procedures, and tests of details of balances.

**Confirmation of Accounts Receivable** (page 532)

We find it sufficient to cover several Review Questions after the definition of confirmation is reviewed.

*(See T-16-5)*

- 16-10 – Type of confirmations (positives versus negatives)
- 16-11 – Timing
- 16-12 – Sample size
- 16-13 – Email and oral responses and authentication
- 16-14 – Items to select

Multiple Choice Question 16-21 and Problem 16-33 (alternative procedures) are also useful at this point. Problem 16-31 can be used to illustrate timing differences and other errors and differences that an auditor may need to resolve when using balance confirmations.
Developing Tests of Details Audit Program (page 538)

We use the Hillsburg Hardware Co. to illustrate how auditors develop detailed audit program steps for tests of details. Refer students especially to Table 16-4 (page 540) and Table 16-5 (page 541) and remind them:

- Figure 16-7 (page 539) is useful for understanding the decision process that the in-charge auditor followed.

(See Figure 16-7)

- The procedures were developed from a unique set of facts (see Figure 16-7). If the facts change, the procedures are likely to change.
- The sample size and items to select are included in the audit program. They were decided on a judgment basis considering the relevant factors in the engagement.
- Notice that confirmation (Procedure 10 in Table 16-5) is used to satisfy multiple objectives.

The procedures in Table 16-5 are those in Table 16-4 (design format) converted to a performance format. We trace one or two procedures in class from Table 16-4 to Table 16-5 to make sure that students understand how this is done. The reasons for the differences between a design and a performance format should be emphasized.

(See Tables 16-4 and 16-5)

Review

Any of Problems 16-23, 16-24, 16-25, or 16-26 are useful to review types of tests and balance-related audit objectives. Problem 16-32 is useful for identifying how audit procedures should change in response to changes in audit circumstances. Case 16-34 is especially useful for identifying audit risks and summarizing the trade-off between tests of controls, substantive tests of transactions, analytical procedures, and tests of details of balances. Problem 16-36 can be used to illustrate the performance of selected procedures using ACL.

If you used the Pinnacle Manufacturing Case in earlier chapters, it is important that you finish it by using Case 16-35, which is the final part.
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>ACL Problem and Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>16-1</td>
<td>16-1, 16-2, 16-18</td>
<td>16-20</td>
<td>16-29</td>
<td>16-34, 16-35</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16-2</td>
<td>16-3</td>
<td></td>
<td>16-22</td>
<td>16-34, 16-35</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16-3</td>
<td>16-4, 16-5, 16-6, 16-7, 16-8, 16-9</td>
<td>16-23, 16-24, 16-25, 16-26, 16-27, 16-29</td>
<td>16-34, 16-35</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16-4</td>
<td>16-9, 16-10, 16-11, 16-12, 16-13, 16-14, 16-15, 16-16, 16-17</td>
<td>16-28, 16-30, 16-31, 16-32, 16-33, 16-34</td>
<td>16-34</td>
<td></td>
</tr>
<tr>
<td>16-5</td>
<td>Describe the methodology for designing tests of details of balances using the audit risk model.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
BALANCE-RELATED AUDIT OBJECTIVES

- Details in the trial balance agree with related master file amounts, foot to the total in the trial balance, and agree to the total in the general ledger.

- Amounts in the trial balance exist.

- Existing amounts are included in the trial balance.

- Amounts in the trial balance are accurate.

- Amounts in the trial balance are properly classified.

- Transactions near the balance sheet date are recorded in the proper period.

- Amounts in the trial balance are stated at realizable value.

- The client has rights to the assets in the trial balance.
# COMPARISON OF TRANSACTION-RELATED AUDIT OBJECTIVES AND BALANCE-RELATED AUDIT OBJECTIVES

<table>
<thead>
<tr>
<th>TRANSACTION-RELATED AUDIT OBJECTIVES</th>
<th>BALANCE-RELATED AUDIT OBJECTIVES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transactions are properly included in the master file and are correctly summarized.</td>
<td>Details in the trial balance agree with related master file amounts, foot to the total in the trial balance, and agree to the total in the general ledger.</td>
</tr>
<tr>
<td>Recorded transactions exist.</td>
<td>Amounts in the trial balance exist.</td>
</tr>
<tr>
<td>Existing transactions are recorded.</td>
<td>Existing amounts are included in the trial balance.</td>
</tr>
<tr>
<td>Transactions are accurately stated.</td>
<td>Amounts in the trial balance are accurate.</td>
</tr>
<tr>
<td>Transactions are properly classified.</td>
<td>Amounts in the trial balance are properly classified.</td>
</tr>
<tr>
<td>Transactions are recorded on the correct dates.</td>
<td>Transactions near the balance sheet date are recorded in the proper period.</td>
</tr>
<tr>
<td>Not applicable.</td>
<td>Amounts in the trial balance are stated at realizable value.</td>
</tr>
<tr>
<td>Not applicable.</td>
<td>The client has rights to assets in the trial balance.</td>
</tr>
</tbody>
</table>
## BALANCE-RELATED AUDIT OBJECTIVES
FOR TESTS OF DETAILS OF BALANCES

<table>
<thead>
<tr>
<th>GENERAL BALANCE-RELATED AUDIT OBJECTIVES</th>
<th>SPECIFIC BALANCE-RELATED AUDIT OBJECTIVES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Detail tie-in</td>
<td></td>
</tr>
<tr>
<td>Existence</td>
<td></td>
</tr>
<tr>
<td>Completeness</td>
<td></td>
</tr>
<tr>
<td>Accuracy</td>
<td></td>
</tr>
<tr>
<td>Classification</td>
<td></td>
</tr>
<tr>
<td>Cutoff</td>
<td></td>
</tr>
<tr>
<td>Realizable value</td>
<td></td>
</tr>
<tr>
<td>Rights</td>
<td></td>
</tr>
</tbody>
</table>
SALES CUTOFF

Assume physical inventory was taken on 12-31-11. Client says that the last shipment made was on shipping document 11639. Shipping documents are issued in numerical sequence. Year-end field work starts 2-6-12.

REQUIRED:

A. What should the auditor do during the physical count to test for sales cutoff?

B. What information should the auditor retain with respect to sales cutoff, and where should it be kept between 12-31-11 and 2-6-12?

C. On 2-6-12, what sales cutoff procedures should be performed?
CHARACTERISTICS OF A CONFIRMATION

1. Receipt

2. Written or electronic

3. Independent third party

4. Requested by auditor

QUESTION:

In what ways may positive or negative confirmations fail to meet these characteristics?
Chapter 17

Audit Sampling for Tests of Details of Balances

The approach to covering audit sampling for tests of details of balances in Chapter 17 is similar to the approach for audit sampling for tests of controls and substantive tests of transactions in Chapter 15. Nonstatistical sampling is covered early in the chapter, followed by discussions of monetary unit sampling and variables sampling (statistical sampling methods).

We believe that the format of Chapter 17 will provide you with maximum flexibility in deciding how you wish to approach the topic of audit sampling for tests of details of balances. The chapter is built around the fourteen steps of audit sampling, which were first introduced in Chapter 15. All fourteen steps apply to both nonstatistical and statistical sampling. Each step is covered in detail during the discussion of nonstatistical sampling on pages 559-567. The discussions of monetary unit sampling (pages 567-577) and variables sampling (pages 578-589) use these same fourteen steps, but focus on the differences between how the steps are applied under these statistical methods compared to nonstatistical sampling.

Before assigning Chapter 17, you must decide how you want to approach the topic of audit sampling for tests of details of balances. There are four possible approaches for covering Chapter 17:

1. Cover nonstatistical sampling only
2. Cover nonstatistical sampling, followed by monetary unit sampling
3. Cover nonstatistical sampling, followed by variables sampling
4. Cover nonstatistical sampling, followed by both monetary unit sampling and variables sampling (this approach is not recommended unless you have extra time in your course schedule)

Note that it is not feasible to cover either monetary unit sampling (MUS) or variables sampling without first covering nonstatistical sampling. This is because the MUS and variables sampling portions of the chapter revolve around the fourteen steps outlined during the nonstatistical sampling discussion.

The following are the primary topical areas that we suggest you cover:

- Chapter opening vignette
- Comparisons of audit sampling for tests of details of balances and for tests of controls and substantive tests of transactions
- Nonstatistical sampling
- Monetary unit sampling [ignore this section if using approach (1) or (3) discussed earlier]
- Variables sampling [ignore this section if using approach (1) or (2) discussed earlier]
Instructor Note: Statistical sampling is a highly complex subject to which justice cannot always be done in an introductory auditing course. There is certainly strong justification for skipping the topic entirely in the introductory course. We recommend this be done when an advanced auditing course is included in the auditing curriculum.

Chapter Opening Vignette – “Both Statistical and Nonstatistical Sampling are Acceptable Under GAAS, But Whichever is Used, It Must be Done Right”

The fundamental point of this vignette in one sense is that statistical sampling requires a greater level of expertise than nonstatistical sampling. However, nonstatistical sampling also requires expertise. Ascertaining how much sampling error to attribute to a nonstatistical sample is not an easy problem.

In the vignette, an "expert" was brought in for part of the statistical task, but did not complete it. The staff auditor who completed the statistical evaluation made an error in the calculations. This case highlights the complexity of statistical calculations, and the need for the auditor to thoroughly understand the requirements of any audit task, regardless of time constraints.

Since the auditor did not understand the statistical method, it is questionable whether a statistical evaluation should have been performed. However, the sample was selected based on the original audit plan, which called for a statistical evaluation. The vignette offers an opportunity to discuss the relative merits of statistical and nonstatistical sampling, and what requirements exist for both to “do it right.”

Comparisons of Audit Sampling for Tests of Details of Balances and for Tests of Controls and Substantive Tests of Transactions (page 558)

We introduce the topic of audit sampling for tests of details of balances using the summary of the audit process in Figure 13-9 (page 425). We then point out to students that Chapter 17 deals with audit sampling for tests of details of balances.

(See Figure 13-9)

Next, we discuss the fact that audit sampling for tests of details of balances focuses on dollar misstatements in account balances. You should compare this to determining an exception rate for tests of controls and the rate of monetary misstatements for substantive tests of transactions (Chapter 15). Review Questions 17-1 and 17-7 can be covered during this discussion.

Nonstatistical Sampling (page 559)

We suggest that you begin your discussion of nonstatistical sampling for tests of details of balances by referring back to the fourteen steps of audit sampling for tests of controls and substantive tests of transactions, which were introduced in Chapter 15. You can then use T-17-1 to show how these fourteen steps compare between audit sampling for tests of details of balances (Chapter 17) and for tests of controls and substantive tests of transactions (Chapter 15).

(See T-17-1)
Next, we cover each of the fourteen steps in detail. The following comments, beyond what the book discusses, are useful.

- **State the objectives of the audit test** (page 559). The purpose of tests of details of balances is to determine whether the account balance being audited is fairly stated.

- **Decide whether audit sampling applies** (page 559). No additional comments.

- **Define a misstatement** (page 560). Stress that any misstatement found in a sample is defined as a misstatement condition.

- **Define the population** (page 560). The population is defined as the recorded dollar population. During this discussion, we usually introduce the concept of stratified sampling. The first table on T-17-2 is a useful way to illustrate the concept of stratified sampling, using the example from page 560 and the accounts receivable population in Table 17-1 (page 560).

  (See T-17-2)

  (See Table 17-1)

- **Define the sampling unit** (page 561). No additional comments.

- **Specify tolerable misstatement** (page 561). Refer students back to Chapter 9 for a discussion of tolerable misstatement.

- **Specify acceptable risk of incorrect acceptance (ARIA)** (page 561). Compare ARIA to the acceptable risk of assessing control risk too low, which applies to audit sampling for tests of controls and substantive tests of transactions. You can also discuss how ARIA affects sample size and the resulting evidence accumulation. Figure 17-1 (page 562) and Table 17-2 (page 562) are helpful here. Review Questions 17-10 and 17-11 also deal with ARIA.

  (See Figure 17-1)

  (See Table 17-2)

- **Estimate misstatements in the population** (page 562). No additional comments.

- **Determine the initial sample size** (page 563). Table 17-3 (page 563) is a good summary of the factors that determine initial sample size. Problem 17-28 part a can be used here.

  (See Table 17-3)
Select the sample (page 563). We refer students back to Chapter 15 and stress that any of the sampling methods discussed in Chapter 15 can be used for nonstatistical sampling. Problem 17-28 part c is helpful during this discussion.

Perform the audit procedures (page 564). The second table on T-17-2 shows the results of performing the audit procedures for the example on page 564.

(See T-17-2)

Generalize from the sample to the population (page 564). We refer students back to the discussion of a point estimate in Chapter 9. The third table on T-17-2 illustrates the calculation of a point estimate for the example on page 565.

(See T-17-2)

Review Question 17-3 can be used here.

Analyze the misstatements (page 566). The mid-chapter vignette on page 566 provides a great example of the importance of properly projecting sample misstatements.

Decide the acceptability of the population (page 564). We explain that for nonstatistical sampling, the auditor calculates the difference between the point estimate and tolerable misstatement (sampling error). This can be related back to Chapter 15’s discussion of SER - TER, which also results in sampling error. We then discuss determining the sufficiency of sampling error in order to determine the acceptability of the population.

Problem 17-28 part d or Problem 17-29 is helpful here. Case 17-37 part a gives students practice in evaluating the results of a nonstatistical sample. Finally, we discuss the auditor’s options when a population is rejected (see page 566).

Monetary Unit Sampling (page 567)

Note: You should skip this section if you decide to use approach (1) or (3) discussed on page 17-1. To provide continuity, the text discussion of monetary unit sampling (MUS) refers to the same fourteen steps discussed during the nonstatistical sampling portion of the chapter. We focus on the differences between how these fourteen steps are applied for MUS compared to nonstatistical sampling. Following are the most important differences that we suggest that you cover (see pages 568-570 for detailed discussion):

- The sampling unit is an individual dollar.
- The population size is the recorded dollar population.
- Preliminary judgment of materiality is used instead of tolerable misstatement.
- Sample size is determined by statistical formula.
- A formal decision rule is used for deciding the acceptability of the population.
- Sample selection is done using probability proportional to size (PPS).
- MUS techniques are used to generalize from the sample to the population.
We suggest using **T-17-1** as a frame of reference for discussing how the fourteen steps are applied using MUS.

**(See T-17-1)**

Next, we discuss the concept of monetary unit sampling and discuss its advantages and disadvantages. We consider it optional to show how to select a sample for monetary unit sampling. Problem 17-30 is a good one to use for demonstrating how such a sample is selected.

Evaluating a sample using monetary unit sampling can be demonstrated by using Problem 17-37. In doing so we go over the terminology from AU 350 plus additional terms needed for monetary unit sampling. As a part of discussing this material it is essential to refer to Chapter 9, discussing both materiality and the different risks.

**(See T-17-3 through T-17-6)**

If you want to show how to calculate a sample size for monetary unit sampling, we recommend Review Question 17-14.

**Variables Sampling** *(page 578)*

*Note: You should skip this section if you decide to use approach (1) or (2) discussed on page 17-1. We typically spend little time on this material. The remainder of the material in this chapter is intended for those who prefer to emphasize variables sampling in their study of audit sampling. If you plan to emphasize variables sampling, we suggest that you also cover the illustration using difference estimation (pages 583-589). Problem 17-34 provides students with practice in applying difference estimation.*

**(See T-17-7 to T-17-11)**
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Discussion Questions and Problems</th>
<th>Multiple Choice Questions</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>17-1 Differentiate audit sampling for tests of details of balances and for tests of controls and substantive tests of transactions.</td>
<td>17-2, 17-3, 17-4, 17-6, 17-7, 17-8, 17-10, 17-12, 17-13</td>
<td>17-28, 17-29, 17-33</td>
<td>17-25, 17-26</td>
<td>17-37, 17-38</td>
</tr>
</tbody>
</table>

To download more slides, ebook, solutions and test bank, visit http://downloadslide.blogspot.com
AUDIT SAMPLING FOR TESTS OF DETAILS OF BALANCES

**Plan the Sample**
1. State the objectives of the audit test.
2. Decide whether audit sampling applies.
3. Define a misstatement.
4. Define the population.
5. Define the sampling unit.
7. Specify acceptable risk of incorrect acceptance.
8. Estimate misstatements in the population.
9. Determine the initial sample size.

**Select the Sample and Perform the Audit Procedures**
10. Select the sample.
11. Perform the audit procedures.

**Evaluate the Results**
12. Generalize from the sample to the population.
13. Analyze the misstatements.
14. Decide the acceptability of the population.

---

AUDIT SAMPLING FOR TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS

**Plan the Sample**
1. State the objectives of the audit test.
2. Decide whether audit sampling applies.
3. Define attributes and exception conditions.
4. Define the population.
5. Define the sampling unit.
6. Specify tolerable exception rate.
7. Specify acceptable risk of assessing control risk too low.
8. Estimate the population exception rate.
9. Determine the initial sample size.

**Select the Sample and Perform the Audit Procedures**
10. Select the sample.
11. Perform the audit procedures.

**Evaluate the Results**
12. Generalize from the sample to the population.
13. Analyze the exceptions.
14. Decide the acceptability of the population.
### SAMPLING ILLUSTRATION

<table>
<thead>
<tr>
<th>Stratum</th>
<th>Stratum Criteria</th>
<th>No. in Population</th>
<th>Dollars in Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>&gt; $15,000</td>
<td>3</td>
<td>$88,955</td>
</tr>
<tr>
<td>2</td>
<td>$5,000-$15,000</td>
<td>10</td>
<td>71,235</td>
</tr>
<tr>
<td>3</td>
<td>&lt; $5,000</td>
<td>27</td>
<td>47,105</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stratum</th>
<th>Sample Size</th>
<th>Recorded Value</th>
<th>Audited Value</th>
<th>Client Misstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3</td>
<td>$88,955</td>
<td>$91,695</td>
<td>$(2,740)</td>
</tr>
<tr>
<td>2</td>
<td>7</td>
<td>43,995</td>
<td>43,024</td>
<td>971</td>
</tr>
<tr>
<td>3</td>
<td>6</td>
<td>13,105</td>
<td>10,947</td>
<td>2,158</td>
</tr>
<tr>
<td></td>
<td>16</td>
<td>$146,055</td>
<td>$145,666</td>
<td>$389</td>
</tr>
</tbody>
</table>

**Client Misstatement / Recorded Value of the Sample x Recorded Book Value for the Stratum = Point Estimate of Misstatement**

<table>
<thead>
<tr>
<th>Stratum</th>
<th>Client Misstatement / Recorded Value of the Sample x Recorded Book Value for the Stratum = Point Estimate of Misstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$(2,740)/ $88,955 = $ (2,740)</td>
</tr>
<tr>
<td>2</td>
<td>$ 971 / $43,995 = 1,572</td>
</tr>
<tr>
<td>3</td>
<td>$ 2,158 / $13,105 = 7,757</td>
</tr>
<tr>
<td>Total</td>
<td>$ 6,589</td>
</tr>
</tbody>
</table>
**PROBLEM 17-31**

**UPPER MISSTATEMENT BOUND**

<table>
<thead>
<tr>
<th>No. of Misstatements</th>
<th>Recorded Value</th>
<th>CUER Portion</th>
<th>Misstatement %</th>
<th>Assumption</th>
<th>Misstatement Bound</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$1,975,000</td>
<td>.023</td>
<td>1.000</td>
<td>1.000</td>
<td>$45,425</td>
</tr>
<tr>
<td>1</td>
<td>1,975,000</td>
<td>.016</td>
<td>.694</td>
<td>21,930</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>1,975,000</td>
<td>.014</td>
<td>.084</td>
<td>2,323</td>
<td></td>
</tr>
</tbody>
</table>

Initial overstatement bound $69,678

Understatement Amounts

| 1         | .892 |
| 2         | .030 |
| 3         | .024 |

\[
.946 / 100 \times 1,975,000 = (18,684)
\]

Adjusted overstatement bound $50,994
### PROBLEM 17-31

**LOWER MISSTATEMENT BOUND**

<table>
<thead>
<tr>
<th>No. of Misstatements</th>
<th>Recorded Value</th>
<th>CUER Portion</th>
<th>Misstatement % Assumption</th>
<th>Misstatement Bound</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$1,975,000</td>
<td>.023</td>
<td>1.000</td>
<td>$45,425</td>
</tr>
<tr>
<td>1</td>
<td>1,975,000</td>
<td>.016</td>
<td>.892</td>
<td>28,187</td>
</tr>
<tr>
<td>2</td>
<td>1,975,000</td>
<td>.014</td>
<td>.030</td>
<td>830</td>
</tr>
<tr>
<td>3</td>
<td>1,975,000</td>
<td>.013</td>
<td>.024</td>
<td>616</td>
</tr>
</tbody>
</table>

Initial understatement bound $75,058

**Overstatement Amounts**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.694</td>
</tr>
<tr>
<td>2</td>
<td>.084</td>
</tr>
</tbody>
</table>

$.778 / 100 \times 1,975,000 = (15,366)

Adjusted understatement bound $59,692
PROBLEM 17-31

DECISION

\[ -50,000 \quad \text{Materiality} \quad +50,000 \]

\[ -59,692 \quad \text{Adjusted} \quad 50,994 \]

Misstatement Bounds

POPULATION IS NOT ACCEPTABLE

Available Options

1. Increase the sample size
2. Segregate a specific type of misstatement and test it separately. The sample would then not include the specified type of misstatement since it is being tested separately.
3. Adjust the account balance.
4. Request the client to correct the population.
5. Consider qualifying the opinion.
6. Expand other areas in the audit of accounts receivable.
PROBLEM 17-31

Recalculate misstatement bounds, assuming elimination of items 3 and 5. The cutoff problem would be investigated separately.

### REVISED UPPER MISSTATEMENT BOUND

<table>
<thead>
<tr>
<th>No. of Misstatements</th>
<th>Recorded Value</th>
<th>CUER x Portion x Assumption = Bound</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$1,975,000</td>
<td>$45,425</td>
</tr>
<tr>
<td>1</td>
<td>1,975,000</td>
<td>2,654</td>
</tr>
</tbody>
</table>

Initial overstatement bound $48,079

### REVISED LOWER MISSTATEMENT BOUND

<table>
<thead>
<tr>
<th>No. of Misstatements</th>
<th>Recorded Value</th>
<th>CUER x Portion x Assumption = Bound</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$1,975,000</td>
<td>$45,425</td>
</tr>
<tr>
<td>1</td>
<td>1,975,000</td>
<td>948</td>
</tr>
<tr>
<td>2</td>
<td>1,975,000</td>
<td>664</td>
</tr>
</tbody>
</table>

Initial understatement bound $47,037

NOTE: Bounds need not be adjusted since both upper and lower bounds are now within materiality limits.
PROBLEM 17-34

Point Estimate

\[ \hat{E} = N \cdot \frac{\sum e_j}{n} \]

\[ \hat{E} = 1840 \cdot \frac{173.69}{80} = 3,994.87 \]
PROBLEM 17-34

COMPUTED PRECISION INTERVAL

\[ CPI = N \cdot Z_A \cdot \frac{SD}{\sqrt{n}} \cdot \sqrt{\frac{N - n}{N}} \]

\[ CPI = 1840 \cdot 1.64 \cdot \frac{14.3}{\sqrt{80}} \cdot \sqrt{\frac{1840 - 80}{1840}} \]

\[ CPI = 4,718.46 \]

STANDARD DEVIATION

\[ SD = \sqrt{\frac{\sum (e_i)^2 - n(\bar{e})^2}{n - 1}} \]

\[ SD = \sqrt{\frac{16521.79 - 80 \left( \frac{173.69}{80} \right)^2}{80 - 1}} \]

\[ SD = 14.3 \]

\[ \begin{array}{cc}
\text{e}_i & (\text{e}_i)^2 \\
$(72.00)$ & $5,184.00$ \\
65.70 & 4,316.49 \\
41.10 & 1,689.21 \\
36.10 & 1,303.21 \\
51.80 & 2,683.24 \\
(.12) & .01 \\
30.00 & 900.00 \\
21.11 & 445.63 \\
\hline
$\text{e}_i$ & $(\text{e}_i)^2$
\end{array} \]

\[ \sum (e_i)^2 = 16521.79 \\
\text{Mean} = \frac{173.69}{80} \]

To download more slides, ebook, solutions and test bank, visit [http://downloadslide.blogspot.com](http://downloadslide.blogspot.com)
**PROBLEM 17-34**

**CONFIDENCE LIMITS**

\[
UCL = \hat{E} + CPI \\
UCL = 3,994.87 + 4,718.46 = 8,713.33
\]

\[
LCL = \hat{E} - CPI \\
LCL = 3,994.87 - 4,718.46 = -723.59
\]
PROBLEM 17-34

DECISION

- TM  + TM
-6000  +6000

LCL  UCL
-724  +8,713

IN GENERAL

- TM  Y  + TM

LCL  E  UCL

DECISION RULE — If both confidence limits are within -TM and +TM accept; otherwise reject.
TEST - Is CPI greater than tolerable misstatement? If so, no adjustment is possible.

IDEAL ADJUSTMENT - reduce book value $3,995

MINIMUM ADJUSTMENT -

UPL $8,713
Tolerable misstatement $6,000
Reduce book value $2,713
To download more slides, ebook, solutions and test bank, visit http://downloadsle.slide.blogspot.com
Chapter 18

Audit of the Acquisition and Payment Cycle: Tests of Controls, Substantive Tests of Transactions, and Accounts Payable

If only two cycles are to be covered in an introductory auditing course, which is what we usually do, we cover the sales and collection cycle and the acquisition and payment cycle. We try to make our coverage parallel to that followed in the sales and collection cycle to emphasize similarities and differences, and reinforce what has already been learned.

The following are the topics covered:

- Chapter opening vignette
- Accounts and classes of transactions in the acquisition and payment cycle
- Business functions in the cycle and related documents and records
- Accounting rules for determining the timing of recording transactions
- Decision making - deciding an approach
- Overview of the audit
- Methodology for designing tests of controls and substantive tests of transactions for the acquisition and payment cycle
- Methodology for designing tests of details of balances for accounts payable
- Summary

Chapter Opening Vignette – “False Purchases Camouflage Overstated Profits”

This vignette is an excellent tool to discuss how fraud occurs in businesses, including fraud involving the acquisition and payment cycle. It is interesting to discuss with students how such a fraud could have been discovered by the auditors and whether the auditors should have been held responsible for not discovering the fraud given management override of controls. We remind students that auditing standards (specifically SAS 99) requires auditors to perform procedures to address management override of controls.

Accounts and Classes of Transactions in the Acquisition and Payment Cycle (page 602)

We use Figure 18-1 (page 602) to identify the accounts affected in the acquisition and payment cycle.

(See Figure 18-1)

Business Functions in the Cycle and Related Documents and Records (page 603)

Next we go through the relationships of account balances to records using T-18-1.

(See T-18-1)
It is important that students understand the documents and records that affect acquisitions and cash disbursements. We spend as much time as is needed to make sure they do. Table 18-1 on page 604 is helpful to accomplish this goal.

*(See Table 18-1)*

Because many companies use the Internet to streamline processes for the acquisition of goods and services, we next address the types of cycle activities that are commonly conducted across the Internet and through private extranets and other EDI arrangements with business suppliers and customers. We emphasize how many of these e-commerce activities may affect the client’s business risks related to transactions and accounts in the acquisition and payment cycle. Problem 18-23 provides a useful example to emphasize potential risks associated with online purchasing activities and related internal controls that might be implemented to mitigate some of those risks.

**Accounting Rules for Determining the Timing of Recording Transactions**

We briefly cover key terms on T-18-2 for definitional purposes, giving an example of each.

*(See T-18-2)*

**Decision Making - Deciding an Approach**

We like to approach the coverage of the audit of the acquisition and payment cycle somewhat differently than we do for the sales and collection cycle. We ask students to turn to Figure 18-1 (page 602) and ask several questions about the cycle as a whole.

1. What are some examples of client business risks that might be related to transactions and accounts in the acquisition and payment cycle?
2. What are some logical analytical procedures to perform for transactions?
3. What are some logical analytical procedures to perform for ending balances?
4. Assuming the auditor decided on a control risk of 100% and did almost no tests of controls and substantive tests of transactions, what tests of details of balances would be necessary for manufacturing expense accounts, accounts payable, property, plant and equipment, etc.?
5. Assuming the auditor decided on a control risk of 60% and did extensive tests of controls and substantive tests of transactions, what tests of details of balances could be reduced, and how?
6. When should the auditor follow the strategy in 4, and when should the strategy in 5 be followed?

*(See Figure 18-1)*
Overview of the Audit

We go back to Figure 13-2 (page 406), role of all audit tests, and discuss the relationships in that figure.

(See Figure 13-2)

Methodology for Designing Tests of Controls and Substantive Tests of Transactions (page 606)

First we review the methodology for designing tests of controls and substantive tests of transactions as it is shown in Figure 18-2 (page 607).

(See Figure 18-2)

In this section we ask the following questions or go over the following assigned problems:

- Discussion Question 18-22 - type of test and objectives
- Discussion Question 18-25 - type of evidence and objectives
- Review Question 18-6 - direction of tests
- Problem 18-24 - controls to prevent misstatements and substantive audit tests
- Problem 18-26 - importance of exceptions and effect of the exceptions on the remainder of the audit

Have students reconstruct Table 18-2 (page 609) for acquisitions using T-18-3 for each transaction-related audit objective. We emphasize why each objective is more or less important than the same objective for sales.

(See T-18-3)

Have students use T-18-4 to reconstruct Table 18-3 (page 611) for cash disbursements in the same manner as they did for acquisitions. Also address the following questions:

- What is a proof of cash disbursements, and what is its relevance?
- How would a performance format audit program be developed from Tables 18-2 and 18-3?
- Could audit sampling be used effectively for acquisitions and cash disbursements?

(See T-18-4)
Methodology for Designing Tests of Details of Balances for Accounts Payable
(page 612)

First we ask about the similarities and differences between accounts receivable and accounts payable.

- Overstatement versus understatement emphasis
- Supplier access through the Internet to accounts payable records and other supply chain management information create client business risks unique to accounts payable
- Available documentary evidence in accounts payable is usually more reliable
- Quality of accounts payable controls varies more from client to client than accounts receivable

Next we review the methodology for designing tests of details of balances as shown in Figure 18-3 (page 613).

(See Figure 18-3)

Next we go over Table 18-5 (page 616) fairly carefully and talk about the balance-related audit objectives, related audit tests, and the basis for the decision as to procedures, sample size, timing and items to select.

Then we go over in more detail, the primary decisions the auditor makes in using accounts payable confirmations, the basis of these decisions, and a comparison with the audit of accounts receivable.

Decisions in the confirmation of accounts payable:

- Confirmation or nonconfirmation
- Sample size for confirmation
- Items to select for confirmation
- Timing of confirmation

If the ideas have not already been covered, we go over the following questions:

- Review Question 18-13 - zero balance confirmations
- Review Question 18-14 - vendor's invoice versus vendor's statement

We distinguish between, and compare, out-of-period liability tests and cutoff. We spend some time on both, but the emphasis is on cutoff tests. The examples on T-18-5 and T-18-6 are helpful:

(See T-18-5 and T-18-6)
We then discuss the following:

- Cutoff procedures at physical inventory
- Documentation of receiving reports between inventory date and year-end work
- Cutoff procedures at year-end
- Inventory-in-transit - tests and methods of recording

Problem 18-27 can provide a useful illustration of the importance of cut-off procedures related to the receipt and purchase of inventory. We finish the section with a problem such as 18-31.

**Summary** (page 620)

*Figure 18-5* (page 620) is helpful in summarizing the chapter. *Figure 18-5* is similar to figures used in other chapters, but this figure is specific to the acquisition and payment cycle.

*(See Figure 18-5)*

Finally, Case 18-32 is intended to cover tests of controls, substantive tests of transactions, and tests of details of balances for acquisitions, cash disbursements, and accounts payable, including consideration of the audit risk model and analytical procedures.
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Cross-Referenced Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>18-1 Identify the accounts and the classes of transactions in the acquisition and payment cycle.</td>
<td>18-1</td>
<td>18-32</td>
</tr>
<tr>
<td>18-2 Describe the business functions and the related documents and records in the acquisition and payment cycle.</td>
<td>18-7, 18-8, 18-9, 18-14</td>
<td>18-32</td>
</tr>
<tr>
<td>18-3 Understand internal control, and design and perform tests of controls and substantive tests of transactions for the acquisition and payment cycle.</td>
<td>18-2, 18-3, 18-4, 18-5, 18-6, 18-7, 18-10, 18-11</td>
<td>18-32</td>
</tr>
<tr>
<td>18-4 Describe the methodology for designing tests of details of balances for accounts payable using the audit risk model.</td>
<td>18-11</td>
<td>18-25</td>
</tr>
<tr>
<td>18-5 Design and perform analytical procedures for accounts payable.</td>
<td>18-10, 18-12, 18-16, 18-17</td>
<td>18-32</td>
</tr>
<tr>
<td>18-6 Design and perform tests of details of balances for accounts payable, including out-of-period liability tests.</td>
<td>18-13, 18-14, 18-15</td>
<td>18-32</td>
</tr>
<tr>
<td>18-7 Distinguish the reliability of vendors' invoices, vendors' statements, and confirmations of accounts payable as audit evidence.</td>
<td>18-26, 18-28, 18-31</td>
<td>18-32</td>
</tr>
</tbody>
</table>

To download more slides, ebook, solutions and test bank, visit [http://downloadslide.blogspot.com](http://downloadslide.blogspot.com)
SOURCE OF INFORMATION FOR ACQUISITIONS AND CASH DISBURSEMENTS

EXAMPLE: ACQUISITION AND SALE OF BUILDINGS AND EQUIPMENT

- Acquisition and payment balances in the statements
- Acquisition and payment accounts in the general ledger (Figure 18 - 1)
- Master files affecting accounts in the general ledger
- Journals and listings affecting accounts in the general ledger
- Transactions recorded in the journals, listings and master files
- Documents related to transactions

Buildings and equipment
Manufacturing buildings
Office buildings
Delivery equipment
Office equipment
Building and equipment master file
Acquisition journal or listing
Cash receipts journal
General journal
Acquisition and disposal of buildings and equipment
KEY POINTS FOR RECORDING ACQUISITIONS AND CASH DISBURSEMENTS

**Acquisitions** -

- **Goods** - F.O.B. destination - when goods are received
- **F.O.B. origin** - when goods are shipped

- **Services** - when services are obtained

**Cash Disbursements** - when currency or check is mailed or delivered

**Cash Discounts** - either when the purchase is made or when the payment is made

**Purchase Allowances** - matched with the original purchase

**Purchase Returns** - when the goods are returned
### TRANSACTION-RELATED AUDIT OBJECTIVES AND RELATED AUDIT TESTS ACQUISITIONS

<table>
<thead>
<tr>
<th>TRANSACTION-RELATED AUDIT OBJECTIVE</th>
<th>OBJECTIVE APPLIED TO TRANSACTIONS: ACQUISITIONS</th>
<th>KEY CONTROL</th>
<th>TESTS OF CONTROLS</th>
<th>SUBSTANTIVE TESTS OF TRANSACTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Completeness</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accuracy</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Posting &amp; summarization</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Classification</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Timing</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## TRANSACTION-RELATED AUDIT OBJECTIVES
### AND RELATED AUDIT TESTS
### CASH DISBURSEMENTS

<table>
<thead>
<tr>
<th>TRANSACTION-RELATED AUDIT OBJECTIVE</th>
<th>OBJECTIVE APPLIED TO TRANSACTIONS: CASH DISBURSEMENTS</th>
<th>KEY CONTROL</th>
<th>TESTS OF CONTROLS</th>
<th>SUBSTANTIVE TESTS OF TRANSACTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Completeness</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accuracy</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Posting &amp; summarization</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Classification</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Timing</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
ACCOUNTS PAYABLE CUTOFF EXAMPLE

Inventory costing $10,000 was received F.O.B. destination at 4:00 p.m. on 12-31-11.

<table>
<thead>
<tr>
<th>WAYS TRANSACTION COULD HAVE BEEN HANDLED</th>
<th>MISSTATEMENT IN NET INCOME</th>
<th>MISSTATEMENT ON BALANCE SHEET</th>
</tr>
</thead>
<tbody>
<tr>
<td>Include in inventory and accounts payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exclude from inventory and accounts payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Include in inventory but not accounts payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Include in accounts payable but not inventory</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
CUTOFF PROBLEM

Last receiving report for which inventory was included in physical count on 12-31 was #2618.

All purchases are recorded as a debit to purchases and a credit to accounts payable.

What is the misstatement, if any, in each of the following (inventory and accounts payable)?

<table>
<thead>
<tr>
<th>AMOUNT</th>
<th>RECEIVING REPORT NO.</th>
<th>FOB ORIGIN OR DESTINATION</th>
<th>SHIPPED</th>
<th>INCLUDED OR NOT INCLUDED IN PURCHASES AND ACCOUNTS PAYABLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. $ 687.12</td>
<td>2611</td>
<td>Origin</td>
<td>12-24</td>
<td>Included</td>
</tr>
<tr>
<td>2. 216.21</td>
<td>2623</td>
<td>Origin</td>
<td>12-30</td>
<td>Included</td>
</tr>
<tr>
<td>3. 456.09</td>
<td>2605</td>
<td>Destination</td>
<td>12-26</td>
<td>Included</td>
</tr>
<tr>
<td>4. 1,271.36</td>
<td>2629</td>
<td>Destination</td>
<td>12-28</td>
<td>Included</td>
</tr>
<tr>
<td>5. 851.09</td>
<td>2620</td>
<td>Origin</td>
<td>12-26</td>
<td>Not included</td>
</tr>
<tr>
<td>6. 401.65</td>
<td>2631</td>
<td>Origin</td>
<td>1-3</td>
<td>Not included</td>
</tr>
</tbody>
</table>
Chapter 19

Completing the Tests in the Acquisition and Payment Cycle: Verification of Selected Accounts

We try to cover the audit of two or three accounts in this cycle, if we cover the chapter at all. Our emphasis is on showing the relationship between tests of controls, substantive tests of transactions, and tests of details, and differences between various types of account balances. The following are the primary topical areas we cover:

- Chapter opening vignette
- Types of tests applied to acquisitions and cash disbursements
- Audit of income and expense accounts
- Audit of property, plant, and equipment
- Related areas

Chapter Opening Vignette – “Incorrect Classifications Hide a Greater Net Loss”

This vignette can be used to emphasize the importance of adequate internal controls and the importance of the auditor adequately understanding and testing of internal control. It is also useful to emphasize one of the reasons that auditors perform tests of account classifications and how these tests should be done. Finally, covering the vignette provides a good opportunity to remind students of the importance of obtaining independent evidence instead of relying solely on inquiry.

Types of Tests Applied to Acquisitions and Cash Disbursements

Start by referring students to the list of accounts in Table 19-1 (page 634) and identify the accounts you plan to discuss. As a review, then ask students to identify the relationship between analytical procedures, tests of controls, substantive tests of transactions, and tests of details of balances for accounts payable. At this point, you should expect fairly specific answers. You may want to use Figure 13-4 (page 415) as a framework to guide the discussion about the audit approach to acquisitions and cash disbursements.

(See Table 19-1)

(See Figure 13-4)

Audit of Income and Expense Accounts (page 646)

We start with this area because it is reasonably easy, yet important. Three terms and phrases are defined before proceeding (see top of next page).
Income statement account balances resulting from transactions (including a discussion of how balances get into the general ledger)

Income statement account balances resulting from allocations (including a discussion of how balances get into the general ledger)

Analysis of account balances

Figure 19-3 (page 645) and Figure 19-4 (page 649) may provide a useful basis for the discussion of the relation between transactions and account balances.

(See Figures 19-3 and 19-4)

The following questions are then asked about the audit of income and expense accounts:

1. Ask students to explain how cost of goods sold for a wholesale company can be verified by each of the following tests: analytical procedures, tests of controls and substantive tests of transactions, analysis of account balances, and tests of details of balance sheet accounts.

2. Assume all tests of controls and substantive tests of transactions and all analytical procedures for the audit have been completed. The audit of the sales and collection cycle, payroll, and all tests of accounts payable have also been completed. The auditor is now auditing utilities expense. How have the objectives on T-19-1 already been partially or fully met?

(See T-19-1)

3. What additional tests of utilities expense would ordinarily be made?

4. Assuming a significant likelihood of misstatements, what additional tests of utilities expense would be performed? Be specific.

5. How do each of the following accounts differ somewhat from utilities expense in the audit approach or evidence requirements?

- Property tax expense
- Depreciation expense
- Legal expense (See Internet Problem 19-1 for an example of a fraud involving unrecorded legal expenses)

6. Use the quiz on T-19-2.

(See T-19-2)

7. Case 19-30 is excellent for deciding tests of income and expense accounts based on the results of analytical procedures.
Audit of Property, Plant, and Equipment (page 634)

The difficult aspect of this area is the need to be concerned with additions, disposals, the asset balance, accumulated depreciation, and depreciation expense. For this area, we emphasize the overall objectives of each segment rather than the balance-related audit objectives.

We start by describing the three accounts that concern the auditor and why they are audited simultaneously. Reference Figure 19-1 (page 635) during this discussion. We emphasize that the discussion is meant to be representative of other audit areas.

(See Figure 19-1)

We then deal with individual balances, starting with the asset account (property, plant, and equipment), and use questions such as the following:

1. What are the most important differences in the audit of property, plant, and equipment and the following:
   - Cash in bank?
   - Accounts receivable?
   - Patents?
   - Inventory?

2. On a continuing engagement, why is the audit of current period additions and disposals emphasized?

3. For additions, which of the balance-related audit objectives in Table 19-4 (page 637) are most important?

(See Table 19-4)

4. How does the audit of current period additions relate to tests of controls and substantive tests of transactions?

5. What factors would determine sample size and items to select in tests of accounts of property, plant, and equipment?

6. Why does the auditor have considerable flexibility in timing for tests of acquisitions of property, plant, and equipment?

7. What are the purposes of each of the procedures listed on T-19-3?

(See T-19-3)

For disposals we ask questions such as the following:

1. What are the two most important objectives in auditing disposals?

2. Identify procedures that are useful for uncovering unrecorded disposals.

3. How is the audit of accumulated depreciation directly related to the accuracy objective for disposals?
For depreciation, we ask questions such as the following:

1. When might analytical procedures be sufficient for auditing depreciation expense?
2. Explain how detailed tests of depreciation might be done assuming that the client has a master file of fixed assets.

For the balance in the fixed asset account we like to ask:

1. Why are the presentation and disclosure-related audit objectives more important for fixed assets than most other asset balances?
2. Why is a physical observation of fixed assets less common than for inventory or marketable securities? When should it be done?
3. What audit problems in fixed assets are encountered when a CPA firm is a successor auditor? How can the problem be solved?

Any of Problems 19-21 to 19-23 will help to reinforce the topic. A good way to finish the audit of fixed assets is to use Problem 19-24 or Case 19-28. It ties the material in Case 18-32 to fixed assets. It should only be used if Case 18-32 was covered.

Related Areas

If there is time left, we like Discussion Question 19-26, which addresses the search for unrecorded liabilities.
# Cross-Reference of Learning Objectives and Problem Material

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>19-1</strong> Recognize the many accounts in the acquisition and payment cycle.</td>
<td></td>
<td></td>
<td>19-23</td>
<td>19-28</td>
</tr>
<tr>
<td><strong>19-3</strong> Design and perform audit tests of prepaid expenses.</td>
<td>19-6, 19-7, 19-8, 19-9</td>
<td></td>
<td>19-23</td>
<td></td>
</tr>
<tr>
<td><strong>19-4</strong> Design and perform audit tests of accrued liabilities.</td>
<td>19-10, 19-11, 19-12</td>
<td>19-20</td>
<td>19-25, 19-26</td>
<td></td>
</tr>
</tbody>
</table>

To download more slides, ebook, solutions and test bank, visit [http://downloadslide.blogspot.com](http://downloadslide.blogspot.com)
BALANCE-RELATED AUDIT OBJECTIVES: UTILITIES EXPENSE

- Recorded utilities expense transactions as listed exist
- Existing utilities services received are recorded
- Utilities expense transactions as listed are correctly stated
- Utilities expense transactions as listed are properly classified
- Utilities expense transactions are recorded in the proper period
- The amounts in the general ledger are correctly totaled and the total agrees with the trial balance
QUIZ - HOW EXPENSES ARE TESTED

Match each of the following eight expense accounts, each one assumed to be material, into one of four categories.

1. Will ordinarily be tested sufficiently by normal tests of controls and substantive tests of transactions, analytical procedures, and accounts payable tests.

2. Frequently requires additional account analysis due to high expectation of misstatements.

3. Typically audited as a part of an accrual or prepaid account.

4. Not tested as a part of (1) except for normal analytical procedures.

Bond discount          Insurance expense
Interest expense       Raw material purchases
Advertising expense   Depletion expense
Miscellaneous expense Repair and main. expense
PARTIAL AUDIT PROGRAM
FOR PROPERTY, PLANT, AND
EQUIPMENT ADDITIONS

- Foot the client-prepared listing of current year additions and reconcile the total with debits to property, plant, and equipment in the general ledger.

- Trace individual additions included on the client-generated listing to the acquisitions journal.

- Examine rent and lease agreements for rented and leased property, plant, and equipment.

- Examine vendors' invoices and receiving reports for additions included on the listing.

- Trace the total of individual additions to the related master files.

- Analyze repair and maintenance expense for large and unusual items.

- Examine loan agreements for equipment acquired by loans or contracts.
Chapter 20

Audit of the Payroll and Personnel Cycle

Usually we do not cover the chapter at all. When we do, we emphasize how the cycle fits into the audit and significant differences between the sales and collection cycle and the payroll and personnel cycle.

Our coverage is as follows:

- Chapter opening vignette
- Overview of the payroll and personnel cycle and functions in the cycle
- Primary engagement concerns
- Methodology for designing tests of controls and substantive tests of transactions
- Methodology for designing tests of details of balances
- Summary

Chapter Opening Vignette – The Staff Auditor Must Never “Simply Follow Orders”

Over the years, a number of our students have contacted us to obtain advice about dealing with an employment situation with which they were very uncomfortable. These are always alarming and some have represented great potential risk to our former students. In some extreme situations, we have even counseled our students to seriously consider changing employment. This vignette represents one of those types of situations. You might ask your students to put themselves in Leslie’s shoes at the point of Stith’s instruction to her and ask them what they could or would have done in that situation, and what exposure Leslie has.

The vignette can also lead to a discussion of working for an unpleasant supervisor, as well as how a staff person can protect themselves in various difficult situations.

Overview of the Payroll and Personnel Cycle Accounts and Business Functions (page 660-663)

We start in much the same way as for the sales and collection cycle. First we want students to have a good understanding of the account balances involved. Figure 20-1 (page 661) provides a good summary of the accounts in a typical payroll and personnel cycle. T-20-1 is also useful to discuss sources of information for the payroll and personnel cycle.

A decision must be made whether to use a manufacturing or non-manufacturing company for discussion. We use a manufacturing company because of the importance of inventory.

(See T-20-1)

(See Figure 20-1)
Next we review the business functions and related documents and records discussed in the early part of the chapter to make sure students understand them. (See Table 20-1 on page 662)

We cover primary engagement concerns by highlighting several questions:

- Review Question 20-2 – relationship of payroll and inventory. We also ask about the effect of classifying a manufacturing expense as a selling expense or vice-versa.
- The importance of fraud in the payroll and personnel cycle.
- Review Question 20-5 – controls related to fraud.

**Methodology for Designing Tests of Controls and Substantive Tests of Transactions** (page 664)

Figure 20-2 (page 672) provides a useful summary of the methodology for designing tests of controls and substantive tests of transactions for the payroll and personnel cycle.

We also cover the following questions and problems related to internal controls in the payroll and personnel cycle:

- Review Question 20-14 – imprest payroll
- Multiple Choice Question 20-17 – multiple choice questions on internal control
- Discussion Question 20-19 – objectives of questions on the internal control questionnaire
- Problem 20-26 – Misappropriation of assets involving payroll and the use of a surprise payroll payoff

We also cover the following questions and problems related to tests of controls and substantive tests of transactions in the payroll and personnel cycle:

- Review Question 20-6 – direction of tests
- Problem 20-20 – tests of controls and substantive tests of transactions
- Problem 20-21 – misstatements and related tests

If there is time we also like to have students close their books and develop a summary of tests of payroll transactions in class much like the one in Table 20-2 (page 666). Start by asking a student to state any of the six transaction-related audit objectives for payroll, then state one or two key controls, the common tests of controls and one or two substantive tests of transactions. We put these on the overhead as we proceed. Covering three or four objectives in depth is usually sufficient.
It is also worthwhile to go to Problem 20-20 and ask students to identify for 1 to 7 whether each would be tested using audit sampling. We find it desirable to finish this section by asking students to identify the major factors affecting the four audit evidence decisions for tests of controls and substantive tests of transactions:

- Which audit procedures to use
- Items to select
- Sample size
- Timing

Methodology for Designing Tests of Details of Balances (page 668)

We ask questions such as the following:

- What types of client business risks might be related to payroll cycle accounts?
- Why do tests of controls and substantive tests of transactions in the payroll and personnel cycle typically have a less important effect on the related balance sheet accounts than they do in the sales and collection cycle?
- What are the primary differences between auditing a payroll accrual and auditing an account such as accounts receivable?
- Review Question 20-8 – analytical procedures in payroll
- Review Question 20-13 – audit of officers’ compensation

Problem 20-27 provides a useful example to discuss how a company’s increased use of the Internet to provide product information and on-line sales for customers may affect the company’s payroll functions and account balances.

Summary (page 672)

A good way to finish the chapter coverage is to review Figure 20-2 (page 672). This figure is similar to figures used in other chapters, but Figure 20-2 is specific to the payroll and personnel cycle.

(See Figure 20-2)
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Multiple Choice Questions</th>
<th>Review Questions</th>
<th>Discussion Questions and Problems</th>
<th>Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>20-3 Understand internal control and design and perform tests of controls and substantive tests of transactions for the payroll and personnel cycle.</td>
<td>20-8</td>
<td></td>
<td>20-17, 20-18</td>
<td>20-22, 20-23, 20-28</td>
</tr>
<tr>
<td>20-4 Design and perform analytical procedures for the payroll and personnel cycle.</td>
<td></td>
<td></td>
<td>20-1-3</td>
<td>20-22, 20-23, 20-28</td>
</tr>
<tr>
<td>20-5 Design and perform tests of details of balances for accounts in the payroll and personnel cycle.</td>
<td></td>
<td></td>
<td></td>
<td>20-7, 20-13</td>
</tr>
</tbody>
</table>
SOURCE OF INFORMATION FOR PAYROLL AND PERSONNEL

- Payroll balances in financial statements
- Payroll accounts in the general ledger (Figure 20-1)
- Master file (earnings records)
- Journals affecting general ledger and master files
- Transactions recorded in the transaction files, journals or listings
- Documents related to the transactions
Chapter 21
Audit of the Inventory and Warehousing Cycle

We find Chapter 21 difficult for students to understand because of the chapter's emphasis on auditing the inventory of a manufacturing company. It works better to discuss the audit of inventory for a retail or wholesale company. At the end of the chapter, we bring in the complexities caused when inventory is manufactured rather than purchased.

The following are topic areas we cover:

- Chapter opening vignette
- Differences between inventory and other audit areas
- Parts of the audit of inventory
- Physical observation
- Audit of pricing and compilation
- Integration of the tests

Chapter Opening Vignette – “Phantom Inventory”

This vignette revolves around the well-known financial statement fraud at Phar-Mor whereby senior management recorded fictitious inventory and manipulated inventory values to overstate inventory and understate cost of goods sold. We use the vignette to illustrate the challenges associated with auditing clients who have massive amounts of inventory items located in numerous locations. As students visualize the volume of products carried by a retail chain like Phar-Mor, they quickly recognize the opportunities management might have to manipulate inventory values. The vignette also provides a nice opportunity to integrate discussions about sample sizes for tests of details (from Chapter 17). Discussion about the auditor’s decision to only visit four of 300 stores and the auditor’s advance disclosure of the locations to be visited help integrate sampling concepts into this chapter’s focus on audit issues related to inventory.

Differences Between Inventory and Other Audit Areas

In this section, we briefly ask students to identify the major differences between the audit of inventory and an account such as accounts receivable.

Parts of the Audit of Inventory (page 684)

We start this section by first assuming no perpetual records for a wholesale company. T-21-1 and T-21-2 are intended to show that cost of goods sold is a residual, and ending inventory is audited independently of any other cycles.

(See T-21-1 and T-21-2)
When there are no perpetuals, there are three major parts of auditing inventory as shown in **T-21-3**. These can be shown as the steps in determining inventory value.

(See T-21-3)

Now add perpetual records, including quantities and unit costs and see the connection to the auditor's procedures as summarized in **T-21-4**.

(See T-21-4)

At this point, the perpetual records can be shown as a link between sales and inventory, and acquisitions and inventory. We emphasize how the information gets into the perpetual inventory records and how it is tested as a part of tests of controls and substantive tests of transactions by using **T-21-5**.

(See T-21-5)

Three major parts of auditing inventory:

1. Physical observation - related to perpetuals (units)
2. Price tests - related to perpetuals (prices)
3. Compilation - independent of other areas

It is also possible to go one step further and show how perpetuals, including total dollar balances, affect the audit. We do not ordinarily do that because we find that it confuses most students without strong accounting systems backgrounds.

**Physical Observation of Inventory** (page 689)

Start by bringing out the following points: (We find it important to use an example to illustrate each point in this area.)

- Distinction between auditor's and management's responsibilities
- Auditing standards requirements to observe inventory in all audits
- The two most important internal controls in the physical count and tests of those controls:
  1. Perpetual records (master files)
  2. Proper inventory instructions

- Audit decisions and factors affecting each decision
  1. Extent to which assessed control risk will be reduced due to the two controls above (affects the following three decisions)
  2. Sample size
  3. Items to select
  4. Timing
What the auditor does during physical examination *(See Table 21-2 on page 694)*
- Recording test counts - why done and how
- Obtaining cutoff information - importance, how, and documentation

Next we cover a few miscellaneous aspects of the physical observation by use of the following Review Questions:

- 21-4 - perpetual records, if concepts have not already been covered. *(T-21-4 is useful again at this point.)*
- 21-5 - deficient internal controls over counting inventory
- 21-6 - control of test counts
- 21-9 - control of tags
- Internet Problem 21-1 – use of inventory count specialists

**Audit of Pricing and Compilation** *(page 693)*

First we define the terms “pricing” and “compilation” using the previously prepared transparency *(T-21-2 - steps in determining inventory value).*

Next we cover Review Question 21-13, to make sure students understand the issues involved in pricing inventory. We ask questions or go over problems as follows:

- What controls would enable the auditor to reduce price tests?
- Why might perpetual inventory records enable the auditor to reduce testing? *(We go through the logic from tests of acquisitions to comparison of unit costs on the inventory summary.)*
- Review Question 21-8 - observe inventory for obsolescence.
- How might audit sampling be used in price tests of inventory?
- Case 21-33 - this is a difficult case, but it nicely illustrates various types of pricing misstatements.

Next we refer to **Table 21-3** *(page 695)* and identify several inventory compilation procedures typically performed. The emphasis is on why each is done.

**Integration of the Tests** *(page 697)*

Once the basics have been covered, we like to make sure the students understand what was discussed. The following are covered if possible (see top of next page):

- Problem 21-23 - purpose of audit tests
- Problem 21-24 - misstatements, controls to prevent misstatements, and substantive audit procedures
- Use of analytical procedures at each stage of the audit of inventory. *(Problem 21-26 provides a useful illustration of how analytical procedures can be used to assess the presence of misstatements in inventory. Also, see Problem 21-29 for another illustration of analytical procedures performed to assess inventory and related balances.)*
Use of the cutoff information for sales and purchases obtained during the physical count to test sales and purchases cutoff. This is a good opportunity to illustrate the tie-in of physical observation with sales (Chapter 14), and acquisitions (Chapter 18). (See Problems 21-30 or 21-32).

Additional problems that arise when work in process and finished goods inventory are introduced.

Review of Figure 21-4 (page 698) and its interrelationships.

(See Figure 21-4)
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Discussion Questions and Problems</th>
<th>Multiple Choice Questions</th>
</tr>
</thead>
<tbody>
<tr>
<td>21-1</td>
<td>21-1, 21-2,</td>
<td>21-17, 21-18, 21-19</td>
<td>21-17, 21-18, 21-19</td>
</tr>
<tr>
<td>Describe the business functions and the related documents and records in the inventory and warehousing cycle.</td>
<td>21-3, 21-4</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
</tr>
<tr>
<td>21-2</td>
<td>21-3, 21-4</td>
<td>21-18</td>
<td>21-18</td>
</tr>
<tr>
<td>Explain the five parts of the audit of the inventory and warehousing cycle.</td>
<td>21-12</td>
<td>21-19</td>
<td>21-19</td>
</tr>
<tr>
<td>Design and perform audit tests of cost accounting.</td>
<td>21-19</td>
<td>21-19</td>
<td>21-19</td>
</tr>
<tr>
<td>21-4</td>
<td>21-5, 21-6,</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
</tr>
<tr>
<td>Apply analytical procedures to the accounts in the inventory and warehousing cycle.</td>
<td>21-4, 21-8, 21-10</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
</tr>
<tr>
<td>21-5</td>
<td>21-6, 21-7,</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
</tr>
<tr>
<td>Design and perform physical observation audit tests for inventory.</td>
<td>21-5, 21-8, 21-10</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
</tr>
<tr>
<td>21-6</td>
<td>21-5, 21-8,</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
</tr>
<tr>
<td>Design and perform audit tests of pricing and compilation for inventory.</td>
<td>21-19</td>
<td>21-19</td>
<td>21-19</td>
</tr>
<tr>
<td>21-7</td>
<td>21-5, 21-8,</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
<td>21-20, 21-21, 21-22, 21-23, 21-24</td>
</tr>
<tr>
<td>Integrate the various parts of the audit of the inventory and warehousing cycle.</td>
<td>21-19</td>
<td>21-19</td>
<td>21-19</td>
</tr>
</tbody>
</table>

To download more slides, ebook, solutions and test bank, visit http://downloadslide.blogspot.com
# Relationship of Inventory to Other Accounts When There Are No Perpetual Records

The relationship between inventory and other accounts can be expressed as follows:

\[
\text{Beginning Inventory} + \text{Purchases of Inventory} - \text{Ending Inventory} = \text{Cost of Goods Sold}
\]

- **Beginning Inventory**: Audited in prior year.
- **Purchases of Inventory**: Audited primarily through TOC, STOT, analytical procedures, and analysis of purchases.
- **Ending Inventory**: Audited through analytical procedures and tests of details of balances.
- **Cost of Goods Sold**: Residual.
STEPS IN DETERMINING INVENTORY VALUE

- Count inventory using tags or count sheets
- Summarize inventory by description
- Determine correct unit cost of inventory
- Extend price and quantity and accumulate extended totals = total inventory value
- Record in general ledger by a journal entry
- Include in financial statements
THREE PARTS OF INVENTORY AUDIT

1. Physical observation - independent of other audit areas.

2. Tests of the unit costs (price tests) - independent of other audit areas.

3. Extensions, footings and tracing of inventory listing (compilation) - independent of other audit areas.
RELATIONSHIP OF INVENTORY TO OTHER ACCOUNTS WHEN THERE ARE QUANTITIES AND UNIT COSTS ON PERPETUALS

Beginning Inventory + Purchases of Inventory - Ending Inventory = Cost of Goods Sold

Audited in prior year through TOC, STOT, analytical procedures and analysis of purchases

Audited primarily through TOC, STOT, analytical procedures and tests of details of balances, plus reliance on TOC, STOT, and analysis of sales

Residual
## PERPETUAL RECORD

### Product C-617

<table>
<thead>
<tr>
<th>DATE</th>
<th>RECEIVING OR SHIPPING #</th>
<th>UNIT COST</th>
<th>PURCHASED</th>
<th>SOLD</th>
<th># OF UNITS BALANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-1-11</td>
<td>R1263</td>
<td>$49.53</td>
<td>94</td>
<td></td>
<td>36</td>
</tr>
<tr>
<td>2-3-11</td>
<td>S26409</td>
<td></td>
<td>69</td>
<td>61</td>
<td></td>
</tr>
<tr>
<td>3-4-11</td>
<td>S26910</td>
<td></td>
<td>47</td>
<td>14</td>
<td></td>
</tr>
<tr>
<td>10-5-11</td>
<td>R1571</td>
<td>51.06</td>
<td>50</td>
<td></td>
<td>64</td>
</tr>
</tbody>
</table>
Chapter 22

Audit of the Capital Acquisition and Repayment Cycle

We have only rarely covered the material in this chapter. Our students have had enough of the detail testing at this point. When we do cover it, it does not get much time. The following are the major things to discuss:

- Chapter opening vignette
- Nature of and accounts in the capital acquisition and repayment cycle
- Audit of notes payable
- Audit of owners’ equity

Chapter Opening Vignette – “A Dishonest Client Will Get the Best of the Auditor Almost Every Time”

This vignette represents an example of how much auditors must rely on client representations, and where those representations can't be corroborated, the auditor is essentially at the client's mercy. This leads to a discussion of several concepts: What is the nature of representations, how can they be corroborated, what does the auditor do when they can't be corroborated, the importance of new client investigation, and the importance of being skeptical.

Nature of and Accounts in the Capital Acquisition and Repayment Cycle (page 712)

We start by identifying the four characteristics affecting the audit of the capital acquisition and repayment cycle that are discussed in the chapter:

1. Relatively few, but highly material, transactions
2. Exclusion of a single transaction could be material in itself
3. Legal relationships
4. Direct relationship of interest to debt and dividends to equity

We then identify the accounts (listed on page 712) that will be discussed.

Audit of Notes Payable (page 713)

First we refer students to Figure 22-1 (page 714) to identify the account balances being audited and to discuss the methodology for designing joint tests for notes payable. This is a good time to discuss why tests of controls and substantive tests of transactions are rarely relevant for the capital acquisition and repayment cycle.

(See Figure 22-1)
The following questions are then asked:

- Review Question 22-3 - audit of notes, interest expense and accrued interest simultaneously
- Review Question 22-4 - internal controls over notes payable
- Review Question 22-6 - search for unrecorded notes
- Why is it common to confirm all notes payable in a typical audit?
- Review Question 22-9 - restrictions on loans
- **Figure 22-2** (pages 718-719) illustrates a 100% audit of notes payable and related accounts. Identify circumstances where this would be done.

To the extent there is time, we also cover one or two of the following:

- Problem 22-23 - procedures and purposes of the procedures for bonds payable
- Problem 22-24 – this can be used to provide an overview of procedures auditors typically perform related to notes payable.
- Problem 22-25 – overview of an audit program for notes payable

**Audit of Owners' Equity** (page 716)

As for all other areas, we start by reviewing the account balances in the owners' equity and related accounts. These are shown in **Figure 22-3** (page 719).

(See Figure 22-3)

We find in the audit of owners' equity it is useful to distinguish between several circumstances as dramatically affecting the evidence needed.

- Closely held company - continuing audit
- Closely held company - first year audit
- Publicly held company - continuing audit - no independent stock registrar
- Publicly held company - continuing audit - independent stock registrar
- Publicly held company - first year audit

For capital stock and paid-in capital, we use the objectives stated in the text, and discuss how the audit is affected by each of the five circumstances listed above. We do the same thing for dividends and retained earnings.

Problem 22-29 provides an overview of various procedures performed related to owners' equity. Internet Problem 22-1 also provides an opportunity for students to better understand the operations of the NYSE and NASDAQ and the basic categories of stock.
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>22-1 Identify the accounts and the unique characteristics of the capital acquisition and repayment cycle.</td>
<td>22-1, 22-2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>22-2 Design and perform audit tests of notes payable and related accounts and transactions.</td>
<td>22-2, 22-3, 22-4, 22-5, 22-6, 22-7, 22-8, 22-9</td>
<td>22-20, 22-21</td>
<td>22-22, 22-23, 22-24, 22-25, 22-26, 22-27</td>
<td></td>
</tr>
<tr>
<td>22-3 Identify the primary concerns in audit of owners’ equity transactions.</td>
<td>22-10, 22-11, 22-12, 22-13, 22-14, 22-19</td>
<td>22-21</td>
<td>22-28, 22-29, 22-30, 22-32</td>
<td></td>
</tr>
<tr>
<td>22-4 Design and perform tests of controls, substantive tests of transactions, and tests of details of balances for capital stock and retained earnings</td>
<td>22-11, 22-15, 22-16, 22-17, 22-18, 22-19</td>
<td>22-21</td>
<td>22-28, 22-29, 22-30, 22-31</td>
<td></td>
</tr>
</tbody>
</table>
Chapter 23
Audit of Cash Balances

This is one chapter we always cover. For one reason, it ties the various transaction cycles together. Secondly, students will frequently do work in this area early in their professional careers. Students are told that there will be reasonably heavy testing of their knowledge of bank reconciliations and proofs of cash on the next exam. The following are the major subjects covered in this session:

- Chapter opening vignette
- Cash in the bank and transaction cycles
- Types of cash accounts
- Effect of proper segregation of duties and an independent bank reconciliation
- Definitions
- Audit of the general cash account
- Cutoff tests
- Summary of audit tests for the general cash account
- Proof of cash
- Audit of an imprest account – payroll

Chapter Opening Vignette – “False Confirmation Hides Massive Fraud”

This vignette on Parmalat illustrates a large financial reporting fraud involving cash at a major international company. We discuss the forged bank confirmation and the need to use professional skepticism even when evidence appears to be highly reliable, such as a bank confirmation.

We also note how many CPA firms now confirm bank balances electronically using a third-party intermediary. We ask students whether they believe this improves the confirmation process.

Cash in the Bank and Transaction Cycles (page 732)

Studying the relationship of cash to the various transaction cycles is an essential part of the course, because it helps students integrate material learned in other chapters. We spend a few minutes on Figure 23-1 (page 733), making sure that students understand these interrelationships.

(See Figure 23-1)

At this point, Review Question 23-2 helps students see the link of testing in the various transaction cycles to the testing of the year-end cash balances.
Types of Cash Accounts (page 734)

It is useful to summarize the types of cash accounts discussed in the beginning of the chapter to make sure that students understand the difference between each one and how they tie into the general cash account. T-23-1 provides a good summary of the types of cash accounts.

(See T-23-1)

Effect of Proper Segregation of Duties and an Independent Bank Reconciliation

The importance of these two controls over cash accounts deserves emphasis. At this point, we refer students to the bank reconciliation in Figure 23-3 (page 738) and talk about the types of misstatements that would and would not be uncovered by an independent bank reconciliation.

(See Figure 23-3)

The questions on T-23-2 help clarify this from a control and an audit point of view.

(See T-23-2)

Definitions (pages 741, 743, and 744)

Before going into detail about the audit of cash in the bank, it is desirable to define certain terms. For the first two, we state their purpose. In the case of kiting, we explain what it is, and how it can be detected.

- Cutoff bank statement (page 741)
- Proof of cash (page 743)
- Kiting (page 744)

Problem 23-23 is a useful one to make sure that students know the procedures to uncover kiting.

Audit of the General Cash Account (page 735)

First we discuss the methodology for designing tests of details of balances, with emphasis on risk and materiality of the cash receipts and cash disbursements transactions. Next we ask students to identify the starting point for auditing cash (client’s year-end bank reconciliation), and why it is the starting point. Students are then asked to refer to Figure 23-3 (page 738) and are asked to identify all procedures that would normally be performed on a client-prepared bank reconciliation. We also discuss a standard bank confirmation, using Figure 23-4 (page 740).

(See Figures 23-3 and 23-4)
The following questions and problems are then used:

- 23-5 – Bank confirmation compared to accounts receivable confirmation
- 23-18 – Multiple choice questions
- 23-21 – Objectives of various audit procedures

Problems 23-22 and 23-25 give students practice in preparing a bank reconciliation.

**Cutoff Tests** (see Table 23-1, page 739, for detailed cutoff tests)

We find Review Question 23-8 is sufficient for discussing cutoff if it is expanded to cash disbursements too.

**Summary of Audit Tests for the General Cash Account** (page 742)

**Figure 23-5** (page 742) provides a good summary of the types of audit tests used for the audit of the general cash account.

*(See Figure 23-5)*

**Proof of Cash** (page 743)

In the discussion of proofs of cash, we ask several questions:

- What is the purpose of a proof of cash?
- Identify several misstatements of cash that a proof of cash will uncover.
- Identify several misstatements of cash that a proof of cash will not uncover.
- When is it necessary to do, and when can it be omitted?

Next, we use **Figure 23-6** (page 745) to show an example of a completed proof of cash.

*(See Figure 23-6)*

**Audit of an Imprest Account – Payroll** (page 746)

We discuss only one imprest account, usually payroll. The following are typical questions:

- What does the term *imprest* mean?
- Why are imprest accounts used by companies?
- How does an imprest account affect the audit?
- Assuming an imprest payroll account, what should be emphasized, the cash balance or changes in the balance?
- At what point in the audit are changes in the payroll cash account balances audited?
- What testing needs to be done at year-end, assuming effective controls?
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Discussion Questions and Problems</th>
<th>Multiple Choice Questions</th>
<th>Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>Show the relationship of cash in the bank to the various transaction cycles.</td>
<td>Identify the major types of cash accounts maintained by business entities.</td>
<td>Design and perform audit tests of the general cash account.</td>
<td>Recognize when to extend audit tests of the general cash account to test further for material fraud.</td>
<td>Design and perform audit tests of the imprest payroll bank account.</td>
</tr>
<tr>
<td>23-2</td>
<td></td>
<td></td>
<td></td>
<td>23-19</td>
</tr>
<tr>
<td>23-3</td>
<td></td>
<td></td>
<td></td>
<td>23-20</td>
</tr>
<tr>
<td>23-4</td>
<td></td>
<td></td>
<td></td>
<td>23-21</td>
</tr>
<tr>
<td>23-5</td>
<td></td>
<td></td>
<td></td>
<td>23-22</td>
</tr>
<tr>
<td>23-6</td>
<td></td>
<td></td>
<td></td>
<td>23-23</td>
</tr>
<tr>
<td>23-7</td>
<td></td>
<td></td>
<td></td>
<td>23-24</td>
</tr>
<tr>
<td>23-8</td>
<td></td>
<td></td>
<td></td>
<td>23-25</td>
</tr>
<tr>
<td>23-9</td>
<td></td>
<td></td>
<td></td>
<td>23-26</td>
</tr>
<tr>
<td>23-10</td>
<td></td>
<td></td>
<td></td>
<td>23-27</td>
</tr>
<tr>
<td>23-11</td>
<td></td>
<td></td>
<td></td>
<td>23-28</td>
</tr>
<tr>
<td>23-12</td>
<td></td>
<td></td>
<td></td>
<td>23-29</td>
</tr>
<tr>
<td>23-13</td>
<td></td>
<td></td>
<td></td>
<td>23-30</td>
</tr>
<tr>
<td>23-14</td>
<td></td>
<td></td>
<td></td>
<td>23-31</td>
</tr>
<tr>
<td>23-15</td>
<td></td>
<td></td>
<td></td>
<td>23-32</td>
</tr>
<tr>
<td>23-16</td>
<td></td>
<td></td>
<td></td>
<td>23-33</td>
</tr>
<tr>
<td>23-17</td>
<td></td>
<td></td>
<td></td>
<td>23-34</td>
</tr>
<tr>
<td>23-18</td>
<td></td>
<td></td>
<td></td>
<td>23-35</td>
</tr>
<tr>
<td>23-19</td>
<td></td>
<td></td>
<td></td>
<td>23-36</td>
</tr>
<tr>
<td>23-20</td>
<td></td>
<td></td>
<td></td>
<td>23-37</td>
</tr>
<tr>
<td>23-21</td>
<td></td>
<td></td>
<td></td>
<td>23-38</td>
</tr>
<tr>
<td>23-22</td>
<td></td>
<td></td>
<td></td>
<td>23-39</td>
</tr>
<tr>
<td>23-23</td>
<td></td>
<td></td>
<td></td>
<td>23-40</td>
</tr>
<tr>
<td>23-24</td>
<td></td>
<td></td>
<td></td>
<td>23-41</td>
</tr>
<tr>
<td>23-25</td>
<td></td>
<td></td>
<td></td>
<td>23-42</td>
</tr>
<tr>
<td>23-26</td>
<td></td>
<td></td>
<td></td>
<td>23-43</td>
</tr>
<tr>
<td>23-27</td>
<td></td>
<td></td>
<td></td>
<td>23-44</td>
</tr>
<tr>
<td>23-28</td>
<td></td>
<td></td>
<td></td>
<td>23-45</td>
</tr>
<tr>
<td>23-29</td>
<td></td>
<td></td>
<td></td>
<td>23-46</td>
</tr>
<tr>
<td>23-30</td>
<td></td>
<td></td>
<td></td>
<td>23-47</td>
</tr>
<tr>
<td>23-31</td>
<td></td>
<td></td>
<td></td>
<td>23-48</td>
</tr>
<tr>
<td>23-32</td>
<td></td>
<td></td>
<td></td>
<td>23-49</td>
</tr>
<tr>
<td>23-33</td>
<td></td>
<td></td>
<td></td>
<td>23-50</td>
</tr>
<tr>
<td>23-34</td>
<td></td>
<td></td>
<td></td>
<td>23-51</td>
</tr>
<tr>
<td>23-35</td>
<td></td>
<td></td>
<td></td>
<td>23-52</td>
</tr>
<tr>
<td>23-36</td>
<td></td>
<td></td>
<td></td>
<td>23-53</td>
</tr>
<tr>
<td>23-37</td>
<td></td>
<td></td>
<td></td>
<td>23-54</td>
</tr>
<tr>
<td>23-38</td>
<td></td>
<td></td>
<td></td>
<td>23-55</td>
</tr>
<tr>
<td>23-39</td>
<td></td>
<td></td>
<td></td>
<td>23-56</td>
</tr>
<tr>
<td>23-40</td>
<td></td>
<td></td>
<td></td>
<td>23-57</td>
</tr>
<tr>
<td>23-41</td>
<td></td>
<td></td>
<td></td>
<td>23-58</td>
</tr>
<tr>
<td>23-42</td>
<td></td>
<td></td>
<td></td>
<td>23-59</td>
</tr>
<tr>
<td>23-43</td>
<td></td>
<td></td>
<td></td>
<td>23-60</td>
</tr>
<tr>
<td>23-44</td>
<td></td>
<td></td>
<td></td>
<td>23-61</td>
</tr>
<tr>
<td>23-45</td>
<td></td>
<td></td>
<td></td>
<td>23-62</td>
</tr>
<tr>
<td>23-46</td>
<td></td>
<td></td>
<td></td>
<td>23-63</td>
</tr>
<tr>
<td>23-47</td>
<td></td>
<td></td>
<td></td>
<td>23-64</td>
</tr>
<tr>
<td>23-48</td>
<td></td>
<td></td>
<td></td>
<td>23-65</td>
</tr>
<tr>
<td>23-49</td>
<td></td>
<td></td>
<td></td>
<td>23-66</td>
</tr>
<tr>
<td>23-50</td>
<td></td>
<td></td>
<td></td>
<td>23-67</td>
</tr>
<tr>
<td>23-51</td>
<td></td>
<td></td>
<td></td>
<td>23-68</td>
</tr>
<tr>
<td>23-52</td>
<td></td>
<td></td>
<td></td>
<td>23-69</td>
</tr>
<tr>
<td>23-53</td>
<td></td>
<td></td>
<td></td>
<td>23-70</td>
</tr>
<tr>
<td>23-54</td>
<td></td>
<td></td>
<td></td>
<td>23-71</td>
</tr>
<tr>
<td>23-55</td>
<td></td>
<td></td>
<td></td>
<td>23-72</td>
</tr>
<tr>
<td>23-56</td>
<td></td>
<td></td>
<td></td>
<td>23-73</td>
</tr>
<tr>
<td>23-57</td>
<td></td>
<td></td>
<td></td>
<td>23-74</td>
</tr>
<tr>
<td>23-58</td>
<td></td>
<td></td>
<td></td>
<td>23-75</td>
</tr>
<tr>
<td>23-59</td>
<td></td>
<td></td>
<td></td>
<td>23-76</td>
</tr>
<tr>
<td>23-60</td>
<td></td>
<td></td>
<td></td>
<td>23-77</td>
</tr>
<tr>
<td>23-61</td>
<td></td>
<td></td>
<td></td>
<td>23-78</td>
</tr>
<tr>
<td>23-62</td>
<td></td>
<td></td>
<td></td>
<td>23-79</td>
</tr>
<tr>
<td>23-63</td>
<td></td>
<td></td>
<td></td>
<td>23-80</td>
</tr>
<tr>
<td>23-64</td>
<td></td>
<td></td>
<td></td>
<td>23-81</td>
</tr>
<tr>
<td>23-65</td>
<td></td>
<td></td>
<td></td>
<td>23-82</td>
</tr>
<tr>
<td>23-66</td>
<td></td>
<td></td>
<td></td>
<td>23-83</td>
</tr>
<tr>
<td>23-67</td>
<td></td>
<td></td>
<td></td>
<td>23-84</td>
</tr>
<tr>
<td>23-68</td>
<td></td>
<td></td>
<td></td>
<td>23-85</td>
</tr>
<tr>
<td>23-69</td>
<td></td>
<td></td>
<td></td>
<td>23-86</td>
</tr>
<tr>
<td>23-70</td>
<td></td>
<td></td>
<td></td>
<td>23-87</td>
</tr>
<tr>
<td>23-71</td>
<td></td>
<td></td>
<td></td>
<td>23-88</td>
</tr>
<tr>
<td>23-72</td>
<td></td>
<td></td>
<td></td>
<td>23-89</td>
</tr>
<tr>
<td>23-73</td>
<td></td>
<td></td>
<td></td>
<td>23-90</td>
</tr>
<tr>
<td>23-74</td>
<td></td>
<td></td>
<td></td>
<td>23-91</td>
</tr>
<tr>
<td>23-75</td>
<td></td>
<td></td>
<td></td>
<td>23-92</td>
</tr>
<tr>
<td>23-76</td>
<td></td>
<td></td>
<td></td>
<td>23-93</td>
</tr>
<tr>
<td>23-77</td>
<td></td>
<td></td>
<td></td>
<td>23-94</td>
</tr>
<tr>
<td>23-78</td>
<td></td>
<td></td>
<td></td>
<td>23-95</td>
</tr>
<tr>
<td>23-79</td>
<td></td>
<td></td>
<td></td>
<td>23-96</td>
</tr>
<tr>
<td>23-80</td>
<td></td>
<td></td>
<td></td>
<td>23-97</td>
</tr>
<tr>
<td>23-81</td>
<td></td>
<td></td>
<td></td>
<td>23-98</td>
</tr>
<tr>
<td>23-82</td>
<td></td>
<td></td>
<td></td>
<td>23-99</td>
</tr>
<tr>
<td>23-83</td>
<td></td>
<td></td>
<td></td>
<td>23-100</td>
</tr>
</tbody>
</table>
TYPES OF CASH ACCOUNTS AND THEIR RELATIONSHIP TO THE GENERAL CASH ACCOUNT

- **Branch Activities**
  - **Branch Bank**
  - **General Cash**
    - **Imprest Payroll Account**
    - **Imprest Petty Fund**
    - **Cash Equivalents**

- Employees
- Small expenditures
- All other expenditures

To download more slides, ebook, solutions and test bank, visit http://downloadslide.blogspot.com
WHICH OF THE FOLLOWING MISSTATEMENTS WILL BE UNCOVERED BY A CAREFULLY PREPARED INDEPENDENT BANK RECONCILIATION?

- Cash receipts recorded in the cash receipts journal but lost before deposit.

- A check recorded in the cash disbursements journal for an amount $1000 greater than the amount the check was written for.

- Cash receipt lost before it was recorded in the cash receipts journal.

- Bank debit memo that should have been charged to a different customer.

- A check written for $100 more than the amount on the vendor’s invoice.

- A stop-payment by a customer where the client was not informed that the stop-payment had taken place.
Chapter 24
Completing the Audit

We always cover completing the audit near the end of the course. The following are the topics we cover:

- Chapter opening vignette
- Overview
- Perform additional tests for presentation and disclosure-related audit objectives
- Review for contingent liabilities and commitments
- Review for subsequent events
- Final evidence accumulation
- Evaluate results
- Audit documentation review
- Communicate with the audit committee and management
- Additional problems

Chapter Opening Vignette – “Good Review Requires More Than Looking at Audit Files”

A significant portion of the overall audit process consists of work being reviewed by supervisory personnel. Although this is both prudent and required by auditing standards, it is important to realize that review is inherently limited in terms of its effectiveness. This underscores the importance of staff doing a good job in the first place. If staff work sloppily thinking that their mistakes will get caught by reviewers, or if supervisors are lax in their delegation procedures thinking that they can compensate through review, audit risk is significantly increased. This vignette illustrates these concepts.

Two other concepts covered in the vignette are the importance of the reviewer having a complete understanding of the client’s business and the use of independent analytical procedures as a part of the review. The combination of these two things enabled the manager to uncover the staff deficiencies.

Overview

We find this a good time to return to Figure 13-9 (page 425) for a review of what the auditor has done to this point, and where completing the audit fits in. Naturally, special emphasis is put on phase IV.

(See Figure 13-9)

Perform Additional Tests for Presentation and Disclosure-Related Audit Objectives (page 758)

Throughout the various chapters focusing on the transaction cycles and related account balances, we have highlighted specific audit procedures performed to satisfy
unique presentation and disclosure-related audit objectives, in addition to audit procedures performed to satisfy transaction-related audit objectives and balance-related audit objectives. However, we emphasize the importance of evaluating the need to perform additional audit procedures during Phase IV of the audit to satisfy the four presentation and disclosure-related audit objectives. Review question 24-1 can be used to help students focus on the four presentation and disclosure-related audit objectives first presented in Chapter 6.

We emphasize that in Phase IV, the auditor evaluates the overall presentation of the financial statements and related footnotes to determine if they comply with accounting standards. Auditors are particularly concerned about the completeness of required disclosures, especially those related to contingent liabilities and commitments discussed next. Review question 24-2 emphasizes the benefits of using a disclosure checklist to assess the completeness of management’s disclosures.

Review for Contingent Liabilities and Commitments (page 759)

First, we define the term *contingent liability*, and discuss the following three conditions that are required for a contingent liability to exist:

- There is a potential future payment to an outside party or a potential future assets impairment.
- There is an uncertainty about the amount of payment or asset impairment.
- The outcome will be resolved by some future event.

Next, we discuss the three levels of likelihood of uncertainty (probable, reasonably possible, and remote) and the consequences of each on the financial statements and the auditor’s report.

We use Problem 24-27 to discuss contingent liabilities, why they are important to the auditor, and the nature of the related audit procedures. We do the following:

- Go over part a - define a contingent liability
- Ask students why contingencies are important to auditors
- Have students identify general types of contingencies and the disclosure and reporting requirements, if any, for each
- Go over parts b and c simultaneously - audit procedures for each of the three situations

Next we briefly discuss confirmation letters auditor obtain from client attorneys as described in auditing standards.

- Reasons why attorneys are reluctant to provide auditors with unlimited statements about contingencies. The mid-chapter vignette on page 764 provides an overview of some of the challenges associated with receiving these confirmation letters.

1. Asserted claims
2. Unasserted claims
Need for auditor to obtain evidence of the following:

1. Existence of conditions or circumstances indicating a possible loss from litigation, claims or assessments
2. Likelihood of an unfavorable outcome
3. Amount of potential loss

Illustration of typical inquiry of attorney (see Figure 24-2, page 763)

Auditor’s responsibility if the attorney fails to respond or responds improperly

Desired date of letter from attorney

Finally, we discuss commitments, their importance to the auditor, and common audit procedures used to discover commitments. Review Question 24-5 is helpful here. Discussion Question 24-26 – part a – can also be used to help students distinguish commitments from contingent liabilities.

Review for Subsequent Events (page 764)

We do the following in this area:

- Ask students to define a review for subsequent events
- Ask why it is important to audit subsequent events
- Relate review for subsequent events to the audit report
- Distinguish between the following two types of subsequent events and give an example of each:
  1) Those that have a direct effect on the financial statements and require adjustment
  2) Those that have no direct effect on the financial statements, but for which disclosure is advisable

Timing of subsequent events review procedures (See Figure 24-3, page 765)

Distinguish between a review for subsequent events and a subsequent discovery of facts after the balance sheet date (see page 778 for discussion of subsequent discovery of facts). Figure 24-9 (page 779) and T-24-1 are helpful here. Consider having students work Problem 24-29 to determine the impact of the subsequent events on the financial statements and audit report.

(See Figure 24-9)

(See T-24-1)
Problem 24-30 (This problem ties everything together nicely.)
Nature of subsequent events review procedures
Impact of subsequent events on a public company auditor’s report on internal control over financial reporting.

Final Evidence Accumulation (page 767)

It is worthwhile to go over the four most important parts of the auditor’s final evidence accumulation process:

- Final analytical procedures
- Evaluate going concern assumption
- Client representation letter
- Other information in annual reports

Students should already be familiar with the first three items from their study of previous chapters, but the last item is new information.

Evaluate Results (page 771)

We find it worthwhile to briefly discuss the need to combine the results of all of the tests. Problem 24-33 provides an illustration of how the auditor evaluates known accumulated misstatements found during audit testing. We briefly discuss how the auditor does each of the following items and draws conclusions about each:

- Evaluate whether sufficient appropriate evidence has been accumulated
- Review for financial statement disclosures
- Determine the appropriate type of opinion to issue

Figure 24-8 (page 775) helps students see where evaluating results fits in with the rest of the audit.

(See Figure 24-8)

Audit Documentation Review (page 774)

We spend little time on this except to discuss the purpose of audit documentation review and different levels of review. T-24-2 helps illustrate the different levels of audit documentation review.

(See T-24-2)

Communicate with the Audit Committee and Management (page 776)

Students have difficulty remembering the primary letters between the CPA firm and management or the audit committee. T-24-3 includes six types of letters with information that we ask students to provide.

(See T-24-3)
Auditing standards require the auditor to communicate certain additional information obtained during the audit to those charged with governance, which is often the audit committee. We emphasize that the purpose of these required communications is to encourage two-way dialogue between the auditor and those charged with governance about matters affecting the audit.

**Additional Problems**

To the extent there is time, we use the following:

- 24-22 to 24-25 - Multiple choice
- 24-28 - Inquiry of client's attorneys
- 24-31 – Letter of representations as audit evidence
- Internet Problem 24-1 – Audit committee responsibilities
## CHAPTER 24
### CROSS-REFERENCE OF LEARNING OBJECTIVES AND PROBLEM MATERIAL

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>24-1</strong> Design and perform audit tests related to presentation and disclosure audit objectives.</td>
<td>24-1, 24-2, 24-16</td>
<td></td>
<td>24-26</td>
<td></td>
</tr>
<tr>
<td><strong>24-2</strong> Conduct a review for contingent liabilities and commitments.</td>
<td>24-3, 24-4, 24-5, 24-7</td>
<td>24-22</td>
<td>24-26, 24-27</td>
<td></td>
</tr>
<tr>
<td><strong>24-3</strong> Obtain and evaluate letters from the client’s attorneys.</td>
<td>24-6, 24-7, 24-8, 24-9, 24-11</td>
<td></td>
<td>24-28</td>
<td></td>
</tr>
<tr>
<td><strong>24-4</strong> Conduct a post-balance-sheet review for subsequent events.</td>
<td>24-10, 24-11, 24-12, 24-13, 24-14</td>
<td>24-24</td>
<td>24-29, 24-30</td>
<td></td>
</tr>
<tr>
<td><strong>24-5</strong> Design and perform the final steps in the evidence-accumulation segment of the audit.</td>
<td>24-15, 24-16, 24-17, 24-18, 24-19</td>
<td>24-23, 24-25</td>
<td>24-31, 24-32</td>
<td></td>
</tr>
<tr>
<td><strong>24-6</strong> Integrate the audit evidence gathered, and evaluate the overall audit results.</td>
<td>24-16, 24-20</td>
<td></td>
<td>24-33</td>
<td>24-35</td>
</tr>
<tr>
<td><strong>24-7</strong> Communicate effectively with the audit committee and management.</td>
<td>24-17, 24-21</td>
<td>24-23</td>
<td>24-34</td>
<td></td>
</tr>
<tr>
<td><strong>24-8</strong> Identify the auditor’s responsibilities when facts affecting the audit report are discovered after its issuance.</td>
<td>24-14</td>
<td></td>
<td>24-30</td>
<td></td>
</tr>
</tbody>
</table>
DISTINCTION BETWEEN REVIEW FOR SUBSEQUENT EVENTS AND SUBSEQUENT DISCOVERY OF FACTS AFTER THE BALANCE SHEET DATE

<table>
<thead>
<tr>
<th>Balance Sheet Date</th>
<th>Audit Report Date</th>
</tr>
</thead>
</table>

**SUBSEQUENT EVENTS**

Requires Adjustment

- Transaction or event took place before the balance sheet date.
- An event or transaction occurred between balance sheet and audit report date that affects the valuation of the original transaction.

**REQUIRES DISCLOSURE**

- An event or transaction that occurred between balance sheet and audit report date is so significant that it requires disclosure even though it does not directly affect current period transactions.

**SUBSEQUENT DISCOVERY OF FACTS**

- Original event took place before audit report date.
- Auditor discovered event after the audit report date.
- If auditor had known of facts existing on the balance sheet date he or she would have required adjustment or issued a different opinion.

**REQUIRES RECALL OF FINANCIAL STATEMENTS**
# TYPES OF AUDIT FILE REVIEW

<table>
<thead>
<tr>
<th>Types of Review</th>
<th>Who Does</th>
<th>When Done</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>In-charge review</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Audit partner review</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Independent review</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Peer review</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To download more slides, ebook, solutions and test bank, visit [http://downloadslide.blogspot.com](http://downloadslide.blogspot.com)
# Letters Between Auditor and Management

<table>
<thead>
<tr>
<th>Letter</th>
<th>Purpose</th>
<th>When Sent</th>
<th>Format</th>
<th>Signed By</th>
<th>Addresssee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Engagement Letter</td>
<td>Internal Control Deficiencies</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Letter of Representation</td>
<td>Management Letter</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fraud &amp; Illegal Acts</td>
<td>Attorney Letter</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Communications to Those Charged with Governance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To download more slides, ebook, solutions and test bank, visit [http://downloadslide.blogspot.com](http://downloadslide.blogspot.com)
Chapter 25

Other Assurance Services

There is wide flexibility in using this chapter. We rarely cover all of the material. Our primary objective is to make sure students are familiar with various types of auditor reports and services.

The following are topics covered in the chapter:

- Chapter opening vignette
- Review and compilation services
- Review of interim financial information for public companies
- Attestation engagements
- WebTrust Services and SysTrust Services
- Reports on controls at service organizations
- Prospective financial statements
- Agreed-upon procedures engagements
- Other audits or limited assurance engagements

Chapter Opening Vignette – “Skepticism Applies to All Types of Engagements”

Auditors, like Sherlock Holmes, should develop a strong sense of suspicion about coincidences. This vignette illustrates this and provides a basis for discussing risk assessment and professional skepticism in a review service, rather than a full audit, context.

This vignette also illustrates an independent accountant withdrawing from an engagement. This presents a basis for discussing the notion of withdrawal: When should it be done, how is it done, what are the possible repercussions of withdrawing or not withdrawing?

Review and Compilation Services (page 790)

The primary emphasis in this section is the differences among compilations, SSARS reviews, and audits, plus reporting requirements for each.

First we use Figure 25-1 (page 790) as a frame of reference to discuss the main differences among compilations, reviews, and audits in terms of level of assurance and evidence. This can be tied back to assurance at the beginning of the course.

(See Figure 25-1)

T-25-1 can be used to summarize the differences among these engagements.

(See T-25-1)
Some or all of the following problems are appropriate after this discussion:

- 25-18 – multiple choice
- 25-21 – responsibility to external users for compilations
- 25-22 – responsibility for review services
- 25-23 – required procedures for compilations and reviews
- 25-24 – extent of procedures for review services
- 25-25 – nature of reports for review services
- Internet Problem 25-1 – overview of the Accounting and Review Services Committee (ARSC)

**Review of Interim Financial Information for Public Companies** (page 795)

We briefly cover the requirements for reviews of interim financial information for public companies. We focus on the differences between such reviews and reviews under SSARS. Review Question 25-9 and Problem 25-25 are useful for the discussion of reviews for public companies.

**Attestation Engagements** (page 796)

First we define an attestation engagement and level of assurance (Figure 25-1, page 790). Next we believe students should understand the difference in the purposes of and the nature of attestation standards and generally accepted auditing standards (Table 25-1, page 797). Finally, we emphasize the difference between the three types of attestation engagements: examinations, reviews and agreed-upon procedures (Figure 25-7, page 799).

*(See Table 25-1 and Figures 25-1 and 25-7)*

**WebTrust and SysTrust Services** (page 799)

We like to provide students with an overview of the *WebTrust* and *SysTrust* services. We begin with a brief overview of *WebTrust* services to provide an example of an attestation service related to business-to-consumer and business-to-business e-commerce. Our objective is to help students obtain a basic understanding of the types of assurance CPAs can provide related to e-commerce. We refer to the five principles for Trust Services, which are highlighted in Table 25-2 (page 800). We ask students to describe why companies may choose to engage a CPA to provide a *WebTrust* seal of assurance related to online transactions. We also like to ask students why many large, well-known companies who offer online services for consumers may not engage CPAs to provide a *WebTrust* seal of assurance. This gives us an opportunity to discuss factors that lead to the demand for these services. We use Review Question 25-12 as a basis for this discussion.

*(See Table 25-2)*
We follow our discussion of *WebTrust* with a brief overview of the *SysTrust* attestation service. We begin by distinguishing the objectives of the *SysTrust* and *WebTrust* engagements. Then we briefly overview the five *Trust Services* principles, which are summarized in Table 25-2 (page 800), and identify how they relate to a *SysTrust* engagement. We use Review Question 25-13 as a basis for this discussion. Discussion Question 25-26 is useful for distinguishing *WebTrust* and *SysTrust* services.

*(See Table 25-2)*

**Reports on Controls at Service Organizations** (page 800)

Because of the number of clients that are likely to outsource a portion of the financial accounting system to a third-party service organization, we believe it is important to briefly discuss how auditors of those clients may benefit from a service auditor’s report on internal controls over financial reporting at the service organization. This is particularly important to address in light of the need for service auditor reports in an audit of internal control over financial reporting for accelerated filer public companies that outsource significant processes to service organizations.

We discuss the user auditor’s responsibility to understand the client’s internal controls as described in Chapter 10, even when that client has outsourced certain accounting and financial reporting processes to a service organization. We review the nature of assurance provided by a service auditor’s Type 1 report and contrast that with the assurance provided by a Type 2 service auditor’s report. We call attention to the fact that they will likely hear these reports referred to as SAS 70 reports, even though the guidance for service auditors that was contained in SAS No. 70 has now been moved to the attestation standards.

Review problem 25-14 and Multiple Choice problem 25-19 part b can be used to summarize reports on controls at service centers.

**Prospective Financial Statements** (page 801)

We try to spend some time covering this topic because of the importance of prospective financial statements for the assurance profession. First we distinguish between forecasts and projections. Next we discuss the requirements for an examination of forecasts and projections. Finally, we discuss the appropriate reports to issue. Discussion Question 25-27 provides a nice illustration of the use of forecasts.

**Agreed-Upon Procedures Engagements** (page 803)

We recommend that you briefly discuss the professional standards that deal with agreed-upon procedures engagements: SAS 75 and SSAE 10. You may wish to discuss these primary differences between an agreed-upon procedures engagement under the two standards:

- SAS 75 deals with financial statement items, while SSAE 10 deals with nonfinancial statement subject matter.
- Management must provide a written assertion for an SSAE 10 engagement, but not for an SAS 75 engagement.
Other Audits or Limited Assurance Engagements (page 804)

We introduce the following types of engagements:

- Other comprehensive basis of accounting
- Specified elements, accounts, or items
- Debt compliance letters and similar reports

We then discuss reports on partial statements or on a basis other than GAAP to familiarize students with the audit of individual items on statements and situations other than where a full set of statements, in accordance with GAAP, is being audited. The following summary is useful as a point of departure.

(See T-25-2)

We find it useful to refer students to the four GAAS reporting standards (GAAS #7 through 10) and emphasize:

- The report must clearly indicate the character of the audit. (What is being audited and, in broad terms, what was done.)
- The degree of responsibility the auditor takes
- An expression of opinion on the information being audited, or a statement that an opinion can not be made.

One or more of the following problems are useful at this point:

- 25-20   - multiple choice
- 25-28   - debt compliance letter
### CHAPTER 25
CROSS-REFERENCE OF LEARNING OBJECTIVES AND PROBLEM MATERIAL

<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-2 Describe special engagements to review interim financial information for public companies.</td>
<td>25-9, 25-10</td>
<td></td>
<td>25-25</td>
<td></td>
</tr>
<tr>
<td>25-3 Distinguish AICPA attestation standards from auditing standards and know the type of engagements to which they apply.</td>
<td>25-11</td>
<td>25-19</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25-4 Understand the nature of WebTrust and SysTrust assurance services.</td>
<td>25-12, 25-13</td>
<td></td>
<td>25-26</td>
<td></td>
</tr>
<tr>
<td>25-5 Describe engagements to report on internal controls at service organizations.</td>
<td>25-14</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>25-6 Understand special engagements to attest to prospective financial statements.</td>
<td>25-15</td>
<td>25-19</td>
<td>25-27</td>
<td></td>
</tr>
<tr>
<td>25-7 Define agreed-upon procedures engagements.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>25-8 Describe other audit and limited assurance engagements related to historical financial statements.</td>
<td>25-16, 25-17</td>
<td>25-20</td>
<td>25-28, 25-29, 25-30</td>
<td></td>
</tr>
<tr>
<td>NATURE OF REPORT</td>
<td>WHEN LIKELY TO BE USED</td>
<td>NATURE OF CPA’s PROCEDURES</td>
<td>NATURE OF REPORT (SEE TEXT)</td>
<td></td>
</tr>
<tr>
<td>------------------</td>
<td>------------------------</td>
<td>-----------------------------</td>
<td>-----------------------------</td>
<td></td>
</tr>
<tr>
<td>Compilation—Full Disclosure</td>
<td>Monthly, quarterly and annual statements; limited external use</td>
<td>Minimal—knowledge of client’s business and read statements for reasonableness</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compilation—Omitted Disclosures</td>
<td>Monthly, quarterly and annual statements; management use only</td>
<td>Minimal—knowledge of client’s business and read statements for reasonableness</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compilation—Lacking Independence</td>
<td>CPA owns part of company; management use only</td>
<td>Minimal—knowledge of client’s business and read statements for reasonableness</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Review—SSARS</td>
<td>Private company; quarterly and annual statements; external use by creditors, but no significant loans</td>
<td>Knowledge of business, analytical procedures, inquiries of management, and read for reasonableness</td>
<td>Includes limited (negative) assurance</td>
<td></td>
</tr>
<tr>
<td>Review of Interim Financial Information</td>
<td>Public company; quarterly reports to the SEC; extensive reliance by external users</td>
<td>Knowledge of business, analytical procedures, inquiries of management, read for reasonableness, and letter of representation</td>
<td>Includes limited (negative) assurance</td>
<td></td>
</tr>
<tr>
<td>Audit</td>
<td>Annual statements; considerable variation in nature and extent of users</td>
<td>Extensive audit evidence</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## AUDIT OF PARTS OR TOTAL FINANCIAL STATEMENTS

<table>
<thead>
<tr>
<th>WHAT IS BEING AUDITED</th>
<th>EXAMPLE</th>
<th>NATURE OF REPORT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual amount on statements</td>
<td>Inventories only</td>
<td>Special report AU 623.11-18</td>
</tr>
<tr>
<td>Individual statement (GAAP)</td>
<td>Balance sheet only</td>
<td>Standard report, modified wording</td>
</tr>
<tr>
<td>All statements except statement of cash flows (GAAP)</td>
<td>Manufacturing company—excludes statement of cash flows</td>
<td>Standard report, &quot;except for&quot; opinion qualification</td>
</tr>
<tr>
<td>All statements (GAAP)</td>
<td>Manufacturing company—all statements and footnotes</td>
<td>Standard report</td>
</tr>
<tr>
<td>Other comprehensive basis of accounting</td>
<td>Cash basis</td>
<td>Special report See AU 623.05-10</td>
</tr>
<tr>
<td>Information accompanying basic financial statements</td>
<td>Manufacturing company—all statements plus supplemental information</td>
<td>Standard report plus report on supplemental information (See AU 551)</td>
</tr>
</tbody>
</table>
Chapter 26

Internal and Governmental Financial Auditing and Operational Auditing

In writing this chapter and in teaching it, we believe that it is essential not to get too detailed in identifying the specific steps in performing internal financial audits, governmental financial audits, or operational audits. We believe that all three types of audits require considerable analytical skill and creativity. We also believe that it is a disservice to operational auditing to spend a lot of time on the steps in performing an operational audit or writing a report. Students are likely to be more interested in applying the concepts learned in the chapter to the cases at the end of the chapter.

Chapter Opening Vignette – “Good Auditing Often Results in Improved Cash Flows”

This vignette is presented in the context of an internal auditor's work, but it could also relate to external auditors. It illustrates the principle that whenever a significant misstatement is found, there should also be a corresponding opportunity for significant improvement in the company's systems. In this case, the improvement results in a significant recovery of receivables and improved cash flows.

Another view of this case is that it represents an example for the use of statistical methods. The specific methods that might be used can be discussed, as well as the problem of discussing statistical results with people who aren’t familiar with such technical subject matter.

Internal Financial Auditing (page 816)

Coverage of internal financial auditing is significant because many students may work as internal auditors sometime during their professional careers. We suggest that this topic be covered before discussing operational auditing. The following topics should be covered:

- The Institute of Internal Auditors (IIA)
- Professional standards (See Figure 26-1, page 817)
- Relationship of internal and external auditors

We emphasize how internal auditors are expected to provide added value. We also suggest that students visit the IIA website (www.theiia.org) to learn more about the IIA and the requirements for becoming a certified internal auditor.

Any of the following problem material can be used to enhance the students' understanding of internal financial auditing:

- Review Questions 26-1, 26-2, and 26-3
- Multiple Choice Question 26-23
- Cases 26-24 and 26-25
- Internet problem 26-1

To download more slides, ebook, solutions and test bank, visit http://downloadslide.blogspot.com
Governmental Financial Auditing (page 819)

We believe that it is important to contrast governmental financial auditing with traditional financial statement auditing. We suggest covering the following topics during the discussion of governmental financial auditing:

- Audit and reporting requirements under the "Yellow Book" (Government Auditing Standards)
- Audit and reporting requirements under the Single Audit Act and OMB Circular A-133
- AICPA guidance, specifically AU 801 and audit guide Government Auditing Standards and Circular A-133 Audits

Review Questions 26-4 through 26-8 may be used during this discussion.

Differences Between Operational and Financial Auditing (page 821)

We discuss this topic at some length because we believe it is important. This topic can be tied into "Phases in Operational Auditing" (page 827), especially with respect to reporting and follow-up.

Effectiveness Versus Efficiency (page 822)

When we discuss effectiveness and efficiency, we make sure that the students understand the difference between them. The use of examples is essential for coverage of this material. It is also useful to discuss why it is more common to see efficiency audits than effectiveness audits (easier to measure results).

Types of Operational Audits (page 823)

We spend some time on this topic and relate it back to our discussion in Chapter 1 (types of auditors - pages 15-16).

We ask the students to tell us how they would audit each of the following entities and what they would be most concerned about in the audits:

- hospital
- university
- library

Generally, the discussion is quite lively and the students become quite resourceful. They seem to enjoy the exercise. Any of cases 26-24 through 26-28 are good tests of their understanding.

Criteria for Evaluating Efficiency and Effectiveness (page 826)

This topic is essential. We point out that the auditor must have some criteria to evaluate efficiency and effectiveness. We discuss GAAP as criteria for a financial audit as an example.
Phases in Operational Auditing (page 827)

We compare these phases to the phases in a financial audit – for example see Figure 13-9 (page 425). We emphasize the differences, especially with respect to "reporting and follow-up." T-26-1 summarizes the three phases of operational auditing.

(See Figure 13-9)

(See T-26-1)

Examples of Operational Audit Findings (page 828)

The students find this section interesting. We also direct them to the Internal Auditor for more examples. An interesting assignment is to have students bring more examples to class from the Internal Auditor. For example, groups of four might be asked to bring one interesting example of an efficiency finding and another interesting example of an effectiveness finding for distribution to the entire class. This project does three things: it familiarizes students with the Internal Auditor, it requires them to compare efficiency and effectiveness auditing, and it requires them to read examples of operational findings, which they are likely to find interesting.
<table>
<thead>
<tr>
<th>Learning Objectives</th>
<th>Review Questions</th>
<th>Multiple Choice Questions</th>
<th>Discussion Questions and Problems</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>26-1 Explain the role of internal auditors in financial auditing.</td>
<td>26-1, 26-2, 26-3</td>
<td>26-20, 26-23</td>
<td></td>
<td>26-24, 26-25</td>
</tr>
<tr>
<td>26-2 Describe the auditing and reporting requirements under Government Auditing Standards and the Single Audit Act.</td>
<td>26-4, 26-5, 26-6, 26-7, 26-8</td>
<td></td>
<td>26-21</td>
<td></td>
</tr>
<tr>
<td>26-3 Distinguish operational auditing from financial auditing.</td>
<td>26-9, 26-10</td>
<td></td>
<td>26-22</td>
<td></td>
</tr>
<tr>
<td>26-4 Provide an overview of operational audits.</td>
<td>26-11, 26-12, 26-13, 26-14, 26-15</td>
<td>26-20, 26-22, 26-23</td>
<td></td>
<td>26-24, 26-25, 26-27, 26-28</td>
</tr>
<tr>
<td>26-5 Plan and perform an operational audit.</td>
<td>26-16, 26-17, 26-18, 26-19</td>
<td>26-22, 26-23</td>
<td></td>
<td>26-25, 26-26, 26-27, 26-28</td>
</tr>
</tbody>
</table>
PHASES IN OPERATIONAL AUDITING

PLANNING
- Scope of engagement
- Staffing
- Background information
- Understand internal control
- Decide on appropriate evidence

EVIDENCE ACCUMULATION AND EVALUATION
- Documentation
- Client inquiry
- Observation

REPORTING AND FOLLOW-UP
- Report usually sent to management
- Tailored reports
- Follow-up on recommendations *with management*