AUDITING
AND ASSURANCE SERVICES
AN INTEGRATED APPROACH
SEVENTEENTH EDITION

ALVIN A. ARENS
Former PricewaterhouseCoopers
Emeritus Professor
Michigan State University

RANDAL J. ELDER
The University of North Carolina at Greensboro
Dixon Hughes Goodman Professor and Department Head

MARK S. BEASLEY
North Carolina State University
Deloitte Professor of Enterprise Risk Management

CHRIS E. HOGAN
Michigan State University
Russell E. Palmer Endowed Professor and Department Chairperson

Pearson
CONTINUING THE LEGACY OF ALVIN A. ARENS

ALVIN A. ARENS: The author team of Randy Elder, Mark Beasley, and Chris Hogan, are pleased to continue the outstanding legacy of our book’s founding author, Al Arens, in this 17th edition of Auditing and Assurance Services: An Integrated Approach. As was done for the 15th and 16th editions, we again dedicate this new edition to Al’s memory.

Randy and Mark joined Al as coauthors on this textbook in the 8th edition, and have been honored to continue Al’s leadership in helping shape classroom instruction and student learning about auditing concepts and their practical implementation around the world. Since the first edition was published, this textbook has impacted audit education for nearly 40 years in the U.S. and globally, including seven different language translations. Al’s leadership at national and international levels and his commitment to expanding knowledge through the development of educational materials, including this textbook, continue to inspire us as we strive to advance his legacy for future generations of auditing professionals.

Al was the PricewaterhouseCoopers Auditing Professor and member of the Accounting & Information Systems faculty in the Eli Broad College of Business at Michigan State University from 1968 through 2007. Thus, we are especially pleased that Chris Hogan, Professor at Michigan State University, joined the author team in the 16th edition, continuing the Michigan State connection started by Al.

Among his many honors, Al was selected as one of five national auditing educators to hold a Price Waterhouse Auditing professorship, was honored as AICPA Educator of the Year, served on the AICPA Auditing Standards Board, and was President of the American Accounting Association. Al taught accounting, mainly auditing, with a passion that is legendary. He had a heart for sharing his knowledge of auditing with students throughout his career.

This 17th edition continues his outstanding legacy in audit education.
ABOUT THE AUTHORS

ALVIN A. ARENS  
Al Arens, founding author of this textbook, was the PricewaterhouseCoopers Professor of Accounting Emeritus at Michigan State University. In addition to writing books on auditing, he was a coauthor of computerized accounting supplements and he was actively involved in the continuing education of practitioners with local and regional CPA firms. Al was a past president of the American Accounting Association and a former member of the AICPA Auditing Standards Board. He practiced public accounting with both a local CPA firm and the predecessor firm to Ernst & Young. He received many awards including the AAA Auditing Section Outstanding Educator award, the AICPA Outstanding Educator award, the national Beta Alpha Psi Professor of the Year award, and many teaching and other awards at Michigan State.

RANDAL J. ELDER  
Randy Elder, who has served as a coauthor of this textbook since the 8th edition, is Dixon Hughes Goodman Professor and Department Head of Accounting and Finance at the University of North Carolina at Greensboro. He teaches undergraduate and graduate auditing courses, and has received several teaching awards. His research focuses on audit quality and current audit firm practices and he served as the team leader for the American Accounting Association Auditing Section PCAOB research synthesis teams on audit confirmations and audit sampling. He has extensive public accounting experience with a large regional CPA firm, frequently teaches continuing education for a large international CPA firm, and is a member of the AICPA.

MARK S. BEASLEY  
Mark Beasley, who has also served as a coauthor of this textbook since the 8th edition, is the Deloitte Professor of Enterprise Risk Management and Professor of Accounting at North Carolina State University. He has taught undergraduate and graduate auditing courses, and has received several teaching awards including membership in NC State’s Academy of Outstanding Teachers. He has extensive professional audit experience with the predecessor firm to Ernst & Young and has extensive standards-setting experience working with the Auditing Standards Board as a Technical Manager in the Audit and Assurance Division of the AICPA. He served on the ASB Fraud Standard Task Force responsible for developing SAS 99, the ASB Antifraud Programs and Controls Task Force, and the Advisory Council overseeing the COSO Enterprise Risk Management—Integrated Framework project. He served over seven years as a member of the COSO Board, representing the AAA.

CHRIS E. HOGAN  
We are pleased that Chris Hogan joined us as a coauthor starting with the 16th edition. Chris is the Russell E. Palmer Endowed Professor of Accounting and Department Chairperson in the Eli Broad College of Business at Michigan State University. We are thrilled to continue the Michigan State connection started by Al Arens. Chris teaches graduate auditing and her research focuses on internal controls and integrated audits, audit firm client portfolios, and the impact of regulation on audit markets. Chris has auditing experience with Price Waterhouse, one of the predecessor firms to PricewaterhouseCoopers, LLP. She has served in multiple leadership roles within the American Accounting Association, including serving as President of the Auditing Section and on the Audit Committee of the AAA.
CONTENTS

PREFACE XVII

THE AUDITING PROFESSION

PART 1

THE DEMAND FOR AUDIT AND OTHER ASSURANCE SERVICES

CHAPTER 1

LEARNING OBJECTIVES 3
Nature of Auditing 4
Distinction Between Auditing and Accounting 6
Economic Demand for Auditing 6
Assurance Services 8
Types of Audits 12
Types of Auditors 14
Certified Public Accountant 16
Summary 17
Essential Terms 17
Review Questions 18
Multiple Choice Questions From CPA Examinations 18
Multiple Choice Questions From Becker CPA Exam Review* 19
Discussion Questions and Problems 20

CHAPTER 2

LEARNING OBJECTIVES 24
Certified Public Accounting Firms 25
Structure of CPA Firms 27
Sarbanes–Oxley Act and Public Company Accounting Oversight Board 29
Securities and Exchange Commission 30
American Institute of Certified Public Accountants (AICPA) 31
International and U.S. Auditing Standards 32
Organization of U.S. Auditing Standards 34
Quality Control 38
Summary 40
Essential Terms 41
Review Questions 42

*Multiple Choice Questions Becker Professional Education.
CONTENTS

CHAPTER 3

AUDIT REPORTS

LEARNING OBJECTIVES  47
Standard Unmodified Opinion Audit Report for Nonpublic Entities  48
Conditions for Standard Unmodified Opinion Audit Report  51
Standard Audit Report and Report on Internal Control Over Financial Reporting Under PCAOB Auditing Standards  52
Modifications to the Opinion in the Audit Report  62
Materiality  63
Discussion of Conditions Requiring a Modification of Opinion  67
Auditor’s Decision Process for Audit Reports  71
International Accounting and Auditing Standards  73
Summary  73
Essential Terms  74
Review Questions  74
Multiple Choice Questions From CPA Examinations  75
Multiple Choice Questions From Becker CPA Exam Review*  76
Discussion Questions and Problems  77

CHAPTER 4

PROFESSIONAL ETHICS

LEARNING OBJECTIVES  82
What Are Ethics?  83
Ethical Dilemmas  84
Special Need for Ethical Conduct in Professions  87
Code of Professional Conduct  89
Independence Rule  94
Sarbanes–Oxley and Related Independence Requirements  98
Other Rules of Conduct  101
Enforcement  108
Summary  110
Essential Terms  111
Review Questions  111
Multiple Choice Questions From CPA Examinations  112
Multiple Choice Questions From Becker CPA Exam Review*  113
Discussion Questions and Problems  113
Cases  117

CHAPTER 5

LEGAL LIABILITY

LEARNING OBJECTIVES  119
Legal Environment for CPAs  120
Distinguishing Business Failure, Audit Failure, and Audit Risk  121
Legal Concepts Affecting Liability  122
CONTENTS

Essential Terms  216
Review Questions  218
Multiple Choice Questions From CPA Examinations  219
Multiple Choice Questions From Becker CPA Exam Review*  220
Discussion Questions and Problems  221

CHAPTER 8
AUDIT PLANNING AND MATERIALITY
LEARNING OBJECTIVES  229
Planning  230
Accept Client and Perform Initial Audit Planning  231
Understand the Client's Business and Industry  236
Perform Preliminary Analytical Procedures  241
Materiality  244
Materiality for Financial Statements as a Whole  245
Determine Performance Materiality  248
Estimate Misstatement and Compare With Preliminary Judgment  250
Summary  252
Essential Terms  254
Review Questions  255
Multiple Choice Questions From CPA Examinations  256
Multiple Choice Questions From Becker CPA Exam Review*  257
Discussion Questions and Problems  258
Case  266
Integrated Case Application—Pinnacle Manufacturing: Part I  267

CHAPTER 9
ASSESSING THE RISK OF MATERIAL MISSTATEMENT
LEARNING OBJECTIVES  270
Audit Risk  271
Risk Assessment Procedures  272
Considering Fraud Risk  276
Identification of Significant Risks  277
Audit Risk Model  278
Assessing Acceptable Audit Risk  282
Assessing Inherent Risk  285
Relationship of Risks to Evidence and Factors Influencing Risks  288
Relationship of Risk and Materiality to Audit Evidence  292
Summary  293
Essential Terms  294
Review Questions  294
Multiple Choice Questions From CPA Examinations  295
Multiple Choice Questions From Becker CPA Exam Review*  297
Discussion Questions and Problems  297
Case  302
Integrated Case Application—Pinnacle Manufacturing: Part II  302
ASSESSING AND RESPONDING TO FRAUD RISKS

LEARNING OBJECTIVES 304
Types of Fraud 305
Conditions for Fraud 306
Assessing the Risk of Fraud 310
Corporate Governance Oversight to Reduce Fraud Risks 314
Responding to the Risk of Fraud 318
Specific Fraud Risk Areas 321
Responsibilities When Fraud is Suspected 326
Documenting the Fraud Assessment 330
Summary 331
Essential Terms 331
Review Questions 332
Multiple Choice Questions From CPA Examinations 333
Multiple Choice Questions From Becker CPA Exam Review* 334
Discussion Questions and Problems 335
Integrated Case Application—Pinnacle Manufacturing: Part III 341

INTERNAL CONTROL AND COSO FRAMEWORK

LEARNING OBJECTIVES 342
Internal Control Objectives 343
Management and Auditor Responsibilities for Internal Control 344
COSO Components of Internal Control 347
Internal Controls Specific to Information Technology 356
Impact of IT Infrastructure on Internal Control 363
Summary 365
Essential Terms 365
Review Questions 367
Multiple Choice Questions From CPA Examinations 368
Multiple Choice Questions From Becker CPA Exam Review* 369
Discussion Questions and Problems 369
Case 373

ASSESSING CONTROL RISK AND REPORTING ON INTERNAL CONTROLS

LEARNING OBJECTIVES 375
Obtain and Document Understanding of Internal Control 376
Assess Control Risk 379
Tests of Controls 384
Decide Planned Detection Risk and Design Substantive Tests 390
Auditor Reporting On Internal Control 390
Evaluating, Reporting, and Testing Internal Control for Nonpublic and Smaller Public Companies  393
Impact of IT Environment on Control Risk Assessment and Testing  395
Summary  399
Essential Terms  399
Review Questions  401
Multiple Choice Questions From CPA Examinations  402
Multiple Choice Questions From Becker CPA Exam Review*  403
Discussion Questions and Problems  404
Case  412
Integrated Case Application—Pinnacle Manufacturing: Part IV  413

CHAPTER
13
OVERALL AUDIT STRATEGY AND AUDIT PROGRAM

LEARNING OBJECTIVES  416
Types of Tests  417
Selecting Which Types of Tests to Perform  423
Evidence Mix  426
Design of the Audit Program  428
Summary of Key Evidence-Related Terms  437
Summary of the Audit Process  438
Summary  442
Essential Terms  442
Review Questions  443
Multiple Choice Questions From CPA Examinations  444
Multiple Choice Questions From Becker CPA Exam Review*  445
Discussion Questions and Problems  446
Cases  451

PART
3
APPLICATION OF THE AUDIT PROCESS TO THE SALES AND COLLECTION CYCLE

CHAPTER
14
AUDIT OF THE SALES AND COLLECTION CYCLE: TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS

LEARNING OBJECTIVES  455
Accounts and Classes of Transactions in the Sales and Collection Cycle  456
Business Functions in the Cycle and Related Documents and Records  457
Methodology for Designing Tests of Controls and Substantive Tests of Transactions for Sales  462
Sales Returns and Allowances  474
Methodology for Designing Tests of Controls and Substantive Tests of Transactions for Cash Receipts  474
Audit Tests for Uncollectible Accounts  478
Effect of Results of Tests of Controls and Substantive Tests of Transactions 479
Summary 480
Essential Terms 481
Review Questions 481
Multiple Choice Questions From CPA Examinations 482
Multiple Choice Questions From Becker CPA Exam Review* 484
Discussion Questions and Problems 484
Case 491
Integrated Case Application—Pinnacle Manufacturing: Part V 492

AUDIT SAMPLING FOR TESTS OF CONTROLS
AND SUBSTANTIVE TESTS OF TRANSACTIONS

LEARNING OBJECTIVES 493
Representative Samples 494
Statistical Versus Nonstatistical Sampling and Probabilistic Versus
Nonprobabilistic Sample Selection 495
Sample Selection Methods 496
Sampling for Exception Rates 499
Application of Nonstatistical Audit Sampling 500
Statistical Audit Sampling 516
Application of Statistical Attributes Sampling 518
Summary 523
Essential Terms 523
Review Questions 524
Multiple Choice Questions From CPA Examinations 525
Multiple Choice Questions From Becker CPA Exam Review* 527
Discussion Questions and Problems 527
Case 533
Integrated Case Application—Pinnacle Manufacturing: Part VI 533

COMPLETING THE TESTS IN THE SALES AND
COLLECTION CYCLE: ACCOUNTS RECEIVABLE

LEARNING OBJECTIVES 535
Methodology for Designing Tests of Details of Balances 536
Designing Tests of Details of Balances 542
Confirmation of Accounts Receivable 549
Developing Tests of Details Audit Program 555
Summary 558
Essential Terms 558
Review Questions 559
Multiple Choice Questions From CPA Examinations 560
Multiple Choice Questions From Becker CPA Exam Review* 562
Discussion Questions and Problems 562
Case 569
Integrated Case Application—Pinnacle Manufacturing: Part VII 570
COMPLETING THE TESTS IN THE ACQUISITION AND PAYMENT CYCLE: VERIFICATION OF SELECTED ACCOUNTS

LEARNING OBJECTIVES 649
Types of Other Accounts in the Acquisition and Payment Cycle 650
Audit of Property, Plant, and Equipment 650
Audit of Prepaid Expenses 658
Audit of Accrued Liabilities 661
Audit of Income and Expense Accounts 663
Summary 666
Essential Terms 667
Review Questions 667
Multiple Choice Questions From CPA Examinations 668
Multiple Choice Questions From Becker CPA Exam Review* 669
Discussion Questions and Problems 670
Cases 673

AUDIT OF THE PAYROLL AND PERSONNEL CYCLE

LEARNING OBJECTIVES 676
Accounts and Transactions in the Payroll and Personnel Cycle 677
Business Functions in the Cycle and Related Documents and Records 677
Methodology for Designing Tests of Controls and Substantive Tests of Transactions 680
Methodology for Designing Substantive Analytical Procedures and Tests of Details of Balances 686
Summary 690
Essential Terms 690
Review Questions 691
Multiple Choice Questions From CPA Examinations 692
Multiple Choice Questions From Becker CPA Exam Review* 693
Discussion Questions and Problems 693
Case 697

AUDIT OF THE INVENTORY AND WAREHOUSING CYCLE

LEARNING OBJECTIVES 699
Business Functions in the Cycle and Related Documents and Records 700
Parts of the Audit of Inventory 702
Audit of Cost Accounting 705
Substantive Analytical Procedures 708
Physical Observation of Inventory 709
Audit of Pricing and Compilation 713
Integration of the Tests 716
## CONTENTS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>Audit of the Capital Acquisition and Repayment Cycle</td>
<td>730</td>
</tr>
<tr>
<td>23</td>
<td>Audit of Cash and Financial Instruments</td>
<td>751</td>
</tr>
<tr>
<td>24</td>
<td>Completing the Audit</td>
<td>781</td>
</tr>
</tbody>
</table>

### Learning Objectives

- **Chapter 22**
  - Accounts in the Cycle 731
  - Notes Payable 732
  - Owners' Equity 736

- **Chapter 23**
  - Types of Cash and Financial Instruments Accounts 752
  - Cash in the Bank and Transaction Cycles 754
  - Audit of the General Cash Account 755
  - Fraud-Oriented Procedures 763
  - Audit of Financial Instruments Accounts 768

- **Chapter 24**
  - Perform Additional Tests for Presentation and Disclosure 782
  - Review for Contingent Liabilities and Commitments 783

### Additional Sections

- Summary 718
- Essential Terms 718
- Review Questions 719
- Multiple Choice Questions From CPA Examinations 720
- Multiple Choice Questions From Becker CPA Exam Review* 720
- Discussion Questions and Problems 721
- Case 728

- Summary 743
- Essential Terms 743
- Review Questions 743
- Multiple Choice Questions From CPA Examinations 744
- Multiple Choice Questions From Becker CPA Exam Review* 745
- Discussion Questions and Problems 746

- Summary 771
- Essential Terms 771
- Review Questions 772
- Multiple Choice Questions From CPA Examinations 773
- Multiple Choice Questions From Becker CPA Exam Review* 774
- Discussion Questions and Problems 774
OTHER ASSURANCE AND NONASSURANCE SERVICES

OTHER ASSURANCE SERVICES

LEARNING OBJECTIVES  815
Review, Compilation, and Preparation Services  816
Review of Interim Financial Information for Public Companies  822
Attestation Engagements  823
Reports on Controls at Service Organizations (SOC Reports)  827
Prospective Financial Statements  829
Agreed-Upon Procedures Engagements  831
Other Audits or Limited Assurance Engagements  831
Summary  834
Essential Terms  834
Review Questions  835
Multiple Choice Questions from CPA Examinations  836
Multiple Choice Questions From Becker CPA Exam Review*  837
Discussion Questions and Problems  838

INTERNAL AND GOVERNMENTAL FINANCIAL AUDITING AND OPERATIONAL AUDITING

LEARNING OBJECTIVES  842
Internal Financial Auditing  843
Governmental Financial Auditing  846
Operational Auditing  849
Summary  856
Essential Terms  856
Review Questions  857
Multiple Choice Questions From CPA, CIA, and CMA Examinations  858
Multiple Choice Questions From Becker CPA Exam Review*  859
Discussion Questions and Problems  860

INDEX  864

CREDITS  874
The primary emphasis in this text is on the auditor’s decision-making process in a financial statement audit, as well as an integrated audit of both financial statements and internal control over financial reporting required for accelerated filer public companies. We believe that the most fundamental concepts in auditing concern determining the nature and amount of evidence the auditor should gather after considering the unique circumstances of each engagement. If students of auditing understand the objectives to be accomplished in a given audit area, the risks related to the engagement, and the decisions to be made, they should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained.

To improve student results, we recommend pairing the text content with MyLab Accounting, which is the teaching and learning platform that empowers you to reach every student. By combining trusted author content with digital tools and a flexible platform, MyLab personalizes the learning experience and will help your students learn and retain key course concepts while developing skills that future employers are seeking in their candidates.

New auditing standards are released without regard to textbook revision cycles. As auditing instructors, we appreciate how critical it is to have the most current content available. This edition includes guidance in the recently issued SAS No. 133, An Auditor Involvement with Exempt Offering Documents, and PCAOB standards, including the new standard auditor’s report contained in AS 3101, The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards. In addition, we have included coverage of the AICPA’s Auditing Standards Board pending revision of the auditor’s standard unmodified opinion audit report, so that our coverage of audit reports is up to date (as discussed further below). It is important to note that as part of this project, the AICPA also revised the management assertions. The changes to the assertions are reflected throughout the text.

Now that the AICPA has completed its Clarity Project for auditing, attestation, and accounting and review services engagements, all chapters of the textbook reflect the various revisions resulting from the issuance of the Clarity standards, including coverage up through the issuance of SSARS No. 23, Omnibus Statement on Standards for Accounting and Review Services—2016 and SSAE No. 18, Attestation Standards: Clarification and Recodification. We are committed to continually providing you with up-to-date content in this dynamic global auditing environment and will keep you updated with highlights posted on our website of major changes in new standards as they are issued.

Both the AICPA’s Auditing Standards Board (ASB) and the PCAOB have recently revised guidance related to auditor reporting to make the audit report more informative to users. These changes significantly changed the format and length of content included in the auditor’s report. Most notably, auditors of public companies must include in the auditor’s standard unmodified opinion report disclosure of “critical audit matters” (CAMs), which represent issues that involved especially challenging, subjective, or complex auditor judgment and how the auditor addressed those matters. While auditors of nonpublic entities are not required to include those disclosures,
the new audit reporting standard proposed by the ASB provides reporting guidance for auditors who are engaged to communicate “key audit matters” (KAMs), which are similar in nature to CAMs in the PCAOB guidance. Chapter 3 provides extensive coverage of these new auditor report guidelines, including a number of illustrations of auditor reports for different engagement circumstances.

The Internet and extensive use of technologies and automation by entities to engage in all types of business transactions and services have dramatically increased the amount of data available for analysis. The audit profession is rapidly exploring how audit data analytics (ADAs) and advanced technologies might allow them to increase both audit quality and efficiency. The 17th edition of this textbook includes new coverage of how ADAs are being used in all phases of the audit, spanning from initial planning through the completion of the audit.

We provide an extensive introduction to ADAs in Chapter 7, including coverage of best practices related to accessing and preparing the data, evaluating the relevance and reliability of that data, addressing large numbers of exceptions for further consideration, and documenting the use of ADAs. We also include coverage of different types of advanced technologies, including artificial intelligence, robotics, machine learning, and deep learning. Additionally, many of the remaining chapters of the textbook include callout “Data Analytics” boxes that highlight different ways auditors are using ADAs in the various financial statement cycles to perform tests of controls, substantive tests of transactions, substantive analytical procedures, and tests of details. These callout boxes help students see how ADAs are transforming the nature, timing, and extent of audit procedures in all aspects of the audit.

To provide students hands-on experience in using various data analytics tools, we have developed an entirely new dataset that includes different files of transaction data related to the sales and collection cycle for a hypothetical company, JA Tire Manufacturing. This dataset, which students can access from the textbook website, includes different sub-files that contain transaction data related to JA Tire Manufacturing’s sales orders, bills of lading, invoices, cash receipts, customer master file, and product master file. We have developed several new homework problems included in different chapters that require students to analyze data in the various sub-files of the dataset for JA Tire Manufacturing. Because the dataset is in Excel, the new homework problems allow
students to use any software, such as ACL, Excel, IDEA, or Tableau, to conduct their data analysis. Thus, instructors have the flexibility to choose which software tool they would like students to use to perform the analyses. These problems are indicated by a data analytics icon in the margin next to the problem.

In addition to the new homework problems using the dataset of JA Tire Manufacturing, we have also included a number of other problems in the text that can be completed using Excel templates that are available on the text website. These problems are indicated by a spreadsheet icon in the margin next to the problem. In addition, we have included selected problems using ACL in several chapters in the text, indicated with a data analytics icon. These problems are related to the topic of the chapter so that students can see how audit software is used to perform specific types of audit tests. Guidance for students on the use of ACL is included on the text website.

Critical thinking and research skills are becoming increasingly important for students as they enter the accounting profession. To help students further develop those skills, we have continued our inclusion of homework problems in the 17th edition that require students to conduct Internet-based research to address various audit issues. Some of those research problems have students work with actual SEC filings by companies, which expose students to relevant examples of audit-related decisions. Other problems require students to conduct research of auditing standards to determine the relevant guidance applicable to a given audit issue.

With the profession’s continued focus on the importance of applying appropriate levels of professional skepticism, we have continued our coverage of this topic in Chapter 6, along with integrated coverage in later chapters, including Chapter 10, which addresses the auditor’s responsibilities for detecting fraud. We discuss the importance of a questioning mindset and the need to critically evaluate audit evidence to strengthen student awareness of the elements of effective professional skepticism.

To assist auditors with maintaining an appropriate level of professional skepticism when making professional judgments during an audit, this edition features the Center for Audit Quality’s Professional Judgment Resource, which outlines key elements of a process that auditors apply when making professional judgments. Chapter 6 illustrates an effective decision-making process that guides auditors’ thinking to help them be aware of their own judgment tendencies, traps, and biases. We include several homework problems that expose students to this judgment framework and a number of the common traps and biases.

The requirements of the Sarbanes-Oxley Act of 2002 and the PCAOB Auditing Standard 5 (now AS 2201) that impact accelerated filer public companies are integrated throughout the text and so are the risk assessment standards issued by the Auditing Standards Board. Chapter 2 emphasizes the importance of understanding the client’s business and its environment, including internal control. Chapter 3...
highlights reporting on internal controls over financial reporting for auditors of accelerated filer public companies.

We have always emphasized understanding the client’s business and industry in planning. Chapters 8–12 include coverage of the auditor’s performance of risk assessment procedures, including the identification of significant risks. Chapter 9 addresses the performance of risk assessment procedures to address the risk of material misstatement, followed in Chapter 10 with discussion of assessing and responding to the risk of fraud.

Our coverage in Chapters 11 and 12 of internal controls, including coverage of IT general and application controls, reflects key elements of COSO’s 2013 revision of its Internal Control—Integrated Framework and integrates the auditor’s consideration of both manual and automated controls. Chapter 11 introduces students to important elements of effective internal controls, including those related to IT, while Chapter 12 outlines the auditor’s responsibilities to understand the design and operating effectiveness of internal control and also highlights auditor reports on internal control over financial reporting. Subsequent chapters that focus on the transaction cycles include extensive coverage of internal controls to help students understand how the auditor’s consideration of internal controls is integrated for audits of the financial statements and internal controls over financial reporting.

---

**Emphasis on International Issues**

Chapter 1 introduces the importance of considering international auditing standards developments, followed by discussion in Chapter 2 about the role of the International Auditing and Assurance Standards Board (IAASB) in the issuance of International Standards on Auditing (ISAs) and the Auditing Standards Board’s efforts to converge U.S. standards to international standards. Chapter 3 highlights implications for auditor reports on companies reporting under International Financial Reporting Standards (IFRS). Several chapters throughout the book include text or mid-chapter vignette coverage of international issues, and international issues are also addressed in homework problems.

**Expanded Coverage of Auditing Asset Impairments**

Given the complexity associated with auditing management’s assessment of the valuation of certain assets, such as property, plant, and equipment and goodwill, we have expanded our coverage of audit issues related to impairment evaluations. Chapter 19 includes expanded coverage of issues surrounding the facts and circumstances of auditing management’s method of determining fair value and whether management has appropriately accounted for and disclosed impairment of those assets. We have included a new vignette in that chapter that specifically addresses the two-step process of conducting a goodwill impairment analysis.

**Coverage of Financial Instruments**

With the increasing volume and complexity of various types of financial instruments and challenges associated with fair value accounting, Chapter 23 addresses issues associated with auditing financial instruments and obtaining sufficient appropriate audit evidence for fair value account estimates. We believe this guidance will help strengthen students’ understanding of the challenges associated with auditing financial instruments.

**Service Organization Controls (SOC) Reports**

With more organizations taking advantage of cloud computing options and third-party IT service providers, there is a greater need for information about the design and operating effectiveness of internal controls provided by these external service providers. This 17th edition contains coverage of service organization control (SOC) reports issued by service center auditors. Both Chapters 12 and 25 reflect the guidance for service auditors reporting on internal controls at service organizations, including coverage of the different types of reports provided in SOC 1, SOC 2, and SOC 3 engagements.
The issuance of SSARS No. 21 introduced a new type of nonattest engagement service that allows nonissuers to engage a CPA to help management prepare monthly, quarterly, or annual financial statements without providing any assurance on the financial statements or issuing a report, even if the financial statements are expected to be used by, or provided to, a third party. Chapter 25 describes this new type of service and distinguishes it from compilation and review engagement requirements.

To help students connect the important auditing concepts to real-world situations, each chapter begins with an opening vignette that illustrates practice issues relevant to that chapter’s content, and each chapter includes several short vignettes spread throughout the content of that chapter. Many of these vignettes have been updated to reflect recent real-world events to help students understand the significance of the content covered.

Concept Checks, introduced in the 16th edition, appear periodically within each chapter and highlight short-answer questions to help students recap content covered within different sections of the chapter. These short in-chapter review questions are intended to help call students’ attention to key concepts as they read the material in the chapter.

Linking in the eText will allow students to check their understanding in MyLab Accounting without interrupting their interaction with the eText. These questions are also available for assignment in MyLab Accounting.
INTEGRATED CASE APPLICATION —
PINEAPPLE MANUFACTURING: PART I

The annual report for the Hillsburg Hardware Company is included as an insert to the text. Financial statements and other information included in the annual report are used in examples throughout the text to illustrate chapter concepts. The annual report also includes management’s report on internal control as required by the Sarbanes-Oxley Act Section 404a and the auditor’s report required by Section 404b, consistent with PCAOB auditing standards.

The Pinnacle Manufacturing integrated case is based on a large, multi-division company. The case has been revised based on new financial statement data, and it consists of seven parts distributed at the end of each respectively relevant chapter. Each part of the case is designed to give students hands-on experience, and the parts of the case are connected so that students will gain a better understanding of how the parts of the audit are integrated by the audit process.

INTEGRATED CASE APPLICATION —
PINEAPPLE MANUFACTURING: PART I

B-39 (objectives 8.3, 8.6)

Introduction

This case study is presented in seven parts. Each part deals largely with the material in the chapter to which that part relates. However, the parts are connected in such a way that in completing all seven, you will gain a better understanding of how the parts of the audit are interrelated and integrated by the audit process. The parts of this case appear in the following textbook chapters:

- Part I—Perform analytical procedures for different phases of the audit, Chapter 8.
- Part II—Understand factors influencing risks and the relationship of risks to audit evidence, Chapter 9.
- Part III—Conduct fraud brainstorming and assess fraud risks, Chapter 10.
- Part IV—Understand internal control and assess control risk for the acquisition and payment cycle, Chapter 12.
- Part V—Design tests of controls and substantive tests of transactions, Chapter 14.
- Part VI—Determine sample sizes using audit sampling and evaluate results, Chapter 15.
- Part VII—Design, perform, and evaluate results for tests of details of balances, Chapter 16.
The primary emphasis in this text is on the auditor’s decision-making process in a financial statement audit, as well as an integrated audit of both financial statements and internal control over financial reporting required for accelerated filer public companies. We believe that the most fundamental concepts in auditing concern determining the nature and amount of evidence the auditor should gather after considering the unique circumstances of each engagement. If students of auditing understand the objectives to be accomplished in a given audit area, the risks related to the engagement, and the decisions to be made, they should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained.

Our objective is to provide up-to-date coverage of globally recognized auditing concepts with practical examples of the implementation of those concepts in real-world settings. The collective experience of the author team in the practice of auditing is extensive. We have all worked in the auditing profession involving both large international audit firms and regional firms. Members of our author team have taught extensively in continuing education for either large international or small CPA firms and have been involved in standards setting activities of the Auditing Standards Board and the PCAOB. One author served over seven years as one of the board members of the Committee of Sponsoring Organizations of the Treadway Commission (COSO). These experiences provide unique perspectives about the integration of auditing concepts in real-world settings.

As the title of this book reflects, our purpose is to integrate the most important internationally recognized concepts of auditing in a logical manner to assist students in understanding audit decision making and evidence accumulation in today’s complex, global auditing environment. For example, developments related to issues affecting auditing in a global and economically volatile environment are described throughout the book and are emphasized in selected mid-chapter vignettes and homework problems. Key concepts related to risk assessment as emphasized in standards issued by the Auditing Standards Board (ASB), the International Auditing and Assurance Standards Board (IAASB), and the Public Company Accounting Oversight Board (PCAOB), including emphasis on significant risks, are integrated into all of the planning chapters, as well as each chapter dealing with a particular transaction cycle and related accounts. Our coverage of internal control is related to tests of controls and substantive tests of transactions that are performed in a financial statement audit and an integrated audit of financial statements and internal control over financial reporting, with an emphasis on the requirements of PCAOB auditing standards. Tests of controls and substantive tests of transactions are, in turn, related to the tests of details of financial statement balances for the area. Audit sampling is applied to the evaluation of audit evidence rather than treated as a separate topic. Risk assessment, technology, fraud, and auditing of internal control issues are integrated throughout the chapters.

TABLE OF CONTENTS OVERVIEW

The text is divided into six parts. The chapters are relatively brief and designed to be easily read and comprehended by students.

Part 1, The Auditing Profession (Chapters 1–5) The book begins with an opening vignette, featuring a Big 4 public accounting firm’s assurance report contained in the Corporate Sustainability Report issued by United Parcel Service (UPS), to help students see the increasingly important role of auditors in providing assurance on a broad range of information important to key stakeholders. Chapter 1 introduces key provisions of the Sarbanes–Oxley Act, including the creation of the PCAOB and Section 404 internal control reporting requirements. Chapter 2 covers the CPA
profession, with particular emphasis on the standards setting responsibilities of the International Auditing and Assurance Standards Board (IAASB) and the PCAOB and how those responsibilities differ from those of the AICPA Auditing Standards Board (ASB). Chapter 3 provides a detailed discussion of the newly revised audit reports issued under AICPA and PCAOB standards, including communications in the audit report about critical audit matters or key audit matters. Chapter 3 also includes a separate section on the report on internal control over financial reporting for an accelerated filer public company. The chapter also emphasizes conditions affecting the type of report the auditor must issue and the type of audit report applicable to each condition under varying levels of materiality. Chapter 4 explains ethical dilemmas, professional ethics, and independence, and it features the recently revised AICPA Code of Professional Conduct. Chapter 5 ends this part with an investigation of auditors’ legal liability.

**Part 2, The Audit Process (Chapters 6–13)** The first two of these chapters deal with auditor and management responsibilities, professional skepticism, a professional judgment framework for auditor decision-making, audit objectives, general concepts of evidence accumulation, and audit documentation, including the management assertions and evidence concepts in the risk assessment standards. Chapter 7 includes extensive coverage of the growing use of audit data analytics (ADAs) and provides best practice guidance to help auditors prepare data for analysis. Chapter 8 deals with planning the engagement, including understanding the company’s business and its industry as part of the auditor’s risk assessment procedures, using analytical procedures as an audit tool, and making preliminary judgments about materiality. Chapter 9 provides expanded coverage of the auditor’s performance of risk assessment procedures used to assess the risk of material misstatement due to fraud or error and how the auditor responds to risks of significant misstatement with further audit procedures. Fraud auditing is the focus of Chapter 10, which builds upon risk assessment concepts covered in the previous chapter to illustrate how risk assessment includes the assessment of fraud risk. The chapter also includes specific examples of fraud and discusses warning signs and procedures performed in response to heightened fraud risk. Chapter 11 outlines the key components of an effective system of internal controls over financial reporting, consistent with the 2013 revision of COSO’s Internal Control—Integrated Framework. Because most internal control systems are heavily dependent on information technologies, this chapter integrates coverage of IT general controls and application controls. Chapter 12 shows how effective internal controls can reduce planned audit evidence in the audit of financial statements, and it outlines procedures auditors perform as tests of those controls to support a low control risk assessment. The chapter also describes how auditors of accelerated filer public companies integrate evidence to provide a basis for their report on the effectiveness of internal control over financial reporting with the assessment of control risk in the financial statement audit. Chapter 13 summarizes Chapters 6 through 12 and integrates them with the remainder of the text. Several of these chapters include Data Analytics callout boxes that highlight how auditors are incorporating ADAs in all aspects of the audit.

**Part 3, Application of the Audit Process to the Sales and Collection Cycle (Chapters 14–17)** These chapters apply the concepts from Part 2 to the audit of sales, cash receipts, and the related income statement and balance sheet accounts. The appropriate audit procedures for accounts in the sales and collection cycle are related to internal control and audit objectives for tests of controls, substantive tests of transactions, and tests of details of balances in the context of both the audit of financial statements and the audit of internal control over financial reporting.

Students also learn to apply audit sampling to the audit of sales, cash receipts, and accounts receivable. Chapter 15 begins with a general discussion of audit sampling for tests of controls and substantive tests of transactions. Similarly, Chapter 17 begins
with general sampling concepts for tests of details of balances. The next topic in each chapter is extensive coverage of nonstatistical sampling. The last part of each chapter covers statistical sampling techniques. Several data analytics examples are included in the Data Analytics callout boxes in these chapters.

**Part 4, Application of the Audit Process to Other Cycles (Chapters 18–23)**

Each of these chapters deals with a specific transaction cycle or part of a transaction cycle in much the same manner as Chapters 14 through 17 cover the sales and collection cycle. Each chapter in Part 4 demonstrates the relationship of internal controls, tests of controls, and substantive tests of transactions for each broad category of transactions to the related balance sheet and income statement accounts. We integrate discussion of implications related to the audit of internal control throughout all these transaction cycle chapters. Audit issues related to evaluating management’s considerations of asset impairment, including goodwill impairment evaluations, are covered in Chapter 19. Cash and financial instruments are studied late in the text to demonstrate how the audit of cash and financial instrument balances is related to most other audit areas.

**Part 5, Completing the Audit (Chapter 24)**

This part includes only one chapter, which deals with performing additional tests to address presentation and disclosure objectives, summarizing all audit tests, reviewing audit documentation, obtaining management representations in an integrated audit of financial statements and internal control, evaluating going concern, communicating with those charged with governance, and all other aspects of completing an audit.

**Part 6, Other Assurance and Nonassurance Services (Chapters 25 and 26)**

The last two chapters deal with various types of engagements and reports, other than the audit of financial statements using generally accepted accounting principles. Topics covered include assurance services; review, compilation, and preparation services; agreed-upon procedures engagements; attestation engagements; other audit engagements; internal financial auditing; governmental financial auditing; and operational auditing. This edition also includes expanded coverage of service organization control (SOC) reports on internal controls at external service providers.

---

**INSTRUCTOR TEACHING RESOURCES**

<table>
<thead>
<tr>
<th>Supplements available to instructor at <a href="http://www.pearsonhighered.com/irc">www.pearsonhighered.com/irc</a></th>
<th>Features of the Supplement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instructor’s Resource Center <a href="http://www.pearsonhighered.com/arens">www.pearsonhighered.com/arens</a></td>
<td>This password-protected site is accessible from the catalog page for Auditing and Assurance Services, 17th ed., and hosts the following resources:</td>
</tr>
<tr>
<td>Instructor’s Resource Manual</td>
<td>Suggestions for each chapter include homework problems, how learning objectives correlate with chapter problem material, and visual aids that can be added to PowerPoint slides or used on document cameras or overhead projectors. Chapters have been designed so that their arrangement and selection provide maximum flexibility in course design. Sample syllabi and suggested term projects are provided.</td>
</tr>
<tr>
<td>Solutions Manual</td>
<td>Included are detailed solutions to all the end-of-chapter exercises, problems, and cases. Guidelines for responses to review questions and discussion questions are offered.</td>
</tr>
</tbody>
</table>
Test Item File & TestGen

The Test Item File includes multiple choice exercises, true/false responses, essay questions, and questions related to the chapter vignettes. To assist the instructor in selecting questions for use in examinations and quizzes, each question has been assigned one of three difficulty ratings—easy, medium, or challenging. In addition, questions that uniquely relate to the integrated audits of large public companies or to the provisions of the Sarbanes–Oxley Act and Section 404 have been separately labeled for easy identification by the professor. TestGen testing software is an easy-to-use computerized testing program. It can create exams as well as evaluate and track student results. All Test Item File questions are available in the TestGen format.

PowerPoint Slides

PowerPoint presentations are available for each chapter of the text. Instructors have the flexibility to add slides and/or modify the existing slides to meet course needs.

Image Library

The Image Library allows access to most of the images and illustrations featured in the text.

Enhanced Companion Website

Pearson’s Learning on the Internet Partnership offers the most expansive Internet-based support available. Our website provides a wealth of resources for students and faculty. Periodically, faculty will be able to access electronic summaries and PowerPoint slides of the most recent changes to professional standards and summaries of major issues affecting the auditing profession. This will help instructors to stay informed of emerging issues.

Auditing Cases, 7th ed., by Beasley/Buckless/Glover/Prawitt

This collection of 50 auditing cases addresses most major activities performed during the conduct of an audit, from client acceptance to issuance of an audit report. Several cases ask students to work with realistic audit evidence to prepare and evaluate audit schedules. The cases are available as part of Pearson Collections. For details, go to collections.pearsoned.com.

MyAccountingLab®

MyAccountingLab is an online homework, tutorial, and assessment program designed to work with this text to engage students and improve results. Within its structured environment, students practice what they learn, test their understanding, and receive immediate feedback to help them better absorb course material and understand difficult concepts.

ACKNOWLEDGMENTS

We acknowledge the American Institute of Certified Public Accountants for permission to quote extensively from Statements on Auditing Standards, the Code of Professional Conduct, Uniform CPA Examinations, and other publications. The willingness of this major accounting organization to permit the use of its materials is a significant contribution to the book and audit education.

We gratefully acknowledge the contributions of the following reviewers for their suggestions and support in the 17th edition as well as previous editions:

Sherri Anderson, Sonoma State University
Stephen K. Asare, University of Florida
David Baglia, Grove City College
Brian Ballou, Miami University
William E. Bealing, Jr., Shippensburg University
Stanley F. Biggs, University of Connecticut
Robert Braun, Southeastern Louisiana University
Joe Brazel, North Carolina State University
Frank Buckless, North Carolina State University
Billy Brewster, University of Texas–Arlington
We especially thank the Pearson book team for their hard work and dedication, including Ellen Geary, acquisitions editor; Gladys Soto, program manager; and Jennifer Gavigan, production project manager.

A. A. A.
R. J. E.
M. S. B.
C. E. H.