Auditing, Assurance Services & Ethics in Australia

An Integrated Approach

Arens / Best / Shailer / Fiedler / Elder / Beasley
## Contents in full

**Preface**  
**Visual preface**  
**About the authors**

### PART 1  
**THE AUDITING PROFESSION**

#### CHAPTER 1  
Demand for audit and assurance services

- Assurance services  
- Economic demand for auditing  
- Causes of information risk  
- Nature of auditing  
- Distinction between auditing and accounting  
- Types of audits  
- Types of auditors  
- Public accounting firms  
- Professional accounting bodies  
- Australian Auditing Standards  
- International auditing standards  
- Quality control  
- *Corporations Act 2001*  
- Impact of e-commerce on public accountants

**Summary**  
**Questions and problems**  
**Online issue**

#### CHAPTER 2  
Auditors’ legal environment

- Audit regulation  
- Statutes and auditors’ liability  
- Criminal liability  
- Legal concepts affecting liability  
- Liability to clients  
- Liability to third parties under common law  
- Fraud and error  
- Managing individual legal liability

**Summary**  
**Questions and problems**  
**Online issue**

Appendix: Chronological schedule of leading cases affecting auditors’ legal liability in Australia

### CHAPTER 3  
Audit quality and ethics

- Audit quality and corporate governance  
- Expectations gap  
- Auditor competence  
- Ethics  
- Ethical dilemmas  
- *Code of Ethics for Professional Accountants*

**Independence**  
**Summary**  
**Questions and problems**  
**Online issue**

### CHAPTER 4  
Audit responsibilities and objectives

- Objective of conducting an audit of financial statements  
- Management’s responsibilities  
- Auditor’s responsibilities  
- Financial statement cycles  
- Setting audit objectives  
- Management assertions  
- Transaction-related audit objectives  
- Balance-related audit objectives  
- Presentation and disclosure-related audit objectives

**How audit objectives are met**  
**Summary**  
**Questions and problems**  
**Online issue**

### CHAPTER 5  
Audit evidence

- Nature of evidence  
- Audit evidence decisions  
- Persuasiveness of evidence  
- Types of audit evidence  
- Analytical procedures  
- Five types of analytical procedures  
- Using statistical techniques and computer software

**Summary**  
**Questions and problems**  
**Online issue**
### PART 2 THE AUDIT PROCESS: DECISIONS AND PLANNING 181

#### CHAPTER 6 Audit planning and documentation 183
- Planning 185
- Accepting audit engagement and performing initial audit planning 186
- Understanding the client’s business and industry 191
- Assessing client business risk 196
- Performing preliminary analytical procedures 197
- Purposes of audit documentation 199
- Content and organisation of audit files 200
- Effect of technology on audit evidence and audit documentation 206
- Summary 208
- Questions and problems 209
- Online issue 217
- Case study: Integrated case application—Pinnacle Manufacturing: Part I 217

#### CHAPTER 7 Materiality and risk 221
- Materiality 223
- Materiality for financial statements as a whole 224
- Determine performance materiality 227
- Estimate misstatement and compare with preliminary judgment 230
- Audit risk 232
- Audit risk model for planning 232
- Assessing acceptable audit risk 236
- Assessing inherent risk 239
- Relationship of risks to evidence and factors influencing risks 242
- Relationship of risk and materiality to audit evidence 246
- Summary 247
- Questions and problems 248
- Online issue 262
- Case study: Integrated case application—Pinnacle Manufacturing: Part II 262

#### CHAPTER 8 Internal control and control risk 264
- Client and auditor concerns 265
- Effect of information technology on internal control 268
- Components of internal control 269
- Procedures to obtain an understanding of internal control 279
- Assessing control risk 284
- Tests of controls 290
- Summary 292
- Questions and problems 294
- Online issue 303
- Case study: Integrated case application—Pinnacle Manufacturing: Part III 303

#### CHAPTER 9 Fraud auditing 306
- Types of fraud 307
- Conditions for fraud 309
- Assessing the risk of fraud 312
- Corporate governance oversight to reduce fraud risks 316
- Responding to the risk of fraud 321
- Specific fraud risk areas 323
- Responsibilities when fraud is suspected 329
- Summary 331
- Questions and problems 332
- Online issue 338

#### CHAPTER 10 The impact of information technology on the audit process 339
- How information technologies enhance internal control 341
- Assessing the risks of information technology 341
- Internal controls specific to IT 343
- Impact of IT on the audit process 349
- Auditing with use of the computer 352
- Using a microcomputer as an audit tool 362
- Issues for different IT environments 365
- Summary 370
- Questions and problems 370
- Online issue 382
- Appendix: Other computer-assisted audit techniques 382
# CONTENTS IN FULL

| CHAPTER 11 Overall audit plan and audit program | 384 |
| Types of tests | 386 |
| Selecting which types of tests to perform | 391 |
| Impact of information technology on audit testing | 395 |
| Evidence mix | 395 |
| Design of the audit program | 396 |
| Relationship of transaction-related audit objectives with balance-related and presentation and disclosure-related audit objectives | 404 |
| Summary of the audit process | 406 |
| Summary | 409 |
| Questions and problems | 410 |
| Online issue | 421 |

| CHAPTER 12 Audit of the sales and collection cycle: Tests of controls and substantive tests of transactions | 422 |
| Accounts and classes of transactions in the sales and collection cycle | 423 |
| Business functions in the cycle and related documents and records | 424 |
| Methodology for designing tests of controls and substantive tests of transactions for sales | 429 |
| Sales returns and allowances | 439 |
| Methodology for designing tests of controls and substantive tests of transactions for cash receipts | 439 |
| Audit tests for the write-off of uncollectable accounts | 443 |
| Summary | 445 |
| Questions and problems | 446 |
| Online issue | 456 |

| PART 3 THE AUDIT PROCESS: APPLICATION | 457 |
| CHAPTER 13 Completing the tests in the sales and collection cycle: Accounts receivable | 459 |
| Methodology for designing tests of details of balances | 460 |
| Designing tests of details of balances | 466 |

| CHAPTER 14 Audit sampling | 493 |
| The role of audit sampling | 494 |
| Representative samples | 495 |
| Statistical vs non-statistical sampling and probabilistic vs non-probabilistic sample selection | 496 |
| Application of statistical and non-statistical sampling | 497 |
| Non-probabilistic sample selection methods | 498 |
| Probabilistic sample selection methods | 499 |
| Sampling for deviation rates and misstatements | 500 |
| Application of non-statistical audit sampling | 501 |
| Application of non-statistical audit sampling for tests of controls and substantive tests of transactions | 502 |
| Non-statistical sampling for tests of details of balances | 513 |
| Statistical audit sampling | 519 |
| Application of attributes sampling | 520 |
| Monetary unit sampling | 524 |
| Variables sampling | 533 |
| Summary | 534 |
| Questions and problems | 535 |
| Online issue | 548 |
| Case study: Integrated case application—Pinnacle Manufacturing: Part IV | 548 |

| CHAPTER 15 Audit of transaction cycles and financial statement balances I | 551 |
| Accounts and classes of transactions in the acquisition and payment cycle | 552 |
| Business functions in the cycle and related documents and records | 553 |
| Methodology for designing tests of controls and substantive tests of transactions | 556 |
| Methodology for designing tests of details of balances for accounts payable | 562 |
Design and perform analytical procedures (phase III) 564
Design and perform tests of details of the accounts payable balance (phase III) 564
Reliability of evidence 568
Business functions in the cycle and related documents and records 571
Parts of the audit of inventory 573
Audit of cost accounting 575
Analytical procedures 578
Physical observation of inventory 579
Auditing of pricing and compilation 583
Integration of the tests 586
Accounts and transactions in the payroll and personnel cycle 589
Business functions in the cycle and related documents and records 590
Methodology for designing tests of controls and substantive tests of transactions 592
Methodology for designing tests of details of balances 597
Perform analytical procedures (phase III) 598
Design and perform tests of details of balances for liability and expense accounts (phase III) 599
Summary 601
Questions and problems 602
Online issues 619
Case study: Integrated case application—Pinnacle Manufacturing: Part V 620
Case study: Integrated case application—Pinnacle Manufacturing: Part VI 621

CHAPTER 16 Audit of transaction cycles and financial statement balances II 626

Types of cash accounts 628
Cash balances and transaction cycles 629
Audit of the general cash account 631
Fraud-oriented procedures 639
Audit of property, plant and equipment 643
Audit of manufacturing equipment and related accounts 644
Audit of prepaid expenses 650
Audit of accrued liabilities 650
Capital acquisition and repayment cycle 652

PART 4 THE AUDIT PROCESS: COMPLETING THE AUDIT 673

CHAPTER 17 Completing the audit 675
Perform additional tests for presentation and disclosure 677
Review for contingent liabilities and commitments 678
Make inquiries regarding litigation and claims 681
Review for subsequent events 683
Final evidence accumulation 686
Evaluate results 688
Communicate with the audit committee and management 694
Subsequent discovery of facts 696
Summary 697
Questions and problems 697
Online issue 705

CHAPTER 18 Audit reporting 706
The audit report 708
Standard unmodified audit report 708
Audit reporting requirements of listed companies 712
Conditions requiring a departure 719
Audit reports other than unmodified 719
Materiality 720
Examples of reports 723
Other reporting issues 725
Impact of e-commerce on audit reporting 727
Summary 727
Questions and problems 728
Online issue 736
PART 5  SPECIAL TOPICS  737

CHAPTER 19  Other auditing and assurance engagements  739

Assurance engagements  742
Audit reports on special purpose financial reports  744
Assurance services pertaining to specific financial information  744
Assurance reports on internal controls  745
Review engagements  752
Audits of prospective financial information  754
Differences between performance auditing and financial auditing  757
Effectiveness versus efficiency  758
Relationship between performance auditing and internal controls  759
Types of performance audits  759
Who undertakes performance audits?  760
Independence and competence of performance auditors  761
Criteria for evaluating efficiency and effectiveness  762
Phases in performance auditing  763
The role of internal auditors  765
Relationship between internal and external auditors  767
Public sector audits in Australia  768
Auditing of Australian Commonwealth Government agencies  769
Auditing standards  772
Features peculiar to the public sector  773
Australia's Clean Energy Scheme  774
Assurance issues  777
External auditor expertise and qualifications  779
Guidelines and standards for conducting external assurance engagements and preparing reports  780
Questions and problems  782
Online issue  792

Index  793

Rouge Clothing Company Ltd case study  793

CONTENTS IN FULL
Objectives

The tenth edition of *Auditing, Assurance Services and Ethics in Australia: An Integrated Approach* is based on the fifteenth US edition of *Auditing and Assurance Services: An Integrated Approach*. It contains numerous changes and revisions, but the principal objectives and emphasis remain unchanged from the previous edition. It represents a conscious effort to focus on the Australian auditing environment in terms of the current practices and standards issued by the Auditing and Assurance Standards Board (AUASB).

The book is an introduction to auditing for students who have not had significant experience in the field and is intended for either a full-year or one-semester course at the undergraduate or graduate level. The book is also appropriate for introductory professional development courses for public accounting firms, internal auditors and government auditors.

The primary emphasis in this textbook is on the auditor’s decision-making process. We believe that the most fundamental concepts in auditing relate to determining the nature and amount of evidence the auditor should accumulate after considering the unique circumstances of each engagement. If students of auditing understand the objectives to be accomplished in a given audit area, the circumstances of 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.

Thus, as the title of the book reflects, our purpose is to integrate the most important concepts of auditing with certain practical aspects in a logical manner to assist students in understanding audit decision making and evidence accumulation. For example, internal control is integrated into each of the chapters dealing with a particular functional area and is related to tests of transactions. Tests of transactions are, in turn, related to tests of details of financial statement balances of the accounts for the area; and audit sampling is applied to the accumulation of audit evidence rather than treated as a separate topic. Technology, e-commerce and fraud issues are also integrated throughout the chapters.

Features of the tenth edition

**Auditing regulations**

The tenth edition incorporates recently issued auditing standards (ASAs, ASREs and ASAEs), Accounting Professional and Ethical Statements (APESs), the Framework for Assurance Engagements, the Explanatory Guide to AUASB Standards Applicable to Review Engagements, and guidance statements (AGSs and GSs). It includes up-to-date referencing of relevant legislation (including the *Corporations Act 2001*) and common law.

**Chapter 9 on fraud auditing and expanded fraud coverage**

This chapter on fraud auditing examines the auditor’s responsibility for assessing the risk of fraud and detecting material misstatements due to fraud. The chapter includes coverage of corporate governance and other factors that reduce fraud risk. Specific fraud risk areas and procedures to detect fraud are also discussed. Additional references to fraud risks have been integrated into other chapters. The results from the KPMG *A Survey of Fraud, Bribery and Corruption in Australia & New Zealand 2012* are incorporated within the chapter.
Increased emphasis on audit quality

There is an emphasis on audit quality, in the context of the role of auditing in corporate governance. The major changes in relevant regulation, including the changes to the *Corporations Act 2001*, are integrated into relevant chapters.

Running case—Rouge Clothing annual report

Extracts from the annual report for the running case of the fictitious Rouge Clothing Company are included as a full-colour insert at the back of the textbook. Financial statements and other information included in the annual report are used in examples throughout the book to illustrate chapter concepts. When Rouge Clothing is referred to in the text, a shopping bag icon is shown in the margin.

Running case—Pinnacle Manufacturing integrated case study

The Pinnacle Manufacturing integrated case represents a larger, multi-division company, and appears in six parts in Chapters 6, 7, 8, 14 and 15. Each part of the case is included at the end of the chapter to which the part relates. The parts of the case are connected so that students will gain a better understanding of how the parts of the audit are interrelated and integrated by the audit process.

Online issues

Each chapter includes Internet-based cases that require students to research relevant auditing issues online.

ACL Education edition student software supplement

Students are exposed to ACL audit software in the opening vignettes for Chapters 9 and 10. Chapter 10 illustrates the application of audit software using an ACL demonstration showing screenshots.

ACL provides a wide range of opportunities for incorporating computer-assisted audit techniques (CAATs) in the auditing curriculum. Instructors may use this supplement in conjunction with Chapter 10, The Impact of Information Technology on the Audit Process, which introduces the study of CAATs. The objectives of this supplement are twofold:

1. developing students’ understanding of CAATs—audit software exercises explore how CAATs can assist the auditor in testing audit objectives

2. developing students’ proficiency in global, market-leading audit software—the marketability of accounting graduates seeking audit-related employment is significantly enhanced through exposure to ACL.

ACL is generalised audit software used by auditors to extract and analyse data on client’s computerised systems. Generalised audit software is discussed on pages 352–358 of the textbook.

ACL is a personal-computer implementation of the English-like Audit Command Language. It has been designed primarily as a powerful auditing tool for easy access to and analysis of data. ACL has a number of key features.

ACL is installed on the auditor’s personal computer and provides universal access to client data. The client’s data tables are downloaded to the auditor’s computer and defined to the system so that data analysis is feasible.

Commands are issued through selections from menus and submenus. Error messages notify the user if the required data for a command have not been entered correctly. Context—sensitive help is available, along with a full Windows-style help system. Commands can also be executed interactively through the command log window. ACL permits both sequential and direct access to data tables. Sequential access involves a complete pass through the consecutive records in a data table and suits most applications; for example, locating all records meeting specified criteria. Direct access permits the location of the first record meeting a criterion or containing a specified key field value (e.g. product number).
ACL possesses powerful expression evaluation capabilities, thereby allowing the creation of computed fields—that is, those calculated from other fields, with formulae and functions. Commands may be batched and executed on request. Groups of commands may be executed concurrently to permit more efficient processing. All commands and results are automatically saved in the command log. This provides the auditor with the basis for review of work, a set of working papers and the potential development of future batch applications. ACL can also extract data to create working audit tables for further processing, and export data to other applications, such as *MS Word*. An in-depth study of its use is beyond the scope of most first auditing courses.

To access the educational ACL software go to [https://accounts.aclgrc.com/promo](https://accounts.aclgrc.com/promo) and enter the promotional code in the front of the book. Further information about the ACL software can be located at [http://www.acl.com/about-us](http://www.acl.com/about-us).

**Auditing and assurance implications of carbon trading**

Chapter 19 has been revised for the Australian developments pertaining to carbon emissions reporting and assurance requirements.

**Acknowledgments**

We wish to thank the Auditing and Assurance Standards Board (AUASB) and the Australian Accounting Standards Board (AASB) for permission to quote their standards, statements and other pronouncements. Material from these Standards Boards is © Commonwealth of Australia. Every attempt has been made to ensure that the material used is current.

The authors and publisher would also like to thank ACL Services Ltd for permission to package the ACL student version with this textbook.

The dedicated contributions of many individuals helped make refinements and improvements in this edition. An impressive cast of reviewers provided many helpful suggestions and enthusiasm for the organisation and content of the book. The authors and publisher are grateful to each one of them. These include:

- Mrs Prerana Agrawal, University of Western Australia
- Dr Tehmina Khan, RMIT
- Associate Professor Conor O’Leary, Griffith University.
- Dr Grace Hsu, The University of Queensland

P. J. Best  
G. E. P. Shailer  
B. A. Fiedler
Auditor's responsibilities for detecting material fraud

Auditors have a responsibility to members, not to the managers of capital who give the big firms audit gigs along with other services. The big firms are Òtoo big to failÓ because the system and its safeguards have failed.

The audit process should be designed to provide the company and users of its accounts with early notice of circumstances that give the auditor reasonable grounds to suspect there has been a contravention, and (2) circumstances that amount to an attempt to unduly influence an auditor or mislead an auditor. It is sometimes suggested that whenever a company fails its auditor must have been at fault. I do not believe this. I believe that the responsibility lies with the system and those who control it, and not with the auditor. The system is broken, the safeguards are broken, and there is a lack of discipline and disciplines. How do I use this book?

Learning objectives

These are listed at the beginning of each chapter and explain the key concepts that you should understand after studying the chapter. They are then signposted throughout the chapter, which steps you through each objective by listing the objective to which each section corresponds.

Professional statements referred to in this chapter

These provide you with a list of relevant auditing and accounting legislation that is explained throughout the chapter.

Chapter opening vignette

Both real and fictitious companies and situations introduce you to the concepts covered in the chapter via a practical 'real-life' example.

Auditing FYI

Some chapters contain boxed features with additional information, examples and/or samples of audit documents to get you thinking.

Auditing in the real world

Excerpts from real auditing cases, standards, news items and reports appear in various chapters to show real-life examples of auditing in action.
Running glossary in the margin
Bolded key terminology and concepts are explained as they occur in the text.

Integrated case study—Pinnacle Manufacturing
This running case appears in Chapters 6, 7, 8, 14 and 15. When all parts of the case are completed you will have a very sound understanding of each stage of the audit and how it relates to the whole process.

Chapter summary
All the material covered in each chapter is encapsulated in a few paragraphs; a great revision tool.

End-of-chapter questions and problems
Review questions, multiple choice questions, discussion questions and problems, case studies and Internet problems help reinforce your understanding of chapter content. All questions are keyed to the learning objective to which they correspond so you can pick and choose the areas you want to work on.

Appendices
Where appropriate, some chapters will have an appendix to extend and explicate chapter content.

Extra features
• Rouge Clothing—Extracts from the annual report for the running case of the fictitious Rouge Clothing Company are included as a four-colour insert at the end of the book. This case illustrates chapter concepts in a 'real-world' business context. When Rouge Clothing is referred to in the text, a shopping bag icon is shown in the margin.

• ACL software will help develop your proficiency in a global, market-leading audit software, and give you more marketability as an accounting graduate seeking audit-related employment.
What else can I use with this book?

For instructors

The following is available for download from the Pearson catalogue site. Contact your sales representative for passwords to access this material.

**Solutions manual**
The solutions manual provides educators with detailed, accuracy-verified solutions to all of the end-of-chapter problems in the book.

**PowerPoint slides**
A comprehensive set of PowerPoint slides can be used by educators for class presentations or by students for lecture preview or review. They include key figures and tables, as well as a summary of key concepts and examples from the text.

**Test bank**
The test bank provides a wealth of accuracy-verified testing material. Updated for the new edition, each chapter offers a wide variety of true/false, short-answer and multiple-choice questions, arranged by learning objective and tagged by AACSB standards.

**ACL software**
Educators may use this software in conjunction with Chapter 10 ‘The impact of information technology on the audit process’, which introduces the study of CAATs.