

E I G H T H E D I T I O N



uditing

J A C K C . R O B E R T S O N

AUDITING

Eighth Edition

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The University of Texas at Austin

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Irwin Book Team

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Designer: Heidi J. Baughman
Compositor: Bi-Comp, Inc.
Typeface: 10/12 Times Roman
Printer: R. R. Donnelley & Sons Company

**Times Mirror****Higher Education Group****Library of Congress Cataloging-in-Publication Data**

Robertson, Jack C.
Auditing / Jack C. Robertson.—8th ed.
p. cm.—(Irwin series in undergraduate accounting)
Includes index.
ISBN 0-256-18800-9
I. Auditing. I. Title. II. Series.
HF5667.R72 1996
657'.45—dc20

95-20776

Printed in the United States of America

2 3 4 5 6 7 8 9 0 D O 2 1 0 9 8 7 6

Auditors are assumed to have knowledge of the philosophy and practice of auditing; to have the degree of training, experience, and skill common to the average independent auditor; to have the ability to recognize indications of irregularities; and to keep abreast of developments in the perpetration and detection of irregularities.

R. K. Mautz and H. A. Sharaf
The Philosophy of Auditing

*This book is dedicated to
Charles T. Zlatkovich
Professor Emeritus
C. Aubrey Smith Professorship
Educator
Mentor
The University of Texas at Austin*

ABOUT THE AUTHOR

Jack C. Robertson is the C. T. Zlatkovich Centennial Professor at The University of Texas at Austin, where he has been a member of the faculty since 1970. In 1975–76, he was the academic fellow on the staff of the managing partner of Coopers & Lybrand; in 1982–83 he served as the Academic Fellow in the SEC Office of the Chief Accountant; in 1988 he was the Visiting Erskine Fellow in the Department of Accountancy at the University of Canterbury in Christchurch, New Zealand. He has given invited presentations in Jerusalem, Tel Aviv, Christchurch, Dunedin, Wellington, Kyoto, Kobe, and Vilnius.

He is a member of the American Institute of CPAs, the Texas Society of CPAs, the American Accounting Association, the Institute of Internal Auditors, and the Association of Certified Fraud Examiners. He has served on committees and task forces of the AICPA and TSCPA, and he has been active in the AAA—serving as secretary, vice-chairman, and chairman of the Auditing Section. In the TSCPA, he is active on the Professional Ethics Committee and has received a presidential citation for meritorious service in the field of ethics. He was a member of the Board of Regents that created the Certified Fraud Examiner program for the Association of Certified Fraud Examiners.

His publications consist of books and articles on auditing, financial reporting, professional ethics, and fraud examination.

At The University of Texas, Professor Robertson has developed three new auditing courses that have served as national models for courses elsewhere. Prior to his appointment as the C. T. Zlatkovich Centennial Professor, he held the Price Waterhouse Auditing Professorship (1979–1984).

PREFACE

The eighth edition of *Auditing* bridges the gap between students' knowledge of accounting principles and the professional practice of accounting and auditing in the working world. The text covers both the concepts and the procedures of auditing. On the conceptual level, students learn about the social role of auditing; the services offered in internal, governmental, and public accounting practice; and the professional standards for behavioral and technical competence. On the technical level, they learn about the programs and procedures for defining audit objectives, gathering evidence, making decisions, and exercising professional skepticism.

Auditing reflects the challenges inherent in accounting and auditing practice, particularly in public accounting firms. Clients who pay the fees expect *value* in the form of consulting advice, recommendations for improvements in the business, and an audit report. On the other hand, public users of these clients' financial statements expect *effective service*; that is, they expect auditors to be objective skeptics working to monitor the business management and blow the whistle on fraudulent financial statements. These dual challenges of service to clients and service to the public merge the business and professional aspects of public accounting practice.

Throughout the 1980s and 1990s, the practice of accounting and auditing expanded its horizons. This book incorporates an important aspect of expansion—*fraud auditing*. Everyone is becoming more interested in fraud examination and fraud auditing. Chapter 8 fills the textbook void with a concise introduction to fraud awareness auditing.

The chapters are organized in sequence to start with an introduction to practice, audit standards, and reports (Chapters 1–3); continue through basic concepts of audit planning, analytical procedures, risk, materiality, control risk assessment, sampling, and fraud awareness (Chapters 4–8); then proceed directly to technical applications in several cycles and the completion of an audit (Chapters 9–13). The remaining chapters deal with statistical sampling and computer auditing (Chapters 14–17) and with other services, operational auditing, professional ethics, and legal liability (Chapters 18–21). This organization is designed to facilitate a basic emphasis on audit performance (Chapters 1–13), while providing other topics (Chapters 14–21) for insertion as instructors desire.

IMPORTANT FEATURES AND SUPPLEMENTS

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This eighth edition maintains an emphasis on financial auditors' decision-making processes: (1) recognizing problems and developing audit objectives, (2) gathering evidence with audit procedures, and (3) making judgments about control risk and the fair presentation of financial statement assertions. The text is designed to guide and direct students' study. The features described below enhance students' ability to comprehend basic concepts and apply them in real case situations.

Fraud Auditing

The eighth edition contains full-chapter coverage of fraud auditing, until now unavailable in introductory auditing books. The basic purpose of the chapter is to create awareness of, and sensitivity to, the signs and signals of potential errors, irregularities, and frauds. The chapter contains some unique insights on extended audit and investigation procedures.

Learning Aids

Each chapter and section in *Auditing* contains features that enhance readability, study, and learning.

Professional Standards References

Each chapter opens with a list of professional standards references from the AICPA, GAO, and IIA standards relevant to the chapter topics. The inside front and back covers list these standards and other library resources used by professional auditors.

Learning Objectives

Each chapter begins with the presentation of several learning objectives. These are repeated as marginal notes within the chapters.

Anecdotes and Asides

All the chapters contain illustrative anecdotes and asides, some of which are in the flow of the chapter text, while others stand alone to add realism and interest. These notes bring the real world into the textbook treatment of auditing.

Review Checkpoints

Instead of placing a long list of review questions at the end of each chapter, *review checkpoints* (questions) are placed inside each chapter in several sections so students can test themselves as they proceed through a chapter. These checkpoint islands make the text user-friendly by effectively breaking each chapter into smaller sections.

Cases

The case stories in Chapters 8, 9, 10, 11, and 12 are *short stories* structured to reveal error, irregularity, or fraud in an account. An *audit approach* section follows each story. The audit approach describes an audit objective, desirable controls, test of controls procedures, and audit of balance procedures that can result in discovering the situation.

The purpose of these case stories is to enliven the study of auditing. They replace the typical lengthy exposition of audit fundamentals (often tedious and boring) with illustrative situations based on real events. Twenty-five cases with audit approaches are in Chapters 8–12. Another 20 cases are in the end-of-chapter discussion cases section. There, the case story is told, and the students' assignment is to write the audit approach section.

Subject Titles on Exercises and Problems

Each of the exercises, problems, and discussion cases at the end of the chapter is identified with a topic title. The titles enable students and instructors to select problems on topics of interest.

Key Terms

Throughout the book, key terms are highlighted in boldface print. An alphabetical key terms reference list with definitions is in the back of the book.


Kingston Company Case

The Kingston Company case is a *practice case-within-a-textbook*. The company description starts in Chapter 4 and continues through Chapter 17. Assignments related to Kingston connect many of the technical topics in a logical sequence of audit engagement activities. However, the end-of-chapter material includes numerous exercises, problems, and discussion cases that are unrelated to the Kingston Company.

Behavioral Exercises

Robert Ashton (Duke University) published several thought-provoking behavioral decision cases for use in auditing courses. *Auditing* reproduces a selection of these cases and their variations for instructors and students who wish to probe the subtle aspects of human information processing and decision making. They are found in Problems 1.40, 2.43, 3.40, 14.37, 14.38, and 21.46.

Computer-Assisted Homework

Some of the homework assignments can be done on an electronic spreadsheet. An appendix at the end of the book contains the *Solution Facilities Student Manual*. This is the student guide for using some Lotus® 1-2-3® templates for work on selected assignments. At the end of many chapters, instructions and the *Solution Facilities Logo*  direct students to these computer-assisted assignments. The *Solution Facilities* disk is distributed in the Instructor's Manual. Students can copy it.

Instructor's Manual

The *Instructor's Manual* contains some sample course syllabi, descriptions of the Kingston Company data, an index to the cases in Chapters 8–12, a few extra cases and explanations, and summaries of the chapter learning objectives. These summaries are prepared for reproduction in a student package where they can serve as guides to lectures and notetaking. The instructor's manual also contains numerous transparency masters for instructor and student use.

Solutions Manual

The *Solutions Manual* contains solutions to all the review checkpoints, Kingston case problems, multiple choice questions, exercises, problems, and discussion cases.

Study Guide

The study guide was prepared by Lawrence P. Kalbers of John Carroll University, Cleveland, Ohio. It contains a guide for CPA Examination study, an outline of each chapter, questions for study and review, and an outline of AICPA statements on auditing standards.

Test Bank and Software

The test bank available to instructors was prepared by Lawrence P. Kalbers of John Carroll University. It contains numerous objective, short-answer, and essay questions. The microcomputer version of the test bank allows editing of questions, provides up to 99 versions of each test, and permits question selection based on type of question and level of difficulty.

Auditing Standards and CPA Examination Integration

A new Richard D. Irwin product is *Auditing: Integration of the AICPA Professional Standards and the CPA Examination* by Richard Roscher of the University of North Carolina at Wilmington. This comprehensive review material presents numerous objective and essay examination questions. The objective is to guide students through the official professional standards and cite specific passages in answer to questions. This form of study will become very important when the CPA Examination is no longer published.

ACKNOWLEDGMENTS

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The American Institute of Certified Public Accountants has generously given permission for liberal quotations from official pronouncements and other AICPA publications, all of which lend authoritative sources to the text. In addition, several publishing houses, professional associations, and accounting firms have granted permission to quote and extract from their copyrighted material. Their cooperation is much appreciated because a great amount of significant auditing thought exists in this wide variety of sources.

A special acknowledgment is due Mr. Joseph T. Wells, founder and chairman of the Association of Certified Fraud Examiners. He created the Certified Fraud Examiner (CFE) designation. Mr. Wells is a nationally known authority in the field of fraud examination education, and his entrepreneurial spirit has captured the interest of fraud examination professionals throughout the United States. The author was privileged to have been a member of the inaugural CFE Board of Regents that produced the first CFE handbook and managed the initial CFE Symposium. Mr. Wells and the Association of Certified Fraud Examiners have been generous contributors to the fraud auditing material in the eighth edition of *Auditing*.

The excellent reviews and suggestions provided by several professors have been a significant help in completing this eighth edition. Sincere appreciation is due to Don Watne, Portland State University; Jeannie Folk, College of DuPage; Elliott Levy, Bentley College; Malcolm Lathan, University of Virginia; Barry Knight, California State-San Bernadino; Eric Johnson, University of Toledo; Michael Fischer, St. Bonaventure University; D'Arcy Becker, University of New Mexico; John Osborn, California State-Fresno. Their attention to reviews greatly enhanced several portions of the text. However, I remain responsible for all errors of commission and omission.

I owe a great debt of gratitude to professional accountants in all walks of life. The first five editions of *Auditing* (beginning in 1976) were dedicated to two accountants who were truly professional in every meaning of the word: Jim Tom Barton,

a CPA and author of Texana literature and Albert L. Wade, a CPA of the "old school." These gentlemen have both passed away, but are remembered well. Still among the living is Professor Emeritus Charles T. Zlatkovich—exemplar, mentor, and friend—to whom this edition is dedicated.

Saving the best to the end, words cannot express the extent of support freely given by Susan Robertson. She has endured the agony and ecstasy of revision many times and has lent her own hand to producing the manuscript and the supplements. Behind this author, she is a force saying, "Get it finished so we can go out for a celebration dinner!"

Jack C. Robertson
Austin, Texas

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