

AUDITING

Concepts and Standards

David N. Ricchiute

AUDITING

Concepts and Standards

David N. Ricchiute, DBA, CPA

Associate Professor of Accountancy
University of Notre Dame



A98

Published by

SOUTH-WESTERN PUBLISHING CO.

CINCINNATI WEST CHICAGO, ILL. DALLAS PELHAM MANOR, N.Y. PALO ALTO, CALIF.

Copyright © 1982
by SOUTH-WESTERN PUBLISHING CO.
Cincinnati, Ohio

ALL RIGHTS RESERVED

The text of this publication, or any part thereof, may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, storage in an information retrieval system, or otherwise, without the prior written permission of the publisher.

ISBN: 0-538-01980-8

Library of Congress Catalog Card Number: 81-86001

2 3 4 5 D 5 4 3

Printed in the United States of America

PREFACE

In comparison with most accounting courses, Auditing — whether at the undergraduate or graduate level — is somewhat less quantitative, less well-defined, and more subjective in nature. As a result, there is a considerable amount of latitude in the focus, intent, and approach of most introductory auditing texts; some are highly conceptual, some highly pragmatic, and some integrate concepts with practice. The focus, intent, and approach of this text are best characterized by its subtitle, “Concepts and Standards.” In general, *Auditing: Concepts and Standards* emphasizes both the concepts and standards of external auditing, though not without considerable discussion related to audit methodology and to the judgments and decision processes inherent in audit practice.

FEATURES

Following are several of the major features incorporated in the text, some of which are unique:

1. A list of major topics at the beginning of each chapter.
2. An introductory overview for each chapter intended to answer the questions, What is this chapter about? How does the material flow and fit together?
3. End-of-chapter references, questions, review problems, and supplemental problems.
4. Discussions of important theoretical and practical publications, such as:
 - Mautz and Sharaf's *The Philosophy of Auditing*
 - AAA Auditing Concepts Committee's *A Statement of Basic Auditing Concepts*
 - Schandl's *Theory of Auditing*
 - Selected journal articles
5. A separate — and extensive — chapter on internal and public-sector auditing.
6. A chapter on an auditor's responsibility for detecting client errors, irregularities, and illegal acts (including extensive discussion of the Foreign Corrupt Practices Act of 1977).

7. Two statistical sampling chapters devoted separately to sampling concepts and to sampling applications, thereby allowing for either a conceptual or applications-oriented approach, or both.
8. Four audit procedures chapters that emphasize both (a) the current trend in practice toward transaction cycles in studying and evaluating internal control and (b) the time-honored detailed testing of account balances.
9. A chapter on how an auditor researches nonroutine accounting and auditing problems.
10. Extensive discussion of the professional literature — including the AICPA's Statements on Auditing Standards — throughout the text.

ORGANIZATION

The text is organized in six parts, each with a specific intent and focus. Part One — *External, Internal, and Public-Sector Auditing* — introduces the accounting profession and the nature of three predominant types of auditing. Chapter 1, an introduction to the accounting profession and external auditing, discusses the need for auditing, the interface between auditing and the scientific method of inquiry, professionalism, and the historical evolution of auditing in the U.S. The attest function and the standard audit report are briefly introduced in Chapter 1 to provide a framework for the chapters that follow. Chapter 2 deals exclusively with internal and public-sector auditing; the remainder of the text, however, focuses primarily on external auditing conducted by independent public accountants.

Part Two — *Theory, Standards, and Ethics* — introduces the nature and role of theory in auditing, the generally accepted standards of auditing, and an auditor's ethical environment. Chapter 3, "Auditing Theory and Standards," discusses three significant studies of auditing theory, several fundamental concepts underlying the structure of auditing theory, the AICPA's generally accepted auditing standards, and the audit standards-setting process in the U.S. Chapter 4, "The Ethical Environment," focuses upon the AICPA's Code of Professional Ethics and ethics enforcement.

Part Three — *Responsibilities and Legal Liability* — introduces an auditor's responsibilities for detecting client errors, irregularities, and illegal acts and his or her resultant legal liability. Chapter 5, "Auditor Responsibilities: Errors, Irregularities, and Illegal Acts," discusses an auditor's responsibilities under generally accepted auditing standards and two independent, nonauthoritative auditor responsibility models. Chapter 6, "Auditors' Legal Liability," identifies the major issues central to most legal liability cases involving independent auditors and describes an auditor's potential liability under common law, the Securities Act of 1933, and the Securities Exchange Act of 1934.

Part Four — *Audit Technology: Evidence, Internal Control, EDP, and Sampling* — introduces the "technology" applied during external opinion audits. Chapter 7, "Evidence, the Audit Process, and Documentation: An Overview," builds upon the foundation developed in Parts One through Three, introducing particulars related to audit evidence, the audit process, working papers, quality control, and peer review. Chapter 8, "The

Nature, Study, and Evaluation of Internal Control," discusses the basic concepts and characteristics underlying accounting control and the purpose and major phases of a study and evaluation of internal control. Continuing the discussion of internal control, Chapter 9, "Auditing and EDP," addresses internal control in the context of automated accounting information systems.

Chapters 10 and 11 discuss in some detail selected concepts and applications, respectively, of statistical sampling for attributes and variables. Chapter 10, "Statistical Sampling for Attributes and Variables: Concepts," focuses upon the nature of both statistical and nonstatistical sampling, the uncertainty inherent in audit sampling, and the relationship among precision, reliability, and risk. Chapter 11, "Statistical Sampling for Attributes and Variables: Applications," illustrates a variety of attributes and variables sampling plans including attribute estimation, discovery sampling, ratio and difference estimation, and dollar-unit sampling.

Part Five — *Audit Method: Auditing Transaction Cycles and Account Balances* — distills auditing concepts and standards into audit procedures applicable to four major transaction cycles: the revenue/receipt cycle (Chapter 12), the expenditure/disbursement cycle (Chapter 13), the conversion cycle (Chapter 14), and the financing cycle (Chapter 15). The chapters in Part Five emphasize both transaction cycles and detailed testing of account balances.

Part Six — *Reporting and Audit Research* — encompasses the auditor's standard report, other types of reporting, and how an auditor researches nonroutine accounting and audit practice problems. Chapter 16, "The Auditor's Standard Report," describes the meaning and historical evolution of the independent auditor's attest function, and the decision process inherent in forming an opinion on financial statements. Chapter 17, "Other Reporting," discusses reporting in a variety of nonaudit situations, such as reports on compilations and reviews, interim financial information, internal accounting control, financial forecasts, and personal financial statements. The text concludes with Chapter 18, "Researching Audit Practice Problems," which describes the role of research in audit practice, an auditor's typical research approach, and several manual and computer-assisted research sources commonly used in practice.

Finally, I gratefully acknowledge the American Institute of Certified Public Accountants, the Association of Government Accountants, the Institute of Internal Auditors, Inc., the Institute of Management Accounting, Deloitte Haskins & Sells, Ernst & Whinney, and Peat, Marwick, Mitchell & Co. for permission to quote from their various pronouncements and/or publications. Further, I would very much appreciate any constructive comments or criticisms that might improve either the content or form of the text.

David N. Ricchiute
Notre Dame, Indiana

CONTENTS

PART ONE

External, Internal, and Public-Sector Auditing

1	The Accounting Profession and External Auditing	1
	Nature of Auditing	2
	The Need for External Auditing	4
	The Scientific Method of Inquiry and Auditing	5
	Public Accounting: An Overview of Professional Practice	6
	Responsibilities and Functions of Independent Auditors (Briefly)	12
	Professionalism	12
	Historical Background: The Evolution of Auditing in the U.S.	14
	Organizations Influencing Accounting and Auditing	18
	Standard Audit Reports: The End Product	20
	Summary	22
 2	 Internal and Public-Sector Auditing	 28
	Internal Auditing	29
	Public-Sector Auditing	38
	Summary	45
	Appendix A: Summary of General and Specific Standards for the Professional Practice of Internal Auditing	48
	Appendix B: Summary of Standards for Audit of Governmental Organizations, Programs, Activities, and Functions	50

PART TWO

Theory, Standards, and Ethics

3	Auditing Theory and Standards	64
	Theory in Auditing	65
	Auditing Concepts	67
	Generally Accepted Auditing Standards	73
	Modifying Conventions	82
	Audit Standards Setting	85
	Summary	87
4	The Ethical Environment	95
	Relating General and Professional Ethics	96
	AICPA Code of Professional Ethics: An Overview	97
	Concepts of Professional Ethics	98
	Rules of Conduct	99
	Ethics Enforcement	112
	Summary	114
	Appendix A: The Institute of Internal Auditors' Code of Ethics	114
	Appendix B: The Association of Government Accountants' Code of Ethics	116

PART THREE

Responsibilities and Legal Liability

5	Auditor Responsibilities: Errors, Irregularities, and Illegal Acts	127
	The Expectation Gap	128
	Detecting Errors or Irregularities	129
	Illegal Acts by Clients	133
	The Foreign Corrupt Practices Act	135
	FCPA-Related Pronouncements: An Overview	141
	Toward a Model of Auditors' Responsibilities	143
	Mautz and Sharaf: Responsibilities and Due Audit Care	143
	The Commission on Auditors' Responsibilities: Fraud Detection and Corporate Accountability	145
	Summary	149
6	Auditors' Legal Liability	156
	The Legal Environment	157
	Liability Under Common and Statutory Law: An Overview	158

Common Law Liability	163
The Securities Acts	168
Statutory Liability	174
Criminal Liability	177
Coping with Potential Liability	178
Summary	180
Appendix: Other Significant Legal Liability Cases	180

PART FOUR

Audit Technology: Evidence, Internal Control, EDP, and Sampling

7	Evidence, the Audit Process, and Documentation: An Overview	192
	Audit Evidence	192
	The Audit Process: An Overview	198
	Audit Working Papers	208
	Quality Control and Peer Review	214
	Summary	220
8	The Nature, Study, and Evaluation of Internal Control	225
	The Nature of Internal Control	226
	Accounting Control	227
	Transaction Cycles	234
	Studying and Evaluating Internal Control	239
	Communicating Accounting Control Weaknesses	247
	Summary	249
9	Auditing and EDP	262
	Nature of EDP Systems	262
	The Impact of EDP on Accounting Control	267
	EDP General and Application Controls	268
	General Controls	269
	Application Controls	278
	File Reconstruction	282
	Studying and Evaluating Accounting Control in an EDP Environment	284
	Summary	288
10	Statistical Sampling for Attributes and Variables: Concepts	295
	The Nature of Audit Sampling	296
	Some Advantages and Disadvantages of Statistical Sampling	296

Basic Statistical Concepts	297
Uncertainty and Ultimate Risk	304
Summary	315

11	Statistical Sampling for Attributes and Variables: Applications	320
	Compliance Testing: Sampling for Attributes	321
	Substantive Testing: Sampling for Variables	332
	Summary	349

PART FIVE

Audit Method: Auditing Transaction Cycles and Account Balances

12	Auditing the Revenue/Receipt Cycle: Sales, Receivables, Cash Receipts, and Cash Balances	355
	Nature of the Revenue/Receipt Cycle	356
	Internal Controls Over Revenue/Receipt Cycle Activities	356
	Studying and Evaluating Internal Control	363
	Substantive Tests	367
	Summary	379
13	Auditing the Expenditure/Disbursement Cycle: Purchases, Payables, Cash Disbursements, Personnel and Payroll	388
	Nature of the Expenditure/Disbursement Cycle	389
	Purchasing	389
	Personnel and Payroll	399
	Summary	405
14	Auditing the Conversion Cycle: Inventory, Cost of Sales, and Plant Assets	411
	Nature of the Conversion Cycle	411
	Inventory	412
	Plant Assets	421
	Summary	428
15	Auditing the Financing Cycle: Equity, Long-Term Debt, and Investments	436
	Nature of the Financing Cycle	436
	Equity and Debt Financing	437

Investments	444
Substantive Tests of Revenue and Expense Accounts	446
Completing an Audit	447
Summary	455

PART SIX

Reporting and Audit Research

16	The Auditor's Standard Report	463
	Evolution of Audit Reports	464
	The Standard Report: An Overview	466
	Forming an Opinion: The Decision Process	472
	Modifications to Standard Reports	474
	Reporting on Information Accompanying Financial Statements	483
	The Commission on Auditors' Responsibilities: Criticisms of the Standard Audit Report	488
	Summary	489
 17	 Other Reporting	 498
	Compilations and Reviews	498
	Interim Financial Information	503
	Reporting on Internal Accounting Control	506
	Comprehensive Bases of Accounting Other Than GAAP	509
	Reports on Specified Elements, Accounts, or Items of a Financial Statement	511
	Reports on Compliance with Contractual Agreements or Regulatory Requirements	513
	Letters for Underwriters	513
	Financial Forecasts	514
	Personal Financial Statements	516
	Summary	517
 18	 Researching Audit Practice Problems	 523
	The Importance of Research in Audit Practice	523
	The Need for Research	525
	A Research Approach	526
	Manual Research Sources	528
	Computer-Assisted Research Sources	533
	Summary	535

1

THE ACCOUNTING PROFESSION AND EXTERNAL AUDITING

Major topics discussed in this chapter are the:

- *Scope of and need for auditing.*
- *Nature of external auditing and the attest function.*
- *Relationship between auditing and the scientific method of inquiry.*
- *Structure of public accounting firms and nature of services offered.*
- *Attributes list and intimidation model approaches to professionalism and their significance to the practice of public accounting.*
- *Evolution of auditing in the United States.*
- *Major contemporary organizations influencing accounting and auditing thought.*
- *Form and content of standard audit reports.*

Within the past several decades, accounting and auditing have matured into vital, complex, and indeed controversial professional activities: vital, because some of the best minds have entered the profession; complex, because accounting and auditing methodology have become increasingly sophisticated; and controversial, because several public- and private-sector organizations have strongly criticized the performance of accountants and auditors. One could have picked no better time to study accounting and auditing, no better time to become an accountant or auditor. Hopefully, if the current pace continues, this comment will be as appropriate ten years from now as it is today; accounting and auditing have matured, yet they continue to grow.

This chapter is an introduction to the accounting profession and external auditing. The chapter begins with a discussion of the nature of auditing in general, the external auditor's attest function, and the need for external auditing. The relationship between auditing and the scientific method of inquiry is subsequently explored, followed by a description of the professional practice of public accounting and a brief introduction to the responsibilities and functions of independent auditors. In turn, professionalism, the historical evolution of auditing in the U.S., and the major professional organizations currently influencing accounting and auditing thought are discussed. The chapter concludes with an overview of the end result of external auditing — the standard audit report.

NATURE OF AUDITING

There are many different types of audits as distinguished by the purposes for which an audit is performed and the information or activities upon which an audit focuses. *External auditing* refers to financial-statement audits performed by external or independent auditors¹ and is the predominant focus of this book. However, the fundamental concepts of auditing are applicable to all types of audits, whether performed by external auditors or by internal or public-sector (government) auditors. Internal and public-sector auditing are discussed in Chapter 2.

Over the years the term "auditing" has been defined by a variety of different organizations and individuals. In 1972, the American Accounting Association's Committee on Basic Auditing Concepts developed a definition that is not only clear, concise, and intuitively logical, but sufficiently broad to encompass many different types of audits. The Committee's report, entitled *A Statement of Basic Auditing Concepts* (ASOBAC), defines auditing as follows:

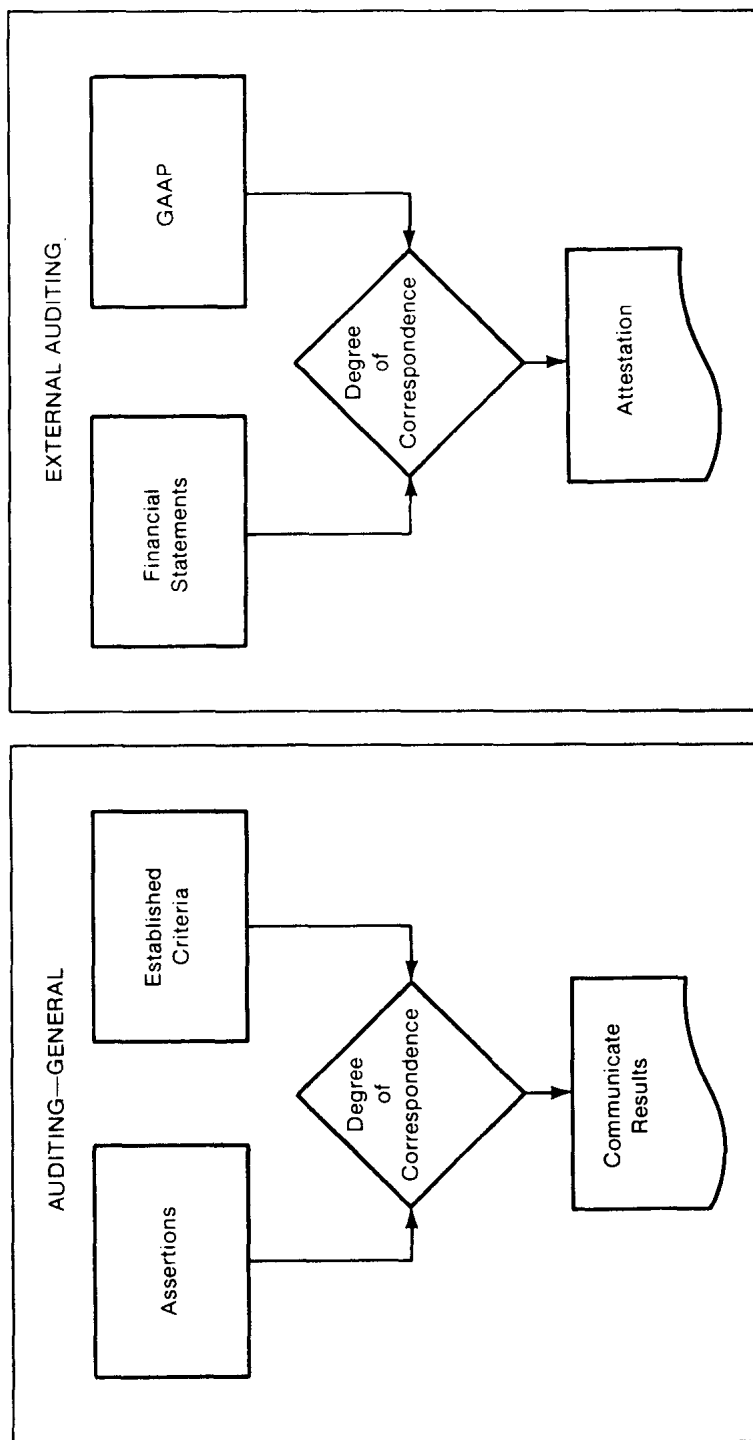
Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.²

As this definition implies, auditing encompasses both an *investigative process* and a *reporting process*. Investigation involves the systematic gathering and evaluation of evidence as a basis for determining whether assertions made, for example, in an entity's financial statements correspond with established criteria, such as generally accepted accounting principles (GAAP). In turn, reporting involves communicating an evaluation or opinion in an audit report to interested users. Figure 1-1 presents a general model of auditing as defined in ASOBAC and adapts the model to external auditing.

¹The phrases *external auditor* and *independent auditor* are used interchangeably throughout this book to designate a CPA practicing in a public accounting firm.

²Committee on Basic Auditing Concepts, "A Statement of Basic Auditing Concepts," *The Accounting Review*, supplement to vol. 47, 1972, p. 18.

FIGURE 1-1
Auditing: A Model



In the context of an external financial-statement audit, the opinion or judgment conveyed in an audit report is referred to as an *attestation* and defined in ASOBAC as follows:

Attestation is a communicated statement of opinion (judgment), based upon convincing evidence, by an independent, competent, authoritative person, concerning the degree of correspondence in all material respects of accounting information communicated by an entity (individual, firm, or governmental unit) with established criteria.³

The opinion or judgment conveyed in a standard report depends upon the results of the audit and may indicate that the financial statements:

1. Are presented in conformity with GAAP.
2. Are *not* presented in conformity with GAAP.
3. Cannot be attested to; for example, if sufficient evidence cannot be obtained.

Of course, an auditor cannot communicate an opinion without conducting an audit; to do so risks communicating inappropriate opinions and sustaining significant legal liability. However, an auditor can communicate "limited assurance," rather than an opinion, without conducting an audit. Limited assurance represents a much lower degree of assurance than an opinion and is discussed more fully in Chapter 17.

THE NEED FOR EXTERNAL AUDITING

Independent auditors perform financial-statement audits because the users of financial information have a need for these services. In short, there is an established market for auditing services.

Users of financial information can be classified as either internal or external to a business entity. *Internal users* include corporate controllers, management accountants, and internal auditors, among others. Because they are directly involved in achieving the business entity's goals, these users are willing to rely initially upon internally generated financial information. Ultimately, however, internal users require an unbiased opinion as a check upon management, employees, and the financial accounting and reporting system.

In contrast, *external users* typically are far removed from the operation of the business entity and are, at best, only indirectly involved in achieving the entity's goals. Thus, external users are reluctant to rely upon internally generated financial information; rather, they prefer the "comfort" of an audit. Although many and varied in their needs, external users can be categorized generally as investors (e.g., present and potential debt and equity security holders), creditors (e.g., banks and suppliers), analysts (e.g., underwriters and credit rating bureaus), and financial information monitors (e.g., regulatory agencies and stock exchanges).

³*Ibid.*, p. 22.

An independent auditor's opinion provides both internal and external users with input to making reasoned, logical, and informed decisions about a variety of financial matters, including a business entity's earnings performance, financial position, liquidity position, managerial performance, and economic vulnerability. Without auditors, decisions such as these are more likely to be made from biased financial information. Auditing helps to minimize biases that might result from a business entity's undisclosed errors, irregularities, or illegal acts.

THE SCIENTIFIC METHOD OF INQUIRY AND AUDITING

An external audit is a systematic process which begins with a client's request for audit services and culminates in an attestation. In the physical sciences, a similar systematic process occurs when a scientist is confronted with a research problem that must be solved; the process referred to is the *scientific method of inquiry*. Of course, there are differences between the activities of auditors and scientists. However, there are remarkable similarities, suggesting that auditors can learn much about the nature of audit methodology from a scientist's method of investigation.

Unlike scientists, auditors must reach conclusions within a reasonable and cost-efficient time frame, usually several weeks. Nevertheless, the judgments of both auditors and scientists rely heavily upon the quality and quantity of evidence obtained. Thus, despite differences between scientists' and auditors' activities, the common dependence upon evidence suggests that "... we should keep in mind the well-deserved prestige of scientific methods and consider the extent to which they suggest the possibility of improvement in the auditing method."⁴

The scientific method of inquiry is a logical, evaluative framework for reaching reasoned, supportable conclusions. Cohen and Nagel, in *An Introduction to Logic and Scientific Method*, capture the essence of the scientific method:

Scientific method . . . is the persistent application of logic as the common feature of all reasoned knowledge.

. . . but in essence scientific method is simply the pursuit of truth as determined by logical considerations.⁵

If the phrase "scientific method" were replaced by "auditing," Cohen and Nagel's comments would capture the essence of auditing as well.

In general, the logical considerations inherent in the scientific method are as follows:

1. Observe and recognize a problem.
2. Formulate overall and composite hypotheses.

⁴R. K. Mautz and H. A. Sharaf, *The Philosophy of Auditing* (Sarasota: American Accounting Association, 1961), p. 23.

⁵M. R. Cohen and E. Nagel, *An Introduction to Logic and Scientific Method* (New York: Harcourt, Brace, and Company, 1934), p. 192.

3. Gather relevant, verifiable evidence to test hypotheses.
4. Evaluate evidence.
5. Develop conclusions.

Figure 1-2 illustrates an external auditing equivalent of each consideration. The auditing scenario developed in Figure 1-2 is common to every professional auditing engagement; an audit is nothing more than a special application of the scientific method of inquiry.

PUBLIC ACCOUNTING: AN OVERVIEW OF PROFESSIONAL PRACTICE

The phrase “public accounting” describes the separate body of knowledge and related services provided to clients by public accountants. The services of public accountants are provided to the general public; the services of internal auditors, management accountants, and government accountants are not. In general, the services of public accountants include auditing, tax services, management advisory services, and accounting services. Other services are also provided by public accountants, but they are minor.⁶

Auditing

As was the case several decades ago, auditing remains the most common service offered by the larger public accounting firms. Generally, there is less emphasis on auditing in smaller firms. Clients typically request audit services because third parties, such as the Securities and Exchange Commission (SEC) or lending institutions, require an independent opinion as to whether financial statements are presented fairly in accordance with generally accepted accounting principles (GAAP). Opinion audits result in a public accounting firm attesting that financial statements are presented in conformity with GAAP, are not so presented, or that an opinion cannot be given.

Tax Services

Because a client's tax liability is dependent upon accounting records, public accounting firms are particularly qualified to provide a variety of tax preparation and planning services. Tax services are usually provided

⁶For discussions of contemporary and emerging services see, for example: J. C. Burton, “Management Auditing,” *Journal of Accountancy* (May, 1968), pp. 41–54; R. J. Bergwerk, “Personal Financial Counseling by CPAs — A Neglected Service,” *Journal of Accountancy* (May, 1978), pp. 50–58; S. P. Gunther, “The CPA's Role in Mergers and Acquisitions,” *Journal of Accountancy* (February, 1979), pp. 47–56; E. H. Morse, Jr., “Performance and Operational Auditing,” *Journal of Accountancy* (June, 1971), pp. 41–46; F. Pomeranz, “Public Sector Auditing: New Opportunities for CPAs,” *Journal of Accountancy* (March, 1978), pp. 48–54; S. Simich and R. Strauss, “The Energy Audit,” *Journal of Accountancy* (November, 1978), pp. 52–59; E. B. Staats, “Grant Audits: A New Vista for CPAs,” *Journal of Accountancy* (April, 1979), pp. 68–72.