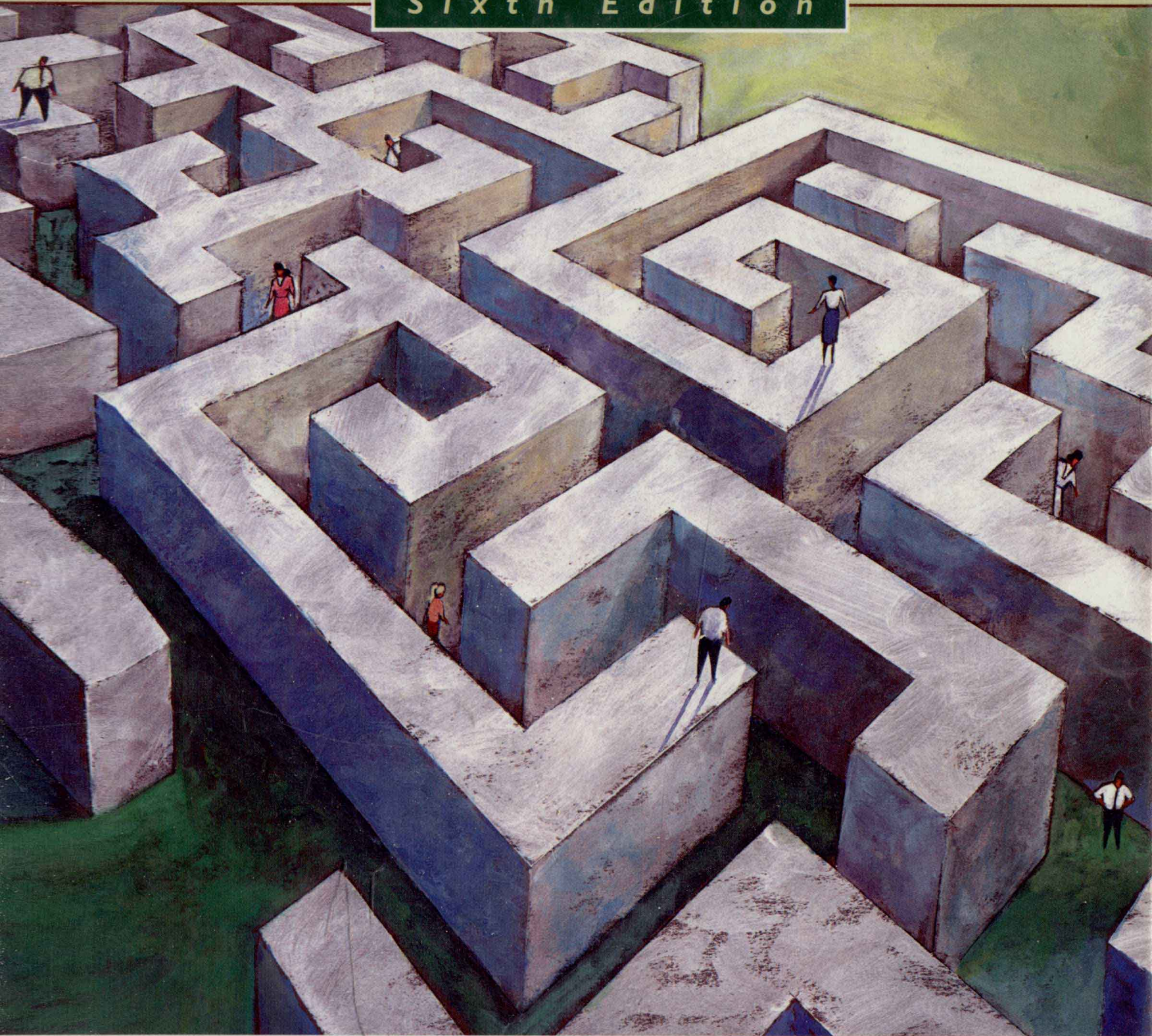


# MODERN AUDITING

*Sixth Edition*



WILLIAM C. BOYNTON / WALTER G. KELL



# MODERN AUDITING

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SIXTH EDITION

**WILLIAM C. BOYNTON**

*California Polytechnic State University at San Luis Obispo*

**WALTER G. KELL**

*University of Michigan*



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# MODERN AUDITING

TO THE STUDENT: A Study Guide for the textbook is available through your college bookstore under the title Study Guide to accompany MODERN AUDITING 6th edition by *William C. Boynton* and *Walter G. Kell*. The Study Guide can help you with course material by acting as a tutorial, review, and study aid. If the Study Guide is not in stock, ask the bookstore manager to order a copy for you.

# ABOUT THE AUTHORS

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# PREFACE

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*Modern Auditing* is designed primarily for the first course in auditing either at the undergraduate or graduate level. Materials in selected chapters and appendices, and cited in chapter bibliographies, may also serve as the core for a second or advanced course in auditing. Throughout the book, every effort has been made to integrate auditing theory and concepts with auditing methodology and practice. In addition, emphasis is given to the professional responsibilities of independent auditors, including the role of auditing in business, government, society, and the international arena.

Our goals in preparing this edition were to (1) make refinements in the style and clarity of presentation to maximize the effectiveness of the text as a learning resource for students, (2) make further refinements in the organization of the text to enhance its flexibility in accommodating different teaching schedules and preferences, and (3) provide comprehensive and integrated coverage of the latest developments in the environment, standards, and methodology of auditing.

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## HIGHLIGHTS OF CHANGES FROM THE PREVIOUS EDITION

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In seeking the goals just enumerated, changes made in this edition include the following:

- A brief historical perspective on the auditing profession has been added to the first chapter.
- New material on general ethics and an ethical decision-making model precedes the completely updated presentation of the *Code of Professional Conduct*.
- The chapter on legal liability provides a perspective on the so-called litigation crisis, assesses the impact of important recent legal cases, and addresses the profession's call for additional legal reforms.
- All chapters containing material on internal controls have been updated to conform to the five-component framework adopted in the COSO report entitled *Internal Control—Integrated Framework*. (This framework is also being incorporated into the Auditing Standards Board's impending revision of *Statement on Auditing Standards No. 55*.)
- Specific transaction class and account balance audit objectives are more clearly defined and linked to tests of controls and substantive tests in each of the cycle chapters.
- The discussion of governmental auditing includes key elements of the 1994 revision of the GAO's *Yellow Book*.
- Increased attention is given to international auditing issues through "global boxes," selected comparisons of U.S. and international auditing practices, and citations to relevant international auditing standards in the chapter bibliographies.

- End-of-chapter materials now include research questions that require students to utilize a variety of professional publications, including the professional standards, professional journals, and SEC *Accounting and Auditing Enforcement Releases*. These can be assigned to individuals or groups, and can serve as a basis for individual or group class presentations by students to complement text coverage on a variety of topics.
- A new appendix to the text discusses the role of auditing research and provides guidance on research tools and their use.
- To assist students to make self-assessments of their understanding of key points, the 20 “review questions” formerly included in end-of-chapter materials are now interspersed throughout each chapter as “Learning Checks” following each major chapter section.

## ORGANIZATION

The organization of the text continues to provide maximum flexibility in choosing the amount and order of material to be covered. For example, the entire-audit process is covered outside the cycle chapters. The chapters dealing with ethics, legal liability, and auditors’ reports can be covered early or late in the course. The chapters on statistical sampling can be covered before the cycle chapters or be interspersed with the cycle chapters.

The Sixth Edition is organized into five parts as follows:

Part	Subject	Chapters
1	The Auditing Environment	1–4
2	Audit Planning	5–8
3	Audit Testing Methodology	9–13
4	Auditing the Transaction Cycles	14–18
5	Completing the Audit, Reporting, and Other Services	19–23

As shown in the foregoing tabulation, **Part 1, The Auditing Environment**, includes four chapters. Chapter 1, “Auditing and the Public Accounting Profession,” provides an historical perspective on the auditing profession, differentiates the types of services performed by CPAs, explains the roles of the key private and public sector organizations that are associated with or influence the profession, and describes the elements of the multilevel regulatory framework that have as their objective enhancing the quality of services provided by the profession. Chapter 2, entitled “Financial Statement Audits and Auditors’ Responsibilities,” describes the role and limitations of financial statement audits, introduces auditing standards and the types of auditors’ reports, and explains the expectation gap and related responsibilities regarding the detection of errors and irregularities, illegal client acts, and circumstances involving substantial doubt about the client’s status as a going concern. Chapter 3, “Professional Ethics,” begins with a discussion of ethics and morality from the perspective of both general and professional ethics, and provides in-depth discussions of the profession’s *Code of Professional Conduct* and its enforcement. Chapter 4, “Auditor’s Legal Liability,” includes a thorough discussion of the legal environment and the auditor’s exposure to liability under the common law and statutory law.

**Part 2, Audit Planning**, is also comprised of four chapters. Chapter 5, "Audit Objectives, Audit Evidence, and Working Papers," lays the foundation for audit planning through explanations of these three fundamentals of auditing. Coverage is given to the relationships among types of evidence, auditing procedures, classes of audit tests, and audit objectives, and to the importance of properly prepared working papers. Chapter 6, "Accepting the Engagement and Planning the Audit," begins with an overview of the four phases of a financial statement audit. Next, the factors that an auditor should evaluate before accepting an audit engagement are explained. The chapter then identifies the steps that should be performed in planning the audit, and concludes with coverage of the use of analytical procedures in audit planning. Chapter 7, "Materiality, Risk, and Preliminary Audit Strategies," provides a solid foundation in these three important auditing concepts. Part 2 concludes with Chapter 8, "Understanding the Internal Control Structure." Attention is focused on the definition, fundamental concepts, components, and limitations of internal control structures, and how the auditor obtains and documents an understanding of internal control structures. An appendix to Chapter 8 supplements the basic coverage of flowcharting that is provided within the body of the chapter.

**Part 3, Audit Testing Methodology**, includes five chapters. Chapter 9, "Assessing Control Risk/Tests of Controls," explains the auditor's methodology for meeting the second standard of field work under alternative audit strategies. Attention is given to the nature, timing, and extent of tests of controls and to documenting the assessed levels of control risk for assertions pertaining to transaction classes. Consideration is then given to combining control risk assessments for transaction class assertions to arrive at control risk assessments for account balance assertions. Chapter 10, "Detection Risk and the Design of Substantive Tests," explains the application of the audit risk model to determine the acceptable level of detection risk for account balance assertions. Consideration is then given to the effects of detection risk on the nature, timing, and extent of substantive tests. The chapter includes the development of a general framework that can be used in designing substantive tests for assertions in each of the transaction cycles.

The use of statistical and nonstatistical sampling in auditing is explained in Chapters 11 and 12. In Chapter 11, the focus is on tests of controls, whereas in Chapter 12 it is on substantive tests. The latter includes both probability-proportional-to-size, or dollar unit sampling, and classical variables sampling. Part 3 concludes with Chapter 13, "Auditing Electronic Data Processing Systems." Although EDP considerations are now integrated throughout the text, this chapter includes additional information on such topics as data organization and processing methods, EDP controls, and computer-assisted audit techniques including mainframe and microcomputer-based audit software.

**Part 4, Auditing the Transaction Cycles**, has five chapters. Chapters 14 and 15 deal with the revenue and expenditure cycles, respectively. Each chapter starts with an overview of the transaction classes, accounts, and activities associated with the cycle. The audit planning and testing methodologies developed in Parts 2 and 3 are then applied in (1) developing specific audit objectives for the cycle; (2) considering materiality, risk, and audit strategy; (3) obtaining an understanding of the internal control structure and assessing control risk; and (4) developing audit programs to meet the acceptable levels of detection risk for assertions pertaining to selected accounts. A similar pattern is followed in both Chapter 16, which covers the production and personnel services cycles that focus on inventory and



payroll assertions, respectively, and Chapter 17, which covers the investing and financing cycles. Since transactions in five of the six cycles affect cash, the audit of cash balances is covered separately in Chapter 18.

The Sixth Edition concludes with **Part 5, Completing the Audit, Reporting, and Other Services**. Chapter 19 covers four topics: completing the field work, evaluating audit findings, communicating with the client, and fulfilling postaudit responsibilities. Chapter 20, "Reporting on Audited Financial Statements," provides in-depth explanations of the four reporting standards, the auditor's standard report, and circumstances requiring departures from the standard report. The chapter includes numerous illustrations of audit reports and a summary of the effects of circumstances on auditors' reports. Chapter 21, "Other Reports and Services," emphasizes the standards and reports associated with other attest and accounting services offered by CPAs. Chapter 22 is entitled "Internal, Operational, and Governmental Auditing." In addition to describing the standards applicable to each type of auditing, extensive consideration is given under governmental auditing to compliance auditing and the requirements of the Single Audit Act. Part 5 concludes with Chapter 23, "The Independent Accountant and the Securities and Exchange Commission." This chapter continues our coverage of the accountant's auditing and reporting responsibilities under the 1933 and 1934 securities acts. A final appendix to the text, which can be assigned at any point in the auditing course, deals with auditing research.

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## CONTINUING FEATURES

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The following popular features of earlier editions are continued in this edition:

- Learning objectives for each chapter, now referenced in the text margins as well as being listed at the beginning of the chapter.
- Integration of material from authoritative auditing and professional literature throughout the text.
- Abundant illustrations of key concepts, flowcharts, and audit reports.
- Real-world vignettes illustrating contemporary applications of text materials interspersed throughout the text.
- Lists of key terms with page references, now located with the "Learning Checks" at the end of each major section of each chapter.
- Chapter bibliographies that include both relevant AICPA professional standards and selected readings from other official literature and accounting journals.

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## END-OF-CHAPTER MATERIALS

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As in previous editions, there is an abundance of end-of-chapter materials, including numerous author-prepared questions, questions from professional examinations, and case studies drawn primarily from practice. In addition to the 20 review questions now interspersed throughout each chapter in the "Learning Checks," a typical chapter includes

- 6 to 15 multiple choice questions drawn from the Uniform CPA Examination unless stated otherwise.
- 10 to 15 comprehensive questions that include essay questions from professional examinations.
- 1 to 3 case studies that generally integrate several key concepts covered in the chapter.
- 1 or more research questions.

Comprehensive questions from professional examinations are designated as follows: AICPA (Uniform CPA Examination), ICMA (Certified Management Accountant Examination), IIA (Certified Internal Auditor Examination). In total, there are over 900 questions and cases that have been carefully edited to related chapter content.

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## SUPPLEMENTARY MATERIALS

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The supplements to this edition of *Modern Auditing* consist of (1) an instructor's resource guide and solutions manual, (2) a test bank, (3) *Microtest* test-generating software, (4) a Lotus-based software package, and (5) a student study guide.

The *Instructor's Resource Guide and Solutions Manual* contains outlines of the text chapters; suggestions for lectures, classroom activities, and assignments; transparency masters; and references to videos and other supplementary aids the instructor may wish to use. As in previous editions, detailed solutions to the end-of-chapter questions and case studies are provided.

The *Test Bank* is available in hard copy and electronic format (*Microtest*) to facilitate test preparation on a personal computer. The test items are all original and include a large selection of multiple choice questions, correct/incorrect statements, matching questions, and short essay and analysis questions. Suggested solutions are included.

The Lotus-based software package, entitled *AUDSAMP: Statistical Sampling Templates for Lotus 1-2-3*, runs on IBM compatible personal computers. A master copy of a diskette and a brief accompanying manual are provided free of charge to adopters for local reproduction and distribution. The templates afford the student an opportunity to design and evaluate statistical samples and produce related working papers using a personal computer. Problems in several chapters of the text that can be solved with these templates have been marked with a disk icon.

The student *Study Guide* to accompany the Sixth Edition includes for each text chapter an expanded outline, 30 chapter highlights, 25 true/false statements, 15 completion questions, and 20 multiple choice questions. Solutions are included at the end of each chapter.

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## ACKNOWLEDGMENTS

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We take this opportunity to express our sincere appreciation to individuals who have made significant contributions to the Sixth Edition of *Modern Auditing*.

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We also gratefully acknowledge the permission given by the American Institute of Certified Public Accountants, the Institute of Management Accountants, and The Institute of Internal Auditors to use materials from their publications, including their professional examinations.

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William C. Boynton  
Walter G. Kell  
March, 1995

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