

MODERN AUDITING

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Preface

DESIGNED PRIMARILY for the first course in auditing at either the undergraduate or graduate level, *Modern Auditing* offers a unique blend of the contemporary and traditional approaches to the study of auditing. This book recognizes the importance of transactions cycles in the study and evaluation of internal control while retaining the time-honored balance sheet approach in the verification of transaction cycle account balances.

Throughout the book, every effort is made to integrate auditing concepts with auditing methodology, and auditing theory with auditing practice. In addition, emphasis is given to the professional responsibilities of the independent auditor.

Organization

The organization of this book is designed to maximize the student's understanding of auditing theory and practice. This book is divided into four parts:

<i>Part</i>	<i>Subject</i>	<i>Chapters</i>
I	Fundamental Relationships	1-3
II	Study and Evaluation of Internal Control	4-10
III	Verification of Account Balances	11-15
IV	Reporting and Other Responsibilities	16-20

This arrangement reflects both sound pedagogy and current auditing practices within the public accounting profession. Part I establishes basic auditing concepts and relationships, Part II describes interim field work, Part III explains year-end field work, and Part IV emphasizes the auditor's reporting and professional responsibilities.

Chapter 1 describes the audit function in our society, the form and

content of the auditor's standard report, and the organization of the public accounting profession. Chapter 2 includes quality control, the first four generally accepted auditing standards, and an overview of the auditing process. Chapter 3 combines a conceptual explanation of audit evidence with the practical importance of audit working papers. We recommend that each of these chapters be assigned in sequence.

Part II contains concepts, methodology, and case studies relating to the study and evaluation of internal control. Chapter 4 describes fundamental principles and audit procedures applicable to internal control, and a campus theater is used to illustrate the basic relationships. Chapter 5 includes a basic introduction to statistical sampling and a case study to illustrate the applicability of attribute sampling to the testing of internal control systems. Chapter 6 considers electronic data processing systems and their effects on the auditor's study and evaluation of internal control. The remaining four chapters discuss internal control principles and audit methodology for testing controls for significant classes of transactions within three transaction cycles: revenue, expenditure, and production. Each chapter includes specific audit objectives, errors and irregularities, audit programs for tests of transactions, and case studies of attribute sampling and EDP applications. The authors believe that a full understanding of this phase of the audit process can be achieved by assigning Chapters 4-8 in sequence. Chapters 9 and 10 are viewed as optional chapters that may be assigned by those who wish to obtain complete coverage of the transaction cycles.

The first of the five chapters in Part III of this book describes the concepts of estimation sampling for variables and their application to the verification of account balances. Chapters 12 and 13 explain the methodology for verifying account balances associated with the transaction cycles included in Part II. In each of these chapters, consideration is given to audit objectives, audit programs, and case studies of variables sampling and electronic data processing applications. Chapter 14 focuses primarily on the verification of investing and financing cycle account balances. The final chapter in Part III covers the verification of income statement accounts and the steps involved in completing an audit engagement. The authors recommend, at a minimum, the assignment of Chapters 11-13 and 15. However, those who do not wish to emphasize statistical sampling can omit Chapter 11 without significant consequence to the remaining chapters.

The concluding part of this book relates to the auditor's reporting and professional responsibilities. There are two chapters on the reporting function. Chapter 16 considers audit reports in the typical engagement and uses reports from actual practice to illustrate the various types of audit reports that may be issued. Chapter 17 involves special reports associated with audit engagements and other communications resulting from other types of professional services rendered by a certified public accountant.

Chapters 18-20 describe the auditor's responsibilities in three areas: (1) professional ethics, (2) legal liability, and (3) the Securities and Exchange Commission. The authors believe Chapters 16, 18, and 19 are essential to a basic course in auditing. In our combined experiences in the teaching of auditing, we are convinced that students gain a much greater understanding of the auditor's ethical and legal responsibilities at the end of the course than at the beginning. Consequently, we recommend that these chapters be assigned in the indicated sequence. However, Chapters 18 and 19 are written as free-standing chapters.

Special Features

The following are among the special features of this book:

- Learning objectives for each chapter.
- Identification of functions, common documents, accounting records, and data files for transaction cycles.
- Extensive coverage of the prevention and detection of errors and irregularities.
- Manual and electronic data processing flowcharts for significant classes of transactions within transaction cycles.
- Statistical sampling case studies for tests of transactions and tests of balances.
- Electronic data processing case studies for transaction cycles and computer-assisted techniques in the verification of account balances.
- Integration of authoritative auditing and professional literature throughout the text.
- Full chapter coverage of SEC accounting and reporting requirements.
- Appendixes on flowcharting and significant legal cases.

End-of-Chapter Materials

This book contains an abundance of end-of-chapter materials that have been carefully integrated with chapter content. Each chapter contains a minimum of twenty review questions and twelve to eighteen comprehensive questions. In addition, sixteen of the chapters have a case study drawn from actual practice. The comprehensive questions include questions and problems from uniform examinations given by four professional organizations. These questions have been carefully edited and adapted to the book. In total, there are over 700 questions and cases.

Supplementary Materials

Supplementary materials to accompany this book consist of an *instructor's manual* and a *student study guide*.

In addition to answers to the questions and cases, the instructor's manual includes suggested course outlines, estimated solution times for the comprehensive questions and cases, and specific date references on uniform professional examination questions. The format of the solution manual is readily adaptable to the use of transparencies in the classroom.

A study guide, co-authored with William C. Boynton, Associate Professor of Accounting at the University of Virginia, is available for use with this book. For each chapter of the text, the study guide contains twenty to twenty-five chapter highlights, fifteen to twenty true or false statements, ten completion statements, and twelve to fifteen multiple choice questions taken primarily from the AICPA examination. Solutions to the statements and questions are included at the end of the study guide.

The authors are happy to note that both men and women are active and successful in the auditing profession. It is gratifying to note that women are entering the field in increasing numbers. However, if every sentence in this book used "he/she," "him/her," and "his/hers" when referring to the auditor, the book would become difficult to read. Therefore, for ease of expression, "he," "his," and "him" are used in this book in their grammatical sense and refer to the female as well as male auditor.

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Many acknowledgments need to be made to those who have made significant contributions to this book. First and foremost is the invaluable assistance provided by David B. Pearson, partner in Arthur Young & Company, who read every draft of every chapter and made countless suggestions to improve the book.

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We also wish to acknowledge with deep appreciation the permission of three firms to use selected cases from their files and training programs for our end-of-chapter material. The firms are Arthur Young & Company, Ernst & Whinney, and Peat, Marwick, Mitchell & Co. These cases are identified by an asterisk.

Appreciation is similarly expressed to the AICPA for permission to quote and reproduce materials from their publications and to use questions from the uniform CPA examination. Thanks are also expressed to the Institute of Management Accounting, the Institute of Internal Auditors, and the Canadian Institute of Chartered Accountants for permission to use questions from their uniform examinations for our end-of-chapter material. These questions are respectively designated as CMA, IIA, and CICA.

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I

Fundamental Relationships

In auditing, as in other fields of knowledge, there are fundamental relationships that are essential to a comprehensive understanding of the subject. The basic relationships of auditing are discussed in the three chapters that comprise Part I of this book.

Chapter 1 describes the function of auditing in society, the auditor's standard report, and the nature of the public accounting profession.

In Chapter 2, consideration is given to quality control, the audit process, and audit planning.

Chapter 3 explains the types of audit evidence that may be obtained by the auditor in an audit engagement and the importance of documenting the auditor's work and findings in audit working papers.

