

AUDITING CONCEPTS AND APPLICATIONS

A Risk-Analysis Approach Third Edition

Larry F. Konrath

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RD EDITION

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A Risk-Analysis Approach

LARRY F. KONRATH

UNIVERSITY OF TOLEDO

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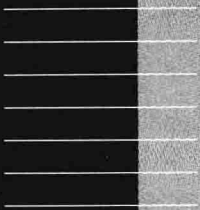
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AUDITING CONCEPTS AND APPLICATIONS

A Risk-Analysis Approach

To the student: A study guide is available to supplement this textbook, entitled *Study Guide to Accompany Auditing Concepts and Applications: A Risk-Analysis Approach, Third Edition*. Containing outlines and review questions/answers, this supplement may be useful in enhancing your understanding of the text material. If your bookstore does not presently stock the study guide, the store manager can order it for you.

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PREFACE

OBJECTIVES AND APPROACH

To cope with today's rapidly changing auditing environment, auditing textbooks must strike a balance between conceptual and applied aspects of the discipline. Therefore, like the earlier editions, the third edition of *Auditing Concepts and Applications: A Risk Analysis Approach* is designed to promote this combination of goals, in addition to stressing the important elements of audit risk analysis. To serve these needs, the text offers a framework that addresses the concepts of audit evidence and materiality in depth. Emphasis is given to the meeting of user expectations through audit risk analysis, application of audit judgment, and ethical considerations in auditing. In meeting the applied goals, *Auditing Concepts and Applications* provides students with an effective preparation source for the auditing part of the Certified Public Accountant examination and is well documented with materials from pronouncements by the American Institute of Certified Public Accountants (AICPA).

To stress the importance of the "risk-driven" audit, audit risk is introduced early in an entire chapter on audit planning and risk analysis (chap. 5). After the topic is developed in chapter 5, the concept of risk analysis is refined and integrated into the remaining chapters as appropriate. Risk is examined relative to all aspects of the audit, from audit planning through internal control evaluation, substantive audit testing, and the audit reporting decision.

To offer full coverage of audit risk, the text assigns much of the accounting systems detail to well-organized and useful chapter appendices. Since many senior-level accounting students have had a course in accounting information systems (AIS), assignment of systems detail to appendices reduces unnecessary topic redundancy in the systems and the auditing courses. For those who have not had a prior systems course, the appendix following chapter 7 should provide sufficient background information.

CHANGES IN THIRD EDITION

The third edition of *Auditing Concepts and Applications* retains and builds upon the risk analysis framework developed in earlier editions. Significant changes have been made, however. Some of the changes involve expansion of topics already covered and the addition of new topics. Other changes improve readability and offer greater flexibility of coverage. The author also has added significant new end-of-chapter materials. The following paragraphs describe the major changes.

EDP Audit Practice Case


Bilrite Bicycles, Inc., a new audit practice case, replaces the Trim Lawn case contained in previous editions of this textbook. The new case is similar to the former in its structure and format, but differs in other respects. The system of internal control, for example, contains strengths and weaknesses that are different from those in the previous case. Also, historical trends in financial position, results of operations, and cash flows differ from these elements of the earlier case. Perhaps most important, the Bilrite modules require the student to conduct more extensive analysis and perform more auditing procedures than did the previous case.

Discussion Cases and Other End-of-Chapter Materials

The author has added fourteen discussion cases following selected chapters. These cases, including Phar Mor, IBM, and Dell Computer Corporation, give added insight into audit risk analysis and the need to exercise due care in conducting audits. Also, this edition of the text contains several new author-prepared problems and essay questions, as well as new essay and multiple-choice questions from recent CPA examinations. Answers to all of the multiple-choice questions, as well as the supporting rationales, are given at the end of the text.

Audit Workpaper Templates

Six of the new author-prepared essay/discussion case questions are accompanied by Lotus 1-2-3 templates contained on the student diskette accompanying this textbook. The templates consist of partially completed audit workpapers. Students are asked to complete the workpapers by analyzing data, performing calculations, stating conclusions, and using audit legends to describe procedures applied. These problems give the student the opportunity to simulate the audit field work experience and to learn how the computer assists in the performance and documenting of audits.

The six cases, identified in the end-of-chapter materials by this computer diskette symbol , are:

- Chapter 4: Discussion Case II—Hanlon, Inc.
- Chapter 5: Discussion Case III—Marcus Publishing, Inc.
- Chapter 11: Problem 11.12—Jones Transfer, Inc.
- Chapter 12: Problem 12.12—Selfers Service Center
- Chapter 13: Problem 13.11—Ronson Manufacturing Company
- Chapter 13: Problem 13.12—Kimberly Wholesale Foods, Inc.

Enlargement of and Changes in Previous Chapter Content

The following sections have been added to selected chapters reflecting current changes in auditing practice:

1. Chapter 4 material on analytical procedures has been expanded and includes an extended illustration to support many of the calculations.

2. Chapter 6 has been completely rewritten to reflect the 1994 report of the Committee of Sponsoring Organizations (the COSO Report).
3. Chapter 15, “Other Accounting Services and Reports,” contains a section on compliance attestation, a rapidly growing segment of public accounting.

In addition, chapter 9, “Auditing with the Computer,” has been eliminated and the material integrated into the other chapters as appropriate.

LEARNING AIDS AND PEDAGOGICAL TOOLS

EDP Audit Practice Case

The appendix following chapter 16 contains a computer audit practice case, Bilrite Bicycles, Inc. The practice case is divided into fifteen modules that parallel related chapter topics. A diskette containing partially completed audit workpapers is included with the textbook. The modules, which may be assigned individually or severally, at the instructor’s option, begin following chapter 8. They continue at the end of succeeding chapters, ending with chapter 14.

The practice case permits the student to discover how much of the typical financial audit can be automated with the computer. In addition, the student obtains a hands-on exposure to computer auditing. The materials are sufficiently menu-driven that excessive amounts of computer time are not consumed by the exercises. However, at the same time the student must assess audit risk, analyze data, apply auditing procedures, and evaluate the results—all with the aid of the computer. These materials make *Auditing Concepts and Applications* unique in the market and add an exciting dimension to the study of auditing.

For students wishing to complete the case without using a computer, a workbook is available at a nominal charge from West Educational Publishing. The workbook contains the same partially completed audit workpapers that are included on the diskette.

Writing Ability

An appendix entitled “Effective Writing in Auditing” appears following chapter 8. The purpose of this appendix is to help accounting students and accounting practitioners improve their writing ability. It is also designed to help CPA candidates become more proficient in answering essay questions on the exam. A case is presented at the end of the appendix. This case requires the student to write a reportable conditions letter (a letter describing significant deficiencies in internal control) and gives them an opportunity to apply the concepts and suggestions offered in the appendix.

As an added benefit, the appendix should help students complete Module I of the Bilrite Bicycles audit practice case. Module I requires the student to prepare a narrative describing the results of his or her analysis of audit risk and justify the chosen risk levels. Students are encouraged to provide clear and complete narrative that flows logically. The guidelines contained in the appendix will facilitate the process.

Audit Objectives and Procedures Matrices

Matrices providing an integrated framework for analysis are included in appendices following chapters 11 through 13.

The matrix approach helps to reinforce students' understanding of substantive audit testing by providing a framework for developing audit programs. This approach also enables students to build their own audit programs around careful risk analysis and formulation of specific objectives.

Use of Cases

To bring the material alive and to emphasize the importance of risk analysis in auditing, *Auditing Concepts and Applications* makes liberal use of case examples. Extensive reference to cases involving auditors serves to reinforce the student's mastery of concepts by relating a given concept to an actual company. Some of the cases are incorporated into the chapters, while others are included as end-of-chapter materials. All of the cases are based on actual events, and are structured to contrast what should have been done with what actually was done.

The Expectation Gap and the Auditor

The 1977 report of the Commission on Auditors' Responsibilities first identified what was subsequently referred to as the "expectation gap." In this report, the Commission stated:

It is vital to the economy that users of information have confidence in auditors. Such confidence is dependent on mutual understanding as to the appropriate responsibilities of auditors and a belief by users that such responsibilities are being fulfilled. . . . The expectation gap is at the heart of the criticism of the profession. Only when this gap is narrowed and reasonable levels of expectation are established as guidelines for professional conduct will the litigious environment in which we exist be sharply narrowed.¹

The many recent cases presented illustrate the continuing seriousness of the expectation gap. The only way to narrow the gap effectively is for auditors to perform *risk-based* audits: the approach developed and emphasized in this textbook.

Illustrations

Extensive use is made of diagrams, tables, and listings to ease the learning process. Control flowcharts and listings of necessary documents, records, and functions appended to the control chapters provide an easy review of control techniques without unnecessarily cluttering the chapter on internal control concepts.

¹Commission on Auditors' Responsibilities, *Report of Conclusions* (New York: AICPA, 1977).

Coverage of AICPA Professional Standards

The standards issued by the American Institute of Certified Public Accountants, referred to as *AICPA Professional Standards*, are given comprehensive coverage throughout the text as they impact given subject areas.

Chapter Organization

Careful attention has been given in *Auditing Concepts and Applications*, Third Edition, to chapter organization in order to maintain maximum clarity and completeness. The study of auditing is organized into five major categories. Chapters 1 through 3 describe the **environment of auditing**; Chapters 4 through 7 present a **conceptual approach to auditing**; Chapters 8 through 10 address **computer and statistical applications in auditing**; Chapters 11 through 13 cover the topic of **substantive audit testing**; and Chapters 14 through 16 discuss **audit reports and other accounting services**.

Chapter Outline, Overview, and Study Objectives

At the beginning of each chapter, an outline, an overview, and a listing of study objectives are presented to introduce the reader to the major topics to be covered and to identify the major concepts to be learned from studying the chapter.

Key Terms and Glossary

A list of key terms is provided at the end of each chapter and serves as additional reinforcement of the learning process. Although auditing is related to accounting, it is not the same. The auditing student encounters many new terms, as well as familiar terms with a different connotation.

A *complete glossary* at the end of the textbook supplements the list of key terms and helps the student learn the language of auditing.

End-of-Chapter Materials

Essay questions, problems, and discussion cases, along with multiple-choice questions from past CPA and CIA exams, are supplied at the end of each chapter. End-of-chapter review questions and applicable parts of the Biltrite computer audit practice case also are included. Flowcharting problems following chapters 7 and 8 afford an opportunity to study an internal control narrative and graphically present it in the form of a flowchart. The template problems, together with the Biltrite practice case, offer a “hands-on” audit field work experience.

When considered collectively, these materials serve the dual purpose of solidifying the learning process and providing the student with questions important to CPA exam preparation. The multiple-choice questions are especially effective in reviewing

the contents of the Statements on Auditing Standards (SASs), a major component of the auditing part of the CPA exam. Answers to the multiple-choice questions, along with the reasons for correct and incorrect choices, are given at the end of the textbook.

SUPPLEMENTS

Materials available to supplement this textbook include an *Instructor's Manual*, a *Study Guide*, a computerized *Test Bank*, and an *Instructor's Diskette*. In addition, for those completing the Bilrite case without using a computer, a *Workbook* of partially completed audit workpapers is available. The *Test Bank* contains over one thousand questions, including multiple-choice questions from past CPA and CIA examinations, as well as author-prepared multiple-choice and completion questions. The Test Bank is computerized and compatible with WESTEST. It also is available in printed form. The *Instructor's Manual* includes the following:

1. Answers to end-of-chapter materials: review questions, multiple-choice questions, essay questions, problems (including the six template problems referred to earlier), and discussion cases. For CPA exam and CIA exam questions, the official answers are supplied. For multiple-choice questions, the answers are accompanied by narrative supporting correct choices and reasons other choices are incorrect.
2. Useful outlines for preparing lectures on the topics presented in each chapter.
3. Printout of solutions to the Bilrite Bicycles audit practice case modules.
4. Transparency masters highlighting important chapter topics.
5. Teaching suggestions at the beginning of each chapter, as appropriate, and for the Bilrite Bicycles audit practice case.

The *Instructor's Diskette* contains

1. Completed worksheets for the Bilrite Bicycles audit practice case;
2. Completed templates for the six case/problem assignments for which partial templates are provided on the student diskette; and
3. Lecture outlines.

The *Study Guide* includes the following materials, which students will find useful in mastering the topics covered in the textbook:

1. A review, in expanded outline form, of key points covered in each chapter.
2. True/false questions, completion questions, and practice exercises highlighting major chapter topics.
3. Answers to questions, including reasons for true/false answers.

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permission to use past professional examination questions as a major part of the end-of-chapter materials. Thanks also go to the AICPA and to Mead Data Central for granting permission to reproduce certain audit reports contained in the NAARS data base.

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AN OVERVIEW OF AUDITING

CHAPTER OUTLINE

- I. Definition of auditing**
- II. Why independent auditing is necessary**
- III. Generally accepted auditing standards**
- IV. Independent versus internal auditing**
- V. Audits by government organizations**
 - A. General Accounting Office
 - B. Defense Contract Audit Agency
 - C. Internal Revenue Service
- VI. How auditing differs from accounting**
- VII. Requirements for an effective audit**
- VIII. Evaluation of evidence**
- IX. Communication of the auditor's findings**
- X. The audit process: An overview**
 - A. Audit planning
 - 1. Preliminaries
 - 2. Engagement letter
 - 3. Audit risk analysis
 - 4. Audit field work planning
 - B. Interim audit work
 - C. Final audit work
 - 1. Inventory observation
 - 2. Tests of transactions and balances
 - D. Audit report
- XI. Other services performed by CPA firms**

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