

# Modern Auditing

7<sup>th</sup> edition

**BOYNTON**

**JOHNSON**

**KELL**



**WILEY**  
**INTERNATIONAL**  
**EDITION**

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# MODERN AUDITING

SEVENTH EDITION



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**Raymond N. Johnson**

PORTLAND STATE UNIVERSITY

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**John Wiley & Sons, Inc.**

New York ■ Chichester ■ Weinheim ■ Brisbane ■ Singapore ■ Toronto

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<i>Production Management Services</i>	Hermitage Publishing Services

This book was set in 10/12 Palatino by Hermitage Publishing Services and printed and bound by Von Hoffmann Press, Inc. The cover was printed by Lehigh Press, Inc.

This book is printed on acid-free paper. ∞

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*Library of Congress Cataloging-in-Publication Data*

Boynton, William C.

Modern auditing/William C. Boynton, Walter G. Kell, Ray Johnson, — 7th ed.  
p. cm.

Includes bibliographical references and index.

ISBN 0-471-18909-X (cloth: alk. paper)

1. Auditing, I. Kell, Walter Gerry, 1921-II. Johnson, Ray, 1948 Apr. 18-III. Title.

HF5667 .K39 2000

657'.45—dc21

00-042887

ISBN: 0-471-18909-X

WIE ISBN: 0-471-39218-9

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

# ABOUT THE AUTHORS

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**Walter G. Kell, Ph.D., CPA** received his doctorate in accounting from the University of Illinois. He is professor emeritus of accounting at the University of Michigan, where he has served as chairman of the Department of Accounting. He also has served as chairman of the Accounting Department of Syracuse University. He has been an active member of the American Institute of Certified Public Accountants and has served on its Committee on Auditing Procedure (predecessor to the Auditing Standards Board) and Auditing Standards Advisory Council. He is a past president of the American Accounting Association. Professor Kell has been a consulting editor and coeditor of the *Accountant's Handbook* and is the coauthor of an accounting principles textbook. He has also served as a member and chairman of the CPA Examination Review Board of the National Association of State Boards of Accountancy. A member of the Michigan Association of Certified Public Accountants, he has served on its Committee on Accounting and Auditing Procedures and its Board of Directors. Professor Kell is a recipient of the Association's Distinguished Service Award for his significant contributions to the public accounting profession.

# PREFACE

*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) integrate the values and competencies for the accounting profession imbedded in the CPA Vision Project throughout the book, (2) balance a transaction-based approach to the audit with a top down understanding of the organization, (3) integrate information technology as an integral part of the financial statement audit throughout the book, and (4) develop a comprehensive case to go with the book.

## ■ HIGHLIGHTS OF CHANGES FROM THE PREVIOUS EDITION

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

- Chapter 1 includes a discussion of the outcome of the CPA Vision Project and introduces new assurance services that are emerging in the CPA profession.
- Chapter 2, and other material throughout the book, have been updated to reflect the auditor's new responsibility for finding fraud based on SAS No. 82.
- The chapter on legal liability is updated for developments since Congress passed the Private Securities Litigation Reform Act of 1995.
- Chapter 5 has been added to provide an overview of the audit process, including the delivery of value-added services that are a natural extension of the auditor's knowledge.
- The impact of information technology on auditing is no longer treated as a separate chapter, but it is integrated throughout the book. All chapters containing materials on internal control have been updated for both SAS No. 78 and to illustrate the use of information technology to accomplish internal control objectives.

- The book discusses how the auditor uses his or her knowledge of the business and industry to develop expectations of financial statement outcomes and to support value-added services throughout the book.
- A new chapter has been added to discuss the emerging assurance services that are being delivered by CPAs.
- An integrated case has been added to the text allow students to make actual audit decisions in the context of a growing business in the office furniture industry.
- Power Point presentations are now available as part of the text package.

## ■ 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 Seventh Edition is organized into five parts as follows:

Part	Subject	Chapters
1	The Auditing Environment	1-4
2	Audit Planning	5-9
3	Audit Testing Methodology	10-13
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, describes the elements of the multilevel regulatory framework that have as their objective enhancing the quality of services provided by the profession, and includes new material from the CPA Vision Project. Chapter 2, entitled "Financial Statement Audits and Auditor's 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 fraud, 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, Auditing Planning**, is comprised of five chapters. Chapter 5, "Overview of the Audit Process," provides an overview of the audit process, including the delivery of value-added services that are a natural extension of the auditor's knowledge. Chapter 6, "Audit Evidence, Audit Objectives, Audit Programs and Working Papers," lays the foundation for audit planning through explanations of these three fundamentals of auditing. Coverage is given to these relationships and to the importance of properly prepared working papers. Chapter 7, "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 auditing planning. Also included are procedures to obtain an understanding of the business. Chapter 8, "Materiality, Risk, and Preliminary Audit Strategies," provides a solid foundation in these three important auditing concepts. Part 2 concludes with Chapter 9, "Understanding the Internal Controls." 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. The chapter also includes new auditing standards related to internal control and integration of information technology into internal control. The appendix to the chapter provides background information to information technology and discusses benefits and risks associated with using information technology in accounting systems.

**Part 3, Audit Testing Methodology**, includes four chapters. Chapter 10, "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 in a technology rich environment 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 11, "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 as well as audit staffing. 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 12 and 13. In Chapter 12, the focus is on tests of controls, whereas in Chapter 13 it is on substantive tests. The latter includes both probability-proportional-to-size, or dollar unit sampling, and classical variables sampling.

**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) using an understanding of the business and industry, used both to develop audit strategy and appropriate audit tests; (3) considering materiality, risk, and audit strategy; (4) obtaining an understanding of the internal control structure and assessing control risk; and (5) 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 and investment in securities are covered separately in Chapter 18.

The Seventh 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, “Assurance Services,” explores the new decision-maker focus paradigm associated with these new services and provides explanations of new assurance opportunities. Chapter 23 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. A final appendix to the text, which can be assigned at any point in the auditing course, deals with auditing research.

## CONTINUING FEATURES

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.

## END-OF-CHAPTER MATERIALS

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.

### COMPREHENSIVE CASE

New to this edition of *Modern Auditing* is a comprehensive case, which allows students to make actual audit decisions in the context of a growing business in the office furniture industry. This integrated case has 12 assignments over the course of 8 chapters. The case begins in Chapter 7, covering Client Acceptance and Understanding Business and Industry and Analytical Procedures. Continuing in Chapter 8, the case assignments cover the topics of Materiality and Audit Risk. The Chapter 10 assignment reflects the topic of Assessing Control Risk. The case picks up again in Chapter 13 with Statistical Sampling. The Chapter 14 assignments cover Evaluating Internal Controls, Conformation Responses, and the Allowance for Doubtful Accounts. The case wraps up in Chapters 19, 20, and 22 by having students concentrate on Completing the Audit, the Audit Report, and Value-Added Services. The case assignments within each chapter have students completing a number of exercises, including evaluating evidence and auditing issues, developing working papers related to the case, comparing and analyzing procedures, and preparing an auditor’s report.

## SUPPLEMENTARY MATERIALS

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) an Excel-based software package, (5) a student study guide, and (6) PowerPoint slides. The instructor’s resource guide and solutions manual, test bank and Excel-based software will be available for instructors through the book’s Web site.

The *Instructor’s Resource Guide and Solutions Manual* contains outlines of the text chapters; suggestions for lectures, classroom activities, and assignments; 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 electronically through the Web Site and in 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 Excel-based software package, entitled *AUDSAMP: Statistical Sampling Templates for Excel*, runs on IBM compatible personal computers. The files and a brief accompanying manual are for download at the instructor's resources section of the Web Site. 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 Seventh 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.

## ACKNOWLEDGEMENTS

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

First, we extend thanks to the many adopters of previous editions for their comments and suggestions.

Our sincere thanks are due to the following professors for comprehensive and constructive critiques of this manuscript for the Seventh Edition: Raymond S. Chen, California State University, Northridge; Freddie Choo, San Francisco State University; Robert R. David, Canisius College; John McEldowney, University of North Florida; Marina Nathan, Houston Community College; Patricia Parker, Columbus State Community College; Nile J. Webb, University of Maryland; and T. Sterling Wetzel, Oklahoma State University.

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.

Sincere thanks are given to Cathy Bruncheon, CPA, for her assistance in helping with chapter materials and the cases and to Janice Weaver for her assistance in proofreading. Dr. Johnson also extends his deepest gratitude to his wife and partner in life, Marilyn, who supported this project in a thousand ways and made the vision a reality.

Last, but not least, we express our appreciation to our editor Julie Kerr; Sandra Russell, Production Editor; Karin Kincheloe, Designer; and Clancy Marshall, Marketing Manager—as well as all of John Wiley & Sons.

William C. Boynton  
Raymond N. Johnson  
Walter G. Kell

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