PRINCIPLES OF AUDITING

Seventh Edition

Meigs, Whittington, and Meigs

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Auditing

Walter B. Meigs
University of Southern California

O. Ray Whittington
School of Accountancy
San Diego State University

Robert F. Meigs
School of Accountancy
San Diego State University

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Preface

This Seventh Edition of *Principles of Auditing* includes significant additions and revisions. These changes reflect the rapid change occurring within the profession of public accounting and the expanding role of the attest function in our society.

Our goal in this book is to emphasize concepts which enable the student to understand the philosophy and environment of auditing. Thus, the first 10 chapters provide a sweeping overview of the public accounting profession with special attention to auditing standards, professional ethics, the legal liability inherent in the attest function, the study and evaluation of internal control, the nature of evidence, the growing use of audit sampling, the impact of electronic data processing, and the basic approach to planning an audit.

In addition to this conceptual approach to the work of the auditor, this edition, like the preceding ones, presents auditing techniques in an organized and understandable manner.

New features of this edition

Among the many new features of this edition are the following:

Increased emphasis is placed on ***planning the audit,*** including the screening of prospective clients, obtaining a knowledge of the client's business, working with audit committees of the board of directors, and developing appropriate audit strategies.

More attention is given to ***transaction cycles*** in the study and evaluation of internal control. However, the traditional emphasis upon substantive testing of financial statements items is retained.

The use of flowcharts and graphic illustrations has been increased throughout the text.

A carefully revised and easy-to-understand chapter on ***audit sampling,*** includes the important concept of beta risk and a clear explanation of modern sampling techniques such as dollar-unit sampling. Emphasis is placed on basic concepts of importance to every auditor rather than on statistical formulas of interest primarily to sampling specialists.

A sustained effort has been made to consolidate material and create a textbook truly suited to a one-semester course in auditing. For example, the chapters on cash and marketable securities have been combined into a single chapter, as have the chapters covering long-term debt and owners' equity. Despite the inclusion of much new material, this Seventh Edition is shorter both in number of chapters and in total pages than the preceding edition.

Expanded coverage of reports by auditors and accountants is now presented in two chapters. The second of these is an all new chapter (Chapter 19), "Other Reports by CPAs." It includes compilations, reviews, limited reviews on quarterly data, and opinions upon the adequacy of internal control.

Both text discussion and problem material have been updated to include the latest pronouncements of the Auditing Standards Board, the SEC, and the FASB. This material is integrated into text and problems to assure coverage of all topical areas included in recent CPA examinations.

The selection of questions and problems at the end of each chapter has been substantially increased.

An increased number of concise ***Illustrative Cases*** are used to demonstrate important audit concepts in "real-world" situations.

Achievement tests and comprehensive examination

Three Achievement Tests and a Comprehensive Examination (all in objective form) are available with the Seventh Edition. Each Achievement Test covers about six chapters, and the Comprehensive Examination covers the entire book. The Achievement Tests are of a length that may conveniently be fitted into the normal class meeting time, and the Comprehensive Examination may be used as a final exam. The CPA Examination in Auditing has used objective questions extensively in recent years. Many of the questions in the Achievement Tests and Comprehensive Examination have been drawn from this source. Thus, they may serve the dual purpose of providing a rapid and efficient means of testing student understanding of course content and also giving the student some first-hand experience with the kinds of questions now playing such an important role in the CPA Examination in Auditing.

Questions, problems, and case studies

The questions, problems, and case materials at the end of each chapter are divided as follows: Group I—Review Questions; Group II—Questions Requiring Analysis; Group III—Problems; and Group IV—Case Studies in Auditing.

The review questions are closely related to the material in the chapter and provide a convenient means of determining whether the student has grasped the major ideas and implications contained in that chapter.

The questions requiring analysis call for thoughtful appraisal of realistic auditing situations and the application of generally accepted auditing standards. Many of these Group II questions are taken from CPA examinations, others from actual audit engagements. These thought-provoking questions requiring analysis differ from the Group III Problems in that they are generally shorter and tend to stress value judgments and conflicting opinions.

Many of the Group III Problems have been drawn from CPA examinations; in the selection of these problems consideration was given to all auditing problems which have appeared in CPA examinations in recent years. Other problems reflect actual audit situations from the experience of practicing accountants. Many of the problems are new, but problems appearing in the previous editions have been retained (usually with some modification) if they were superior to other available problems. In response to the recent shift in content of the auditing section of the CPA examination, problems requiring extensive working papers and quantitative applications have been minimized, and short case-type questions have been emphasized.

Case studies in auditing

The six case studies in auditing appear at the ends of the chapters on "Audit Working Papers: Quality Control for Audits"; "Cash and Marketable Securities"; "Accounts and Notes Receivable and Sales Transactions"; "Inventories and Cost of Goods Sold"; "Debt and Equity Capital: Loss Contingencies"; and "Further Verification of Revenue and Expenses." The cases present specific issues covered in these chapters, but they also place these issues in proper perspective in relation to the entire examination and to the issuance of an audit report.

The authors' experience in teaching the auditing course has been that the use of case studies at strategic intervals is one of the highlights of the course. Case studies in auditing are a means of viewing audit engagements through the eyes of a partner in a CPA firm and also from the viewpoint of the client. Students enjoy the cases thoroughly because of the lively class discussions they produce and the arguments of opposing views. In preparing and discussing these cases the student must identify the important issues, weigh the opposing arguments, and then reach a conclusion. Class discussions in which each student evaluates the arguments of others and participates in reaching common grounds of agreement can bring the auditing course close to the realities of the professional practice of the certified public accountant.

References to authoritative sources

Numerous references are made to the pronouncements of the Financial Accounting Standards Board, the Securities and Exchange Commission, the Auditing Standards Board, and the American Institute of

Certified Public Accountants. Special attention is given to the Code of Professional Ethics, and to Statements on Auditing Standards. The cooperation of the AICPA in permitting the use of its published materials and of questions from the Uniform CPA Examination brings to an auditing text an element of authority not otherwise available.

Contributions by others

We gratefully acknowledge the able and thorough reviews of Dorothy Brandon of East Carolina University, Wai P. Lam of the University of Windsor, and John A. Tracy of the University of Colorado. Their many suggestions for this Seventh Edition were most valuable.

Finally, to the many faculty members at various schools who used the preceding editions and offered constructive suggestions, and to the students in the auditing courses taught by the authors—our sincere thanks.

Walter B. Meigs
O. Ray Whittington
Robert F. Meigs

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The role of the auditor in the American economy

Financial reporting—an essential in achieving social and economic goals

In our complex, industrialized society the communication of financial and other economic data is vitally important. Our economy is characterized by large corporate organizations that have gathered capital from millions of investors and that control economic resources spread throughout the country, or even throughout the world. Top management in the corporate headquarters is remote from the operations of company plants and branches and must rely on financial reports and other communications of economic data to control the company's far-flung resources. In brief, the decision makers in a large organization cannot get much information on a firsthand basis. They must rely on information provided by others.

The millions of individuals who have entrusted their savings to corporations by investing in securities rely upon annual and quarterly financial statements for assurance that their invested funds are being used honestly and efficiently. Even greater numbers of people entrust their savings to banks, insurance companies, and pension funds. However, these financial institutions, in turn, invest the money in corporate securities. Thus, directly or indirectly, almost everyone has a financial stake in corporate enterprise, and the public interest demands prompt, *dependable* financial reporting on the operations and the financial health of publicly owned corporations.

The need for honest, candid public disclosure exists for federal, state, and city governments as well as for business entities. The federal government expends a major share of the gross national product and, in so doing, relies upon the communication of financial data to assure that the costs it incurs are reasonable, regardless of whether the project be a trip to the moon, a mass transit system, or a foreign aid program. The financial crises in large city governments in recent years are further reminders that all large organizations must be held accountable for proper management of resources entrusted to them if they are to carry out the responsibilities with which they are charged.

The importance of dependable financial reporting applies to the revenue of federal, state, and local governments as well as to their expenditures. The revenue of the federal and state governments is derived in large part from income taxes based on the reported incomes of individuals and corporations. Thus the financial support of the government rests on the measurement and communication of information concerning taxable income.

Good accounting and financial reporting aid society in allocating its resources in the most efficient manner. The goal is to allocate our limited capital resources to the production of those goods and services for which demand is greatest. Economic resources tend to be attracted to the industries, the areas, and the organizational entities that are shown by accounting measurements to be capable of using more resources to the best advantage. Inadequate accounting and inaccurate reporting, on the other hand, conceal waste and inefficiency and thereby prevent our economic resources from being allocated in a rational manner.

Finally, most of our national policies, such as developing energy sources, controlling inflation, combatting pollution, and increasing employment rely directly on quantitative measurement of economic activity and the communication of these data. Appropriate accounting standards and reliable financial reporting are key factors in the pursuit of our economic and social goals.

What we have said thus far clearly indicates the importance of good financial reporting to the very existence of our society. Implicit in this line of reasoning is recognition of the social need for independent auditors—individuals of professional competence and integrity who can tell us whether the financial reports being provided to the public by corporations and by governmental units constitute a fair and complete picture of what is really going on.

The attest function

The principal reason for the existence of a public accounting profession is to perform the attest function. To ***attest*** to financial statements means to provide assurance as to their fairness and dependability. The attest function includes two distinct steps or stages. First, the independent public accountants must carry out an examination (or audit); this examination provides the objective evidence that enables the auditors to express an informed opinion on the financial statements. The second stage of the attest function is the issuance of the auditors' report, which conveys to users of the financial statements the auditors' opinion as to the fairness and dependability of the financial statements.

It may be helpful to pose the question: Who is qualified to perform the attest function? As a brief answer, we can say that the persons who attest to financial statements must be both ***technically competent*** to conduct an audit and ***independent*** of the company being audited, so that the public will have confidence in their objectivity and impartiality. One reason for retaining a firm of independent public accountants to attest to financial statements is the conflict of interest which may exist between the company preparing the financial statements and those persons who use the financial statements. For example, a business that prepares financial statements to support its application for a bank loan has an incentive to emphasize the strong aspects of its financial position and downplay the weak points. In other words, there is an incentive to prepare distorted financial statements in order to secure the loan.

Regular audits by independent public accountants offer the most important kind of protection to the public. Although every investment involves some degree of risk, investors will incur unnecessary risks if they invest in companies that do not have regular audits of their financial statements by independent public accountants.

Recognition of the responsibility of independent accountants to third parties led to the organization in Scotland and England more than a century ago of Institutes of Chartered Accountants. The technical competence of persons desiring to become chartered accountants was tested by examinations. Independence, integrity, and professional responsibility were recognized as qualities quite as important in chartered accountants as technical skill. Through the Institutes of Chartered Accountants, ethical principles were evolved to encourage auditors to follow professional standards in performing the attest function of auditing. In the United States, the American Institute of Certified Public Accountants (AICPA) has played a similar role in establishing professional standards for its members.

Credibility—the contribution of the independent auditor to financial reporting

The contribution of the independent auditor is to give credibility to financial statements. ***Credibility***, in this usage, means that the financial statements can be ***believed;*** that is, they can be relied upon by outsiders, such as stockholders, creditors, government, and other interested third parties.

Audited financial statements are now the accepted means by which business corporations report their operating results and financial position. The word ***audited*** when applied to financial statements means that the balance sheet, statements of income and retained earnings, and statement of changes in financial position are accompanied by an audit report prepared by independent public accountants, expressing their professional opinion as to the fairness of the company's financial statements.

What is an audit?

An audit is an examination of a company's financial statements by a firm of independent public accountants. The audit consists of a searching investigation of the accounting records and other evidence supporting those financial statements. Through the study and evaluation of the company's system of internal control, and by inspection of documents, observation of assets, making of inquiries within and outside the company, and by other auditing procedures, the auditors will gather the evidence necessary to determine whether the financial statements provide a fair and reasonably complete picture of the company's financial position and its activities during the period being audited.

The following authoritative definition of an audit appears in *Statement on Auditing Standards* (*SAS*) *No. 1*, "Codification of Auditing Standards and Procedures":

> The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. The auditor's report is the medium through which he expresses his opinion or, if the circumstances require, disclaims an opinion.[1]

The examination conducted by the independent auditors provides the basis for the audit report. ***Never do auditors express an opinion on the fairness of financial statements without first performing an audit.*** Personal experience with the business, audits made in prior years, belief in the integrity of the owners and managers—none of these factors is sufficient to warrant an expression of opinion on the financial statements by the independent public accountants. Either they make an audit of the current year's financial statements or they do not. If they do not perform an audit, they do not express an opinion on the fairness of the financial statements.

The evidence gathered by the auditors during an examination will prove that the assets listed in the balance sheet really exist, that the company has title to these assets, and that the valuations assigned to these assets have been established in conformity with generally accepted

[1] American Institute of Certified Public Accountants, *Statement on Auditing Standards No. 1*, AICPA (New York, 1973), par. 110.01.

accounting principles. Evidence will be gathered to show that the balance sheet contains ***all the liabilities*** of the company; otherwise the balance sheet might be grossly misleading because certain important liabilities had been deliberately or accidentally omitted. Similarly, the auditors will gather evidence about the income statement. They will demand proof that the reported sales really occurred, proof that the goods were actually shipped to customers, and proof that the recorded costs and expenses are applicable to the current period and that all expenses have been recognized.

The audit procedures comprising an examination will vary considerably from one engagement to the next. Many of the procedures appropriate to the audit of a small retail store would not be appropriate for the audit of a giant manufacturing corporation such as General Motors. Auditors make examinations of all types of business enterprise, and of not-for-profit organizations as well. Banks and breweries, factories and stores, colleges and churches, airlines and labor unions—all of these are regularly visited by auditors. The selection of the audit procedures best suited to each engagement requires the exercise of professional skill and judgment.

Other types of audits and auditors

The type of audit we are primarily concerned with throughout this book is an independent, financial audit performed by a firm of certified public accountants. Such an audit is sometimes referred to as a ***financial compliance audit***, because it emphasizes compliance of the financial statements with generally accepted accounting principles.

The Internal Revenue Service also conducts a type of financial compliance audit when its revenue agents audit the income tax return of an individual or a business to determine that the tax return is in compliance with tax laws and regulations. Bank examiners are another group of government auditors who conduct financial compliance audits.

The performance of any type of compliance audit is based on the existence of recognized criteria or standards, established by an authoritative body. The existence of such authoritative standards makes it possible to determine whether the entity being audited is or is not in compliance with the standards.

Operational audits. An operational audit (in contrast to a compliance audit) is designed to measure the ***efficiency*** of a business or governmental organization. Often the operational audit focuses on a single department or other unit of an organization. The operations under study may be accounting, manufacturing, marketing, personnel, or any other elements of the organization's operations. Because the criteria for efficiency are not as clearly established as are generally accepted accounting standards, an operational audit tends to require more subjective judgments than do financial compliance audits. The