

AUDITING CONCEPTS AND METHODS

Third Edition

John J. Willingham
D.R. Carmichael



5
2
1
2
3
4
5
6
2
2
6
0
2
3
1
9
1
2
0
9
8
1
6
2
1
3
9
2
0
9
1
0
6
5
0
0
0
3

AUDITING CONCEPTS AND METHODS

Third Edition

John J. Willingham, Ph.D., CPA

Professor of Accounting
University of Houston

D. R. Carmichael, Ph.D., CPA

Vice President, Auditing
American Institute of Certified Public Accountants

McGRAW-HILL BOOK COMPANY

New York St. Louis San Francisco Auckland Bogotá Düsseldorf
Johannesburg London Madrid Mexico Montreal New Delhi
Panama Paris São Paulo Singapore Sydney Tokyo Toronto

AUDITING CONCEPTS AND METHODS

Copyright © 1979, 1975, 1971 by McGraw-Hill, Inc. All rights reserved. Printed in the United States of America. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher.

3 4 5 6 7 8 9 0 D O D O 8 3 2

This book was set in Primer by Black Dot, Inc.
The editors were Donald E. Chatham, Jr., Annette Hall, and
M. Susan Norton;
the cover was designed by Carla Bauer;
the production supervisor was Leroy A. Young.
R. R. Donnelley & Sons Company was printer and binder.

Library of Congress Cataloging in Publication Data

Willingham, John J.

Auditing concepts and methods.

Includes bibliographies and index.

1. Auditing. I. Carmichael, Douglas R., joint
author. II. Title.

HF5667.W532 1979 657'.45 78-17174

ISBN 0-07-070606-9

Preface

The guiding principle of this edition of *Auditing Concepts and Methods* is the same as that of the first two editions: An understanding of concepts makes the methods of audit practice more meaningful and provides a foundation for continuing study. However, this edition is changed substantially in several ways:

1. Experience in teaching auditing has demonstrated the usefulness of certain devices to aid students in learning the diverse and technical subjects they are exposed to for the first time in an auditing course. These devices should make this book easier to use.
2. Developments in audit practice and auditing standards have resulted in a basic approach to the conduct of audits that has substantial similarities for most CPA firms and most client companies. This approach is used as a framework for presenting auditing concepts and methods.
3. Use of computers and statistical sampling in audit practice has developed sufficiently to permit presentation in a manner similar to the coverage of accounting standards and accounting systems. Emphasis is placed on the auditing aspects of these subjects. This approach is a significant departure from past editions and most other auditing textbooks.
4. Official pronouncements play an increasingly important role in current audit practice. Coverage of pronouncements is more extensive and specific in this edition and is as up to date as possible.
5. Audit practice is subject to rapid change, and controversy abounds. Recent years have been filled with turmoil. This edition attempts to capture the *flavor of controversy and change that is a normal part of audit practice.*

Each chapter begins with a list of major topics to allow the student to anticipate the subjects to be learned. Assignments for each chapter begin with review questions which specifically cover the essential details of major topics. Students may use the review questions to test their own understanding, or the questions may be used as surprise quizzes by the instructor.

Assignments are an integral part of this book. Discussion problems in each chapter involve the thoughtful application of concepts rather than repetition of matters explained in the chapter. The relation between discussion problems and chapter coverage has been strengthened. Most chapters also contain one

or more cases, which are more comprehensive or more involved than discussion problems.

The book is divided into the same four parts as past editions:

1. The Audit Profession
2. The Audit Process
3. Audit Examinations
4. Audit Reports

Part One, on the audit profession, is relatively unchanged except for being updated for current developments. Significant additions are explanations of congressional interest in the profession and prominent legal cases.

Part Two is substantially changed. There are three chapters:

1. Elements of the Audit Process
2. Audit Planning
3. Computer, Statistical, and Other Specialists

The elements of the audit process are evidence, procedures, work papers, and the *components of the accounting process and its relation to auditing*.

The chapter on audit planning is substantially new. It covers audit strategy, detailed program planning, and assigning and scheduling audit staff. Audit strategy introduces the major steps in the audit:

1. Understanding the client
2. Study and evaluation of accounting control
3. Tests of transactions
4. Tests of balances
5. Completion and review

These steps in the audit provide the framework for Part Three, on audit examinations. The discussion of alternative audit strategies includes consideration of materiality and audit risk and related decisions that must be made in planning and scheduling audit tests.

The chapter on computers and statistical sampling is a departure from past editions and from the approach in most other auditing textbooks. The subjects are presented as specialties that require expert knowledge and advanced training to apply in practice. For some time it has been accepted that there are too many important topics to cover in an auditing course to permit review of topics covered in other courses. For example, accounting systems and accounting standards are covered in auditing only to the extent needed to explain the auditor's interest in them.

The emphasis in the chapter on computers and statistical sampling is on the auditing aspects of the subjects. It is assumed that students have had a statistics course and are familiar with random-number tables and formulas to

compute standard deviation and sample size. These details are not repeated. No auditing textbook has ever equipped students to apply statistical sampling or to run a computer audit program. In practice, specialists are needed for most applications. The effect of EDP on internal control is explained in the chapter on the study and evaluation of accounting control. However, for use of both computers and statistical sampling in audit tests coverage is confined to basic concepts.

For those with a particular interest in developing more detailed knowledge of statistical sampling, we recommend Donald M. Robert's *Statistical Auditing*, published by the AICPA in 1978. There are also several fine books available on computers and auditing. We do not discourage attention to these subjects. However, we believe the first auditing course should concentrate on the basics of auditing.

Part Three presents the audit of financial statements using the framework introduced in Part Two. We believe this approach has several advantages. The student is able to achieve an integrated understanding of the logic of the audit. This understanding is fragmented by the traditional approach organized around specific general ledger accounts.

The framework is suitable for almost all audits. The size of the client firm and that of the CPA firm conducting the audit do not make the framework inapplicable. The approach to auditing which emphasizes the accounting system and organizes the audit around transaction cycles is explained and fits within the framework. However, the framework presented also accommodates other approaches. Thus, the framework is flexible and adequately describes the approaches used by most CPA firms; it is not tailored to the practice of any one firm.

Finally, this framework creates economies in the coverage of material which permit saving space in the book and time in teaching the course. One of the biggest problems in teaching auditing is still cramming into one course all the essential knowledge on the rapidly expanding field of auditing.

Statements on Auditing Standards published by the American Institute of Certified Public Accountants are the official literature of auditing in the United States. A thorough understanding of SASs is an indispensable part of the working knowledge of an independent auditor. Since the publication of the second edition of this book, twenty-one additional SASs have been issued. All of them are covered in this edition. Inevitably, there will be many more SASs before the next edition. We recommend that instructors supplement the book by assigning current SASs. There is no substitute for first-hand contact with pronouncements.

The Auditing Standards Executive Committee, the senior technical committee of the AICPA that issues SASs, is discussed in Chapter 3. Other chapters introduce relevant SASs. For ease of presentation, this book refers only to original pronouncements. SASs are also available in codified volumes. The loose-leaf service *Professional Standards* (Volume 1) is continually updated as new SASs are released. The AICPA publishes a bound version of

the loose-leaf service annually and also publishes a separate codification of current SASs. The choice between original pronouncements and one of the codified versions is a matter of personal preference. To avoid long and cumbersome citations we have not included dual references. Original pronouncements can easily be located in the codified versions. For example, SAS No. 2 is now AU Section 509, which can be determined by reference to Appendix B of one of the codified versions.

One of the advantages of an official literature is uniformity of terms. In this book, extensive reliance is placed on the terms for audit tests and the basic approach to auditing found in SASs. This book introduces a minimum of original terms. Particularly in the chapters on the study and evaluation of accounting control, tests of transactions, and tests of balances the discussion rests on the basic concepts and terms introduced in SAP No. 54, and now found in SAS No. 1, Section 320.

The discussion of tests of transactions and tests of balances emphasizes the auditor's objectives in making tests and contains expanded coverage of the auditor's approach to reviewing management's selection and application of accounting principles and evaluating management's judgments in making accounting estimates.

Part Four, on audit reports, has been substantially rewritten to reflect changes in reporting practice and new SASs. The last chapter includes coverage of the final report of the Commission on Auditors' Responsibilities.

As in past editions, we owe a substantial debt to the AICPA for permission to use its copyrighted materials. The importance of SASs has been mentioned. The AICPA's Code of Professional Ethics is reproduced in its entirety. Concepts of Professional Ethics appear in Chapter 3. The Rules of Conduct and Interpretations of Rules of Conduct appear in the Appendix, along with proposed changes to the Code that were being voted on by the AICPA membership as this book went to press. Assignments for each chapter contain many problems from past Uniform CPA Examinations.

In addition, we thank the Canadian Institute of Chartered Accountants for allowing us to use problems from Canadian CA examinations, and the Institute of Management Accounting of the National Association of Accountants for use of CMA problems.

For convenience the pronoun "he" has been used throughout this book to refer nonspecifically to the auditor. We are aware that many women are also active and successful in auditing practice and we do not intend to exclude them through the traditional choice of pronoun. In fact, we take pleasure in noting that public accounting is increasingly an excellent career opportunity for women. However, for ease of expression we have adopted the practice, which is predominant in auditing literature, of using the pronoun "he."

John J. Willingham
D. R. Carmichael

Contents

Preface	ix
---------	----

Part One THE AUDIT PROFESSION

Chapter 1	THE AUDIT FUNCTION	3
	<i>History of the Audit Function</i>	3
	<i>The Audit Report</i>	5
	<i>The Auditor-Client-Public Relationship</i>	10
	<i>Other Applications of the Audit Function</i>	11
	<i>Assignments</i>	14

Chapter 2	THE STRUCTURE OF THE AUDIT PROFESSION	23
	<i>The Audit Environment</i>	23
	<i>Profile of the Audit Profession</i>	28
	<i>Internal Structure of a CPA Firm</i>	31
	<i>Assignments</i>	36

Chapter 3	PROFESSIONAL STATUS AND RESPONSIBILITIES OF AUDITORS	41
	<i>The Auditor: Professional Status</i>	41
	<i>Professional Responsibilities of Auditors</i>	43
	<i>Concepts of Professional Ethics</i>	47
	<i>Legal Responsibilities</i>	56
	<i>Assignments</i>	65

Part Two THE AUDIT PROCESS

Chapter 4	ELEMENTS OF THE AUDIT PROCESS	79
	<i>Accounting and Auditing Contrasted</i>	79
	<i>Areas of Audit Interest</i>	80
	<i>Audit Procedures and Evidence</i>	86
	<i>Record of Audit Tests—Work Papers</i>	91
	<i>Assignments</i>	100

Chapter 5	AUDIT PLANNING	115
	Audit Strategy	115
	Detailed Program Planning	123
	Assignment and Scheduling of Audit Staff	130
	Assignments	132
Chapter 6	COMPUTER, STATISTICAL, AND OTHER SPECIALISTS	145
	Use of CPA Firm Specialists in Auditing	145
	Computers and Auditing	147
	Statistical Sampling and Auditing	151
	Using the Work of an Outside Specialist	160
	Assignments	161
Part Three	AUDIT EXAMINATIONS	
Chapter 7	UNDERSTANDING THE CLIENT	175
	Client Acceptance and Continuance	175
	Knowledge of the Business	179
	Analytic Review	183
	Analysis of Results of Operations	186
	Assignments	188
Chapter 8	STUDY AND EVALUATION OF INTERNAL ACCOUNTING CONTROL	199
	<i>The Nature and Scope of the Auditor's Study and Evaluation</i>	199
	The Elements of Internal Accounting Control	204
	Audit Procedures for the Study and Evaluation of Accounting Control	208
	Coordinating the Review with Other Audit Procedures	222
	Assignments	223
Chapter 9	TESTS OF TRANSACTIONS	246
	Objectives of Tests of Transactions	246
	Timing of Tests of Transactions	250
	Auditing Major Classes of Transactions	251
	Auditing Contractual Transactions	260
	Assignments	265
Chapter 10	TESTS OF BALANCES	274
	The Nature and Objectives of Tests of Balances	274
	Tests of Asset Balances	278
	Tests of Equity Balances	285
	Tests of Allocations	288

	A Case Study of Tests of Balances for Accounts Receivable	292
	Assignments	296
Chapter 11	COMPLETION AND REVIEW	322
	The Nature of Completion and Review Procedures	322
	Subsequent Events and Related Review Procedures	323
	Representation Letters	326
	Review of Work Papers and Financial Statements	334
	After the Audit	337
	Assignments	339
Part Four	AUDIT REPORTS	
Chapter 12	THE AUDITOR'S REPORT	351
	The Auditor's Reporting Obligation	351
	Qualifications, Disclaimers, and Adverse Opinions	356
	Other Report Modifications	364
	Auditor-Client Communications	367
	Assignments	372
Chapter 13	OTHER REPORTS AND RESPONSIBILITIES	388
	Unaudited Financial Statements	388
	Specialized Reports	391
	Audits of Efficiency, Economy, and Effectiveness	396
	Expansion of the Audit Function	398
	Assignments	400
Appendix	AICPA RULES OF CONDUCT, INTERPRETATIONS OF RULES OF CONDUCT, AND PROPOSED AMENDMENTS	408
Index		435

Part One

The Audit Profession

Our society is an organizational society. We are born in organizations, educated by organizations, and most of us spend much of our lives working for organizations. We spend much of our leisure time paying, playing, and praying in organizations. Most of us will die in an organization, and when the time comes for burial, the largest organization of all—the state—must grant official permission.

In contrast to earlier societies, modern society has placed a high moral value on rationality, effectiveness, and efficiency. Modern civilization depends largely on organizations as the most rational and efficient form of social grouping known. By coordinating a large number of human actions, the organization creates a powerful social tool. It combines its personnel with its resources, weaving together leaders, experts, workers, machines, and raw materials. At the same time it continually evaluates how well it is performing and tries to adjust itself accordingly in order to achieve its goals. . . . All this allows organizations to serve the various needs of society and its citizens more efficiently than smaller and more natural human groupings, such as families, friendship groups, and communities.¹

Organizations achieve their goals through the use of human and economic resources. Most often, economic resources are entrusted to the organization by groups or individuals outside it; frequently these outsiders are quite remote from internal operations. Thus, organizations must issue stewardship reports on resource administration—source, quantity, allocation, accumulation, and depletion.

A primary function of the public accounting profession is to render independent and expert opinions on these stewardship reports based on an examination of the objective evidence underlying the data reported. This examination—called an *audit*—is the central subject of this book.

This chapter explains some of the concepts that are important for understanding the audit function. Its topics include:

1. The origin of independent audits in the United States
2. The meaning and significance of the standard report issued at the completion of an audit
3. The nature of the independent auditor's relationships to clients and other users of his work
4. Other types of audits

HISTORY OF THE AUDIT FUNCTION

Audits have been performed at least since the fifteenth century. The exact origin of audits of financial reports is in dispute, but it is known that as early as the fifteenth century auditors were called on to assure the absence of fraud in the records kept by stewards of wealthy household estates in England. While its origins are ancient, development of the audit function has occurred most rapidly in the last century.

Independent Audits Prior to 1900

The origin of the audit function in North America is decidedly British. Accountancy as a profession was introduced on this continent by the British during the second half of the nineteenth century. North American accountants adopted the British form for audit reports and British procedures for carrying out examinations.

In the United Kingdom then, as today, public corporations were formed under a national law known as the Companies Act. All public companies must abide by this law. When the audit function was exported to the United States, the British form of reporting was adopted even though there were no comparable United States statutes. In addition, while British public companies were required to have audits, American companies were not. Even today, the state laws under which United States corporations are formed generally do not require audits. Rather, audit requirements generally arise from requirements of stock exchanges, regulations of the Securities and Exchange Commission, and general acceptance of the usefulness of an independent auditor's opinion on financial representations.

The absence of statutory requirements for audits to be submitted to stockholders resulted in nineteenth-century audits that varied from balance sheet audits to full, detailed examinations of all accounts of corporations. An auditor was engaged usually by management or the board of directors of a corporation, and his report was addressed and directed to these insiders rather than shareholders. Reports to shareholders on the representations of management were not common. Instead, the corporate managers were interested in being assured by the auditors that fraud and clerical errors had not occurred.

Twentieth-Century Developments

By 1900 the industrial revolution was approximately 50 years old and industrial companies had expanded greatly in size. There were many more absentee stockholders, many of whom began to receive auditors' reports. Many of these new stockholders did not understand the significance of an auditor's work, and misunderstanding was widespread even among businessmen and bankers. In fact, it was widely believed that the auditor's opinion was a guaranty of the accuracy of financial statements.

The American accounting profession developed rapidly after World War I. Continued misunderstanding of the independent auditor's function was so widespread that in 1917 the Federal Reserve Board published in the Federal Reserve Bulletin a reprint of a document prepared by the American Institute of Accountants (which became the American Institute of Certified Public Accountants in 1957) dealing with uniform accounting. This United States technical pronouncement was the first of many to be issued by the American profession throughout the twentieth century.

During a major portion of the current century CPAs drafted their reports with little formal guidance. In this century, however, the profession rapidly developed common report language through the AICPA. Common report language is so well developed today that audit reporting is no longer a writing exercise; it is a decision process. There are a limited number of alternative types of reports from which an auditor can choose, and once he has made a decision about the type of opinion to render in a specific situation, he can select the report form designated to express that opinion.

THE AUDIT REPORT

The contemporary audit report, like any other report, is essentially a communication device. Through the report the auditor conveys, in summary form, his professional judgment on the client's representations in the financial statements. The auditor's task is to clearly and concisely present a highly technical subject to a variety of interested readers.

The Standard Report

The wording of the auditor's standard report usually follows the pattern recommended by the Committee on Auditing Procedure of the AICPA in 1948. The wording has changed only slightly since that time to allow for changes in financial reporting policies. The currently recommended report form is used by almost all CPAs. Since the specific words and phrases in the report have an established meaning, use of the precise wording serves the ends of conciseness and clarity.

A typical example of an auditor's standard report is shown in Figure 1-1. The standard report makes two general representations:

1. A statement of fact that the *scope* of the examination was adequate to enable the auditor to form an opinion on the statements
2. An informed, expert *opinion* that the statements present fairly the financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles consistently applied

Report of Certified Public Accountants

The Board of Directors

Texas Instruments Incorporated

We have examined the consolidated balance sheet of Texas Instruments Incorporated and subsidiaries at December 31, 1977 and 1976, and the related consolidated statements of income and retained earnings and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Texas Instruments Incorporated and subsidiaries at December 31, 1977 and 1976, the consolidated results of its operations, and the changes in its consolidated financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis during the period.

Arthur Young & Company
Dallas, Texas
January 30, 1978

Figure 1-1: A typical auditor's standard report

The auditor's report contains two distinct parts: the scope paragraph and the opinion paragraph. These paragraphs contain a number of key words and phrases which concisely express the responsibility assumed by the auditor in rendering his report.

The Scope Paragraph In the scope paragraph the auditor makes certain statements of fact about the audit.

"We have examined" This phrase emphasizes the point that an audit was performed. An auditor cannot express an opinion on financial statements without first conducting an audit.

"The balance sheets . . . and the related statements of income and retained earnings and changes in financial position" An auditor must clearly identify the statements covered by his report. The financial statements accompany the auditor's report and should be securely bound under the same cover. The standard report applies to profit-seeking organizations. For other types of organizations, appropriate modification of the identification of the statements and other aspects of the report is required.

"Of XYZ Company" This phrase directs attention to the fact that the financial statements are the representations of the client, not the auditor. Management, not the auditor, is primarily responsible for the adequacy and accuracy of the statements. Although the auditor may draft the statements himself, he does so on behalf of the client.

"Generally accepted auditing standards" By stating he has complied with generally accepted auditing standards the auditor represents that an examination adequate to support an opinion on the financial statements was performed with professional competence by properly trained persons. Generally accepted auditing standards are listed and discussed in detail in Chapter 3, and a major portion of this text is concerned with the meaning of these standards.

"Tests of the accounting records" An audit does not involve an examination of 100 percent of the accounting records. This phrase emphasizes the fact that an audit involves tests of selected underlying data rather than a complete review of all such data. The subordinate position of this phrase also indicates that, while the examination includes tests of the records, it is centered on the financial statements. The accounting records are examined because they represent data underlying the statements.

"Procedures . . . considered necessary in the circumstances" This phrase emphasizes the importance of professional judgment. Tests and procedures should be tailored to the specific circumstances of a particular engagement.

On the other hand, generally accepted auditing standards are applicable to every engagement.

The Opinion Paragraph In contrast to the scope paragraph, the opinion paragraph is not a statement of fact. This is made clear by the first key phrase.

“In our opinion” An auditor’s opinion is an expression of his informed judgment. His conclusions are not the same as absolute certainty. The auditor is an expert in the fields of accounting and auditing. Therefore, his opinion carries substantial weight. Nevertheless, he cannot ensure or warrant the accuracy of the financial statements.

“Present fairly . . . generally accepted accounting principles” The auditor does not state that the statements are true and correct. Financial statements necessarily are the result of estimates and approximations. Their precision cannot be absolute. On the other hand, the auditor can conclude that the statements are free from material misstatements and omissions. Note that the auditor must form a conclusion not only on the freedom of the statements from material misstatement, but also on their freedom from material omissions. Financial statements may be misleading if they do not contain all the information necessary to interpret them properly. For example, the existence of contingent liabilities might significantly influence decisions based on the statements.

Recently, court decisions and critics of the public accounting profession have raised the issue of whether the auditor’s opinion includes a judgment on fairness separate from conformity with generally accepted accounting principles. Those who raise this issue confuse the broad concept of generally accepted accounting principles with specific pronouncements on accounting by an authoritative body. Unfortunately, there is some basis for the belief that the letter of some accounting pronouncements has been adhered to while their spirit has been violated. However, “fairness” is too loose a term to provide a practical basis for evaluating the presentation of financial information without some specific guide, such as generally accepted accounting principles.

Statement on Auditing Standards No. 5 was issued to explain the judgments an auditor makes in forming an opinion on fair presentation in conformity with generally accepted accounting principles. Paragraph 4 identifies the following judgments:

1. The accounting principles selected and applied have general acceptance.
2. The accounting principles are appropriate in the circumstances.
3. The financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation.
4. The information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed.