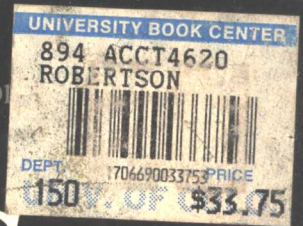
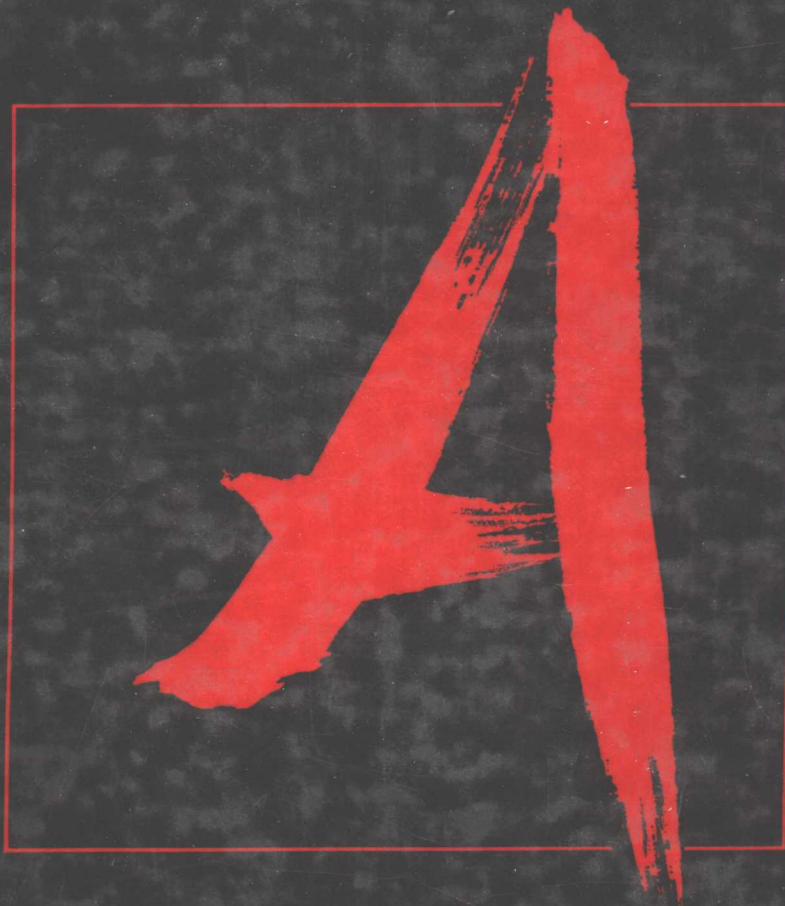


Fifth Edition



# AUDITING



Jack C. Robertson  
Frederick G. Davis

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# *AUDITING*

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*Dedicated to Jim Tom Barton  
and the late Albert L. Wade*

# Preface

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The recurring theme throughout this fifth edition of *Auditing* is the *practical audit method*—an emphasis on decision making that consists of these parts:

1. Problem recognition.
2. Evidence collection.
3. Evidence evaluation.

We introduce the practical audit method in Chapter 1 and carry it through all the chapter topics—audit standards, ethics, legal liability, internal control, sampling in auditing, computer auditing, control evaluation and account balance auditing, and audit reports. The three-step method is an overall approach, and our challenge is to make it *practical*. Our means of making the method practical is to use the Kingston Company—a model audit client used throughout the exhibits and problems as an integral part of Chapters 6 through 21.

## LEARNING BY DOING

In our view as textbook authors, we believe students learn auditing by *doing* audits. Naturally, we believe *Auditing* provides the foundation of concepts and methods that enables students to understand their activities as financial statement auditors, but there is no real substitute for some “hands on” experience. The Kingston Company case is a practice case-within-a-textbook. The stage is set in Chapter 6 (Beginning an Audit Engagement) with a description of the company’s business and organization. Additional information is added to the case in each subsequent chapter, according to the chapter topics. In Chapters 11 and 12, Kingston converts its accounting to a computer system. In Chapters 13 through 18, the text itself describes control systems and account balances with reference to the Kingston Company, providing the background to enable students to apply the chapter concepts in the case assignments at the end of the chapter.

These technical chapters (13 through 18) strike a balance between abstract,

general coverage of control system evaluation and account balance auditing and illustrative examples based on the Kingston Company. Students can reinforce their understanding of the text material by doing the Kingston assignments. These assignments are arranged in the sequence of work typical of financial audits.

## PROFESSIONAL STANDARDS

*Auditing* contains numerous references to authoritative statements on auditing standards and to standards governing other areas of practice. Even so, the text tries to avoid mere repetition of passages from the standards, concentrating instead on explaining their substance and operational meaning in the context of the practical audit method. Instructors and students may wish to supplement the text with current editions of pronouncements published by the American Institute of Certified Public Accountants (AICPA) and by Commerce Clearing House (CCH).

The following abbreviations, used by the AICPA and by CCH in their compendiums of standards, are used throughout the book:

- AU     Auditing Standards
- MS     Management Advisory Services Standards
- TX     Responsibilities in Tax Practice
- AR     Accounting and Review Services Standards
- ET     Ethics Rules, Interpretations, and Rulings
- BL     AICPA Bylaws
- QC     Quality Control Standards
- AC     Accounting Standards

Our practice in previous editions has been to avoid jumping on the bandwagon of proposed additions and changes in professional standards. In the past, we have not presented text material based on exposure drafts of new auditing standards and other professional practice standards. (Several years ago, we prepared an extensive explanation of the "new standard report," but it was not adopted, and we barely had time to remove the "new" explanation before the book went to press!) This year seems to be different. By mid-1987, wide-ranging proposals for change had been proposed. Nine proposed auditing standards were in the exposure draft stage, with action expected late in 1987 and thereafter. The AICPA was in the planning stages of implementing changes in the Code of Ethics (according to recommendations in the Anderson Committee report). The U.S. General Accounting Office (GAO) had also released proposed changes in the *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions* (the "yellow book").

In this fifth edition of *Auditing*, we continue to present the basic material with reference to existing adopted standards. However, we also present the proposed standards set apart in stylistic boxes prominently labeled as "pro-

posals” and “exposure drafts.” These boxes contain brief explanations of how the proposals would *change* existing standards already described in the text chapter. We believe this treatment will enable students to identify the newest proposals and distinguish them from prior standards, and we believe this treatment will help instructors pinpoint the latest developments as changes are enacted (or fail to be enacted as proposed).

The major exception to this general policy is our revision of Chapter 7, Study and Evaluation of Internal Control. We redesigned the chapter for two reasons: (1) to make the explanations flow more smoothly and avoid the AU 320 definitions problem, and (2) to align the chapter with the more current professional emphasis on “control risk assessment.” We believe the chapter presents lucid explanations of the audit process of study and evaluation of internal control.

## LEARNING AIDS

We have retained three important features of the previous edition to help instructors and students organize their study of auditing. These are the *professional standards sources* and the *learning objectives* at the beginning of each chapter and the *problem topic labels* in the end-of-chapter problem sections.

- The facing page of each chapter lists the professional standards related to the chapter. This list can help instructors assign supplementary readings and can help students refer to relevant pronouncements.
- Each chapter begins with a set of learning objectives for students. These objectives are expressed in terms of what the student should be able to *do* after studying the chapter.
- The end-of-chapter review questions, problems, and discussion cases carry topical titles for easy identification. All the questions and problems are associated with one or more of the learning objectives. (The instructor’s manual contains a matrix for each chapter, associating the learning objectives with the review questions, problems, and cases.)

We also have prepared two other features new for this edition of *Auditing*.

- Some of the chapters include Robert Ashton’s behavioral decision cases. They provide interesting vehicles for discussion.
- A separate supplement contains computer-assisted homework materials based on Lotus 1-2-3® worksheets. These worksheets enable students to make calculations quickly and to experiment with multiple versions of statistical and other kinds of problems.

## APPLICATIONS CHAPTER REORGANIZATION

We have reorganized the applications text material (Chapters 13 through 18). The chapters begin with explanations of control systems and control evaluation

and end with procedures for auditing the major account balances in a cycle. The organization of these chapters is as follows:

Chapter	Transaction Cycles/Topics	Account Balances/Topics
13	Revenue and collection, cash receipts	Sales, cash, accounts receivable, bad debts
14	Acquisition and expenditure, cash disbursements	Prepays, accounts payable, accrued liabilities
15	Acquisition and expenditure	Cost of sales, inventory, fixed assets and depreciation
16	Production and conversion, personnel and payroll	Cost of goods manufactured, salaries and wages
17	Financing and investment	Investments, intangibles, notes payable, owner equity
18	Completing the audit	Other revenue and expense, attorney letter, client representations, subsequent events, engagement review, management letter

## ACKNOWLEDGMENTS

The American Institute of Certified Public Accountants has generously given permission for liberal quotations from official pronouncements and other AICPA publications, all of which lend authoritative sources to the text. In addition, several publishing houses, professional associations, and accounting firms have granted permission to quote and extract from their copyrighted material. Since a great amount of significant auditing thought exists in a wide variety of sources, we are especially grateful for the cooperation of all those interested in auditing education.

We appreciate receiving permission from the Institute of Management Accounting of the National Association of Accountants and the Institute of Internal Auditors, Inc. to use problem materials from past CMA and CIA examinations. We also appreciate permission granted by the Hewlett-Packard Corporation to describe a particular H-P computer system in Chapter 11.

We also gratefully acknowledge the reviews and suggestions offered by Mr. Clarence Staubs of the U.S. Securities and Exchange Commission, by professors James McKee of North Carolina State University, Malcolm Lathan of the University of Virginia, Robert Rouse of Clemson University, Virginia Bakay of the University of Nevada at Las Vegas, and by other anonymous reviewers, all of whom contributed many worthwhile recommendations. Their attention to



reviews greatly enhanced several portions of the text. However, we remain responsible for all errors of commission and omission.

We owe a great debt of gratitude to professional accountants in all walks of life. The first four editions of *Auditing* (since 1976) have been dedicated to two accountants who are truly professional in every meaning of the word: To Jim Tom Barton, an author of Texana literature, and to Albert L. Wade, who died in 1987, we rededicate this fifth edition in trust that it conveys to others the sense of professional values these two men have exhibited freely in their personal and professional lives. We also dedicate this edition to former students who received their auditing foundation through dedicated teachers using previous editions of *Auditing*. We are proud to have had a part in their professional development. Last, but far from least, we gratefully acknowledge Susan and Laura. Their enduring support was exceeded only by their practical skills of editing, word processing, and general management (of us), in which they excel.

Jack C. Robertson  
Frederick G. Davis

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# PART I

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