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THIRD EDITION  
**AUDITING  
PRINCIPLES**

HOWARD F. STETTLER

Concentrates on the conceptual and practical aspects of examinations of financial statements...details the objectives and techniques practiced by today's professionals

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# AUDITING PRINCIPLES

*Third Edition*

**Howard F. Stettler**

*Professor of Business Administration  
University of Kansas*



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# **AUDITING PRINCIPLES**

## **Author to reader**

Thank you for permitting me to share with you these comments on the third edition of *Auditing Principles*. My remarks are based on the presumption that you have certain questions about the book, and in turning to these pages you are seeking answers to those questions. I hope that I have correctly anticipated your questions, and that my responses are sufficiently informative.

*This is the third edition; how does it differ from the previous edition?* Most importantly, it reflects recent developments presented in the Statements on Auditing Procedure issued by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants, the Opinions of the Accounting Principles Board, the AICPA's Code of Professional Ethics, and regulatory and legal decisions. Material on the auditing of systems maintained by electronic data processing has been expanded to a full chapter covering the special problems of reviewing internal controls for such systems, testing the systems, and using the computer in conducting examinations. There is also some expansion of the material on management advisory services, particularly with respect to problems that a public accounting firm faces in providing such services, including that of maintaining independence when auditing services are also provided.

The long-form reports chapter now contains a novel development in the form of a standardized report format that has been developed by a regional CPA firm. The summaries of the three AICPA audit case studies have been deleted, but of course similar case studies may be obtained from the Institute. The illustrative audit working papers are no longer bound in the text, but are supplied as a separate booklet, thus more closely approximating a file of working papers and facilitating reference to the working papers when they are commented on in the text. Finally,

the problems in the text have been updated by including material from recent CPA examinations.

*How does this book differ from your other auditing text, Systems Based Independent Audits?* There are two major differences. First, the chapters of *Auditing Principles* dealing with examination procedures are arranged in the traditional working-paper sequence that corresponds to the order of items in the financial statements, whereas the comparable material in the other book is organized on a “transaction” basis, with the balance sheet and income statement accounts affected by each of the usual types of operating transactions covered in a single chapter. The second difference is in the amount of descriptive material on accounting systems and procedures. *Auditing Principles* contains much less detailed descriptive material, although the discussion of the internal control aspects of the accounting system is equally thorough in both books.

*What do you consider to be the principal features of Auditing Principles?* The balance of conceptual and practical material is of first importance. The six introductory chapters orient the reader to the subject by discussing historical developments, the auditor’s report and its relationship to auditing standards and accounting principles, the importance of independence and other aspects of the code of professional ethics, legal liability, internal control, the closely related field of internal auditing, sampling, types of evidence, and the general approach to auditing as it is practiced today. The final chapters are likewise largely conceptual in their approach to the history of the auditor’s report, principles underlying preparation of the report, considerations in the preparation of long-form reports, meeting the challenge of computer-based accounting systems and using computers in auditing activities, understanding and utilizing statistical sampling techniques, and problems encountered in providing management advisory services as an adjunct to auditing services.

Even the “core” chapters that cover the auditing of the various financial statement items are conceptual in their approach. Internal control is discussed from the standpoint of the underlying objectives in controlling activities in the various accounting and operating areas, and typical audit procedures are discussed in relation to the objectives that guide the auditor in his examination of items in the financial statements. Although the discussion of procedures has a strong practical flavor, reflecting the author’s own extensive auditing experience, the procedures are not presented as a simple “how-to-do-it” program listing to be memorized. Rather, the procedures are presented as a means of strengthening the reader’s conceptual understanding of audit objectives, and how procedures may be varied according to the circumstances in reaching an acceptable level of satisfaction relative to the objectives.

Restating the preceding comment in the words of the preface to the second edition, “The approach to the subject retains the point of view of

the senior accountant, who must keep firmly in mind the requirements of his principal, the conduct of his own activities, and the purpose and technique of the auditing steps being carried out by the assistants, or junior accountants, whom he is supervising." To strengthen the understanding of practice, the core chapters include frequent references and explanatory comments pertaining to the illustrative working papers for the audit of Machine Products Co., designed to accompany the text, and further depth may be achieved by completing the separately available *Practice Case for Auditing* that covers the following year's examination of Machine Products Co.

Pronouncements of the American Institute of Certified Public Accountants are liberally referred to or quoted for the reader's benefit and as a means of making the text as authoritative as possible. The cooperation of the Institute in granting permission for extensive use of its published material and for use and adaptation of questions and problems from its Uniform CPA Examinations is deeply appreciated as a significant contribution to the book.

HOWARD F. STETTLER

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# 1

## ***Independent audits— what and why***

The opinion of an independent public accountant concerning the financial statements of a business is the best possible indication of whether persons who are not associated with the business may justifiably rely upon those statements in making important financial decisions. Such an opinion will ordinarily be based on a comprehensive examination of the statements and supporting data, and it will indicate whether or not the statements present fairly the financial position of the concern and the results of the firm's operations for the period specified.

Those who use financial statements are likely to insist that the statements have such an independent opinion, or "attestation," accompanying them. Any decisions to invest or extend credit can be only as sound as the information on which such decisions are based. Without the professional opinion of an independent public accountant, financial statements are open to question, because they will normally have been prepared by the same management officials who are responsible for the operation of the business.

### **Why Unaudited Statements Are Not Acceptable**

Using financial statements prepared by management and submitted to third parties without the statements having been first subjected to an independent review would be comparable to having a judge hear a case in which he was a litigant, or to having a member of an opposing athletic team act as official referee and scorekeeper. In any of these situations, there is opportunity for the results to be affected by personal bias, self-interest, carelessness, or even outright dishonesty. In the case of financial statements, management understandably might be reluctant to admit that the receivable resulting from a sale that it had approved was doubt-