PRINCIPLES OF AUDITING

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Principles of auditing

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Preface

THIS SIXTH EDITION of *Principles of Auditing* reflects substantial changes, for the profession of public accounting is itself in an era of rapid change. New challenges and new goals for independent auditors are arising from a variety of sources. A demand for more complete disclosure of corporate affairs, increased activity by the Securities and Exchange Commission in shaping the reporting process, constant litigation involving CPA firms, extension of the auditor's responsibility to quarterly financial statements, new policies set forth by the Auditing Standards Executive Committee—these are but a few of the new issues presented in this new edition.

Our goal in this book is to emphasize concepts which enable the student to understand the philosophy and environment of auditing. Thus, the first ten 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 statistical 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

Chapter 1, The Role of the Auditor in the American Economy, has been extensively revised to give more emphasis to financial reporting in achieving social and economic goals. The need for credibility in business and in public affairs is linked to the work of the independent auditor.

Recent court cases helping to define the legal responsibilities of the auditor have been incorporated in an extensive revision of Chapter 3.

Chapter 4 has been thoroughly revised and features a logical framework of the fundamental steps comprising the audit process. This framework provides the student with an understanding of the auditor's approach to an engagement.

Chapter 8, Statistical Sampling, is virtually a new chapter and features a readable, easy-to-grasp approach to statistical concepts and techniques of major importance to every CPA firm. The topic of quality control standards has been added to Chapter 9.

Chapter 10 includes a generalized audit program stated in terms of audit objectives. This conceptual audit program provides the student with a framework which may be used to construct a specific set of audit procedures for any item in the financial statements.

The chapters dealing with investments in securities and with inventories and depreciable assets have been particularly affected by recent pronouncements of the Financial Accounting Standards Board and by those of the Securities and Exchange Commission. Throughout the book the Statements on Auditing Standards issued by the AICPA's Auditing Standards Executive Committee have been interwoven into both text and problem material.

Glossary of key terms

At the end of each chapter is a list of key terms introduced in that chapter, with concise definitions for these terms. This new feature is very useful in enabling students to use auditing terminology with judgment and precision.

Achievement tests and comprehensive examination

Three Achievement Tests and a Comprehensive Examination (all in objective form) are available with the Sixth 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.

Reduction in number of chapters

In recognition of the tightness of many curricula with a limited number of units made available for the study of auditing, every effort has been made in this edition to condense the coverage of less vital topics. Some chapters have been shortened and the total number of chapters has been reduced from 21 to 20.

Continued emphasis on internal control

The strong emphasis on internal control which characterized the preceding editions is continued in this Sixth Edition. When appropriate, those auditing procedures associated with internal control tests of transactions have been segregated from "year-end" auditing procedures. The expanded role of computers has caused some changes in concepts of internal control but has not lessened its importance.

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.

Most 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 for the past 15 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 seven case studies in auditing appear at the ends of the chapters on Audit Working Papers, Quality Control for Audits; Cash; Accounts and Notes Receivable and Sales Transactions; Inventories and Cost of Goods Sold; Interest-Bearing Debt and Interest Expense; Owners' Equity; 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, and the American Institute of Certified Public Accountants. Special attention is given to the Code of Professional Ethics, Statements on Auditing Standards, Statements on Responsibilities in Tax Practice, and Industry Audit Guides. 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 the Fifth Edition provided by Richard A. Epaves of Cleveland State University and by Fred Everett of Western Michigan University. Their many suggestions for this Sixth Edition were most valuable.

Our special thanks go to Edwin M. Lamb, Partner, Arthur Young & Company, who has contributed importantly to the content of Chapter 8, Statistical Sampling.

Robert Dodson, Partner, Touche Ross & Co., was also most helpful with respect to Chapter 6 on the audit of electronic data processing systems.

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.

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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, highly industrialized society the communication of financial and other economic data is vitally important. Our economy is characterized by large corporate organizations which have gathered capital from millions of investors and which 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 its far-flung resources. 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.

Although millions of individuals invest directly in corporate securities, 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 an increasing 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 is a further reminder 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 which 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, combating pollution, increasing employment, and maintaining a satisfactory balance of payments, 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 assume responsibility for 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