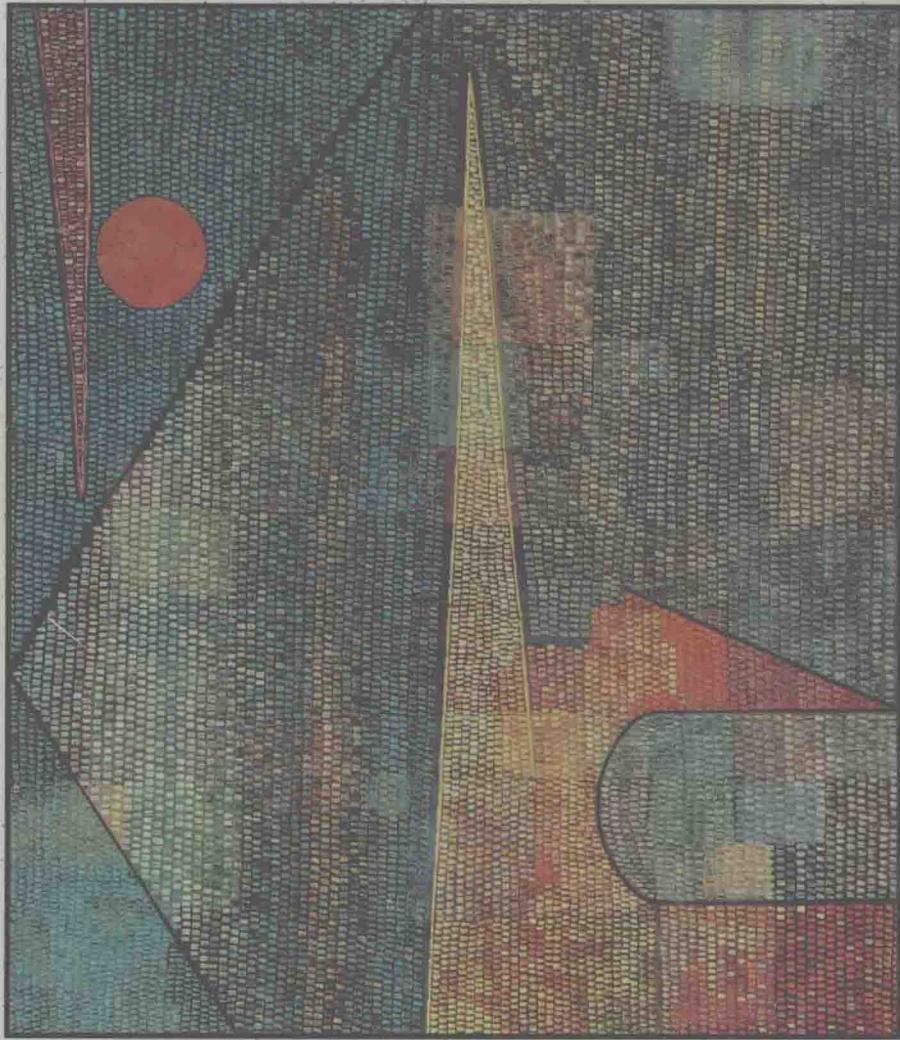


SIXTH EDITION



# AUDITING

An Integrated Approach

ALVIN A. ARENS • JAMES K. LOEBBECKE

# AUDITING

## An Integrated Approach

### Sixth Edition

---

Alvin A. Arens

*Price Waterhouse  
Auditing Professor  
Michigan State University*

James K. Loebbecke

*Kenneth A. Sorensen  
Peat Marwick Professor of Accounting  
University of Utah*



Prentice Hall, Englewood Cliffs, New Jersey 07632

**Library of Congress Cataloging-in-Publication Data**

Arens, Alvin A.

Auditing : an integrated approach / Alvin A. Arens, James K.

Loebbecke. — 6th ed.

p. cm. — (Prentice Hall series in accounting)

Includes index.

ISBN 0-13-289100-X

1. Auditing. I. Loebbecke, James K. II. Title. III. Series

HF5667.A69 1994

657'.45—dc20

94-5463  
CIP

Acquisitions editor: Bill Webber  
Interior design: Jeannette Jacobs  
Cover design: Wendy Helft, Design W  
Manufacturing buyer: Herb Klein

This book contains quotations and adaptations from publications copyrighted by the American Institute of Certified Public Accountants, Inc. Such passages have been reprinted or adapted with permission of the American Institute of Certified Public Accountants.



© 1994, 1991, 1988, 1984, 1980, 1976 by Prentice-Hall, Inc.  
A Paramount Communications Company  
Englewood Cliffs, New Jersey 07632

All rights reserved. No part of this book may be reproduced, in any form or by any means, without permission in writing from the publisher.

Printed in the United States of America

10 9 8 7 6 5 4 3 2

**ISBN 0-13-289100-X**

Prentice-Hall International (UK) Limited, *London*  
Prentice-Hall of Australia Pty. Limited, *Sydney*  
Prentice-Hall of Canada Inc., *Toronto*  
Prentice-Hall Hispanoamericana, S.A., *Mexico*  
Prentice-Hall of India Private Limited, *New Delhi*  
Prentice-Hall of Japan, Inc., *Tokyo*  
Simon & Schuster Asia Pte. Ltd., *Singapore*  
Editora Prentice-Hall do Brasil, Ltda., *Rio de Janeiro*

# PREFACE

---

## OBJECTIVES

The sixth edition of *Auditing: An Integrated Approach* contains numerous changes and revisions, but the objectives and emphasis remain essentially the same.

The book is an introduction to auditing for students who have not had significant experience in auditing. It is intended for either a one-quarter or one-semester course at the undergraduate or graduate level. The book is also appropriate for introductory professional development courses for CPA firms, internal auditors, and government auditors.

The primary emphasis in this text is on the auditor's decision-making process. We believe that the most fundamental concepts in auditing relate to determining the nature and amount of evidence the auditor should accumulate after considering the unique circumstances of each engagement. If a student of auditing understands the objectives to be accomplished in a given audit area, the circumstances of the engagement, and the decisions to be made, he or she should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained.

Thus, as the title of the book reflects, our purpose is to integrate the most important concepts of auditing as well as certain practical aspects in a logical manner to assist students in understanding audit decision making and evidence accumulation. For example, the internal control structure is integrated into each of the chapters dealing with a particular functional area and is related to tests of controls and substantive tests of transactions; tests of controls and substantive tests of transactions are, in turn, related to the tests of details of financial statement balances for the area; and statistical sampling is applied to the accumulation of audit evidence rather than treated as a separate topic.

---

## ORGANIZATION

The text is divided into six parts.

**Part 1, The Auditing Profession (Chapters 1-4)** The book begins with a description of the nature of auditing and auditing firms, the AICPA, and the SEC. In Chapter 2, there is a detailed discussion of audit reports. It emphasizes the conditions affecting the type of report the auditor must issue and the type of audit report applicable to each condition under varying levels of materiality. Chapter 3 explains ethical dilemmas, professional ethics, and the AICPA *Code of Professional Conduct*. Chapter 4 ends this part with an investigation of auditors' legal liability.

**Part 2, The Auditing Process (Chapters 5-10)** The first two of these chapters deal with auditors' and managements' responsibilities, audit objectives, and general concepts of evidence accumulation. In addition, Chapter 6 emphasizes analytical procedures as an audit tool. The remaining chapters deal with planning the engagement and the decision process the auditor goes through. Chapter 8 introduces materiality and risk, and shows their effect on the audit. The study of the internal control structure and assessment of control risk are discussed in Chapter 9, which emphasizes a proper methodology for obtaining an understanding of the five components of an internal control structure. Chapter 10 summarizes Chapters 5 through 9 and integrates them with the remainder of the text.

**Part 3, Application of the Auditing Process to the Sales and Collection Cycle (Chapters 11-14)** These chapters apply the concepts from Part 2 to the audit of sales, cash receipts, and the related income statement and balance sheet accounts. The appropriate audit procedures for accounts in the sales and collection cycle are related to the internal control structure and audit objectives for tests of controls, substantive tests of transactions, and tests of details of balances. Students learn to apply attributes sampling to the audit of sales and cash receipts, and monetary unit sampling and variables sampling to the audit of accounts receivable.

**Part 4, Auditing Complex EDP Systems (Chapter 15)** This chapter covers understanding the internal control structure and assessing control risk for more complex EDP systems, the audit of systems that include significant EDP applications, and auditing with or without the use of the computer. The emphasis in this chapter is on the effect of more complex EDP on the way an audit is conducted.

**Part 5, Application of the Auditing Process to Other Cycles (Chapters 16-21)** Each of these chapters deals with a specific transaction cycle or part of a transaction cycle in much the same manner as Chapters 11 through 14 deal with the sales and collection cycle. Each chapter in Part 5 is meant to demonstrate the relationship of the internal control structure, tests of controls, and substantive tests of transactions for each broad category of transactions to the related balance sheet and income statement accounts. Cash in the bank is studied late in the text to demonstrate how the audit of cash balances is related to most other audit areas.

**Part 6, Completing the Audit and Offering Other Services (Chapters 22-24)** This set of chapters begins with summarizing all audit tests, reviewing working papers and other aspects of completing the audit. The remaining two chapters deal with various types of engagements and reports, other than the audit of financial statements using generally accepted accounting principles. Topics covered include other audit engagements, attestation services, compilation engagements, internal auditing, governmental financial auditing, and operational auditing.

---

## SUPPLEMENTS

Several supplements are available for faculty and/or students' use.

**Solutions Manual** Solutions to all end-of-chapter review questions, multiple choice questions, problems, and cases.

**Instructor's Resource Manual** Items to assist the instructor in teaching the course:

- Suggestions by the authors for effective ways to use each chapter
- Instructions for assignments and use of software templates
- Enlarged transparency masters for each chapter of key tables and figures in the text
- Transparency masters for each chapter of figures not included in the text that enhance learning.

**Software Templates** Problem materials from text converted to a computerized format. Faculty members can assign identified problems for students to solve using their computer and the software templates. Available at no charge to adopters.

**Test Items File** Instructor-prepared multiple choice and matching questions and answers. All questions are original and are not taken from professional examinations.

**Student Study Guide** Prepared by Dennis L. Kimmell of Akron University. Includes an outline of each chapter, multiple choice and other questions, and solutions. It is available through book stores.

**Computerized Practice Set—Lakeside Company: An Auditing Practice Case** Prepared by Joseph Hoyle and Richard Scott, includes actual practice in conducting an audit.

---

## ACKNOWLEDGMENTS

We acknowledge the American Institute of Certified Public Accountants for permission to quote extensively from statements on auditing standards, the *Code of Professional Conduct*, Accounting Principles Board Opinions, Uniform CPA Examinations, and other publications. The willingness of this major accounting organization to permit the use of its materials is a significant contribution to the book.

The continuing generous support of the Price Waterhouse Foundation is acknowledged, particularly in regard to the word processing, editing, and moral support for this text.

We also gratefully acknowledge the contributions of the following reviewers for their suggestions and support: Sherri Anderson, Sonoma State University; Dale E. Armstrong, Oklahoma State University; Stephen K. Asare, University of Florida; Mark Beasley, Michigan State University; Stanley F. Biggs, University of Connecticut; Joseph V. Calmie, Thomas Nelson Community College; Randy Elder, Syracuse University; William L. Felix, University of Arizona; Gary L. Holstrum, University of South Florida; C. Randy Howard, Eastern Montana College; James Jambalvo, University of Washington; David S. Kerr, Texas A & M University; Dennis Lee Kimmell, University of Akron; William R. Kinney, Jr., University of Texas; W. Robert Knechel, University of Florida; Heidi H. Meier, Cleveland State University; Tad Miller, California Polytechnic State University; Lawrence C. Mohrweis, Indiana University; Frederick L. Neumann, University of Illinois; Robert R. Tucker, University of Wisconsin; D. Dewey Ward, Michigan State University.

A special note of thanks is extended to Carol Borsum for her editorial and production efforts and to Mary Jo Mercer for word processing.

We are especially grateful to Philip Rotner for his review of Chapter 4 on legal liability.

Finally, the encouragement and support of our families are acknowledged.

# CONTENTS

---

## PREFACE

XV

## PART 1 THE AUDITING PROFESSION

### 1 AN OVERVIEW OF AUDITING

1

#### *Learning Objectives*

1

Nature of Auditing

1

Distinction between Auditing and Accounting

3

Types of Audits

4

Types of Auditors

6

Economic Demand for Auditing

7

Certified Public Accountant

10

Certified Public Accounting Firms

11

Activities of CPA Firms

12

Structure of CPA Firms

14

AICPA

14

Ways CPAs Are Encouraged to Perform Effectively

16

Generally Accepted Auditing Standards

16

Statements on Auditing Standards

17

Quality Control

20

Securities and Exchange Commission

24

#### *Essential Terms*

25

#### *Review Questions*

26

#### *Multiple Choice Questions from CPA Examinations*

27

#### *Discussion Questions and Problems*

28

### 2 AUDIT REPORTS

33

#### *Learning Objectives*

33

Standard Unqualified Audit Report

34

Conditions Requiring a Departure from an Unqualified Audit Report

37

Audit Reports Other than Unqualified

38

Materiality

39

Discussion of Conditions Requiring a Departure

42

Unqualified Audit Report with Explanatory Paragraph or

Modified Wording

47

More than One Condition Requiring a Departure or Modification

52

Number of Paragraphs in the Report

53

Negative Assurances

53

Auditor's Decision Process for Audit Reports

53

#### *Summary*

55

#### *Essential Terms*

55

#### *Review Questions*

55

#### *Multiple Choice Questions from CPA Examinations*

56

#### *Discussion Questions and Problems*

57

#### *Case*

63

V

3	PROFESSIONAL ETHICS	65
	<i>Learning Objectives</i>	65
	What Are Ethics?	65
	Ethics in Business	67
	Ethical Dilemmas	68
	Special Need for Ethical Conduct in Professions	72
	Ways CPAs Are Encouraged to Conduct Themselves Professionally	73
	Code of Professional Conduct	74
	Independence	79
	Integrity and Objectivity	85
	Technical Standards	85
	Confidentiality	86
	Contingent Fees	88
	Discreditable Acts	89
	Advertising and Solicitation	90
	Commissions and Referral Fees	91
	Form of Organization and Name	92
	Enforcement	93
	<i>Essential Terms</i>	93
	<i>Review Questions</i>	94
	<i>Multiple Choice Questions from CPA Examinations</i>	94
	<i>Discussion Questions and Problems</i>	96
	<i>Cases</i>	98
4	LEGAL LIABILITY	103
	<i>Learning Objectives</i>	103
	Changed Legal Environment	104
	Distinction among Business Failure, Audit Failure, and Audit Risk	105
	Legal Concepts Affecting Liability	106
	Definitions of Legal Terms	107
	Liability to Clients	109
	Liability to Third Parties under Common Law	111
	Civil Liability under the Federal Securities Laws	113
	Criminal Liability	119
	The Profession's Response to Legal Liability	121
	The Individual CPA's Response to Legal Liability	122
	<i>Summary</i>	123
	<i>Essential Terms</i>	124
	<i>Review Questions</i>	124
	<i>Multiple Choice Questions from CPA Examinations</i>	125
	<i>Discussion Questions and Problems</i>	127
	<i>Cases</i>	130
PART 2	THE AUDITING PROCESS	
5	AUDIT RESPONSIBILITIES AND OBJECTIVES	133
	<i>Learning Objectives</i>	133
	Objective of Conducting an Audit of Financial Statements	134
	Management's Responsibilities	137

Auditor's Responsibilities	138
Financial Statement Cycles	141
Setting Audit Objectives	144
Transaction-Related Audit Objectives	146
Balance-Related Audit Objectives	147
How Audit Objectives Are Met	150
<i>Summary</i>	154
<i>Essential Terms</i>	154
<i>Review Questions</i>	155
<i>Multiple Choice Questions from CPA Examinations</i>	155
<i>Discussion Questions and Problems</i>	157
 6 AUDIT EVIDENCE	 165
<i>Learning Objectives</i>	165
Nature of Evidence	165
Audit Evidence Decisions	166
Persuasiveness of Evidence	168
Types of Audit Evidence	171
Terms Used in Audit Procedures	179
Analytical Procedures	180
Purposes and Timing of Analytical Procedures	180
Five Types of Analytical Procedures	183
Using Statistical Techniques and Computer Software	187
Appendix A: Common Financial Ratios	188
Short-Term Debt-Paying Ability	188
Short-Term Liquidity	189
Ability to Meet Long-Term Debt Obligations and Preferred Dividends	190
Operating and Performance Ratios	191
Illustration	192
<i>Essential Terms</i>	193
<i>Review Questions</i>	194
<i>Multiple Choice Questions from CPA Examinations</i>	195
<i>Discussion Questions and Problems</i>	196
<i>Case</i>	202
 7 AUDIT PLANNING AND DOCUMENTATION	 205
<i>Learning Objectives</i>	205
Planning	205
Preplan the Audit	207
Obtain Background Information	210
Obtain Information about Client's Legal Obligations	212
Perform Preliminary Analytical Procedures	214
Working Papers	214
Summary of Working Papers	223
<i>Essential Terms</i>	223
<i>Review Questions</i>	224
<i>Multiple Choice Questions from CPA Examinations</i>	225
<i>Discussion Questions and Problems</i>	226

8	MATERIALITY AND RISK	231
	<i>Learning Objectives</i>	231
	Materiality	231
	Set Preliminary Judgment about Materiality	233
	Allocate Preliminary Judgment about Materiality to Segments (Tolerable Misstatement)	236
	Estimate Misstatement and Compare	238
	Risk	239
	Inherent Risk	246
	Other Materiality and Risk Considerations	250
	Evaluating Results	254
	<i>Summary</i>	256
	<i>Essential Terms</i>	257
	<i>Review Questions</i>	257
	<i>Multiple Choice Questions from CPA Examinations</i>	258
	<i>Discussion Questions and Problems</i>	259
	<i>Case</i>	265
9	THE STUDY OF THE CLIENT'S INTERNAL CONTROL STRUCTURE AND ASSESSMENT OF CONTROL RISK	271
	<i>Learning Objectives</i>	271
	Client and Auditor Concerns	272
	Key Concepts	274
	Method of Data Processing	275
	Components of the Internal Control Structure	275
	The Control Environment	275
	Management's Risk Assessment	277
	The Accounting Information and Communication System	277
	Control Activities	277
	Monitoring	282
	Overview of Obtaining an Understanding of the Internal Control Structure Assessing Control Risk	284
	Procedures to Obtain an Understanding	289
	Assessing Control Risk	292
	Tests of Controls	297
	Appendix A: Illustrative Internal Verification Procedures	299
	<i>Essential Terms</i>	302
	<i>Review Questions</i>	303
	<i>Multiple Choice Questions from CPA Examinations</i>	304
	<i>Discussion Questions and Problems</i>	305
	<i>Case</i>	309
	<i>Integrated Case Application</i>	311
10	OVERALL AUDIT PLAN AND AUDIT PROGRAM	313
	<i>Learning Objectives</i>	313
	Types of Tests	314
	Relationship between Tests and Evidence	318
	Evidence Mix	320
	Design of the Audit Program	321

Summary of the Audit Process	330
<i>Essential Terms</i>	333
<i>Review Questions</i>	334
<i>Multiple Choice Questions from CPA Examinations</i>	335
<i>Discussion Questions and Problems</i>	336
<i>Case</i>	340
 PART 3 APPLICATION OF THE AUDITING PROCESS TO THE SALES AND COLLECTION CYCLE	
 11 AUDIT OF THE SALES AND COLLECTION CYCLE: TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS	343
<i>Learning Objectives</i>	343
Nature of the Sales and Collection Cycle	345
Business Functions in the Cycle and Related Documents and Records	346
Methodology for Designing Tests of Controls and Substantive Tests of Transactions for Sales	350
Sales Returns and Allowances	358
Internal Controls, Tests of Controls, and Substantive Tests of Transactions for Cash Receipts	359
Audit Tests for Uncollectible Accounts	361
Additional Internal Controls over Account Balances	361
Effect of Results of Tests of Controls and Substantive Tests of Transactions	362
Case Illustration—Hillsburg Hardware, Part I	362
<i>Essential Terms</i>	371
<i>Review Questions</i>	372
<i>Multiple Choice Questions from CPA Examinations</i>	373
<i>Discussion Questions and Problems</i>	374
<i>Case</i>	380
<i>Integrated Case Application</i>	381
 12 AUDIT SAMPLING FOR TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS	383
<i>Learning Objectives</i>	383
Representative Samples	383
Statistical versus Nonstatistical Sampling	384
Nonprobabilistic Sample Selection Methods	386
Probabilistic Sample Selection	387
Attributes Sampling	393
Sampling Distribution	394
Application of Attributes Sampling	395
Other Considerations	407
Case Illustration—Hillsburg Hardware, Part II	407
<i>Essential Terms</i>	414
<i>Review Questions</i>	415
<i>Multiple Choice Questions from CPA Examinations</i>	416
<i>Discussion Questions and Problems</i>	417
<i>Case</i>	420
<i>Integrated Case Application</i>	421

13	COMPLETING THE TESTS IN THE SALES AND COLLECTION CYCLE: ACCOUNTS RECEIVABLE	423
	<i>Learning Objectives</i>	423
	Methodology for Designing Tests of Details of Balances	424
	Accounts Receivable Balance-Related Audit Objectives	424
	Tests of Details of Balances	429
	Confirmation of Accounts Receivable	434
	Case Illustration—Hillsburg Hardware—Part III	440
	<i>Essential Terms</i>	444
	<i>Review Questions</i>	445
	<i>Multiple Choice Questions from CPA Examinations</i>	446
	<i>Discussion Questions and Problems</i>	447
	<i>Case</i>	452
	<i>Integrated Case Application</i>	452
14	AUDIT SAMPLING FOR TESTS OF DETAILS OF BALANCES	459
	<i>Learning Objectives</i>	459
	Comparison with Attributes Sampling for Tests of Controls and Substantive Tests of Transactions	459
	Nature of the Problem for Tests of Details of Balances	460
	Monetary Unit Sampling	463
	Appendix A: Variables Sampling	479
	Illustration Using Difference Estimation	484
	Appendix B: Formulas for Monetary Unit Sampling	490
	<i>Essential Terms</i>	492
	<i>Review Questions</i>	492
	<i>Multiple Choice Questions from CPA Examinations</i>	493
	<i>Discussion Questions and Problems</i>	494
	<i>Case</i>	498
PART 4	AUDITING COMPLEX EDP SYSTEMS	
15	AUDITING COMPLEX EDP SYSTEMS	499
	<i>Learning Objectives</i>	499
	Complexity of EDP Systems	500
	Effect of EDP on Organizations	502
	EDP Controls	505
	Understanding the Internal Control Structure in an EDP Environment	508
	Auditing Around the Computer	509
	Auditing with Use of the Computer	510
	Microcomputer-Aided Auditing	517
	Audit of Computer Service Centers	520
	<i>Essential Terms</i>	521
	<i>Review Questions</i>	522
	<i>Multiple Choice Questions from CPA Examinations</i>	522
	<i>Discussion Questions and Problems</i>	523

## PART 5 APPLICATION OF THE AUDITING PROCESS TO OTHER CYCLES

16	AUDIT OF THE PAYROLL AND PERSONNEL CYCLE	527
	<i>Learning Objectives</i>	527
	Functions in the Cycle, Related Documents and Records, and Internal Controls	528
	Tests of Controls and Substantive Tests of Transactions	532
	Analytical Procedures	537
	Tests of Details of Balances for Liability and Expense Accounts	537
	<i>Essential Terms</i>	540
	<i>Review Questions</i>	541
	<i>Multiple Choice Questions from CPA Examinations</i>	542
	<i>Discussion Questions and Problems</i>	542
	<i>Case</i>	547
17	AUDIT OF THE ACQUISITION AND PAYMENT CYCLE	549
	<i>Learning Objectives</i>	549
	Nature of the Cycle	551
	Tests of Controls and Substantive Tests of Transactions	554
	Accounts Payable	558
	<i>Essential Terms</i>	568
	<i>Review Questions</i>	568
	<i>Multiple Choice Questions from CPA Examinations</i>	569
	<i>Discussion Questions and Problems</i>	570
	<i>Case</i>	576
18	THE ACQUISITION AND PAYMENT CYCLE: VERIFICATION OF SELECTED ACCOUNTS	579
	<i>Learning Objectives</i>	579
	Audit of Manufacturing Equipment	580
	Audit of Prepaid Expenses	588
	Audit of Accrued Liabilities	592
	Audit of Operations	596
	<i>Essential Terms</i>	600
	<i>Review Questions</i>	600
	<i>Multiple Choice Questions from CPA Examinations</i>	601
	<i>Discussion Questions and Problems</i>	602
	<i>Cases</i>	605
19	AUDIT OF THE INVENTORY AND WAREHOUSING CYCLE	609
	<i>Learning Objectives</i>	609
	Functions in the Cycle and Internal Controls	610
	Parts of the Audit of Inventory	613
	Audit of Cost Accounting	614
	Analytical Procedures	617
	Tests of Details for Inventory	618
	Physical Observation of Inventory	619
	Audit of Pricing and Compilation	622
	Integration of the Tests	626

	<i>Essential Terms</i>	628
	<i>Review Questions</i>	628
	<i>Multiple Choice Questions from CPA Examinations</i>	629
	<i>Discussion Questions and Problems</i>	630
	<i>Cases</i>	635
20	AUDIT OF THE CAPITAL ACQUISITION AND REPAYMENT CYCLE	639
	<i>Learning Objectives</i>	639
	Notes Payable	641
	Owners' Equity	647
	<i>Essential Terms</i>	652
	<i>Review Questions</i>	652
	<i>Multiple Choice Questions from CPA Examinations</i>	653
	<i>Discussion Questions and Problems</i>	654
21	AUDIT OF CASH BALANCES	659
	<i>Learning Objectives</i>	659
	Types of Cash Accounts	659
	Cash in the Bank and Transaction Cycles	661
	Audit of the General Cash Account	663
	Audit of the Payroll Bank Account	674
	Audit of Petty Cash	674
	<i>Essential Terms</i>	675
	<i>Review Questions</i>	676
	<i>Multiple Choice Questions from CPA Examinations</i>	677
	<i>Discussion Questions and Problems</i>	677
	<i>Case</i>	682
PART 6	COMPLETING THE AUDIT AND OFFERING OTHER SERVICES	
22	COMPLETING THE AUDIT	685
	<i>Learning Objectives</i>	685
	Review for Contingent Liabilities and Commitments	685
	Inquiry of Client's Attorneys	688
	Review for Subsequent Events	690
	Final Evidence Accumulation	693
	Evaluate Results	695
	Communicate with the Audit Committee and Management	701
	Subsequent Discovery of Facts	702
	<i>Essential Terms</i>	703
	<i>Review Questions</i>	704
	<i>Multiple Choice Questions from CPA Examinations</i>	705
	<i>Discussion Questions and Problems</i>	706
	<i>Case</i>	710

23	OTHER AUDIT, ATTESTATION SERVICES, AND COMPILATION ENGAGEMENTS	713
	<i>Learning Objectives</i>	713
	Review and Compilation Services	713
	Review of Interim Financial Information for Public Companies	719
	Other Audits or Limited Assurance Engagements	721
	Attestation Engagements	728
	Prospective Financial Statements	731
	Internal Control Structure over Financial Reporting	734
	Compliance Attestation	735
	<i>Essential Terms</i>	737
	<i>Review Questions</i>	738
	<i>Multiple Choice Questions from CPA Examinations</i>	738
	<i>Discussion Questions and Problems</i>	741
24	INTERNAL AND GOVERNMENT FINANCIAL AUDITING AND OPERATIONAL AUDITING	747
	<i>Learning Objectives</i>	747
	Internal Financial Auditing	747
	Government Financial Auditing	750
	Operational Auditing	754
	<i>Essential Terms</i>	764
	<i>Review Questions</i>	765
	<i>Multiple Choice Questions from CPA, IIA, and CMA Examinations</i>	766
	<i>Cases</i>	768
	ESSENTIAL TERMS	773
	INDEX	787

## LEARNING OBJECTIVES

Thorough study of this chapter will enable you to:

1. Define and explain auditing (pages 1–3).
2. Distinguish between auditing and accounting (pages 3–4).
3. Describe the three primary types of audits (pages 4–5).
4. Describe the primary types of auditors (pages 6–7).
5. Discuss why reducing information risk is the prime economic reason behind the demand for audits (pages 7–10).
6. Describe the requirements for being a CPA (pages 10–11).
7. Describe the nature of CPA firms, what they do, and their structure (pages 11–14).
8. Describe the key functions performed by the AICPA (pages 14–15).
9. Identify ways CPAs are encouraged to perform effectively (page 16).
10. Use generally accepted auditing standards as a basis for further study (pages 16–20).
11. Identify quality control standards and practices within the accounting profession (pages 20–24).
12. Summarize the role of the Securities and Exchange Commission in accounting and auditing (pages 24–25).

# 1

## AN OVERVIEW OF AUDITING

**T**his chapter presents background information about the nature of auditing and the major influences affecting auditing activities. The first part of the chapter discusses auditing in the broad sense. It describes what auditing is, why it is needed, and the various types of audits and auditors. The remainder of the chapter focuses on audits performed for purposes of external reporting by independent certified public accountants. It discusses the nature of certified public accounting (CPA) firms, the influence of the American Institute of Certified Public Accountants (AICPA), the nature of generally accepted auditing standards and interpretations of the standards, quality control, and the role of the Securities and Exchange Commission (SEC).

### NATURE OF AUDITING

Auditing is the accumulation and evaluation of evidence about quantifiable information of an economic entity to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent independent person.

This definition includes several key words and phrases. Each is discussed in this section and analyzed more extensively in later chapters. For ease of understanding, the terms are discussed in a different order than they occur in the definition.

### QUANTIFIABLE INFORMATION AND ESTABLISHED CRITERIA

To do an audit, there must be information in a *verifiable form* and some standards (*criteria*) by which the auditor can evaluate the information. To be verifiable, the information must be quantifiable. Quantifiable information can and does take many forms. It is possible to audit such things as a company's financial statements, the amount of time it takes an employee to complete an assigned task, the total cost of a government construction contract, and an individual's tax return.

**OBJECTIVE 1**  
Define and explain  
auditing.

The criteria for evaluating quantifiable information also vary. For example, in the audit of historical financial statements by CPA firms, the criteria are usually generally accepted accounting principles. To illustrate, this means that in the audit of General Motors' financial statements the CPA firm determines whether General Motors' financial statements have been prepared in accordance with generally accepted accounting principles. For the audit of tax returns by the Internal Revenue Service, the criteria are found in the Internal Revenue Code. In the audit of General Motors' corporate tax return by the Internal Revenue Service, the internal revenue agent would use the Internal Revenue Code as the criteria for correctness, not generally accepted accounting principles.

**ECONOMIC ENTITY**

Whenever an audit is conducted, two aspects of the auditor's responsibility must be made clear: defining the *economic entity* and the *time period*. In most instances the economic entity is also a legal entity, such as a corporation, unit of government, partnership, or proprietorship. In some cases, however, the entity is defined as a division, a department, or even an individual. The time period for conducting an audit is typically one year, but there are also audits for a month, a quarter, several years, and in some cases the lifetime of an entity.

**ACCUMULATING  
AND EVALUATING  
EVIDENCE**

*Evidence* is defined as any information used by the auditor to determine whether the quantifiable information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including oral testimony of the auditee (client), written communication with outsiders, and observations by the auditor. It is important to obtain a sufficient quality and volume of evidence to satisfy the purpose of the audit. Determining the types and amount of evidence necessary and evaluating whether the quantifiable information corresponds to the established criteria is a critical part of every audit. It is the primary subject of this book.

**COMPETENT,  
INDEPENDENT  
PERSON**

The auditor must be *qualified* to understand the criteria used and *competent* to know the types and amount of evidence to accumulate to reach the proper conclusion after the evidence has been examined. The auditor also must have an *independent mental attitude*. It does little good to have a competent person who is biased performing the evidence accumulation when unbiased information and objective thinking are needed for the judgments and decisions to be made.

Independence cannot be absolute by any means, but it must be a goal that is worked toward, and it can be achieved to the necessary degree. For example, even though an auditor is paid a fee by a company, he or she is normally sufficiently independent to conduct audits that can be relied upon by users. Auditors may not be sufficiently independent if they are also company employees.

**REPORTING**

The final stage in the audit process is the *audit report*, which is the communication of the findings to users. Reports differ in nature, but in all cases they must inform readers of the degree of correspondence between quantifiable information and established criteria. Reports also differ in form and can vary from the highly technical type usually associated with financial statement audits to a simple oral report in the case of an operational audit done of a small department's effectiveness.