

AUDITING



THEORY & PRACTICE

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Auditing: Theory and Practice



Ninth Edition

Jerry R. Strawser
University of Houston

Robert H. Strawser
Texas A&M University

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Desktop Publishing: Sheryl New

Jan Tiefel

Artist: June DeMarsico

Pam Porter

Jan Tiefel

Cover Design: Andrea P. Leggett

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Preface

The ninth edition of *Auditing Theory and Practice* continues the traditions established in previous versions. This edition incorporates accounting and auditing pronouncements issued through the spring of 2000 (through *Statement on Auditing Standards No. 90*). In addition, this edition includes recent debate and deliberations regarding the auditing profession, independence of the auditor, and the effect of providing consulting services on the auditor's ability to serve the public interest. Finally, the recently-emerging area of assurance services is discussed as a framework for understanding the broad range of services potentially provided by accountants.

The ninth edition continues the use of the following key features from previous editions:

1. Numerous excerpts from articles in both the business and popular press are included to illustrate the application of concepts discussed in the text to "real world" settings. These publications include *The Wall Street Journal*, *Forbes*, *Business Week*, and *Fortune*.
2. The discussion of the basic auditing process continues to emphasize the "audit risk" approach established by *Statement on Auditing Standards No. 47*. For each account balance, the relevant text chapter discusses factors affecting the inherent risk and control risk associated with each account balance or class of transactions. In addition, the effect of these risk levels on the nature, timing, and extent of substantive tests are discussed. These discussions focus on individual assertions affecting the account balance or class of transactions.
3. The text utilized both a "cycle" approach and a "balance sheet" approach in discussing the auditor's examination. From an internal control standpoint, the text focuses on the four major operating cycles (the Revenue cycle, the Purchases and Disbursements cycle, the Conversion cycle, and the Investing and Financing cycle). In this discussion, relevant control activities are discussed and mapped as to the management assertions they impact. In substantive testing, the discussion links the various substantive tests performed by the auditor for important account balances and classes of transactions to the management assertions.

❏ ORGANIZATION OF THE CONTENTS

The material is divided into five categories:

| | | |
|---------|----------------|--------------------------|
| Part I | (Chapters 1-3) | The Auditing Environment |
| Part II | (Chapters 4-9) | The Audit Process |

| | | |
|----------|------------------|--------------------------|
| Part III | (Chapters 10-16) | Audit Procedures |
| Part IV | (Chapters 17-19) | Auditors' Communications |
| Part V | (Chapter 20) | Other Types of Auditing |

Part I introduces the auditing environment, discusses the Code of Professional Conduct, and summarizes the accountant's legal liability under both common and statutory law. Important highlights in these chapters include excerpted articles from the business press discussing pressures faced by auditors in today's financial reporting environment. In addition, Chapter 3 begins with a Position Paper authored by the then-Big Six accounting firms which illustrates the various issues facing auditors in today's litigious environment.

Part II covers the basic audit process. Chapters 4, 5, and 6 focus on the major standards of field work (planning the audit, studying internal control, and gathering sufficient and competent evidential matter). As noted previously, these chapters have been substantially revised to focus on the risk assessment process as demonstrated by the audit risk model provided by *Statement on Auditing Standards No. 47*. In addition, Chapter 4 has been significantly revised to discuss the auditor's responsibilities for fraud; the Appendix to this chapter provides an overview of recent frauds at *Cendant Corporation*, *Sunbeam*, *Bausch & Lomb*, *W. R. Grace*, and *California Micro Devices*. Chapters 7 and 8 cover audit sampling through comprehensive illustrations and examples. Finally, Chapter 9 provides a discussion of auditing in a computerized processing environment.

Part III is concerned with specific auditing procedures for various types of accounts. This part discusses the four major operating cycles affecting most companies: (1) the Revenue cycle (Chapters 10 and 11), (2) the Purchases and Disbursements cycle (Chapters 12 and 13), (3) the Conversion cycle (Chapter 14), and (4) the Investing and Financing cycle (Chapter 15). As noted earlier, these chapters have been extensively revised to accommodate both a "cycle" and "balance sheet" approach to auditing. In addition, figures summarizing the relationship between various control activities and substantive testing procedures to the five management assertions are provided. The discussion of internal control related to the Conversion cycle is a particularly important addition from the previous version of the text. This section concludes with various procedures performed by the auditor in the completion stages of the audit (Chapter 16).

Part IV discusses the auditor's reporting responsibility. Chapter 17 introduces audit reporting, and the various types of opinions that can be issued by the auditor on the client's financial statements; this discussion is expanded in Chapter 18 by including the auditor's responsibility for reporting on other information accompanying the financial statements and other types of reports that may be issued in an audit examination. These other reports include special reports, reports on financial statements prepared for use in other countries, reports on interim financial information, letters to underwriters, and reports on condensed financial information and selected data. Finally Chapter 19 includes an expanded discussion of attestation and accounting and review service engagements and reports. The dedication of an entire chapter to these engagements and reports is consistent with the increased frequency with which these engagements are performed and allows instructors to have maximum flexibility in discussing audit reporting.

The final part of the text (Part V) discusses compliance, internal, and operational auditing and contrasts these types of auditing with financial statements audits. Particular emphasis has been placed on compliance auditing, since this topic has been the subject of recent pronouncements of the AICPA.

■ Acknowledgements

The authors appreciate the permissions to use materials under copyright. We especially thank the American Institute of Certified Public Accountants for permission to use material from the Uniform CPA Examination as well as from other sources. Throughout the text, constant reference is made to current AICPA pronouncements.

Several individuals have made helpful comments on various portions of the manuscript. These individuals include James C. Flagg, David S. Kerr, and L. Murphy Smith of Texas A&M University; John Ledbetter of Ball State University; Eric Typpo of the University of the Pacific; and Roselyn Morris of Southwest Texas State University. We are also indebted to Lou Orchard of the University of Houston, who provided a detailed and insightful review of the previous version of this text; many of the changes in the current version are a direct result of that review. We would like to thank Jeffrey W. Strawser of Sam Houston State University for his careful review of the text and for his suggestions. Finally, a special thanks is given to Timothy Louwers of Louisiana State University for the numerous discussions, insights, and comments he has shared with regards to this text and auditing education in general.

Finally, we acknowledge a special thanks to Sheryl New, June DeMarsico, and Jan Tiefel for turning our draft materials into the finished product. Without their valuable assistance, the final output would not have been possible. These individuals made the entire process truly enjoyable and ensured a timely completion of all necessary tasks. Of course, the authors are solely responsible for any shortcomings in the final version.

July 2000

*Jerry R. Strawser
Robert H. Strawser*

Auditing Theory and Practice

Ninth Edition

TO THE STUDENT

A Study Guide is available through your bookstore. The purpose of the Study Guide is to assist you in studying and reviewing the text material and provide you with a means of self-test by the study of the detailed outline, true-false questions, and other objective questions, completion statements, and exercise. These may be used both in your initial study of the chapter material and in your subsequent review. If the Study Guide is not in stock in your bookstore, ask the bookstore manager to order a copy for yourself.

Part I

The Auditing Environment

Learning Objectives

Study of the material in this chapter is designed to achieve a number of learning objectives. After studying this chapter, you should be able to:

1. Understand the purpose of auditing and identify why audits are performed.
2. Define financial statement audits, compliance audits, and operational audits.
3. List the types of services other than audits that are provided by public accountants and accounting firms.
4. Describe the types of accounting firms and the typical hierarchical structure within a public accounting firm.
5. Define auditing standards and list the ten generally accepted auditing standards.
6. Describe the basic contents of the auditor's report.

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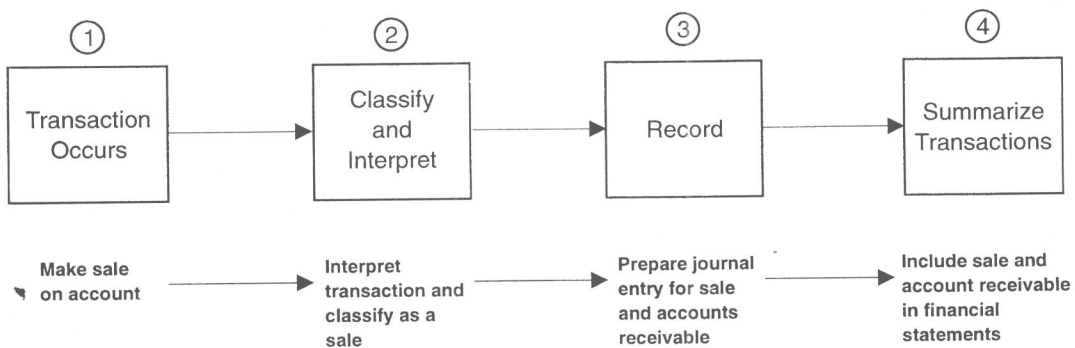
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1

The CPA and the Auditing Environment

THE PURPOSE OF AUDITING

To this point in your accounting education, the focus has been on the process of financial accounting. **Financial accounting** is commonly defined as the process of interpreting, classifying, recording, and summarizing financial data. To provide a cursory overview of the financial accounting process, consider the following sequence of events.



As shown above, the accounting process begins with the occurrence of a transaction or event. In the above illustration, the event represents a sale made on account to one of the entity's customers (Step 1). The entity then interprets this event and determines that a sale has occurred (classification and interpretation) (Step 2). Once the transaction has been interpreted and classified as a sale, the appropriate journal entry is made; this represents the recording element (Step 3). Finally, the information is summarized by including the effects of the journal entry in the entity's financial statements (Step 4). Thus, financial accounting begins with the occurrence of an event or transaction and culminates in the preparation of the entity's financial statements.