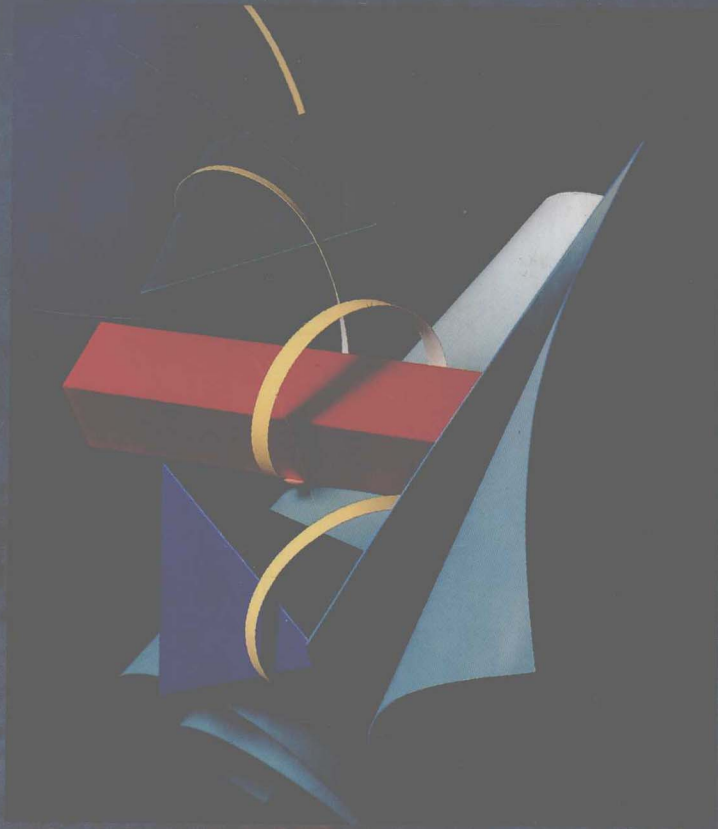


S e c o n d E d i t i o n

AUDITING



KURT PANY

O. RAY WHITTINGTON

AUDITING

Second Edition

Kurt Pany
Arizona State University

O. Ray Whittington
San Diego State University

IRWIN

*Chicago • Bogotá • Boston • Buenos Aires • Caracas
London • Madrid • Mexico City • Sydney • Toronto*



IRWIN Concerned about Our Environment

In recognition of the fact that our company is a large end-user of fragile yet replenishable resources, we at IRWIN can assure you that every effort is made to meet or exceed Environmental Protection Agency (EPA) recommendations and requirements for a "greener" workplace.

To preserve these natural assets, a number of environmental policies, both companywide and department-specific, have been implemented. From the use of 50% recycled paper in our textbooks to the printing of promotional materials with recycled stock and soy inks to our office paper recycling program, we are committed to reducing waste and replacing environmentally unsafe products with safer alternatives.

© The McGraw-Hill Companies, Inc., 1994 and 1997

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher.

Irwin Book Team

Publisher: *Michael W. Junior*

Associate editor: *George Werthman*

Editorial assistant: *Marc Chernoff*

Marketing manager: *James Rogers*

Project supervisor: *Paula M. Buschman*

Production supervisor: *Pat Frederickson*

Art director: *Keith McPherson*

Cover illustration: *David Bishop*

Prepress buyer: *Charlene R. Perez*

Compositor: *Weimer Graphics, Inc., Division of Shepard Poorman Communications Corp.*

Typeface: *10/12 Times Roman*

Printer: *R. R. Donnelley & Sons Company*

Library of Congress Cataloging-in-Publication Data

Pany, Kurt.

Auditing / Kurt Pany, O. Ray Whittington.—2nd ed.

p. cm.

Includes index.

ISBN 0-256-17086-X

1. Auditing. 2. Auditors' reports. I. Whittington, Ray, 1948—

II. Title.

HF5667.P344 1977
657'.45—dc20

96-31811

Printed in the United States of America

2 3 4 5 6 7 8 9 0 DO 3 2 1 0 9 8 7



AUDITING

Second Edition

THE IRWIN SERIES IN UNDERGRADUATE ACCOUNTING

- Ainsworth, Deines, Plumlee and Larson
Introduction to Accounting: An Integrated Approach
Ansari (Editor—Modular Series)
Management Accounting: A Strategic Focus
Bernstein
Financial Statement Analysis: Theory, Application and Interpretation
Fifth Edition
Bernstein and Maksy
Cases in Financial Statement Reporting and Analysis
Second Edition
Boatsman, Griffin, Vickrey and Williams
Advanced Accounting
Eighth Edition
Boockholdt
Accounting Information Systems
Fourth Edition
Booker, Caldwell, Gallbreath, and Rand
Praxis Ready Slides
Praxis Ready Shows
Praxis Ready Notes
Power Point Classroom Presentation Products
Carse and Slater
Payroll Accounting
1997 Edition
Danos and Imhoff
Introduction to Financial Accounting
Second Edition
Dyckman, Dukes and Davis
Intermediate Accounting
Third Edition
Engler, Bernstein and Lambert
Advanced Accounting
Third Edition
Engstrom and Hay
Essentials of Accounting for Governmental and Not-for-Profit Organizations
Fourth Edition
Epstein and Spalding
The Accountant's Guide to Legal Liability and Ethics
Ferris
Financial Accounting and Corporate Reporting: A Casebook
Fourth Edition
Garrison and Noreen
Managerial Accounting
Eighth Edition
Hay and Wilson
Accounting for Governmental and Nonprofit Entities
Tenth Edition
Hermanson and Edwards
Financial Accounting: A Business Perspective
Sixth Edition
Hermanson, Edwards and Maher
Accounting: A Business Perspective
Sixth Edition
Hermanson and Walker
Computerized Accounting with Peachtree Complete® Accounting, Version 8.0
Hoyle
Advanced Accounting
Fourth Edition
Larson
Financial Accounting
Seventh Edition
Larson and Chiappetta
Fundamental Accounting Principles
Fourteenth Edition
Larson, Spoede and Miller
Fundamentals of Financial and Managerial Accounting
Libby, Libby and Short
Financial Accounting
Maher
Cost Accounting
Fifth Edition
Mansuetti and Weidkamp
Introductory/Intermediate Practice Set Series
Fourth Edition
Marshall and McManus
Accounting: What the Numbers Mean
Third Edition
Miller, Redding and Bahnson
The FASB: The People, the Process and the Politics
Third Edition
Morris
Short Audit Case
Seventh Edition
Morse and Zimmerman
Managerial Accounting
Mueller, Gernon and Meek
Accounting: An International Perspective
Fourth Edition
Pasewark and Louwers
Real World Accounting Series
Athletronic, Inc.
Shoe Business, Inc.
Understanding Corporate Annual Reports
Pany and Whittington
Auditing
Second Edition
Peters and Peters
College Accounting
Second Edition
Peters, Peters and Yacht
Computerized College Accounting
Pratt and Kulsrud
Corporate, Partnership, Estate and Gift Taxation, 1997 Edition
Pratt and Kulsrud
Federal Taxation, 1997 Edition
Pratt and Kulsrud
Individual Taxation, 1997 Edition
Rayburn
Cost Accounting: Using a Cost Management Approach
Sixth Edition
Robertson
Auditing
Eighth Edition
Schrader
College Accounting: A Small Business Approach
Second Edition
Van Breda and Hendriksen
Accounting Theory
Sixth Edition
Whittington and Pany
Principles of Auditing
Eleventh Edition
Yacht
Computer Accounting with Peachtree® for Microsoft® Windows® Release 3.0/3.5
Yacht and Terry
Computer Accounting for Microsoft® Windows®



PREFACE

The second edition of *Auditing* provides a carefully balanced presentation of auditing theory and practice. Written in a clear and understandable manner, it is appropriate for students with no audit experience. The text's approach is to integrate auditing material with that obtained by students in previous courses in accounting systems and in financial and managerial accounting.

Auditing is well suited for the introductory one-semester or one-quarter course. Alternatively, key chapters may be covered in greater detail in a first course, with other chapters being included in a subsequent auditing course. One way to divide the information is to cover in the second course the second sampling chapter (Chapter 11), cycles other than the revenue cycle (Chapters 14 through 17), and other responsibilities (Chapters 19 and 20). In this way the first course would include professional responsibilities, design of an audit, the fundamentals of audit sampling, and extensive coverage of the revenue cycle.

While the text stresses accounting systems with computerized applications throughout, it recognizes the reality that most accounting systems are not computerized or manual, but are composed of a combination of computerized and manual subsystems. Accordingly, the text illustrates these types of systems.

ORGANIZATION OF TEXT

The textbook is divided into five major parts:

Part	Title	Chapters
I.	Professional Responsibilities	1–5
II.	The Design of Audits	6–8
III.	Technology and Sampling Approaches	9–11
IV.	Testing Controls and Performing Substantive Tests	12–18
V.	Other Responsibilities	19–20

The chapters are written to stand alone, with the exceptions of Chapters 11 and 13 on sampling and the revenue cycle, respectively, which rely upon the chapter that precedes them. Therefore, various combinations and ordering of chapters may be used.

Part I—Professional Responsibilities. The opening chapters describe the role and professional responsibilities of auditors. Rather than focus only on audits of financial statements, the discussion in the first chapter covers the broad concepts of the attest function, and illustrates how audits of financial statements relate to that function. Chapter 2 covers the professional standards that provide the overall measures of performance for audits and various other types of attest engagements. Chapter 3, on audit reports, presents the various reporting responsibilities when audits of financial statements are performed. Chapter 4 discusses ethical standards and emphasizes emerging and controversial issues that illustrate the need for judgment in evaluating situations that might impair the auditors' independence. An up-to-date description of the legal liability of auditors in the 1990s, including the Private Securities Litigation Reform Act of 1995, is presented in Chapter 5.

Part II—The Design of Audits. Chapter 6 presents the audit risk model with its components of inherent risk, control risk, and detection risk. It also describes the nature of audit evidence and includes an integrated discussion of the relationships among audit risk, the components of audit risk, financial statement assertions, and the nature, timing, and extent of evidence. These relationships are emphasized throughout the remainder of the text. Chapter 7 discusses the major factors to be considered in planning an audit, with an emphasis on the critical aspect of assessing risk and has been updated to include discussion of *Statement on Auditing Standards (SAS)* 82 on the auditor's consideration of fraud in a financial statement audit. Chapter 8 presents information on the auditors' consideration of internal control and has been reorganized to reflect changes made by *SAS* 78 which modifies *SAS* 55 to align the professional literature with the control criteria developed by the Committee of Sponsoring Organizations (COSO).

Part III—Technology and Sampling Approaches. Chapter 9, on internal control in a computer system, has been structured around the most recent professional pronouncements (including *SAS* 78 and various recently issued *Auditing Procedures Studies*). While all of the procedural chapters of the text incorporate discussions of accounting systems with computerized operations, Chapter 9 emphasizes the auditors' consideration of computerized internal control systems ranging in sophistication from those using a single microcomputer to those using complex, networked mainframe computers. Like Chapter 8, it has been revised to reflect the COSO's *Integrated Framework*.

Chapters 10 and 11 provide an easy-to-understand discussion of audit sampling, both statistical and nonstatistical. Chapter 10, which many instructors may consider sufficient topical coverage of the area, includes discussions of overall concepts, attributes sampling, and the essentials of variables sampling. Chapter 11 has been restructured in the second edition of the textbook to include three stand-alone modules on variables sampling—classical methods, probability-proportional-to-size sampling, and nonstatistical sampling. Any combination of these modules may be selected for inclusion in the course.

Part IV—Testing Controls and Performing Substantive Tests. Information on testing controls and performing substantive tests may be structured in several ways, including by account or by transaction cycle. This text provides a cycles-based approach that attempts to capture the essence of SAS 55 and 78 on internal control and the earlier SAS 31 on evidential matter. Since SAS 55 and 78 require auditors to assess control risk by assertion, the text deals directly with assertions and avoids the intermediate stage of “internal control” objectives.

Chapter 12 on the auditors’ consideration of internal control for the revenue cycle illustrates a computerized system similar to those one might expect to encounter in practice. The illustration is described in simple terms so students with a limited background in systems and computers can understand it. The inclusion of detailed systems flowcharts in Chapter 12 facilitates very specific coverage of the cycle. Alternatively, the flowcharts may be quickly covered in class, with increased emphasis on the broader concepts. The material on substantive tests of the revenue cycle accounts, including sales, receivables, and cash is presented in Chapter 13. Chapters 14 through 17 provide similar coverage for the other accounting cycles. All of these chapters have been revised to reflect the CSO framework. Finally, Chapter 18 includes information about auditing the operations of the company and completing the audit.

Part V—Other Responsibilities. Chapter 19 presents a discussion of other attest and nonattest services provided by Certified Public Accountants. Chapter 20, on internal, operational, and compliance auditing, describes the professional standards of internal auditors, the purpose and nature of operational audits, and various types of compliance audit engagements. Compliance auditing continues to gain importance as auditors receive increasing requests from Congress and regulatory agencies to audit for compliance with laws and regulations, especially those relating to the use of taxpayers’ funds.

FEATURES OF THIS TEXT

This text includes a variety of features to enhance the learning experience:

Chapter Objectives provide a concise presentation of each chapter’s most important concepts.

Keystone Computers & Networks, Inc. is the text’s **Illustrative Audit Case**. It is based on an actual company and begins in the planning chapter (Chapter 7). It continues in Chapters 12, 13, 14, and 18 (case only). Keystone both illustrates audit methods and provides realistic, thought-provoking case exercises. Although each portion of the case is designed to stand alone, if used in combination, it will help the student develop problem-solving activities in planning (Chapter 7), assessing internal control over the revenue and acquisition cycles (Chapters 12 and 14), testing account balances (Chapter 13), and completing the audit (Chapter 18). In addition to incorporating the use of computerized accounting applications, the case integrates the fundamentals of audit sampling.

Illustrative Cases use actual business and accounting examples to illustrate key chapter concepts. The cases are boxed and appear throughout the text.

Industry Focus Cases, new to this edition, use examples from specific industries to provide students with detailed “real world” illustration of points being emphasized in the text. These cases show the importance of having a thorough knowledge of the audit client’s business. Like the illustrative cases, these cases are boxed and appear throughout the text.

International Auditing Standards are discussed as appropriate. These standards are becoming increasingly significant as countries attempt to create international markets for securities.

Key Terms Introduced or Emphasized is a glossary of each chapter’s most important terms. The terms are boldface within the chapter and are defined at the end of the chapter. Placing the definitions at the end of each chapter allows the student to quickly find the meaning of unfamiliar terms while reading the material. The glossary also serves as an excellent review tool and helps the student see how well he or she understands the major ideas presented.

Illustrations, tables, and flowcharts are used throughout to enhance and clarify the presentation. **Chapter Summaries** recap the most important information presented in the chapter.

END-OF-CHAPTER PROBLEM MATERIAL

A combination of questions carefully selected to address each chapter’s objectives have been written by the authors and adapted from various professional examinations. The questions at the end of each chapter are segregated as follows: Review Questions, Questions Requiring Analysis, Problems, Research and Discussion Cases, and Audit Case Exercises.

The **Review Questions** are closely related to the material in the chapter and provide a convenient means of determining whether students have grasped the major concepts and details contained in that chapter.

The **Questions Requiring Analysis** call for thoughtful consideration of realistic auditing situations and the application of generally accepted auditing standards. A number of these questions are taken from CPA and other professional examinations, and others describe real-world audit situations. These questions, generally shorter than Problems, tend to stress value judgments and conflicting opinions. New to this edition is a group of questions in Chapters 7 and 13 that require students to use the **Internet** to perform audit research. The Internet problems are identified with a WWW logo in the margin.

Many of the **Problems** have been drawn from CPA and CIA examinations. In selecting these problems, consideration was given to ones appearing in recent professional exams. However, older questions are included when they are superior to others available.

Research and Discussion Cases involve controversial situations that do not lend themselves to clear-cut answers. Students are required to research appropriate auditing and accounting literature and to then apply critical thinking skills to logically formulate and justify their personal positions on the issues involved in each case. The cases acquaint students with the professional literature, develop research and communication skills, and



demonstrate that several diverse, yet defensible, positions may be argued persuasively in a given situation.

The **Audit Case Exercises** all pertain to the text's continuing integrated case, **Keystone Computers & Networks, Inc.** While each exercise may stand alone, when used in combination these case exercises lead the students from the original planning of an audit through the process of performing tests of controls and substantive tests to evaluating the audit results. Audit Case Exercises are included in Chapters 7, 12, 13, 14, and 18. A **Computer Disk of Spreadsheet Templates** is available to be used in conjunction with selected audit case exercises. The exercises with templates available may be identified by a *floppy disk* logo in the margin.



REFERENCES TO AUTHORITATIVE SOURCES

Numerous references are made to the pronouncements of the American Institute of Certified Public Accountants (AICPA), the Institute of Internal Auditors (IIA), the Financial Accounting Standards Board, the Governmental Accounting Standards Board, and the Securities and Exchange Commission. The cooperation of the AICPA and the IIA in permitting the use of their published materials and of questions from the CPA and CIA examinations brings to an auditing text an element of authority not otherwise available.

SUPPLEMENTS

A **Study Guide**, written by the text's authors, enables students to review text material and to test their understanding. The guide includes a summary of each chapter's highlights and an abundance of objective questions and exercises. Since the guide includes answers to the questions and exercises, it provides immediate feedback to students.

Our **Instructor's Lecture Guide** includes topical outlines of each chapter, the authors' personal comments on each chapter, and numerous instructional aids, including transparency masters. A **Solutions Manual** includes thorough and up-to-date solutions to the text's questions, problems, and exercises.

The **Test Bank** includes both original questions and problems, and questions adapted from various professional examinations. It has been significantly expanded in this edition by the inclusion of more than 100 additional multiple choice questions, with approximately 1/2 author-prepared and 1/2 from recent professional exams; in addition, the number of essay type questions has been significantly increased.

Computest3 is the computerized version of the test bank. This advanced-feature test generator allows the instructor to add and edit questions; save and reload tests; create up to 99 versions of each test; attach graphics to questions and answers; import and export ASCII files; and select questions based on type, level of difficulty, or keyword. Computest3 provides password protection of saved tests and question databases and can run on a network. It is available on 5.25 and 3.5 disks.

Powerpoint Presentations are available to assist in classroom presentations.

CONTRIBUTIONS BY OTHERS

Many people have made valuable contributions to this textbook. Special thanks are offered to John Broughton, CIA, CISA, CMA, for his assistance in the revision of Chapter 9 on internal control in a computerized system. The work of Donald A. Schwartz, J.D., CPA, of National University in developing the software supplement for the audit case exercises is especially appreciated. In addition, our sincere thanks is extended to the many professors, practitioners, and governmental regulators who have offered helpful suggestions for this text. Especially helpful were the advice and suggestions of the following reviewers:

Professor Sherri Anderson

Sonoma State University

Professor Rich Brody

Central Connecticut University

Professor Randy Elder

Syracuse University

Professor Steve Kaplan

Arizona State University

Professor Keith Moreland

University of Michigan—Flint

Professor Jane F. Mutchler

Penn State University

Professor Thomas R. Weirich

Central Michigan University

Kurt Pany

O. Ray Whittington



CONTENTS IN BRIEF

PART 1

Professional Responsibilities 1

- 1 THE ROLE OF THE AUDITOR IN THE AMERICAN ECONOMY 2
- 2 PROFESSIONAL STANDARDS 33
- 3 AUDITORS' REPORTS 62
- 4 PROFESSIONAL ETHICS 98
- 5 LEGAL LIABILITY OF AUDITORS 134

PART 2

The Design of Audits 165

- 6 AUDIT EVIDENCE 166
- 7 PLANNING THE AUDIT; DESIGNING AUDIT PROGRAMS 214
- 8 INTERNAL CONTROL 268

PART 3

Technology and Sampling Approaches 311

- 9 CONSIDERATION OF INTERNAL CONTROL IN A COMPUTER ENVIRONMENT 312
- 10 AUDIT SAMPLING: CONCEPTS AND TECHNIQUES 351
- 11 AUDIT SAMPLING: APPLICATIONS FOR SUBSTANTIVE TESTING 391

PART 4

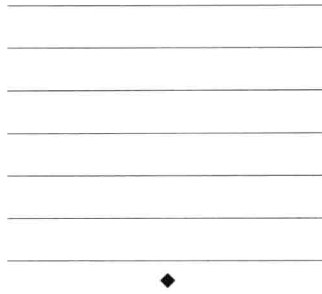
Testing Cycle Controls and Performing Substantive Tests 425

- 12 REVENUE CYCLE—OBTAINING AN UNDERSTANDING AND TESTING CONTROLS 426
- 13 REVENUE CYCLE—SUBSTANTIVE TESTS 476
- 14 AUDITING THE ACQUISITION CYCLE 524
- 15 AUDITING THE CONVERSION AND PAYROLL CYCLES 570
- 16 AUDITING THE FINANCING CYCLE 621
- 17 AUDITING THE INVESTMENT CYCLE 652
- 18 AUDITING OPERATIONS AND COMPLETING THE AUDIT 685

PART 5

Other Responsibilities 723

- 19 OTHER ATTESTATION AND ACCOUNTING SERVICES 724
- 20 INTERNAL, OPERATIONAL, AND COMPLIANCE AUDITING 763
- INDEX 800



CONTENTS

PART 1

Professional Responsibilities 1

1 THE ROLE OF THE AUDITOR IN THE AMERICAN ECONOMY 2

What Is the Attest Function?	2
<i>Financial Statement Audits</i>	3
<i>What Creates the Demand for Audits?</i>	7
<i>Major Audit Developments of the 20th Century</i>	9
<i>Types of Audits</i>	12
<i>Types of Auditors</i>	13
The Public Accounting Profession	14
<i>American Institute of Certified Public Accountants</i>	14
<i>The CPA Examination</i>	17
<i>State Boards of Accountancy</i>	17
<i>Financial Accounting Standards Board</i>	17
<i>Governmental Accounting Standards Board</i>	18
<i>Securities and Exchange Commission</i>	18
<i>Other Types of Professional Services</i>	19
<i>Organization of the Public Accounting Profession</i>	20
<i>Industry Specialization—The Wave of the Future</i>	21
<i>Responsibilities of the Professional Staff</i>	22
<i>Professional Development for CPA Firm Personnel</i>	23

Seasonal Fluctuations in Public Accounting Work

24

Relationships with Clients

24

2 PROFESSIONAL STANDARDS 33

Generally Accepted Auditing Standards (GAAS)	34
<i>Application of Auditing Standards</i>	35
<i>Training and Proficiency</i>	35
<i>Independence</i>	35
<i>Due Professional Care</i>	36
<i>Standards of Field Work—Accumulating and Evaluating Evidence</i>	36
<i>Adequate Planning and Supervision</i>	36
<i>Sufficient Understanding of Internal Control</i>	37
<i>Sufficient Competent Evidential Matter</i>	37
<i>Standards of Reporting</i>	37
<i>Statements on Auditing Standards (SASs)</i>	37
The Auditors' Responsibility for Detecting Misstatements	39
The Auditors' Report	41
<i>The Scope Paragraph of the Auditors' Report</i>	43
<i>The Opinion Paragraph of the Auditors' Report</i>	43
<i>Generally Accepted Accounting Principles (GAAP)</i>	45
<i>Other Types of Auditors' Reports</i>	45
The Attestation Standards	47
<i>Expansions of the Attest Function</i>	47
Quality Control in CPA Firms	48
<i>Division for CPA Firms</i>	49

<i>The Public Oversight Board</i>	51	
<i>Peer Reviews</i>	51	
International Accounting and Auditing Standards	51	
3 AUDITORS' REPORTS	62	
<i>Financial Statements</i>	63	
<i>Financial Statement Disclosures</i>	64	
<i>Comparative Financial Statements</i>	64	
<i>The Auditors' Standard Report</i>	65	
Expression of an Opinion	66	
<i>The Unqualified Opinion</i>	67	
<i>Qualified Opinions</i>	72	
<i>Adverse Opinions</i>	76	
<i>Disclaimer of Opinion</i>	77	
Summary of Auditors' Reports	79	
<i>Two or More Report Modifications</i>	79	
<i>Different Opinions on Different Statements</i>	81	
<i>Reporting on Comparative Financial Statements</i>	81	
<i>Reports to the SEC</i>	82	
4 PROFESSIONAL ETHICS	98	
The Nature of Ethics	99	
<i>What Are Ethical Dilemmas?</i>	99	
<i>A Framework for Ethical Decisions</i>	99	
<i>Making Ethical Decisions—A Professional Example</i>	100	
The Need for Professional Ethics	103	
<i>Professional Ethics in Public Accounting</i>	104	
The AICPA Code of Professional Conduct	105	
<i>Rule 101—Independence</i>	108	
<i>Analysis of Independence</i>	109	
<i>Rule 102—Integrity and Objectivity</i>	114	
<i>Analysis of Integrity and Objectivity</i>	114	
<i>Rule 201—General Standards</i>	115	
<i>Analysis of General Standards</i>	115	
<i>Rule 202—Compliance with Standards</i>	115	
<i>Analysis of Compliance with Standards</i>	115	
<i>Rule 203—Accounting Principles</i>	116	
<i>Analysis of Accounting Principles</i>	117	
<i>Rule 301—Confidential Client Information</i>	117	
<i>Analysis of Confidential Client Information</i>	117	
<i>Rule 302—Contingent Fees</i>	118	
<i>Analysis of Contingent Fees</i>	119	
<i>Rule 501—Acts Discreditable</i>	119	
<i>Analysis of Acts Discreditable</i>	119	
<i>Rule 502—Advertising and Other Forms of Solicitation</i>	120	
<i>Analysis of Advertising and Other Forms of Solicitation</i>	120	
<i>Rule 503—Commissions and Referral Fees</i>	120	
<i>Analysis of Commissions and Referral Fees</i>	121	
<i>Rule 505—Form of Organization and Name</i>	121	
<i>Analysis of Form of Organization and Name</i>	121	
<i>The CPA as Tax Adviser—Ethical Problems</i>	122	
<i>Enforcement of Professional Ethics</i>	123	
Ethics for Internal Auditors	123	
5 LEGAL LIABILITY OF AUDITORS	134	
<i>Unique Vulnerability of Accountants to Lawsuits</i>	135	
<i>Definition of Terms</i>	136	
<i>Litigation Placed in Perspective</i>	137	
Auditors' Liability to Their Clients under Common Law	138	
<i>Lawsuits by Clients</i>	138	
Auditors' Common-Law Liability to Third Parties	139	
<i>Ultramares Approach</i>	139	
<i>Restatement of Torts Approach</i>	140	
<i>Rosenblum Approach</i>	141	
<i>Joint and Several Liability</i>	141	
Liability to Third Parties under Statutory Law	142	
<i>Securities Act of 1933</i>	142	
<i>Securities Exchange Act of 1934</i>	144	
<i>Comparison of the 1933 and 1934 Acts</i>	147	
<i>The Racketeer Influenced and Corrupt Organizations Act</i>	147	
<i>Auditors' Civil Liability: A Summary</i>	147	
<i>Auditors' Criminal Liability under the Securities Acts</i>	149	
<i>The SEC's Regulation of Accountants</i>	150	
<i>Accountants' Liability for Accounting and Review Services</i>	150	
<i>The CPA's Posture in the Age of Litigation</i>	152	
PART 2		
The Design of Audits	165	
6 AUDIT EVIDENCE	166	
The Relationship of Audit Risk to Evidence	167	
<i>Financial Statement Assertions</i>	167	

<i>Audit Risk at the Assertion Level</i>	168	<i>The Audit Trail</i>	232
<i>Audit Risk Illustrated</i>	169	<i>Organization of the Audit Program</i>	234
<i>Measuring Audit Risk</i>	169	<i>Objectives of Audit Programs</i>	237
Audit Evidence	171	<i>General Objectives of Audit Programs for Asset Accounts</i>	237
<i>Types of Evidence</i>	172	<i>Substantiation of Account Balances</i>	238
Audit Procedures	179	<i>Existence of Assets</i>	238
<i>The Nature of Audit Procedures</i>	179	<i>Rights to the Assets</i>	238
<i>Timing of Audit Procedures</i>	179	<i>Establishing Completeness</i>	239
<i>Extent of Audit Procedures</i>	179	<i>Valuation of Assets</i>	240
<i>The Cost of Audit Procedures</i>	181	<i>Clerical Accuracy of Records</i>	240
<i>Analytical Procedures</i>	181	<i>Financial Statement Presentation and Disclosure</i>	240
<i>Developing an Expectation</i>	182	<i>An Illustration of Audit Program Design</i>	240
<i>Timing of Analytical Procedures</i>	185	Audit Process	242
<i>Extent of Analytical Procedures</i>	186	<i>Timing of Audit Work</i>	244
<i>Evidence on Accounting Estimates</i>	187	Illustrative Audit Case	245
<i>Evidence on Related-Party Transactions</i>	188	8 INTERNAL CONTROL	268
Documentation	189	The Meaning of Internal Control	269
<i>Functions of Working Papers</i>	189	<i>The Foreign Corrupt Practices Act of 1977</i>	271
<i>Confidential Nature of Working Papers</i>	191	<i>Means of Achieving Internal Control</i>	271
<i>Ownership of Audit Working Papers</i>	191	The Control Environment	271
<i>Working Papers and Auditors' Liability</i>	191	<i>Integrity and Ethical Values</i>	272
<i>Types of Working Papers</i>	192	<i>Commitment to Competence</i>	272
<i>Organization of Working Papers</i>	195	<i>Board of Directors or Audit Committee</i>	272
<i>Guidelines for Preparation of Working Papers</i>	196	<i>Management Philosophy and Operating Style</i>	272
<i>Computer-Generated Working Papers</i>	198	<i>Organizational Structure</i>	273
<i>The Review of Audit Working Papers</i>	198	<i>Assignment of Authority and Responsibility</i>	275
7 PLANNING THE AUDIT: DESIGNING AUDIT PROGRAMS	214	<i>Human Resource Policies and Procedures</i>	275
Client Acceptance	215	Risk Assessment	276
<i>Communication with Predecessor Auditors</i>	216	The Accounting Information and Communication System	277
<i>Other Communications</i>	217	Control Activities	277
<i>Other Considerations in Accepting an Audit Client</i>	217	<i>Performance Reviews</i>	278
Obtaining the Engagement	217	<i>Information Processing</i>	278
<i>Audit Committees</i>	218	<i>Physical Controls</i>	279
<i>Fee Arrangements</i>	218	<i>Segregation of Duties</i>	280
<i>Engagement Letters</i>	219	Monitoring	281
Audit Planning	219	<i>The Internal Audit Function</i>	281
<i>Obtaining an Understanding of the Client's Business</i>	219	Limitations of Internal Control	281
<i>Developing an Overall Audit Strategy</i>	222	The Auditors' Consideration of Internal Control	282
<i>Audit Plans</i>	230	<i>Obtaining an Understanding of Internal Control to Plan the Audit</i>	282
<i>Time Budgets for Audit Engagements</i>	231	<i>Assess Control Risk</i>	288
<i>Planning a Recurring Engagement</i>	231		
Designing Audit Programs	232		

<i>Decision Aids for Audit Program Modification</i>	294
<i>Consideration of the Work of Internal Auditors</i>	294
<i>Communication of Control Related Matters</i>	296
<i>Internal Control in the Small Company</i>	298

PART 3

Technology and Sampling Approaches 311

9 CONSIDERATION OF INTERNAL CONTROL IN A COMPUTER ENVIRONMENT 312

Nature of Computer Systems	313
<i>Characteristics of Various Types of Computer Systems</i>	314
<i>Impact of Computers on the Audit Trail</i>	317
Internal Control in a Computer Environment	318
<i>Organizational Structure of the Information System Function</i>	318
<i>Computer-Centered Fraud</i>	321
<i>Internal Auditing in a Computer Environment</i>	323
<i>Control Activities in a Computer System</i>	323
General Control Activities	323
Application Control Activities	327
Manual Follow-Up Activities	328
User Control Activities	328
Control in Microcomputer Systems	328
The Auditors' Consideration of Internal Control in a Computer Environment	329
<i>Obtaining an Understanding of Computerized Internal Control</i>	329
<i>Documenting Computerized Internal Control</i>	329
<i>Assessing Control Risk—Testing Computer Controls</i>	332
Substantive Testing with Computers	337
<i>Using Audit Software: An Illustration</i>	338
Computer Service Centers and Outsourced Computer Processing	339

10 AUDIT SAMPLING: CONCEPTS AND TECHNIQUES 351

Comparison of Statistical and Nonstatistical Sampling	352
<i>Selecting a Random Sample</i>	353
<i>Other Methods of Sample Selection</i>	356
Stratification	357

<i>Types of Statistical Sampling Plans</i>	358
<i>Allowance for Sampling Risk (Precision)</i>	359
Sample Size	359
Audit Sampling for Tests of Controls	360
<i>Sampling Risk for Tests of Controls</i>	360
Attributes Sampling	361
<i>Determine the Objective of the Test</i>	362
<i>Define the Attributes and "Deviation"</i>	
Conditions	362
Define the Population	362
Specify the Risk of Assessing Control Risk Too Low and the Tolerable Deviation Rate	363
Estimate the Expected Population Deviation Rate	364
Determine the Sample Size	364
Select the Sample	367
Test the Sample Items	367
Evaluate the Sample Results	367
Document the Sampling Procedure	370
Detailed Illustration of Attributes Sampling	370
Other Statistical Attributes Sampling Approaches	372
Nonstatistical Attributes Sampling	374
Audit Sampling for Substantive Tests	375
<i>Sampling Risk for Substantive Tests</i>	375
Statistical Sampling for Substantive Tests	376
<i>Determine the Objective of the Test</i>	376
<i>Define the Population and Sampling Unit</i>	376
<i>Choose an Audit Sampling Technique</i>	377
<i>Determine the Sample Size</i>	377
Select the Sample	380
Test the Sample Items	380
Evaluate the Sample Results	381
Document the Sampling Procedure	381

11 AUDIT SAMPLING: APPLICATIONS FOR SUBSTANTIVE TESTING 391

Module A—Classical Variables Sampling	392
<i>Mean-per-Unit Estimation</i>	392
Controlling Sampling Risk	394
Determination of Sample Size	395
Evaluation of Sample Results	396
Illustration of Mean-per-Unit Estimation	396
Ratio and Difference Estimation	400
Illustration of Ratio and Difference Estimation	402

Module B—Probability-Proportional-to-Size (PPS)

Sampling	405
<i>Controlling Sampling Risk</i>	406
<i>Determination of Sample Size</i>	406
<i>Method of Sample Selection</i>	407
<i>Evaluation of Sample Results</i>	408
<i>Illustration of PPS Sampling</i>	408
<i>Considerations in Using PPS Sampling</i>	412

Module C—Nonstatistical Sampling for Substantive

Tests	416
<i>Determination of Sample Size</i>	416
<i>Evaluating of Sample Results</i>	416
<i>Illustration of Nonstatistical Sampling</i>	418

PART 4**Testing Cycle Controls and Performing Substantive Tests 425****12 REVENUE CYCLE—OBTAINING AN UNDERSTANDING AND TESTING CONTROLS 426**

The Nature of the Revenue Cycle	427
<i>Internal Control over Sales</i>	427
<i>Internal Control over Cash Receipts</i>	433
<i>An Overview of the Revenue Cycle</i>	437
The Auditors' Consideration of Internal Control	440
<i>Obtain an Understanding of Internal Control over the Revenue Cycle</i>	440
<i>Document the Understanding of the Revenue Cycle</i>	441
<i>The System Walk-Through</i>	441
<i>Consider Potential Misstatements of Revenue Cycle Accounts</i>	442
<i>Test Controls and Assess Control Risk for Revenue Cycle Accounts</i>	442
<i>Reassess Control Risk for Revenue Cycle Accounts</i>	450
Illustrative Audit Case	452

13 REVENUE CYCLE—SUBSTANTIVE TESTS 476

Designing Substantive Tests of Receivables and Sales	477
<i>Objectives for Substantive Tests of Receivables and Sales</i>	477
Substantive Tests of Receivables and Sales	478
<i>Obtain Aged Schedule of Accounts Receivable</i>	479
<i>Obtain Analysis of Notes Receivable</i>	479

<i>Inspect Notes Receivable</i>	479
<i>Confirm Receivables</i>	481
<i>Review Sales Cutoff</i>	486
<i>Perform Analytical Procedures</i>	487
<i>Verify Interest on Notes Receivable</i>	489
<i>Evaluate the Accounting for Revenue Recognition</i>	490
<i>Evaluate Allowance for Uncollectible Accounts</i>	491
<i>Investigate Pledged Receivables</i>	492
<i>Investigate Receivables from Related Parties</i>	492
<i>Evaluate Disclosures</i>	493
<i>Interim Audit Work on Receivables and Sales</i>	493
<i>Audit Working Papers for Receivables and Sales</i>	494

Designing Substantive Tests of Cash	494
<i>Objectives for Substantive Tests of Cash</i>	495
<i>How Much Audit Time for Cash?</i>	496

Substantive Tests for Cash	497
<i>Obtain Analyses of Cash Accounts</i>	497
<i>Confirm Cash Accounts</i>	498
<i>Analyze Reconciliations</i>	498
<i>Obtain Cutoff Statement</i>	501
<i>Count Cash on Hand</i>	502
<i>Verify Cash Cutoff</i>	503
<i>Analyze Bank Transfers</i>	503
<i>Investigate Related Party Transactions</i>	505
<i>Evaluate Disclosures</i>	505
<i>Interim Audit Work on Cash</i>	505
<i>Audit Working Papers for Cash</i>	505
Illustrative Audit Case	506

14 AUDITING THE ACQUISITION CYCLE 524

The Nature of the Acquisition Cycle	525
<i>Internal Control over Purchases</i>	525
<i>Internal Control over Cash Disbursements</i>	531
The Auditors' Consideration of Internal Control	532
<i>Obtain an Understanding of Internal Control over the Acquisition Cycle</i>	532
<i>Document the Understanding of the Acquisition Cycle</i>	533
<i>Consider Potential Misstatements of Acquisition Cycle Accounts</i>	536
<i>Test Controls and Assess Control Risk</i>	536
<i>Reassess Control Risk for Acquisition Cycle Accounts</i>	539