

*PRINCIPLES
OF
AUDITING*

Walter B. Meigs
E. John Larsen
Robert F. Meigs

F239.1
M512
E.6

9948

9660191

Principles of auditing

WALTER B. MEIGS, Ph.D., C.P.A.

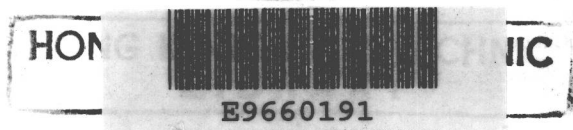
Professor of Accounting
University of Southern California

E. JOHN LARSEN, D.B.A., C.P.A.

Associate Professor of Accounting
University of Southern California

ROBERT F. MEIGS, D.B.A.

Associate Professor of Accounting
California State University at San Diego



Sixth Edition 1977

RICHARD D. IRWIN, INC. Homewood, Illinois 60430

Irwin-Dorsey Limited Georgetown, Ontario L7G 4B3

HF

5667

1743

1977

C.4

© RICHARD D. IRWIN, INC., 1953, 1959, 1964, 1969, 1973, and 1977

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.

Sixth Edition

First Printing, February 1977

ISBN 0-256-01902-9

Library of Congress Catalog Card No. 76-28887

Printed in the United States of America

LEARNING SYSTEMS COMPANY—

a division of Richard D. Irwin, Inc.—has developed a
PROGRAMMED LEARNING AID

to accompany texts in this subject area.

Copies can be purchased through your bookstore
or by writing PLAIDS,

1818 Ridge Road, Homewood, Illinois 60430.

Principles of auditing

7239.1
61512
E.6

The Willard J. Graham Series in Accounting

Consulting Editor **ROBERT N. ANTHONY** *Harvard University*

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 achiev-

ing 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.

January 1977

WALTER B. MEIGS
E. JOHN LARSEN
ROBERT F. MEIGS

Contents

1. The role of the auditor in the American economy 1

Financial reporting—an essential in achieving social and economic goals. The attest function. Credibility—the contribution of the independent auditor to financial reporting. What is an audit? Unaudited financial statements—the credibility gap. Auditing—then and now. Determining fairness of financial statements—a major auditing objective. The growing problem of management fraud. The demand for more disclosure. Development of sampling techniques. Internal control as a basis for testing and sampling. The advent of electronic data processing. Major auditing developments of the 20th century. The certified public accountant. The CPA examination. American Institute of Certified Public Accountants. Research and publications of the AICPA—auditing literature. Development of financial accounting standards. Financial Accounting Standards Board. Securities and Exchange Commission. Cost Accounting Standards Board. The audit report. The long-form report. Importance of the auditors' report. Auditors' reports and clients' financial statements. Auditing standards. Application of auditing standards. Training and proficiency. Independence—the most important auditing standard. Auditing standards contrasted with auditing procedures. Audit procedures not determined by the client. The opinion paragraph of the auditors' report. The financial statements “present fairly. . . .” Adequate informative disclosure. Materiality. Generally accepted accounting principles. Consistency. Other types of auditors' reports. Extensions of the auditors' attest function. Key terms introduced in Chapter 1.

2. Professional ethics**45**

The need for professional ethics. Professional ethics in public accounting. The AICPA Code of Professional Ethics. RULES OF CONDUCT. Applicability of rules. Independence, integrity and objectivity. Competence and technical standards. Responsibilities to clients. Responsibilities to colleagues. Other responsibilities and practices. Analysis of AICPA Code of Professional Ethics. Client confidences and privileged communications. Enforcement of professional ethics. Securities and Exchange Commission—impact on professional ethics. Independence as defined by the SEC. SEC rules compared with AICPA Code of Professional Ethics. The CPA as tax adviser—ethical problems. Management advisory services and professional ethics. Does rendering of management advisory services threaten the auditors' independence? Possible modifications of the Code of Professional Ethics. Key terms introduced or emphasized in Chapter 2.

3. Legal liability of auditors**73**

Legal environment of the times. Definition of terms. Auditors' liability to clients and to third party beneficiaries. Auditors' liability to other third parties. The *Hochfelder* case and its impact on accountants' liability. Auditors' criminal liability under the Securities Acts. The SEC's regulation of accountants. Accountants' liability for unaudited financial statements. Auditors' responsibility for the detection of fraud. The CPAs' posture in the "age of litigation." Key terms introduced or emphasized in Chapter 3.

4. The public accounting profession; an overview**103**

The public accounting profession. Organization of the public accounting firm. The tax department. Management advisory services. Management advisory services by small public accounting firms. Professional development within the CPA firm. Continuing education—The CPAs' response to change. Seasonal fluctuations in public accounting work. The CPA as an expert witness. Courtroom tactics. Types of cases in which the CPA may testify. Obtaining clients. Relationships with clients. PLANNING THE AUDIT. Background information on clients. Preliminary arrangements with clients. Engagement letters. Audit plans. Audit programs. Time budgets for audit engagements. The audit trail. THE AUDIT PROCESS. Review internal control. Test the system. Evaluate the system. Report to management. Complete the audit. Issue the report. Timing of audit work. Auditing terminology. Key terms introduced or emphasized in Chapter 4.

5. Internal control**139**

The meaning of internal control. Internal accounting controls versus internal administrative controls. The need for internal control. MEANS OF ACHIEVING INTERNAL ACCOUNTING CONTROL. Plan of organization. The accounting structure. Internal auditing—its relationship to internal control. Limitations of internal control. Fidelity bonds. THE AUDITORS' REVIEW OF

INTERNAL CONTROL. Reliance by the auditors upon internal control. Scope of the auditors' investigation of internal control. Review and description of internal control. Compliance tests of internal control. Evaluation of internal control. Preparation of a "management letter." Electronic data processing—effect upon internal control. Internal control in the small company. Key terms introduced or emphasized in Chapter 5.

6. The audit of electronic data processing systems 181

Nature of an electronic data processing system. Internal control in the electronic data processing system. Organizational controls in an electronic data processing system. Organizational controls and computer-centered fraud. Documentation. Equipment controls. Security for files and equipment. Controls over input. Controls over processing. Controls over output. Internal auditing and EDP. Impact of EDP on the audit trail. Implications of on-line, real-time systems. The auditors' study and evaluation of internal control in an EDP system. Review of internal control. Tests of compliance. Evaluation of internal control. Computer service centers. Time-sharing systems. Auditing EDP systems—a look to the future. Key terms introduced or emphasized in Chapter 6.

7. Evidence—what kind and how much? 216

Auditors' opinion based on evidence. Auditing procedures—a means of gathering evidence. Evidence needed for material items. Sufficient competent evidential matter. Types of audit evidence. Internal control as evidence. Physical evidence. Documentary evidence. Accounting records as evidence. Computations as evidence. Evidence provided by specialists. The cost of obtaining evidence. Relative risk. Evidence provided by subsequent events. Footnote disclosure of subsequent events. The auditors' responsibility for subsequent events. The auditors' "S-1 review" in an SEC registration. The auditors' subsequent discovery of facts existing at the date of their report. Evidence for related party transactions. Key terms introduced or emphasized in Chapter 7.

8. Statistical sampling 246

Comparison of statistical sampling with judgmental sampling. Random selection. Random number tables. Random number generators. Systematic selection. Cluster selection. Judgment block samples. Statistical measurement. Precision. Confidence level (reliability). Sample size. Estimation sampling for attributes. Illustration of estimation sampling for attributes. Acceptance sampling. Discovery sampling. Sampling for variables. Estimation sampling for variables. Theory of estimation sampling for variables. Determination of sample size. Illustration of estimation sampling for variables. Ratio and difference estimation. Illustration of ratio and difference estimation. Stratification. Measurement of the authors' risk. Key terms introduced or emphasized in Chapter 8.

9. Audit working papers; quality control for audits 285

AUDIT WORKING PAPERS. Definition of working papers. Confidential nature of working papers. Purposes of audit working papers. Working papers and auditing standards. Working papers and accountants' liability. Essentials of good working papers. Types of working papers. Adjusting journal entries and reclassification entries. Distinction between adjusting entries and reclassification entries. Adjusting entries for material items only. Auditors' adjusting entries recorded by client. Supporting schedules. Analysis of a ledger account. Computational working papers. Copies of minutes and other records or documents. Letters of representations provided by clients. Lawyers' letters. The permanent file. Arrangement of working papers in the annual file. Storage and retention of working papers. Guidelines for preparation of working papers. The review of working papers. Review for compliance with standards of field work. Review for support of CPA firm's opinion. QUALITY CONTROL FOR AUDITS. Quality control standards. Review of CPA firms. Key terms introduced or emphasized in Chapter 9.

10. Examination of the general records; audit program design 325

Articles of incorporation and bylaws. Partnership contract. Corporate minutes book. Contracts held or issued by client. Government regulations. Correspondence files. Income tax returns of prior years. Financial statements and annual reports of prior years. Reports to the SEC. Review and testing of the accounting records. The general ledger. The general journal. Audit working papers for the examination of accounting records. AUDIT PROGRAM DESIGN. Basic objectives of audit programs for asset accounts. Substantiation of account balances. Existence and ownership of assets. Valuation of assets. Establishing a proper cutoff. Related income statement amounts. Financial statement presentation. Key terms introduced or emphasized in Chapter 10.

11. Cash 355

What are the auditors looking for? The auditors' objectives in examination of cash. How much audit time for cash? Internal control over cash transactions. Internal control over cash sales. Internal control over collections from customers. Internal control over cash disbursements. Internal control aspects of petty cash funds. Internal control and the computer. Audit working papers for cash. Audit program for cash. Study and evaluation of internal control for cash. Substantive tests of cash transactions and balances. Interim audit work on cash. Key terms introduced or emphasized in Chapter 11.

12. Securities and other investments, and investment revenue 400

The auditors' objectives in examination of securities. Internal control. Internal control questionnaire. Audit working papers for securities. Audit

program. Study and evaluation of internal control for securities. Substantive tests of securities transactions and year-end balances. **OTHER INVESTMENTS.** Balance sheet presentation of other investments. Key terms introduced or emphasized in Chapter 12.

13. Accounts and notes receivable; and sales transactions 427

Various types of accounts receivable. Notes receivable. The auditors' objectives in examination of receivables and sales. Internal control of sales transactions and accounts receivable. Internal control of notes receivable. Internal control and the computer. Audit working papers. Audit program. Study and evaluation of internal control for receivables and sales. Substantive tests of receivables and sales transactions. Interim audit work. Key terms introduced or emphasized in Chapter 13.

14. Inventories and cost of goods sold 475

Critical importance of inventories to the auditors. The auditors' objectives in examination of inventories and cost of goods sold. Internal control. Internal control and the computer. Audit working papers. Audit program. Study and evaluation of internal control for inventories and cost of goods sold. Substantive tests of inventories and cost of goods sold transactions. Key terms introduced or emphasized in Chapter 14.

15. Property, plant, and equipment: Depreciation and depletion 525

The auditors' objectives in examination of property, plant, and equipment. Contrast with audit of current assets. Cost as the basis of valuation. Replacement cost. Internal controls over plant and equipment. The plant and equipment budget. Other major control devices. Audit working papers. Initial audits and repeat engagements. Audit program. Study and evaluation of internal control. Substantive tests of property, plant, and equipment and related revenue and expenses. Depreciation. The auditors' objectives in review of depreciation. Audit program—depreciation expense and accumulated depreciation. Testing the client's provision for depreciation. Verification of natural resources. Verification of intangible assets. Examination of plant and equipment in advance of the balance sheet date. Key terms introduced or emphasized in Chapter 15.

16. Accounts payable and other liabilities 554

Types of accounts payable. The auditors' objectives in examination of accounts payable. Internal control. Internal control and the computer. Audit working papers for accounts payable. Audit program. Study and evaluation of internal control. Substantive tests of accounts payable transactions and balances. **OTHER LIABILITIES.** Amounts withheld from employees' pay. Sales taxes payable. Unclaimed wages. Customers' deposits.

Liabilities for fines and other penalties. Accrued liabilities. Pension plan accruals. Balance sheet presentation. Time of examination. Key terms introduced or emphasized in Chapter 16.

17. Interest-bearing debt and interest expense; disclosure of contingencies **586**

The auditors' objectives in examination of interest-bearing debt. Internal control over interest-bearing debt. Audit working papers. Audit program for interest-bearing debt. Time of examination. DISCLOSURE OF CONTINGENCIES. Commitments. General risk contingencies. General audit procedures. Liability representations. Financial statement presentation. Key terms introduced or emphasized in Chapter 17.

18. Owners' equity **622**

The auditors' objectives in examination of owners' equity. Internal control. Control of capital stock transactions by board of directors. Independent registrar and stock transfer agent. The stock certificate book. The stockholders ledger. Internal control over other paid-in capital and retained earnings. Internal control over dividends. Audit working papers. Audit program—capital stock. Audit procedures—additional paid-in capital. Audit program—retained earnings and dividends. Donated capital. Time of examination. FINANCIAL STATEMENT PRESENTATION. Capital stock. Treasury stock. Other paid-in capital. Retained earnings. AUDIT OF SOLE PROPRIETORSHIPS AND PARTNERSHIPS. Key terms introduced or emphasized in Chapter 19.

19. Further verification of revenue and expenses **652**

The auditors' approach to verification of income. Audit by comparison. Conservatism in the measurement of income. Time of examination. REVENUE. Audit objectives. Relationship of revenue to balance sheet accounts. Miscellaneous revenue. EXPENSES. Audit objectives. Relationship of expenses to balance sheet accounts. The forecast—a vital element in controlling costs and expenses. Payrolls. Internal control. Methods of achieving internal control. The employment function. Timekeeping. Payroll records and payroll preparation. Distributing paychecks or cash to employees. Description of internal control for payroll. Audit program for payrolls. Audit program for selling, general, and administrative expenses. INCOME STATEMENT PRESENTATION. How much detail in the income statement? Discontinued operations. Extraordinary items. Cumulative effects of changes in accounting principle. Reporting earnings per share. Reporting by diversified companies. Key terms introduced or emphasized in Chapter 18.

20. Audit reports **683**

Financial statements. Notes to financial statements. The standard short-form audit report. Restatement of basic points concerning the short-form

report. Expression of an opinion by the auditors. Unqualified opinions. Conditions preventing issuance of an unqualified opinion. Qualified opinions. Adverse opinions. Disclaimer of opinion. Negative assurance clause in audit report. Comparative financial statements in audit reports. Dating the audit report; dual dating. Auditors' responsibility for other data in the annual report. Long-form audit reports. Reports to the SEC. Reporting on audits of sole proprietorships. Reporting on audits of personal financial statements. OTHER REPORTS BY AUDITORS. Disclaimers on unaudited financial statements. Reports on unaudited quarterly financial data. Letters for underwriters. Reports to regulatory agencies on internal control. Special reports. Reports on cash basis statements. Reports on not-for-profit organizations. Audit reports—a look to the future. Key terms introduced or emphasized in Chapter 20.

Index**729**