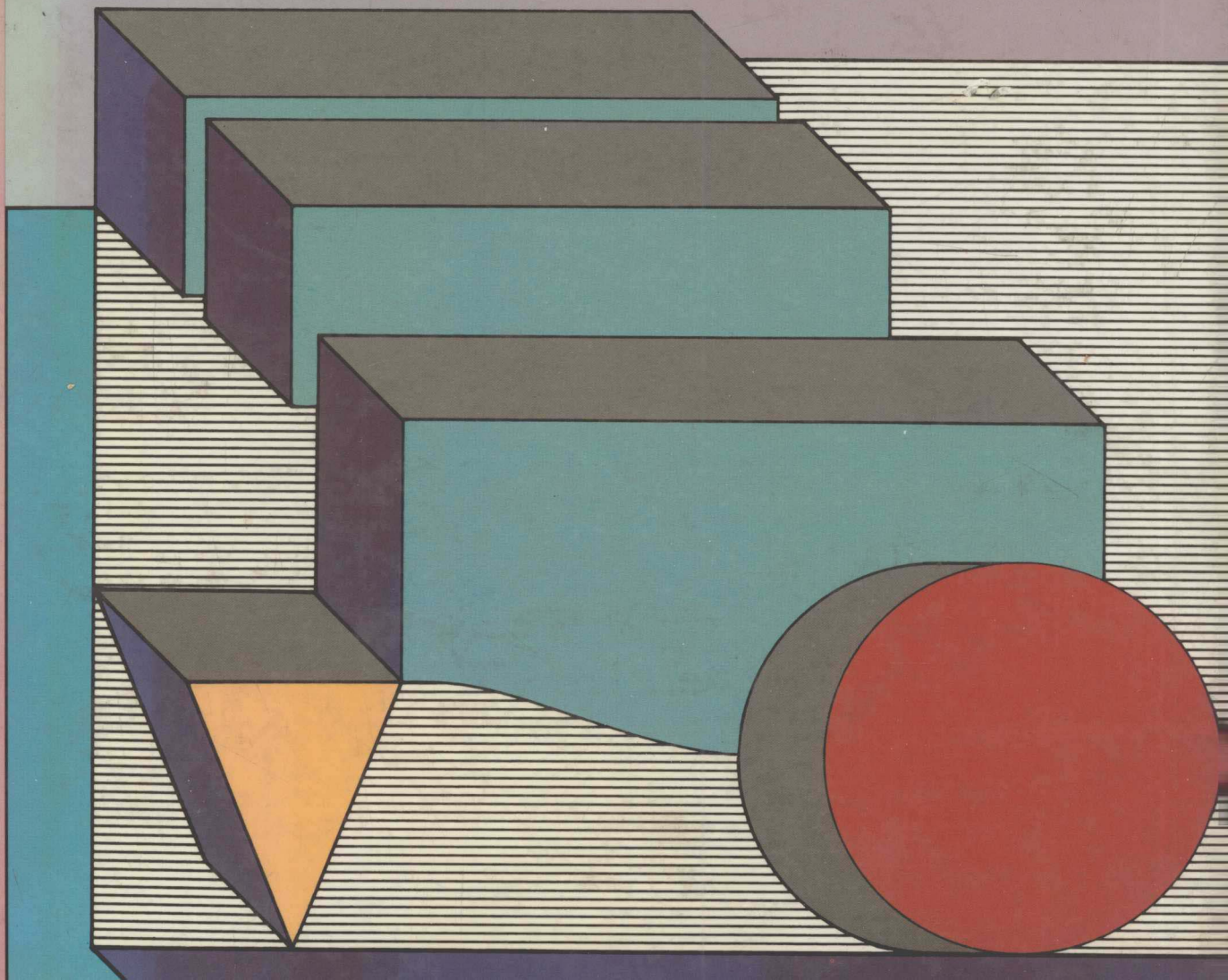


MODERN AUDITING

FOURTH EDITION

WALTER G. KELL
WILLIAM C. BOYNTON
RICHARD E. ZIEGLER



FOURTH EDITION

*MODERN
AUDITING*

*Walter G. Kell
William C. Boynton
Richard E. Ziegler*



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PREFACE

This, the Fourth Edition of *Modern Auditing*, represents a major revision of a successful book. The extent of the changes can be contrasted to the difference between remodeling the interior of a house and repainting one room. The changes in *Modern Auditing* were necessitated by two significant developments in the public accounting profession: (1) In April 1988, the Auditing Standards Board issued ten *Statements on Auditing Standards* including nine specifically designed to close the expectation gap of those who rely on audited financial statements. (2) In January 1988, the membership of the American Institute of Certified Public Accountants overwhelmingly approved six proposals to restructure professional standards.

Our goal in the Fourth Edition was to provide comprehensive coverage and integration of these developments into *Modern Auditing*. To achieve this objective, it was necessary to completely rewrite eight chapters and to make major changes in all but three chapters. In addition, there is one new chapter: Chapter 21 on internal, operational, and governmental auditing.

ORGANIZATION

As in previous editions, this textbook is divided into four parts:

Part	Subject	Chapters
I	Fundamental Relationships	1-4
II	Internal Control Structure Considerations	5-11
III	Verification of Account Balances	12-16
IV	Reporting and Other Responsibilities	17-22

Three of the chapters in Part I have been significantly revised. In Chapter 1, "Auditing and the Public Accounting Profession," material on the restructuring of professional standards and contemporary developments has been added. Chapter 2, "Financial Statement Audits," covers the new *Statements on Auditing Standards* on audit reports, errors and irregularities, and illegal client acts. Each of the basic elements of the new standard report is identified and the content of the report is carefully explained. In Chapter 3, "Accepting and Planning the Audit," new material has been added on consideration of the internal control structure, expanded coverage is given to the importance of materiality and audit risk, and a new graphic has been added on audit risk relationships. Chapter 4, "Evidential Matter/Working Papers," again combines a conceptual explanation of audit evidence and auditing procedures with a practical discussion of the nature and importance of working papers.

Part II contains seven chapters of which five have been almost completely revised because of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. Comprehensive coverage of SAS No. 55 is given in Chapter 5, "Understanding the Control Structure" and Chapter 6, "Assessing Control Risk." In each chapter, the requirements of the new SAS are carefully explained and illustrated, including an overview flowchart of the auditor's methodology in meeting the second standard of field work. Chapter 6 also discusses the new SAS on reporting on internal control structure matters. The basic relationships of the auditor's consideration of the internal control structure are then applied to electronic data processing systems in Chapter 7 and to three transaction cycles in Chapters 8–10: revenue, expenditure, and production. The cycle chapters contain numerous illustrations as well as EDP applications. Chapter 11, "Audit Sampling in Tests of Controls," completes Part II. This chapter explains the use of both statistical and nonstatistical sampling. A case study in using statistical sampling is also provided.

There are five chapters in Part III. Chapter 12, "Audit Sampling in Substantive Tests," explains the role of audit sampling in the verification of account balances. This chapter continues the coverage of both probability-proportional-to-size and classical variables sampling started in the second edition of *Modern Auditing*. Chapters 13 and 14 explain the correlation of inherent and control risks with detection risk and the design of substantive tests for account balances resulting from the transaction cycles in Part II. Chapter 15, "Auditing the Investing and Financing Cycles," combines the consideration of the internal control structure and substantive tests of balances. The concluding chapter of Part III is Chapter 16, which covers three topics: tests of income statement balances, completing the audit, and postaudit responsibilities.

Part IV contains six chapters. Chapter 17, "Reporting on Audited Financial Statements," has been completely revised based on SAS No. 58, *Reporting on Audited Financial Statements*. In addition to comprehensive explanations, there are extensive report illustrations. Chapter 18, "Other Services and Reports," begins with an explanation of the 11 attestation standards and covers a variety of attest engagements. The chapter concludes with a discussion of accounting services and the reports applicable to this type of service. Chapter 19, "Professional Ethics," is essentially a new chapter based on the Code of Professional Conduct adopted by the membership of the AICPA in 1988. The accountant's legal liability is the subject of Chapter 20. As in previous editions, this chapter covers both common law and statutory law. New in this edition is an explanation of the accountant's liability under the Racketeer Influenced and Corrupt Organization Act. Chapter 21 is an entirely new chapter that explains three types of auditing: internal, operational, and governmental. Also included are the audit and reporting requirements under the Single Audit Act. Chapter 22, "The Independent Accountant and the Securities and Exchange Commission," continues our coverage of the accountant's auditing and reporting responsibilities under the 1933 and 1934 securities acts.

NEW FEATURES

SAS No. 55 significantly changes the auditor's approach in considering an entity's internal controls. This SAS also has caused the following changes in this edition of *Modern Auditing*:

- There are two chapters on basic internal control concepts: Chapter 5, "Understanding the Internal Control Structure," and Chapter 6, "Assessing Control Risk."
 - Both chapters contain (1) graphics that illustrate the new requirements and their interrelationships, and (2) numerous author-developed comprehensive questions that have been meticulously integrated with the text material.
 - Each chapter has been carefully reviewed by individuals from both practice and academia for accuracy, clarity, and completeness.
 - Chapter 5 develops a framework of internal control objectives and illustrates the relationships between control procedures and control objectives.
 - Chapter 6 explains how control objectives are used in assessing control risk and the correlation of control risk in determining detection risk for financial statement assertions.
- In Chapters 8–10, the basic concepts are applied to specific transaction cycles.
 - The explanation of control procedures and internal control questionnaires is organized by control objectives.
 - Control risk considerations are developed for each control objective.
 - The relationship of the control risk assessments to financial statement assertions is explained and illustrated.

In Chapters 13–15, the material on substantive tests of cycle balances has been revised to show the

- Correlation of inherent and control risks with detection risk for financial statement assertions.
- Relationships between substantive tests and financial statement assertions for each account balance.

CONTINUING FEATURES

The following features of earlier editions are continued in the Fourth Edition of *Modern Auditing*:

- Study objectives for each chapter.
- Integration of authoritative auditing and professional literature throughout the text.

- Abundant illustrations of key relationships, flowcharts, and audit reports.
- Coverage of internal control considerations by transaction cycles.
- Extensive use of internal control questionnaires and analyses of errors and irregularities for major classes of transactions.
- EDP case studies for major classes of transactions.
- Separate chapters on audit sampling in tests of controls and substantive tests with case study applications in each chapter.
- Computer-assisted techniques in the verification of account balances.
- Objective questions from professional examinations and case studies from actual practice.
- Full chapter coverage of SEC auditing and reporting requirements.

NEW TOPICS

The following new topics are included in this edition:

- Restructuring of professional standards (Chapters 1, 3, and 19).
- Treadway Commission report on fraudulent financial reporting (Chapters 1 and 5).
- Auditor's standard report required by SAS No. 58 (Chapters 2 and 17).
- Attestation services and standards (Chapter 18).
- AICPA Code of Professional Conduct (Chapter 19).
- Full chapter coverage of internal, operational, and governmental auditing (Chapter 21).
- Internal control structure considerations in audit planning (Chapters 3 and 5).
- Racketeer Influenced and Corrupt Organization Act (Chapter 20).
- Auditing accounting estimates required by SAS No. 57 (Chapter 4).
- Communication with audit committees required by SAS No. 61 (Chapters 2 and 16).
- Communication of internal control structure matters required by SAS No. 60 (Chapter 6).

END-OF-CHAPTER MATERIALS

As in previous editions, there is an abundance of end-of-chapter materials organized as review questions, objective questions from professional examinations, comprehensive questions, and case studies. Each chapter has

- 20 review questions that are carefully integrated with text material.
- 6–10 multiple choice questions. The questions are drawn primarily from the Uniform CPA Examination but also include some questions from the

Certificate in Management Accounting Examination and Certified Internal Auditor Examination.

- 10–15 comprehensive questions that include essay questions from the professional examinations identified above, and questions from CPA firm staff training programs.
- A case study drawn primarily from practice.

Comprehensive questions from professional examinations are designated as follows: AICPA (Uniform CPA Examination), CMA (Certificate in Management Accounting) Examination, and IIA (Certified Internal Auditor Examination). *All objective and comprehensive questions from professional examinations have been edited and adapted to conform with the new SASs.* There are also numerous author-designed comprehensive questions including many tailor-made for the new SASs.

The questions from CPA staff training programs and case studies from actual practice are identified by an asterisk (*). They have been provided by three public accounting firms: Arthur Young & Company, Ernst & Whinney, and Peat Marwick Main & Co.

In total, there are over 950 questions and cases that have been carefully edited to related chapter content.

SUPPLEMENTARY MATERIALS

The supplements to this edition of *Modern Auditing* consist of (1) a software package, (2) an *Instructor's Manual*, and (3) a *Student Study Guide*.

The software package, *AUDSAMP: Statistical Sampling Templates for Lotus 1-2-3*, consists of a disk and a workbook that is also compatible with an IBM-PC microcomputer. *AUDSAMP* provides the student with an opportunity to solve a variety of attribute and variables sampling problems with the aid of a personal computer.

As in previous editions, the *Instructor's Manual* consists of three parts: (1) solutions to end-of-chapter questions and case studies, (2) selected exhibits and teaching aids for use as transparencies in the classroom, and (3) a test bank of examination questions for each chapter. The test bank has multiple-choice questions, correct/incorrect statements, matching questions, and short essay and analysis questions designed almost totally by the authors. There are over 350 questions in the test bank, and solutions to the questions are included.

The format and content of the *Student Study Guide* remains the same as in previous editions. In this edition, there are 30 chapter highlights, 25 true/false statements, 15 completion questions, and 20 objective questions from professional examinations for each chapter. In total, there are approximately 1300 true/false statements and questions. This edition of the *Study Guide* has been extensively revised because of the major revisions in *Modern Auditing*. Solutions are included at the end of the *Study Guide*.

ACKNOWLEDGMENTS

We take this opportunity to express our sincere appreciation to individuals who have made significant contributions to the Fourth Edition of *Modern Auditing*.

David B. Pearson of Arthur Young & Company made many helpful suggestions on many of the substantive changes in the edition, and we are grateful for his perceptive comments.

We are very fortunate to have received comprehensive and constructive critiques of the Third Edition of the textbook from the following professors: Fred Christensen, Boise State University, John E. Delaney, Southwestern University, and Nicky Andrew Dauber, Queens College.

Individuals who have made helpful suggestions on selected chapters of the Fourth Edition include Professors Christensen and Delaney; Professor George Siedel, III, of the University of Michigan; Earl C. Keller, California Polytechnic State University; and Mary Finan, Terry A. Klebe, and Deborah A. Koebele, all of Arthur Young.

Special thanks are extended to the many adopters of the previous editions for their comments and suggestions.

We also gratefully acknowledge the permission granted by the American Institute of Certified Public Accountants, the Institute of Certified Management Accounting, and the Institute of Internal Auditors to use materials from their professional examinations.

Last, but definitely not least, we express our appreciation to our editor, Lucille Sutton, supervising copy editor, Gilda Stahl, and production supervisor, Suzanne Hendrickson of John Wiley & Sons.

Walter G. Kell
William C. Boynton
Richard E. Ziegler

December 1988

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