# AUDITING PRINCIPLES

FOURTH EDITION

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# PREFACE

Auditing, despite certain outward appearances, is kaleidoscopic in nature, and that condition has been exacerbated by an action-oriented Securities and Exchange Commission as well as by its Chief Accountant, who is charged with the administration of filing requirements and serves as the watchdog over disclosure standards. Also playing an important part in changing the status quo have been a variety of court cases involving accountants. Civil actions have predominated, but there have been isolated criminal actions as well, with most of both types of cases arising out of situations involving faltering enterprises, and often associated with the efforts of disgruntled investors seeking a scapegoat for their losses.

Nevertheless, some of the cases have involved problems of disclosure and accounting principles, and others have involved auditing standards and their application, with the profession responding positively when the need for such response has been present. Noteworthy among such responses and evident at numerous points throughout this edition of *Auditing Principles* are references to statements of the fully independent Financial Accounting Standards Board as successor to the AICPA-affiliated Accounting Principles Board; Statements on Auditing Standards issued by the AICPA Auditing Standards Executive Committee, successor to the AICPA Committee on Auditing Procedure; new or changed requirements of the Securities and Exchange Commission; and a completely revised AICPA Code of Professional Ethics.

In addition to the above important aspects of the updating of this edition of *Auditing Principles,* the reader is invited to note the newly incorporated flow charts of the audit process in Chapter 7; a chart in Chapter 20 depicting how the mix of reliance on internal control and substantive tests varies among major financial statement items; a diagram in Chapter 20 highlighting the importance of directionality in making audit tests; and a substantially expanded chapter on the examination of computer-based accounting systems that includes an electronic data processing system questionnaire for the review of system and applications controls developed by a national public accounting firm.

Noteworthy aspects of the text that have been retained include a meaningful balance of conceptual and practical material; extensive discussion of the theory involved in the design and application of auditing techniques; a stress on the underlying audit objectives and the organization of the discussion of audit procedures relative to those objectives; an explanation of *why* things should be done in a certain way while at the same time there is a strong practical flavor in terms of *how* they should be done; a tightly knit organization plan that is used consistently throughout the "core" chapters and is designed to facilitate the reader's ability to grasp the material as it is presented; retention of the summaries covering internal control, financial reporting standards, and audit objectives and procedures at the conclusion of each core-chapter topic; and continued use of an informal style that includes an occasional "light" touch to aid the reader in grasping the material and assimilating its content.

Although the chapters on statistical sampling and auditing EDP systems appear at the end of the text, where I personally feel that they can be used with maximum meaning and benefit, the instructor who is intensely interested in these topics and prefers to orient the entire course toward these aspects of auditing can readily introduce the chapters along with the introductory material on accounting systems, internal control, and sampling.

Throughout the text there are frequent references to specific matters in the Machine Products Co. illustrative audit working papers. These working papers appear as "last year's work papers" in *Practice Case for Auditing*, 3rd edition, by Sherwood W. Newton and myself, an audit case that is specifically designed to accompany this text. Assignments in the case are intended to be used as a substitute for problems included in the text, or they may be used as a supplement to those problems. For those who may wish to refer to the illustrative working papers but are not interested in completing the case for the current year audit, the previous year's working papers are available in a separate pamphlet, *Audit Work Papers*, 2nd edition, from Prentice-Hall.

Pronouncements of the American Institute of Certified Public Accountants are liberally referred to or quoted throughout the text for the reader's benefit and as a means of making the text as authoritative as possible. The cooperation of the Institute in granting permission for extensive use of its published material, including questions and problems from the Uniform CPA Examination, is gratefully acknowledged as a significant contribution to the book. I also wish to express my appreciation to the firm of McGladrey,

Hansen, Dunn & Company for permission to reproduce its "Model Corporation" annual report; to the firm of Elmer Fox, Westheimer & Co. for permission to reproduce its EDP Internal Control Questionnaire; and to Lawrence B. Sawyer, Certified Internal Auditor and nationally known consultant in internal auditing, for his advice and guidance in connection with the material in the chapter on internal auditing.

**Howard F. Stettler**

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# 1

# INDEPENDENT AUDITS—WHAT AND WHY

Shakespeare said, "What's past is prologue." Our knowledge of the past is often used in attempting to project the future, whether it be Toynbee's analysis of the course of civilization, the forecaster's prediction of election results, or the creditor's or investor's use of the "track record" of a business concern in reaching a decision to lend or invest. But business history revealed through financial statements may be suspect because unlike most situations where the historian or keeper of the records is independent of the participants and activities being chronicled, the financial account of what a business has done is based on records maintained by employees of the business. Furthermore, the information is presented in financial statements that are prepared under management direction from those business records. Thus, the business situation is somewhat akin to having the home team keep the score in an athletic contest, or having a judge hear a case in which he is a litigant.

Under these circumstances there is opportunity for the results to be affected by ignorance, personal bias, self-interest, carelessness, or even outright dishonesty. For instance, in the business situation mere oversight might be responsible for the omission from financial statements of liabilities and the related expenses that are not yet a matter of book record. In another vein, the reluctance of management would be understandable in hesitating to admit that a credit sale that it had approved has become doubtful of collection or that depreciation charges are inadequate when net income is the basis for determining management bonuses. As an extreme situation, figures might even be intentionally falsified to present an appearance of improved financial position or better operating results. The possible effect of such eventualities on financial statements has prompted the observation that a balance sheet is sometimes not so much a "snapshot" of the financial status of a business as a "colored transparency," or even an "optical delusion."

### Strengthening Financial Statement Credibility

Management is logically assigned to "keep the score" because it needs similar information for its own use in guiding the affairs of the business, and creditors and investors use the resulting financial statements in reaching decisions on whether to lend or invest seemingly without questioning the reliability of the financial information contained in those statements. Does such use of the statements by third parties represent utter disregard of the possibility that personal bias, self-interest, carelessness, or dishonesty might lie hidden in the financial statements given the circumstances of their preparation? Not at all! In most instances the financial statements and underlying records will have been audited by an independent certified public accountant, who on the basis of an audit examination will have attested to the fairness of the financial statements in an accompanying audit report.

Such attestations have acted as a lubricant to the financial machinery in the capitalistic countries of the world, keeping the economic systems operating at peak efficiency and providing the basis for tremendous capital markets that have made it possible for capitalistic countries to achieve their enviable standard of living. Consider, for example, the allocation of scarce capital resources when the optimal goal is to maximize the production of goods and services desired by an insatiable consuming public. In these circumstances, funds are attracted to those concerns earning the greatest return on investment and with a sound financial position. If, however, a concern should attract funds by misrepresenting its operating results or financial condition, the resulting misdirection of those funds would involve a loss to the economy as a whole.

The existence of reliable financial information has likewise been a boon to investors, encouraging them to supply the vast amounts of capital for capital-intensive industry by obviating the fear of potential loss from relying on misleading financial information. The basis for the fears and doubts that would otherwise exist is the subject of a thoughtful analysis by A. M. C. Morison.[1] He points to each of the following as justifiable and sufficient reasons for questioning unaudited financial statements:

1. There is considerable uncertainty associated with asset realization, future benefits to be obtained from present expenditures, and the question of whether all obligations have been fully reflected in financial statements.
2. The need to classify, condense, and make estimates in recording and

[1]See "Auditing: The Reasons Why," *The Journal of Accountancy*, April, 1971, pp. 59–62.

summarizing financial events poses a difficult problem of ascertaining and conveying the truth, especially in the face of the known presence and effect of bias and a point of view that are subject to the self interest of the preparer.

3. The possibility always exists that financial statements may be distorted by an intent to deceive or by inadvertent errors.
4. There is a growing awareness of the effect on financial figures of choosing from among acceptable accounting alternatives, especially when such choices may be made in a conscious effort to produce a desired effect.

The audit examination that adds the needed credibility to such unaudited financial statements is the principal focus of this text. As the conduct of such an examination is explained and discussed in subsequent pages, the reader should become increasingly aware that an auditor does not keep accounts or prepare financial statements–an auditor is not the "official scorekeeper." Rather, the auditor is a disinterested observer who keeps watch over the business concern's own scorekeeper by looking over that person's shoulder as the accounting work is done and testing the results for propriety and accuracy.

## Professional Qualifications to Perform Independent Audits

In view of the reliance by third parties on the work of auditors engaged in performing the attest function, it is understandable that there would be concern for the professional qualification of the public accountants who do this work. Because in some states anyone who wishes may assume the designation public accountant, such a designation gives no indication that the person is qualified to render competent service to the public. The public interest in this matter is the basis for legislation in the United States in all fifty states and the District of Columbia creating the designation "Certified Public Accountant" to indicate those persons who have proven their qualifications to render competent service to the public. The requirements for the CPA certificate vary among jurisdictions, but each state requires the applicant to pass the Uniform Certified Public Accountant Examination prepared by the Board of Examiners of the American Institute of Certified Public Accountants.[2] This rigorous two-and-one-half-day examination lasting

[2]The AICPA is the national professional organization of Certified Public Accountants. The former name of the organization, "American Institute of Accountants," was changed in 1957 to indicate more clearly to the public that the organization represents only Certified Public Accountants, since membership is limited to CPAs. The present organization is an outgrowth of the American Association of Public Accountants, organized in 1887, and a merger in 1936 with the American Society of Certified Public Accountants.