1951

Auditing standards and procedures : illustrated by a case study

Lawrence Clifton Sullivan

AUDITING STANDARDS AND PROCEDURES ILLUSTRATED BY A CASE STUDY

BY

LAWRENCE CLIFTON SULLIVAN

A THESIS
SUBMITTED TO THE GRADUATE FACULTY
OF THE UNIVERSITY OF RICHMOND
IN CANDIDACY
FOR THE DEGREE OF
MASTER OF SCIENCE IN BUSINESS ADMINISTRATION

APPROVED BY:
F. Byers Miller

AUGUST, 1951

PREFACE

This thesis is confined to a discussion of auditing standards and procedures and their application illustrated by a case study of an actual audit or examination. Such a discussion is addressed primarily to students and practitioners of professional accountancy. However, it should be enlightening to anyone interested in the work done in a typical case by an independent certified public accountant in order to express an opinion on the financial statements.

Frequent reference has been made to pronouncements and recommendations of the American Institute of Accountants and the requirements of the Securities and Exchange Commission concerning auditing standards and procedures. The American Institute of Accountants, which has more than 16,000 members, is the national organization of professional accountants. It has exerted great influence in promoting and maintaining high professional and moral standards in the profession. While its pronouncements are binding upon its members only when formally adopted by the membership and are not binding upon the profession as a whole, they are thoughtfully considered and in most cases followed by its members. Pronouncements regarding auditing standards and procedures are important to nonmembers as well as members, since ignorance of any generally accepted auditing standard or procedure does not excuse the public accountant from liability.

TABLE OF CONTENTS

	Page
Preface	i
Chapter	
I. Introduction	1
II. Auditing Standards	11
III. General or Personal Standards	15
Training and Proficiency of the Auditor	15
Independence in the Auditor's Mental Attitude and Approach	17
Due Care by the Auditor in the Performance of His Work	20
IV. Standards of Field Work	21
Adequacy of Preparatory Planning of Field Work	21
Proper Evaluation of the Examinee's Existing Internal Control for Reliance Thereon by the Auditor	22
Competence of Evidential Matter. . . .	26
V. Standards of Reporting	29
Adherence to Generally Accepted Accounting Principles.	29

Chapter | Page

V. Standards of Reporting (Cont.)

Observance of Consistency in the Application of Generally Accepted Accounting Principles 32

Adequacy of Informative Disclosures . 33

VI. The Accountant's Report or Certificate . . 35

VII. Auditing Procedures 42

VIII. A Case Study of an Audit of a Wholesale Automobile Parts and Supplies Dealer. . . 52

Description of Business 52

Major Accounting Policies 56

Preparatory Planning of Work 60

Audit Procedures Applied 62

Sales and Other Income 62

Cash 65

U. S. Treasury Notes 67

Notes Receivable. 67

Accounts Receivable 68

Merchandise Inventory 69

Prepaid Expenses. 71

Due from Employees 73

Cash Surrender Value of Life Insurance 73

Fixed Assets 73

Accounts Payable-Trade Creditors. 75

Mortgage Payable. 76

Chapter Page

VIII. A Case Study of an Audit of a Wholesale Automobile Parts and Supplies Dealer (Cont.)

Other Liabilities 77

Capital 78

Costs and Expenses of Operations. 79

Other Procedures. 82

Client's Written Representations . . . 83

Conclusion 85

Bibliography 88

Vita 92

CHAPTER I

INTRODUCTION

Before undertaking to discuss auditing standards and procedures and to illustrate their application by means of a case study of the procedures which were actually followed in performing a particular audit, it is desirable to define the term "audit".

> "A special committee of the American Institute of Accountants has defined an audit as 'an examination of the books of account, vouchers and other records of a public body, institution, corporation, firm or person, or of any person or persons standing in any fiduciary capacity, for the purpose of ascertaining the accuracy or inaccuracy of the records and of expressing opinion upon the statements rendered, usually in the form of a certificate'. . . ."[1]
>
> "Using the word 'audit' in its broadest sense, the purposes for which accounts and records are audited may be stated generally as follows:
>
> 1. General verification (as far as practicable) of the accounts of a business to determine

---

[1] Bell and Johns, Auditing, New York, Prentice-Hall, Inc., 1946, p. 1, quoting a special committee of the American Institute of Accountants, Accounting Terminology.

its financial condition, its operating results, and/or the fiduciary integrity of those in charge - with a view to reporting thereon to the owners, stockholders, executives, boards of directors or trustees, securities exchanges, Securities and Exchange Commission and other governmental or regulatory bodies, receivers, present or prospective lenders, prospective investors or purchasers, creditors' committees, mercantile agencies, mortgage trustees, or any other interested parties.

2. To determine whether funds of an organization have been properly accounted for and its affairs properly administered, for the satisfaction of the public, donors, and so forth; as in the case of governmental, religious, educational, and eleemosynary institutions.

3. To determine the profits or losses of a business, with a view to reporting to interested parties in connection with such matters as royalty agreements, profit-sharing agreements, and patent infringement suits.

4. To determine costs, inventories, fire losses, circulation of publications, and other specific matters for various special purposes.

5. To detect fraud.

6. To determine the extent of fraud already detected.

7. To prevent fraud by the moral effect upon the client's staff."[2]

The term "audit" as used in this treatise will refer to an examination or audit made by the independent certified public accountant for the purpose of expressing an opinion on the fairness of the presentation of the financial position and the operating results as shown in the financial statements accompanying his report. The

---

[2] _Ibid._, p. 1.

independent auditor's opinion presented in his report is an expression of his personal judgment after performing an examination in accordance with generally accepted auditing standards which accordingly include the auditing procedures considered necessary in the circumstances.

These auditing standards and procedures have developed and have become generally accepted through an evolutionary process which parallels the development and growth of the relatively young profession of public accounting. The position of the public accountant prior to 1900 was described at the fiftieth anniversary celebration of the American Institute of Accountants in October, 1937, by its president when he said:

> "Fifty years ago in the United States the public accountant was little known, little recognized, little wanted. His virtues were unheralded, unsung. He was little known because his kind were few and because enterprises were relatively small and in most cases their accounts as well as their affairs were supervised by the owners. He was little recognized because the matters which were referred to him at the time were relatively unimportant and this unimportance tended to reduce him to the level of a clerk."[3]

The change in position of the public accountant is illustrated by the following words from a message from the President of the United States to the president of the American Institute of Accountants at the fiftieth

---

[3]Robert H. Montgomery, "What Have We Done, and How?", The Journal of Accountancy, LXIV (November, 1937), 335.

anniversary celebration.

> "A public accountant has one of the most responsible and trusted positions in the world. When he examines the books of a corporation he not only looks for errors on the part of the bookkeepers but he must also disclose whether the management itself, by accident or intention, is deceiving the stockholders and creditors with false reports."[4]

Social and economic changes in society during the last sixty years have been one of the principal factors contributing to the growth of the public accounting profession to its present position of recognized importance. The primary social and economic change has been the separation of ownership and management resulting from large corporate enterprises with thousands of stockholders, many of whom are transitory owners of stock. In addition, there has been a tremendous increase in the number of relatively small enterprises in which the owners can no longer supervise both their accounts and their other affairs. Out of these changes has grown the need for the independent certified public accountant to examine the books of account and records for the purpose of ascertaining the accuracy or inaccuracy of the records and expressing an opinion upon the statements rendered, which usually include the balance sheet, profit and loss or income statement, and statement of surplus. He has a great responsibility to

---

[4] "Message from the President of the United States", The Journal of Accountancy, LXIV (November, 1937), 331.

anyone who may rightfully rely upon his professional opinion as to the fairness of the information contained in the financial statements. This is particularly true with reference to owners, creditors, and persons not engaged in the management of the business. Banks are a specific example of creditors who have found it necessary to rely more and more upon financial statements, and consequently upon the accountant's certificate, since in our increasingly complex society individual loans to companies are larger in amount and the bank credit officer in many cases does not have the close personal contact with the borrowers that he once did.

The second principal factor in the growth and importance of public accounting has been the body of laws passed by Congress. The most significant of these laws which have exerted great influence upon accounting and auditing principles, conventions, rules, and procedures have been the income-tax and securities and exchange laws. The Revenue Act of 1913 was adopted October 3, 1913, effective as of March 1, 1913. The importance of the new legislation was realized at once as evidenced by an editorial appearing in the November, 1913, issue of _The Journal of Accountancy_ which reads, in part, as follows:

> "It is indubitable that the income-tax law is to have a more far-reaching effect upon the public accountants than upon any other profession or business in the country. Hundreds of men who have never seen the necessity for a correct system of accounting now find themselves compelled to prepare statements of income and expenditure; and the work in nine cases out of ten will fall upon the shoulders of the public accountants of the several states."[5]

The Securities Act of 1933, the Securities-Exchange Act of 1934, and the Public-Utility Act of 1935 gave the Securities and Exchange Commission extensive powers for the regulation of accounting matters and the methods to be followed in the presentation of financial statements to the Securities and Exchange Commission. Under these Acts, corporations which have securities registered upon a national securities exchange are required to file an annual report with the commission and the exchange. The financial statements contained in the reports must be certified by independent public or independent certified public accountants. The Securities and Exchange Commission and the American Institute of Accountants have worked together on their mutual problems resulting in improved standards of accounting and auditing, more adequate disclosure, and the adoption of sounder practices in the presentation of accounting statements.

---

[5] Norman L. McLaren, "The Influence of Federal Taxation upon Accountants", The Journal of Accountancy, LXIV (December, 1937), 433-434.

With this brief history of public accounting in the United States, the evolutionary process through which auditing standards and procedures and accounting principles and rules have developed can be seen. In the early period of public accounting, each individual practitioner performed audits in accordance with his knowledge and understanding of auditing procedures and accounting principles which were in a developing stage and not generally accepted. There was a need for an outline of a minimum audit program by the accountants. Bankers were interested in uniform accounting for all manufacturing and merchandising businesses. Consequently, the first written outline of suggested procedures was prepared by the American Institute of Accountants at the instigation of a member of the Federal Trade Commission and was published by the Federal Reserve Board in the Federal Reserve Bulletin of April, 1917. Reprints were widely disseminated under the name of "Uniform Accounting; A Tentative Proposal Submitted by the Federal Reserve Board," to banks, businessmen, auditors, and accountants. The pamphlet was reissued in 1918 with its title changed to "Approved Methods for the Preparation of Balance-Sheet Statements." These early pamphlets were criticized by some accountants for being too comprehensive and by other accountants who said the procedures were not comprehensive enough and would not bring out all the desired information.[6]

The impracticability of a standard audit program is evidenced by the opening paragraph of "General Instructions" in the pamphlet revised in 1929 by the American Institute of Accountants and published by the Federal Reserve Board under the title of "Verification of Financial Statements":

> "The extent of verification will be determined by the conditions in each concern. In some cases the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others, where the system of internal check is good, tests only may suffice. The responsibility for the extent of the work required must be assumed by the auditor."[7]

This pamphlet also showed the growing emphasis on earnings by giving equal status to the income statement. In earlier days when the balance sheet was considered the most important statement, conservatism was considered so great a virtue that income statements were charged with costs and expenses which should frequently have been deferred to future periods. Today's primary objective is to secure a fair statement of income by a proper apportionment and

---

[6]Committee on Auditing Procedure, Tentative Statement of Auditing Standards - Their Generally Accepted Significance and Scope, p. 1.

[7]Ibid, p. 1.

matching of costs and revenues with the residual amount of the expenditure or income finding its place in the balance sheet. It is generally recognized that the investor is more interested in the earnings and dividends of a corporation than in its assets and liabilities shown on the balance sheet. While creditors are more interested in the nature and adequacy of working capital on the balance sheet, they also have a real interest in the profits from which repayment of loans may depend.

The next revision of these pamphlets was prepared and published by the American Institute of Accountants in January, 1936, under the title of "Examination of Financial Statements by Independent Public Accountants." Here again the title change was significant. The substitution of the word "examination" for "verification" indicated the growing realization that the latter was too strong a word for the auditor's function where his need for reliance on a system of carefully devised testing was his justification in accepting the representations of the client. This revision gives increased emphasis to the importance of consistency in the application of accounting principles both during the year under review and from one year to the next. For example, it is a generally accepted principle that the cost of fixed assets should be charged against operations over the useful life of the asset. Although there are many methods of depreciation used in arriving at this result, the important fact lies not in the method employed but in the consistent application of the method. Where the method is changed, the reader of the statements must be advised if the change makes a material difference in the results of operations for the period. The prominence given to accounting principles and consistency in their application by the Securities and Exchange Commission and in the correspondence between the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange certainly exerted much influence on the 1936 revision and may have been the primary cause of this revision. The Securities and Exchange Commission requires disclosure of any significant change in accounting principle or practice. It was also during the 1930's that "the organized practitioners and teachers of accounting began the first methodical efforts to codify accounting principles and procedures."[8]

---

[8]John L. Carey, "Editorial", The Journal of Accountancy, LXVIII, (December, 1939), 361.

CHAPTER II

AUDITING STANDARDS

In February, 1941, the Committee on Auditing Procedure of the American Institute of Accountants recommended the addition of one sentence to the short form accountant's report or certificate then in general use. The sentence summarized the auditor's representations as to the scope of examination in two significant statements:

> (1) "Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and
>
> (2) "it included all procedures which we considered necessary."[1]

This was the first time a recommended short form accountant's report or certificate had ever referred to auditing standards, and it was the first time a distinction had been made between auditing standards and auditing procedures.

---

[1] Committee on Auditing Procedure, "The Revised S. E. C. Rule on Accountants' Certificates", Statements on Auditing Procedure - No. 5, pp. 40-41.

The Securities and Exchange Commission was directly responsible for this change in the accountant's certificate. As a result of the Commission's study of accountants' certificates and audit procedures in its investigations of the celebrated McKesson & Robbins case and other auditing cases and matters, the Commission revised the rule regarding accountants' certificates contained in amendment No. 3 to Regulation S-X effective March 1, 1941. Rule 2-02, section (b) states the following requirements:

> "The accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made including, if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case."[2]

The Commission thus made a distinction between auditing procedures and auditing standards in Rule 2-02. The S. E. C. Release contained the following explanatory statements:

> "In referring to generally recognized normal auditing procedures the Commission has in mind those ordinarily employed by skilled accountants and those prescribed by authoritative bodies dealing with this subject, as for example, the various accounting societies and governmental bodies having jurisdiction. In referring to generally accepted auditing standards

---

[2]Securities and Exchange Commission, Accounting Series Release No. 21, February 5, 1941.

> the Commission has in mind, in addition to the employment of generally recognized normal auditing procedures, their application with professional competence by properly trained persons."[3]

It was not until six years later in October, 1947, that the Committee on Auditing Procedure issued a special report entitled "Tentative Statement of Auditing Standards - Their Generally Accepted Significance and Scope" from which came the following summary of the meaning of generally accepted auditing standards:

> "General Standards
>
> 1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
> 2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
> 3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.
>
> "Standards of Field Work
>
> 1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
> 2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
> 3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.
>
> "Standards of Reporting
>
> 1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

---

[3] _Ibid._

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."[4]

Upon consideration of these standards, it may be said that auditing standards are the underlying principles of auditing which deal with the broad objectives to be attained by the use of auditing procedures and are concerned with the professional qualities of the auditor and with his exercise of judgment in the conduct of his examination and in his report. Auditing procedures are the acts performed in attaining or complying with the generally accepted auditing standards applicable to field work.

---

[4] Committee on Auditing Procedure, Tentative Statement of Auditing Standards - Their Generally Accepted Significance and Scope, p. 11.

CHAPTER III

GENERAL OR PERSONAL STANDARDS

The general standards are personal standards which are concerned with the conditions necessary for the satisfactory attainment of the other standards of field work and reporting.

TRAINING AND PROFICIENCY OF THE AUDITOR

Concerning the training and proficiency of the certified public accountant, the Committee on Auditing Procedure has said:

> "In order to qualify himself to carry out his function, the independent certified public accountant has completed a rigorous course of professional study and training as a background to the essential practical experience he must obtain, for it is only by study, training, and practical experience that the independent auditor acquires skill in accounting and related matters. In the ordinary course of his day-to-day practice, he encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to examine and report upon the affairs of a concern because, through his training and experience, he has become not only skilled in accounting and auditing but has acquired the ability and habit of considering dispassionately

> and independently the facts recorded in books of account or otherwise disclosed by his examination and because, as a result, his opinion provides reasonable assurance that a fair and adequate presentation of pertinent information has been made in the financial statements."[1]

It is obvious that the opinion of an auditor would mean little if he did not have adequate training and proficiency. State laws have provided for the recognition of persons who are qualified to perform the function of auditing as "certified public accountants". These laws prescribe the degree of education, training and experience required. In addition, all the states require the passing of a written examination prior to the issuance of the C. P. A. certificate; and to insure uniformity, all except Pennsylvania are at present using examinations prepared by the American Institute of Accountants which are given simultaneously throughout the country once or twice a year. Thus, the independent certified public accountant must be professionally and legally qualified before he can express an opinion as to the fairness and adequacy of the information presented in the financial statements.

However, the independent auditor's opinion is not a guarantee that the figures presented in the financial statements are literally correct. If his client sustains losses through reliance upon his report, he is legally responsible for

---

[1]Committee on Auditing Procedure, "Extensions of Auditing Procedure", Statements on Auditing Procedure No. 1, p. 4.

the losses due to negligence in the performance of his work. He is required by law to exercise the skill of the ordinarily skilful practitioner. To third parties who have relied upon his report, he is liable only for damages due to fraud committed by him; except that in the case of registration statements filed with the Securities and Exchange Commission, it is not necessary for a contractual relationship to exist in order for any person acquiring such securities to bring suit on a basis other than fraud.[2]

INDEPENDENCE IN THE AUDITOR'S MENTAL ATTITUDE AND APPROACH

The importance of this standard cannot be overemphasized when it is recognized that the professional auditor's existence is dependent upon his independence. His independence implies and requires unbiased, impartial judgment and consideration of the facts in formulating and expressing his opinion. He owes a fair presentation of the financial statements to anyone who may have a right to rely upon his report. This would include the management, owners, creditors, and prospective owners or creditors whose interests frequently conflict. "It is the peculiar obligation of the certified public accountant, which no other profession has to impose on its members, to maintain a wholly objective and impartial attitude toward the

---

[2]Bell and Johns, Auditing, New York, Prentice-Hall, Inc., 1946, pp. 15-17.

affairs of the client whose financial statements he certifies."[3]

The American Institute of Accountants' rules of professional conduct and the similar pronouncements of its state societies are the public accounting profession's code of ethics. Five of the sixteen rules of professional conduct of the American Institute of Accountants relate to the matter of independence and the rules are listed below in the order of their importance:

> "Rule 5. In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if:
>
> (a) He fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or
>
> (b) He fails to report any material misstatement known to him to appear in the financial statement; or
>
> (c) He is materially negligent in the conduct of his examination or in making his report thereon; or
>
> (d) He fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or
>
> (e) He fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.
>
> "Rule 9. Professional service shall not be rendered or offered for a fee which shall be contingent upon findings or results of such service. This rule does not apply to cases involving federal, state or other taxes, in which the findings are those of the tax authorities and not those of the accountant. Fees to be fixed by courts or other public authorities,

---

[3]John L. Carey, Professional Ethics of Public Accounting, New York, American Institute of Accountants, 1946, p. 13.

which are therefore of an indeterminate amount at the time when the engagement is undertaken, are not regarded as contingent fees within the meaning of this rule.

"Rule 13. A member shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise. A member shall not express his opinion on financial statements which are used as a basis of credit if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise, unless in his report he discloses such interest.

"Rule 3. Commissions, brokerage, or other participation in the fees or profits of professional work shall not be allowed directly or indirectly to the laity by a member.

Commissions, brokerage, or other participation in the fees, charges, or profits of work recommended or turned over to the laity as incident to services for clients shall not be accepted directly or indirectly by a member.

"Rule 4. A member shall not engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith."[4]

While independence is a personal quality requiring intellectual honesty which cannot be regulated, these rules have developed as signposts to assure the public that the profession has the public's interest at heart, to guard the profession against

---

[4]American Institute of Accountants, By-Laws ... Rules of Professional Conduct, pp. 12-13.

selfish members, and to guide the individual members.

DUE CARE BY THE AUDITOR IN THE PERFORMANCE OF HIS WORK

The exercise of due professional care in the performance of the examination and the preparation of the report is another personal standard. It demands that the auditor exercise his judgment and skill in observing the standards of field work and reporting in such a manner that the work will be done professionally rather than perfunctorily. This implies that all necessary procedures in the particular case will be properly applied and coordinated.

Due care should also be exercised in connection with the auditor's working papers. The working papers should be safeguarded against the possibility of unauthorized access wherein any employee of the client could tamper with them or gain information to which he is not entitled. They should be skilfully designed in such a manner as to assure complete and competent information; and, as far as possible, they should assist in bringing to light errors on the part of the auditor's staff as well as errors on the books of the client. It is always a possibility that the working papers will be useful in showing that the auditor has met generally accepted auditing standards.

CHAPTER IV

STANDARDS OF FIELD WORK

The standards of field work and the standards of reporting may be referred to as the procedural standards since they are concerned with preparatory planning, evaluation of internal control, competence of evidential matter, and the information presented in the report.

ADEQUACY OF PREPARATORY PLANNING OF THE FIELD WORK

In order to facilitate the adequate planning and carrying out of his work, it is desirable that the auditor be appointed as early as possible in the year to be reviewed. Much of the field work can be more effectively accomplished as preliminary work prior to the effective date of the financial statements. At times this makes it possible to bring improper practices or procedures to the attention of the management in time for corrective action which may benefit both the auditor and the company. Preliminary work also makes possible the early completion of the examination after the balance sheet date by reducing the amount of post-closing work.

Preparatory planning is a prerequisite to the coordinating of the auditing procedures to be applied. Preparatory planning prior to the close of the year is particularly important in connection with the auditor's participation in planning for the taking of a physical inventory. In order to insure a reasonably accurate inventory, he should confer in advance with the management as to the time it will be taken and the methods to be employed in taking the inventory and arriving at a proper cut-off of shipments and receipts.

Proper supervision of assistants is necessary and is related to adequate planning. It is also related to the first general standard requiring that the examination be performed by a person or persons having adequate technical training and proficiency as an auditor since the answer as to how a junior assistant can meet this standard is through proper supervision and critical review of his work.

PROPER EVALUATION OF THE EXAMINEE'S EXISTING INTERNAL CONTROL FOR RELIANCE THEREON BY THE AUDITOR

> "Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies."[1]

---

[1]Committee on Auditing Procedure, Internal Control - Elements of A Coordinated System and Its Importance to Management and the Independent Public Accountant, p. 6.

One of the primary functions of internal control is to provide a check and review which so far as possible prevents and detects errors or fraud. Internal control is accomplished through a division of duties so that no one individual or department handles a transaction from beginning to end. For example, a person handling the cash should not record the labor time and prepare the payroll, nor should a person handling cash have any part in posting the accounts receivable ledgers or sending statements to customers. Stock records and inventory control should be separated from the shipping and receiving departments.

The independent auditor is primarily concerned with how well the system of internal control safeguards the accuracy of the accounting data. It is a matter of judgment after evaluating the existing internal control as to the reliance to be placed thereon and the resulting auditing procedures considered necessary. In connection with this standard, certain excerpts from Statements on Auditing Procedure No. 1 are deemed important.

> "The independent auditor must exercise his best judgment in determining the scope of his examination and in deciding whether the interests of the stockholders are creditors justify the time and expense involved in the extension of any particular line of inquiry .... It is the duty of the independent auditor to review the system of internal check and accounting control so as to determine the extent to which he considers that he is entitled to rely upon it. To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor

would have to examine in detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises - a cost which would pass all bounds of reasonable expectation of benefit or safeguard therefrom, and place an undue burden on industry."[2]

"It is worthy of repetition that the extent of sampling and testing should be based upon the independent auditor's judgment as to the effectiveness of internal control, arrived at as the result of investigations, tests, and inquiries. Depending upon his conclusions in this respect, the independent certified public accountant should extend or may restrict the degree of detailed examination."[3]

Inquiries of officers and employees of the company and tests of the accounting records are the primary means of evaluating the system of internal control. The inquiries as to the procedures and methods in use may be oral or may be a written list of questions to be answered. When the audit procedures are applied, tests will determine whether the internal control is operating as planned. Such tests may include an examination of all the evidence supporting the entries to particular accounts or books of original entry for a selected period; or such tests may comprise the investigation of a series of related transactions from beginning to end. Many auditors follow the practice of reviewing the internal checks and controls while the related accounts are under review rather

---

[2]Committee on Auditing Procedure, "Extensions of Auditing Procedure," Statements on Auditing Procedure No. 1, pp. 4-5.

[3]*Ibid*., p. 11.

than by separately evaluating the system of internal control as a whole. Regardless of the manner in which internal control is evaluated, the tests employed may show that expansion of the auditing procedures is desirable because some phase of internal control is not functioning as the response to inquiries indicated it should be.

Because of their complexity with branches and subsidiaries, many larger companies have recognized the need for internal auditing departments. Naturally, the existence of such departments have an important bearing on the auditing procedures applied and the extent of their application by the independent auditor. The Committee on Auditing Procedure has had the following words to say concerning the relationship of the independent auditor and internal auditing.

> "Internal auditing departments are an important part of the system of internal check and control, particularly where a concern has numerous plants or offices. The work of the internal auditor reduces the volume of testing and checking required of the independent auditor. However, the objectives, purposes, and points of emphasis of the two are by no means parallel. An internal audit stresses particularly the accuracy of the bookkeeping records, the fact that they conform with standard accounting procedures of the concern, and the discovery of irregularities and possible shortages. The independent auditor also has these matters in mind but they are not his primary objective. He concerns himself more particularly with the soundness of the judgments of the management as reflected in the financial statements and their conformity with generally accepted accounting principles and conventions. Furthermore, one of the safeguards of an independent audit is the

> fact that it is made by those independent of the concern under examination. For the reasons stated, an internal audit however efficient, cannot be considered as a substitute for the work of the independent auditor."[4]

COMPETENCE OF EVIDENTIAL MATTER

Evidential matter may be classified as internal or external depending upon whether the source of the information or data is from within the organization under examination or from sources outside the organization.

Internal evidence includes the books of original entry together with the supporting documents such as the bank statements, cancelled checks, sales invoices, purchase invoices, contracts, minutes of stockholders' and directors' meetings, and correspondence. The auditor examines the internal evidential matter by the tests he makes for the purpose of determining whether he can rely upon the books of account and financial statements of the client.

External evidence is developed by the auditor to supplement the internal evidence. For example, confirmation of the cash on deposit at the balance sheet date is obtained directly from the depositary, and requests for confirmation of accounts receivable are made by the independent auditor where practicable and reasonable. The extent and method of direct communication with debtors are dependent upon the circumstances.

---

[4]Committee on Auditing Procedure, "The Auditor's Opinion on the Basis of a Restricted Examination," <u>Statements on Auditing Procedure No. 2</u>, p. 15.

Other techniques employed to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements are inspection, observation, inquiry, computation, and analysis and review. Inspection includes such procedures as testing inventory counts; counting cash on hand; examining checks, invoices, titles, and other documents supporting book entries; and reading minutes. Observation is used most frequently to refer to the auditor's presence at the physical inventory taking to observe the manner in which it is taken, but it also includes the observance of the manner in which other procedures are performed by company employees. Inquiries are constantly made of the officers and employees concerning the various questions that arise. Frequently, the inquiries are of such a nature that the information can be supplied only by the management, and the responses are reduced to a written statement and signed by an officer. For instance, contingencies and unrecorded liabilities might be brought out only through specific inquiries. The information gained should be substantiated by any practicable means. Computation, as a technique, includes the testing of arithmetical calculations, computations of depreciation, prepaid or accrued items, tax liabilities, and other amounts. Several of the procedures employed in the last mentioned technique of analyzing and reviewing the data presented are the comparison of account balances as shown by the trial balance with the balances at the end of the preceding year, noting unusual differences for further investigation; comparison of the gross profit ratio with that of previous periods; and analysis of individual accounts in order that unusual or significant items may be investigated.

CHAPTER V

STANDARDS OF REPORTING

ADHERENCE TO GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

While it is true that there are generally accepted accounting principles, they have not been codified. They may be found in textbooks, in treatises, and in authoritative pronouncements. In 1936 one practitioner commented as follows:

> "First, what has frequently been spoken of as accounting principles includes a conglomeration of accounting practices, procedures, policies, methods and conventions relating both to the construction of the accounts and their presentation; and second, there seems to be a general agreement among commentators that the difficulty of any attempt to formulate so-called principles or prescribed rules and regulations on accounting matters is so large and the conditions encountered so diverse that few, if any, sweeping generalizations can safely be adopted."[1]

---

[1] F. B. Byerly, "Formulation of Accounting Principles or Conventions," The Journal of Accountancy, LXIV (August, 1937), 94.

Since that time, the American Accounting Association in its 1941 statement of "Accounting Principles Underlying Corporate Financial Statements," the research staff of the American Institute in a statement of "Corporate Accounting Principles" which appeared in the October, 1945, Journal of Accountancy, the Accounting Procedures Committee of the American Institute in its bulletins, and numerous other bodies and individual practitioners have made notable efforts to formulate underlying accounting principles.[2]

The most important of the generally recognized accounting principles taken from various sources are listed below:

> 1. "Financial statements of a going concern are prepared on the assumption that the company will continue in business."[3]
>
> 2. "Consistency should be maintained, between the statements prepared at the end of one period, and between the statements of successive periods. However, a proper regard for consistency need not preclude a desirable change in procedure."[4]

---

[2]Frank S. Calkins, "What Are Generally Accepted Accounting Principles?", The Virginia Accountant, IV (January, 1951), p. 4.

[3]Committee on Accounting Procedure, "Current Assets and Current Liabilities - Working Capital," Accounting Research Bulletin No. 30, p. 247.

[4]H. A. Finney, Principles of Accounting-Intermediate, 3rd. Ed., New York, Prentice-Hall, Inc., 1946, p. 196.

3. "Cost is the proper basis for the accounting for assets and expenses, but modifications to a going concern basis of valuation are sometimes acceptable."[5] "In the case of non-cash acquisitions, cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident."[6]

4. "Revenues should not be regarded as earned until an asset increment has been realized, or until its realization is reasonably assured."[7]

5. "All costs expired during a period should be charged against the income for the period (or perhaps in special instances against earned surplus), and provision should be made for probable losses not actually incurred."[8]

6. "Capital stock and paid-in surplus should represent contributed capital, and earned surplus should represent the increment in proprietorship resulting from revenue-producing transactions."[9]

7. "Statements should be truthful and should make full disclosure of significant information."[10]

Three factors are important in the exercise of the independent auditor's judgment as to whether generally accepted accounting principles have been adhered to in the

---

[5] Ibid., p. 196.

[6] Committee on Accounting Procedure, "Accounting for Intangible Assets," Accounting Research Bulletin No. 24, p. 196.

[7] H. A. Finney, op.cit., p. 196.

[8] Ibid., p. 196.

[9] Ibid., p. 196.

[10] Ibid., p. 196.

practices of the examinee. First, the auditor must have knowledge as to what principles have found general acceptance. Second, he must bear in mind that there is a considerable diversity of practices in the application of accounting principles and that certain methods may be generally accepted even though they may have only limited application. Third, materiality enters into the considerations when a generally accepted principle is not followed.

OBSERVANCE OF CONSISTENCY IN THE APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

The determination of whether generally accepted accounting principles have been applied consistently is another matter requiring judgment exercise. It is not intended that this standard deny a recognition of consistency where a desirable change in procedure has been made. A desirable change may be made necessary by changes in operations and circumstances or may be a change to a procedure more preferred in general practice.

A change for the purpose of reducing or distorting income would require a denial of consistently applied accounting principles. The change by many concerns to the "last-in, first-out" method of valuing inventories during the 1940 excess profits tax years for the resultant tax saving is illustrative of such a change.

Where any significant change in the application of accounting principles has been made, the independent auditor should give full disclosure and a full explanation if the change affects proper comparison with the preceding period. This is also required by the Securities and Exchange Commission.

ADEQUACY OF INFORMATIVE DISCLOSURES

The requirement for adequate disclosure is both an auditing standard and an accounting principle. Both apply to the financial statements. The auditing standard is broader, since required disclosures, such as omission of confirmation of accounts receivable or physical inventory observation or test, have to do with the scope of the examination in addition to the necessary disclosures with regard to the financial statements.

The nature of necessary disclosures concerning the financial statements has been explained by the Committee on Auditing Procedure in the following pertinent excerpts:

> ". . . fairness of presentation, apart from relationship to generally accepted accounting principles, requires consideration of adequacy of disclosure of material matters, whether relating to the form, arrangement, and content of the financial statements with their appended notes; the terminology used; the amount of detail given; the sufficiency of explanatory or descriptive matter; the classification of items in statements; the bases of amounts set forth, for example,

> with respect to such assets as inventories and plants; liens on assets; preferred dividend arrearages; restrictions on dividends; contingent liabilities. This enumeration is not intended to be exhaustive but indicative of the nature of the disclosures necessary in order that the financial statements be sufficiently informative.
>
> "Mere verbosity in disclosure should not be mistaken for completeness; brevity of disclosure is often more helpful to the discerning reader than amplitude of words. What constitutes material information requiring disclosure in or in connection with, financial statements is for the auditor to determine in the best exercise of his judgment. . . Matters which the auditor deems of such importance as to require disclosure, if omitted from the financial statements or from footnotes thereto, should be included in his report or 'certificate,' whether these matters be qualifications or necessary explanations."[11]

Adequate disclosure does not require that certain types of information which would be detrimental to the company and its stockholders be publicized if there would be no fully compensating advantage to its stockholders or creditors.

---

[11] Committee on Auditing Procedure, Tentative Statement of Auditing Standards - Their Generally Accepted Significance and Scope, p. 41.

CHAPTER VI

THE ACCOUNTANT'S REPORT OR CERTIFICATE

The final objective of the examination of financial statements by the independent certified public accountant is the expression of an opinion upon the statements rendered in the report or certificate. A description of the work done and a presentation of the auditor's findings are included in either a long-form or short-form report. The long-form report is usually submitted for the management and a small group of creditors, whereas the short-form report is used in connection with financial statements to be published in stockholders' reports. The wording of the accountant's certificate is frequently the same in either type report although additional information is presented in the long-form report. Such additional information in the long-form report may include comparative summaries of balance sheets, comparative summaries of income or profit and loss statements, the aging of receivables and payables, an application of funds statement, a summary of insurance coverage, comments on results of operations and balance sheet items, and more details with respect to the scope of examination.

The short-form type report, recommended by the American Institute of Accountants in the 1936 bulletin, "Examination of Financial Statements," has been subject to numerous revisions in wording. However, the suggested form has always consisted of two paragraphs - one outlining the scope of the examination made in general terms and the other stating the independent auditor's opinion regarding the fairness of the financial statements. In February, 1941, the following report was recommended by the Committee on Auditing Procedure:

> "We have examined the balance-sheet of the XYZ Company as of February 28, 1941, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.
>
> "In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at February 28, 1941, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."[1]

---

[1]Committee on Auditing Procedure, "The Revised S. E. C. Rule on 'Accountants' Certificates,'" Statements on Auditing Procedure No. 5, pp. 40-41.

The Committee on Auditing Procedure recommended further changes in the accountant's short-form report or certificate after members attending the annual meeting of the American Institute of Accountants in September, 1948, formally approved the summary of auditing standards, which have been previously discussed, and in the same resolution stated that reference to "generally accepted auditing standards" shall be deemed to refer to said summary. In view of the official status thus given the term "generally accepted auditing standards," it was believed to be no longer necessary to refer to having "reviewed the system of internal control" in the certificate since reviewing the system of internal control is one of the auditing standards. It was believed no longer necessary to specifically state that a detailed audit of the transactions has not been made since the words "and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances" clearly indicates the test nature of the examination. The inconsistent phraseology relating to auditing standards applicable in the circumstances was corrected by omitting the words "applicable in the circumstances," and simply saying "Our examination was made in accordance with generally accepted auditing standards." The revised short-form report as recommended in October, 1948, is shown below:

> "We have examined the balance-sheet of X Company as of December 31, 19__ and the related statement(s)

> of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> "In our opinion, the accompanying balance-sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19__, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."[2]

The certificate quoted above is used if the independent auditor in his judgment is satisfied that the financial statements present fairly the financial position and results of operations. This is known as an unqualified report.

Under certain circumstances, the independent auditor may qualify his report or disclaim an opinion altogether in accordance with a report of the Committee on Auditing Procedure which was adopted by the membership of the American Institute on September 19, 1939, which stated, in part:

> "The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary."[3]

---

[2]Committee on Auditing Procedure, "Revision in Short-Form Accountant's Report or Certificate," Statements on Auditing Procedure No. 24, p. 164.

[3]Committee on Auditing Procedure, "Extensions of Auditing Procedure," Statements on Auditing Procedure No. 1, p. 5.

If he has found violations of accepted accounting principles or there has been inconsistency in their application, or if he has not been able to carry out certain auditing procedures normally considered necessary, the auditor must weigh the significance of his exceptions or reservations and judge whether the matter in question is of sufficient importance to prohibit the expression of an opinion on the statements taken as a whole. If the exceptions are not such as to negative the opinion, he may indicate his exception or qualification and express the opinion that the statements fairly present the financial position and results of operations subject to such exception or qualification. An illustration of a qualified opinion with respect to an inconsistency in the application of accounting principles follows:

> "As stated in the notes to the financial statements, the company changed its methods of computing depreciation, effective January 1, 19__. This change, which we approve, resulted in an increase of $______ in the depreciation provision for the year and a corresponding decrease in net worth for the year.
>
> "In our opinion, ... present fairly .... in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year, except for the change in the method of computing depreciation referred to in the preceding paragraph."[4]

---

[4]Research Department, American Institute of Accountants, <u>Audits By Certified Public Accountants</u>, p. 20.

If exceptions are such as to negative the opinion on the statements taken as a whole, the auditor should clearly indicate that he is not expressing an opinion and state why.[5] The following wording might be used in the report in such cases:

> "The terms of our engagement did not include the verification of accounts receivable by direct correspondence, nor did it include the physical observation or price tests of inventories and we did not satisfy ourselves in regard to these assets by other means. Nothing came to our attention during the examination which would indicate that these items are not stated fairly. However, in view of the materiality of these assets, we are unable to express an opinion on the over-all representations in the attached statements."[6]

It should be remembered that the financial statements are the representations of the company, and the fact that they are audited by an independent certified public accountant does not relieve the management of the primary responsibility for the fairness of the information presented. This point is emphasized by the following paragraph from Statement on Auditing Procedure No. 22:

> "As has been frequently enunciated by the American Institute of Accountants, the financial statements are primarily the statements and representations of the company. The fact that the statements are accompanied by the report of an independent public accountant does not alter

---

[5]Committee on Auditing Procedure, "Clarification of Accountant's Report When Opinion Is Omitted," Statements on Auditing Procedure No. 23 (Revised), p. 162a.

[6]Research Department, American Institute of Accountants, op. cit., p. 33.

the situation. The accountant's representations are confined to and expressed in his report, or opinion, upon the statements. The transactions with which the accounting records have to do, and the recording of those transactions in the books and accounts are matters within the direct or primary knowledge of the company. The accountant's knowledge of them is a secondary one, based on his examination. Accordingly, even though the form of the statements may show the influence of the accountant - it can only do so if the company accepts, and adopts, the form of disclosure advised by the accountant - the substance of the financial statements of necessity constitutes the representations of the company."[7]

Furthermore, the Securities and Exchange Commission has said:

> "The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting."[8]

---

[7]Committee on Auditing Procedure, "References to the Independent Accountant in Securities Registrations," Statements on Auditing Procedure No. 22, pp. 153-154.

[8]Ibid., quoting from 4 SEC 721 (1939), p. 154.

CHAPTER VII

AUDITING PROCEDURES

Auditing procedures have been described previously as the acts performed in attaining or complying with generally accepted auditing standards applicable to field work. The procedures employed by the auditor depend upon the degree of internal control as well as other circumstances in each individual case and upon his exercise of judgment as to the procedures which are necessary.

The elements of "materiality" and "relative risk" are important factors in the auditor's determination of the necessary procedures and the extent of their application. The independent auditor should have stronger evidence to support an opinion concerning items which are relatively more important and consequently more susceptible to material error than less important items. For example, a manufacturing concern may have relatively few, but large, individual accounts receivable; whereas, a public utility probably would have a relatively large number of accounts receivable with small individual balances. The risk of a material error would be much greater in the case of few, but large, accounts receivable, and the independent accountant would more than likely communicate directly with each debtor asking him to confirm the balance owed. Under circumstances of good internal control, the "mass" accounts receivable balances of the public utility would be reliable for financial statement purposes, and confirmation of a very small proportion of the accounts would be sufficient as a test of internal control.[1] Accounts receivable in either case would entail a much greater expenditure of time than a less material item such as prepaid insurance. The degree of risk involved with regard to cash and marketable securities requires more exacting procedures than do other items. The relative risk of error depends to a great extent upon the functioning of the system of internal control. When the internal check and control is effective, the risk is smaller, and less extensive detail work is required.

Auditing procedures are so numerous and vary so widely in each examination that any particular list of procedures could be applied to only a narrow field. However,

---

[1]Committee on Auditing Procedure, "Confirmation of Public Utility Accounts Receivable," Statements on Auditing Procedure No. 14, p. 98.

since certain extended procedures with regard to examination of inventories and receivables have been formally adopted by the membership of the American Institute of Accountants, they deserve considerable emphasis. In the 1936 bulletin, "Examination of Financial Statements," direct communication with the debtor was recognized as the best verification of accounts receivable, but was mentioned as a "course which may be taken after arrangement with the client."[2] The testing of inventory quantities was likewise mentioned as a possible procedure by special arrangement with the client in the case of a business which did not call for technical knowledge and presented no substantial difficulties.[3] In other words, these procedures were undertaken in some cases after arrangement with the client but were not considered to be generally accepted auditing procedures.

Then the McKesson & Robbins case became public in December, 1938. Assets were overvalued in published financial statements which had been audited by independent certified public accountants. Certain non-existent inventories were included in the financial statements by means

---

[2]American Institute of Accountants, Examination of Financial Statements by Independent Public Accountants, p. 14.

[3]*Ibid.*, pp. 17-18.

of collusion, fraud and forgery on the part of the highest officers of the company. Public accountants were the target for much criticism and were not long in taking steps to improve auditing procedures.

In May, 1939, the council of the American Institute of Accountants adopted the report of the Committee on Auditing Procedure entitled "Extensions of Auditing Procedure." Investors, credit grantors, the press, and the public, as well as certified public accountants, heartily approved the action of the council.[4] The report of May 9, 1939, was modified and approved at the annual meeting in September, 1939. In this report, which is still in effect although it has been subject to several amendments, certain recommended additional procedures were adopted as generally accepted practice wherever they are practicable and reasonable. These recommended procedures were, in part, as follows:

> "(A) That hereafter, where the independent certified public accountant intends to report over his signature on the financial statements of a concern in which inventories are a material factor, it should be generally accepted auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and by suitable

---

[4]Committee on Auditing Procedure, "Extensions of Auditing Procedure," <u>Statements on Auditing Procedure No. 1</u>, p. 1.

observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified public accountant may require physical tests of inventories to be made under his observation....

"(B) That hereafter, in the case of inventories which in the ordinary course of business are in the hands of public warehouses or other outside custodians, direct confirmation in writing from such custodians is acceptable procedure; except that, where the amount involved represents a significant proportion of the current assets or of the total assets of a concern, the independent certified public accountant shall make supplementary inquiries....

"That hereafter, wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of confirming receivable in each engagement, and whether all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment."[5]

"Extensions of Auditing Procedure" required a clear-cut exception in the accountant's certificate if inventories and/or receivables were material and the independent auditor omitted the foregoing generally

---

[5] _Ibid._, pp. 6-8.

accepted procedures where practicable and reasonable in the circumstances. If in his judgment the additional procedures were not practicable and reasonable and he satisfied himself by other methods regarding inventories and/or receivables, he was not required to state an exception or qualification. There would be few cases where such procedures would not be practicable - that is, not capable of being put into practice - but there are cases where the procedures would not be practicable in the light of being reasonable or sensible. For example, the cost of carrying out the procedures could be so great in relation to the possible benefit that the tests could be considered impractible in the sense of being unreasonable. An illustration of a strictly impracticable procedure was the confirmation of receivables from United States Governmental departments and agencies because they rarely confirmed amounts stated in requests for confirmation during World War II.

Although the independent certified public accountant must still decide whether it is practicable and reasonable to be present at the inventory-taking and to confirm accounts receivable by direct communication with the debtors, he no longer has a choice of whether to make an exception or qualification in his report, as was implied, when it was stated in the previous paragraph that "he was not required to state an exception or qualification." According to the supplemental report of the Committee on Auditing Procedure, which was formally approved at the annual meeting of the American Institute of Accountants on October 1, 1942, disclosure is now required in all cases where these extended procedures are not carried out, regardless of whether they are practicable and reasonable, and regardless of whether the independent auditor has satisfied himself by other methods.[6] The purpose of this amendment was to avoid the appearance of different standards between listed and unlisted companies since the Securities and Exchange Commission had made such disclosure mandatory in reports filed with the Commission.[7]

With regard to the auditing procedures in connection with inventories, it should be noted that the auditor is not a general appraiser, valuer, or expert in materials and does not assume such responsibility. "Such procedures are only for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition."[8] Where adequate perpetual

---

[6]Committee on Auditing Procedure, "Amendment to Extensions of Auditing Procedure," <u>Statements on Auditing Procedure No. 12</u>, pp. 87-89.

[7]Securities and Exchange Commission, <u>Accounting Series Release No. 21</u>, Rule 2-02 (b) (1) of Regulation S-X.

[8]Committee on Auditing Procedure, "Extensions of Auditing Procedure," <u>Statements on Auditing Procedure No. 1</u>, p.6.

inventory records are kept, the necessary procedures may be undertaken at an interim date rather than at the balance sheet date for the purpose of determining the reliability of the perpetual inventory records. If a physical inventory is the only means of determining the inventory, the procedures have to be carried out at the balance sheet date or within a short time thereof where there are adequate records supporting the changes.

It should be remembered that the method, extent, and time of confirming receivables in each examination are determined by the individual auditor. Either the "positive" method or the "negative" method or a combination of both may be used to communicate directly with the debtor. If the "positive" method is used, the communication, usually a form letter, is addressed to the debtor requesting him to reply directly to the independent auditor and confirm the accuracy of the balance shown or explain any differences. The form letter is mailed by the auditor and bears his return address on the envelope in order that those undelivered will be returned to him to be investigated for their reliability. If the "negative" method is used, a sticker is usually attached to the regular statements at the end of a period, or a rubber stamp is imprinted on the statements, requesting that a reply be made directly to the auditor only in case the balance on the statement is incorrect.

They would also be mailed by the auditor in envelopes bearing his return address. Confirmation of accounts receivable may be performed at a date other than that of the balance sheet to afford a test of the reliability of accounts receivable as to bookkeeping accuracy and to provide a check on fictitious accounts. Concerning the method to be used, the Committee on Auditing Procedure has said:

> "In cases in which there is reason to believe that the possibility of disputes, inaccuracies or irregularities in the accounts is greater than usual, or where the balance involved is of outstanding materiality, it is probably desirable that the 'positive' method of confirmation be adopted. For example, it is generally customary to use the 'positive' method of confirmation in the case of receivables of stock brokerage houses. Also, where a company sells a substantial portion of its output to one, or only a few, customers, so that the balances involved are of relatively major importance, the 'positive' method of confirmation would seem preferable.
>
> "On the other hand, it is the opinion of the committee that the 'negative' type of confirmation is in accordance with generally accepted auditing standards and practice in the majority of circumstances, and that an independent public accountant using this method of confirmation, where there are no indications that it may be inadequate, is conforming with generally accepted auditing standards.
>
> "Not infrequently independent public accountants employ both the 'positive' and 'negative' methods upon the same engagement - the 'positive' as to accounts where a definite reply may be deemed desirable and the 'negative' as to accounts where this consideration does not apply."[9]

---

[9]Committee on Auditing Procedure, "Confirmation of Receivables (Positive and Negative Methods)," Statements on Auditing Procedure No. 19, pp. 132-133.

Since auditing procedures vary so widely and the procedures applied depend upon the circumstances in each individual examination, the Committee on Auditing Procedure requested that members of the American Institute of Accountants prepare case studies describing in detail the circumstances and procedures actually followed on a particular engagement as a means of illustrating typical procedures by which the independent auditor complies with generally accepted auditing standards. Nine such case studies have been accepted and published as of this date. The following case study describes the work performed by the writer in auditing a wholesale automobile parts and supplies dealer.

CHAPTER VIII

A CASE STUDY OF AN AUDIT OF A WHOLESALE AUTOMOBILE PARTS AND SUPPLIES DEALER

DESCRIPTION OF BUSINESS

The wholesale automobile parts and supplies dealer chosen for this study is located in a city of approximately 200,000 - 250,000 population. Sales are made over the counter, by telephone, and by salesmen to service stations, automobile dealers, other parts and supplies dealers, and to commercial fleet accounts. The salesmen cover Virginia, West Virginia, North Carolina, and South Carolina. The greater portion of sales are made in one state. Deliveries are made in the city in company trucks; out of the city by parcel post, railroad, and motor freight. The parts and accessories sold vary from tires and grilles to nuts and bolts. The client is an exclusive distributor of a reputable line of tires, tubes, batteries, fan belts and radiator hose for a territory covering the four states. A complete line of automobile grille guards is stocked on a consignment basis. However, no parts and supplies are out on consignment.

The officers of the corporation are the sole stockholders and devote their full time to operation of the business. The president is considered general manager and does the majority of the buying. The vice president, who is also the sales manager, is wholly responsible for the supervision of the salesmen and assists in the buying. The secretary-treasurer supervises the office employees; makes all entries in the general ledger, cash book, general journal, and payroll records; and is in charge of credits and collections. However, each officer consults the others in all matters of importance.

The corporation has three salesmen employed in the city in which the business is located and four in the remaining territory. There are six store and warehouse employees and two office employees.

In order to show the size of tho corporation and the accounts involved, a somewhat disguised balance sheet and profit and loss statement follow:

BALANCE SHEET

June 30, 1950

A S S E T S

CURRENT ASSETS:			
Cash		$ 10 000 00	
U. S. Treasury Notes - Series "D"		1 000 00	
Accounts Receivable - Trade	$ 55 000 00		
Less: Reserve for Bad Debts	5 000 00	50 000 00	
Commissions Receivable		2 500 00	
Suppliers' Debit Balances		50 00	
Merchandise Inventory (At Lower of Cost or Market)		100 000 00	
Prepaid Expenses:			
Insurance	$ 1 000 00		
Taxes and Licenses	500 00	1 500 00	
Total Current Assets			$165 050 00
OTHER ASSETS:			
Due from Employees		$ 200 00	
Cash Surrender Value of Life Insurance		5 000 00	5 200 00

FIXED ASSETS (Land and Buildings Subject to Deed of Trust Securing Mortgage Payable):

	Cost	Depreciation	Book Value	
Land	$ 10 000 00	$ -	$ 10 000 00	
Buildings	40 000 00	20 000 00	20 000 00	
Furniture and Fixtures	6 000 00	3 000 00	3 000 00	
Delivery Equipment	8 000 00	4 000 00	4 000 00	
Totals	$ 64 000 00	$ 27 000 00	$ 37 000 00	37 000 00
				$207 250 00

LIABILITIES AND CAPITAL

CURRENT LIABILITIES:			
Accounts Payable - Trade Creditors		$ 60 000 00	
Mortgage Payable - Due Currently (Below)		1 200 00	
Customers' Credit Balances		250 00	
Employees' Withholding Taxes		500 00	
Accrued Salaries and Bonuses		10 000 00	
Accrued Interest		10 00	
Accrued Taxes:			
Federal Income Taxes	$ 3 000 00		
State Income Tax	600 00		
Payroll Taxes	640 00		
Property Taxes	100 00	4 340 00	
Total Current Liabilities			$ 76 300 00
LONG-TERM INDEBTEDNESS:			
4-1/2% Mortgage Payable (Secured by Deed of Trust on Land and Buildings) (Payable in Monthly Installments of $200.00, Including Principal and Interest; Last Payment Due January 1, 1959):			
Original Amount		$ 30 000 00	
Less: Amount Retired		15 000 00	
		$ 15 000 00	
Less: Amount Due Currently (Above)		1 200 00	13 800 00
CAPITAL:			
Capital Stock (Par Value - $100.00;			
Authorized - 1,000 Shares):			
Issued and Outstanding - 500 Shares		$ 50 000 00	
Earned Surplus (Since Date of Incorporation):			
Balance - July 1, 1949	$ 55 150 00		
Add: Net Profit for Year	12 000 00	67 150 00	117 150 00
			$207 250 00

PROFIT AND LOSS STATEMENT

For the Year Ended June 30, 1950

SALES - NET		$365 000 00
COST OF SALES:		
Inventory - July 1, 1949	$ 66 000 00	
Purchases	285 000 00	
Freight	4 000 00	
	$355 000 00	
Less: Inventory - June 30, 1950	100 000 00	
Cost of Sales		255 000 00
Gross Profit		$110 000 00
EXPENSES		99 400 00
Profit on Operations		$ 10 600 00
OTHER INCOME:		
Commissions Earned	$ 5 000 00	
Discounts Earned	4 000 00	9 000 00
		$ 19 600 00
OTHER DEDUCTIONS:		
Discounts Allowed	$ 2 500 00	
Life Insurance Expense	1 500 00	4 000 00
Profit before Income Taxes		$ 15 600 00
INCOME TAXES:		
Federal	$ 3 000 00	
State	600 00	3 600 00
NET PROFIT FOR YEAR		$ 12 000 00

MAJOR ACCOUNTING POLICIES

The corporation maintains its records on an accrual basis and has a fiscal year ending June 30. Monthly balance sheets and profit and loss statements are prepared for the guidance of the management.

Cash received is deposited intact in the corporation's only bank account with the exception of cash paid out for cash sales returned. Small expenses are paid out of the petty cash fund. All other payments are made by checks.

Notes and accounts receivable are carried at the actual amounts due from debtors exclusive of interest receivable which is accrued only at the end of the fiscal year. The reserve for doubtful accounts is increased each month by a percentage of net sales for the month. The percentage used has been determined from experience. Accounts receivable are charged to the reserve for bad debts when determined to be uncollectible by the management. Collection costs are also charged to the reserve for bad debts, and collections on accounts previously charged off are credited to the reserve for bad debts. The balance shown in the reserve account is adjusted at the end of the year to a reasonable amount in view of the actual age of notes and accounts receivable. The aggregate amount of customers' credit balances is classified in the balance sheet as a current liability.

Commissions received from suppliers for warehousing services and in connection with sales to jobbers are recorded upon receipt of cash during the year. Uncollected commissions are accrued at June 30.

The opening merchandise inventory remains on the books throughout the year without adjustment. The closing inventory at the end of each month is estimated and used for the purpose of preparing the monthly statements. A perpetual inventory record of tires, representing approximately thirty per cent of the total merchandise inventory value, is maintained as a control over this item and as an aid to management in purchasing. At the end of the year a physical count of merchandise inventory is made, and the inventory is priced at the lower of cost or market, cost being determined on a "first-in, first-out" basis. Obsolete merchandise is priced at a realizable value, and no inventory reserve is provided. Merchandise in transit at June 30 is included in the inventory, and the related liability is included in accounts payable.

A memorandum inventory of grille guards received on consignment is also maintained. No entry is made in the books of original entry until the sale is recorded, at which time the liability to the consignor is also recorded, and the cost of the merchandise is charged to purchases.

Prepaid expenses are recorded at their cost to the corporation and are amortized on a monthly basis over the applicable period. Insurance, taxes and licenses are the usual prepaid expenses.

Cash advances to employees are recorded in a separate account in the general ledger and shown in the balance sheet under the other assets caption.

In connection with a stock repurchase agreement, the corporation is the beneficiary of insurance policies on the lives of the officers who are also the stockholders. The premiums paid by the corporation are expensed and the increase in cash surrender value recorded as of June 30 each year. The cash surrender value is shown under other assets in the balance sheet. It is not shown as a current asset since there is no intention of realizing the cash value of any of these policies prior to the death of a stockholder.

The fixed assets are carried at actual cost to the corporation. The ledger accounts are supported by a detailed record showing the cost basis and the depreciation taken on each fixed asset. Depreciation is provided on each individual item, using the straight-line method of depreciation at rates which the Bureau of Internal Revenue has allowed.

Current liabilities consist of accounts payable to trade creditors and other usual liabilities arising in the normal course of business, including accrued liabilities such as interest and taxes. The total payments due currently (within one year) on the mortgage payable are shown under current liabilities while the remainder is shown in the balance sheet under the long-term indebtedness caption.

Capital stock outstanding is carried at par value. The earned surplus account represents the accumulated excess of profits over dividends paid since the beginning of corporate operations. It is the policy of the corporation to make minor adjustments of prior years' earnings through the operation accounts rather than through surplus.

The principal accounting records and their contents are as follows:

> The general ledger contains the asset, liability, reserves for bad debts and depreciation, capital stock, surplus, income and expense accounts.
>
> The combination cash book and sales journal provides for the recording of the summarized cash receipts, net cash sales, and net charge sales by daily totals; deposits in bank; and all disbursements by check and their distribution to the proper asset, liability, income and expense accounts.
>
> The received-on-account journal provides for the listing of the payments received on accounts receivable and shows the discounts allowed.
>
> The purchase journal provides for the recording of each merchandise purchase invoice and credit memorandum and its distribution to accounts payable, purchases and freight.
>
> The general journal is the book of original entry for miscellaneous entries not covered above, such as monthly entries for depreciation and prepaid and accrued items.
>
> The accounts receivable trays contain the individual customer accounts on cards which are machine posted.

The accounts payable ledger contains the record of the corporation's account with each supplier.

The employees' earnings book contains an account with each employee reflecting his gross earnings, deductions, and net earnings.

PREPARATORY PLANNING OF WORK

This engagement consisted of the annual examination of the books and records of the corporation, preparation of the balance sheet as of June 30, 1950, and the related statement of profit and loss for the year then ended, preparation of the corporation's federal and state income tax returns, and presentation of the audit report to the officers and directors.

Prior to the close of the fiscal year the partner in charge of this engagement discussed with the president and secretary-treasurer of the corporation any important changes made during the year in the corporation's operating policies, accounting records, or system of internal control. He also arranged for a specific starting date which was in the middle of June.

Since the space in the client's office was limited and one man could do the work in approximately three weeks, the partner informed the staff accountant who was to make the audit of the starting date and discussed with him any new problems which were known and any phases of the examination which were to be given more or less attention than in the preceding year. Little more needed to be done in the way of preparatory planning since the staff accountant had performed the audit for several preceding years and was already familiar with the operations and accounting policies and practices of the corporation. He reviewed the permanent file and the work papers of the preceding year and prepared a schedule of the work to be done with a column to use to "check off" the procedures accomplished. This was important, first, to be sure that some necessary procedure was not unintentionally omitted; and, secondly, to have a written record of the work done so that someone else, if it became necessary, could complete the audit without the difficulty of not knowing what had already been done.

While preparing the work schedule, procedures which could be done conveniently before the end of the fiscal year were noted. Examples of such procedures follow:

1. Examination of cancelled checks
2. Tracing of cash receipts to the record of deposit in bank
3. Tests of footings
4. Tests of postings from books of original entry to the general ledger
5. Examination of invoices and other evidences for disbursements
6. Tests of sales invoices

Approximately thirty-five per cent of the total time on this audit was devoted to auditing procedures prior to June 30.

AUDIT PROCEDURES APPLIED

SALES AND OTHER INCOME

Prenumbered sales tickets are written in triplicate for both cash and charge sales on sales register machines which allow the triplicate copy to fall into the bottom compartment of the sales register. However, since these are not locked, no measure of internal control is afforded. The customer receives one copy. The original is run through the cash register which imprints on the sales ticket the date, amount rung-up, and indicates whether it is a charge or cash sale. In this manner, all sales are recorded on the cash register tape. Cash received on account over the counter is also rung-up on the cash register by one of the employees behind the counter. The incoming mail is opened by the treasurer, who lists the names of the customers and the amounts received on account in a journal before ringing them up on the cash register. This journal becomes the basis for the credit entry to the individual accounts receivable. He makes a separate entry in the cash book for any other income such as commissions or refunds.

When merchandise is returned or allowances are made, the regular sales ticket is used as a credit memorandum by checking an appropriate square on the ticket which is signed by any person receiving cash. The person receiving the returned merchandise also initials the credit memorandum.

Either the president or vice president reviews the credit memorandums daily and questions anything he did not already know about. Cash is paid out of the cash register only for sales returns and allowances and the net sales are recorded on the books.

At the close of the day one of the officers counts the cash in the drawers and compares the total with the cash register tape which shows the total cash received by drawers. Each man behind the counter has a separate drawer for which he is responsible. The tape also gives separate totals for charge sales, total sales, collections on accounts receivable, and paid outs. The following morning a clerk in the office adds the cash sales tickets, charge sales tickets, and paid out tickets separately. These totals are compared with the cash register tape and reconciled if not in agreement. The cash register tape becomes the basis for the entry in the combination cash book and sales journal. The clerk is also responsible for checking extensions and additions on the sales tickets. The president or vice president, depending upon which is available, checks the pricing on the sales tickets and, at the same time, reviews the sales returns. In addition the treasurer scans the sales invoices each day for anything unusual. Accountability for the sales tickets, which are not filed numerically, is accomplished by a test check of a thousand numbers about four times a year by the treasurer.

The original cash sales and charge sales tickets are filed separately as to dates with adding machine tapes attached for each daily total. The triplicate copies are filed according to salesmen and used in computing salesmen's commissions.

Sales were tested in the following manner:

1. The daily cash register tapes were examined and the amounts thereon traced to their proper recording in the cash book for November and April.

2. Where the amounts were not the same, a reconciliation had been made on the cash register tape. The auditor verified this reconciliation by examination of the sales tickets. Usually an error had been made in ringing-up an amount or a ticket had not been rung-up, resulting in cash being over before a reconciliation was made. Since the discrepancies were small in amount and appeared to be normal errors, two months were considered a sufficient test of the register tapes and sales tickets.

3. It was noted that the sales tickets had been checked as to extensions and footings, and the president informed the auditor that he or the vice president had checked the pricings. It was further observed during the course of the audit that the company's procedures previously described were being followed.

4. That a proper cut-off of sales had been made at the end of the year was determined by tracing the June 30 cash register tape to the cash book where it was the last entry to sales for the year.

In view of the direct internal control over the employees and the further control afforded by the presence of the officer-stockholders supervising and actively participating in even the smallest details of the business, it was believed that the audit procedures followed constituted a sufficient test to assure reliability of the recording of sales and cash receipts. The auditor relied upon comparison with previous years and the officers participation for the proper computation and recording of sales commissions received and miscellaneous income. Any unusual items were noted and a satisfactory explanation received.

Testing of sales required approximately three per cent of the total time to complete the entire audit, including the preparation of the audit report.

CASH

All cash receipts and disbursements are recorded in the cash book. The recording of cash receipts and cash paid out for returned merchandise has been discussed in connection with sales. Small cash expenses are paid out of the petty cash fund and distributed in the cash book to the proper accounts when the check reimbursing petty cash is entered. All other payments, including salaries and wages, are made by prenumbered checks and recorded in the cash book. A checkwriting machine is used to record the amount on each check issued, and the signatures of any two officers are required. Blank checks are not signed in advance.

The auditor considered it necessary to make a comprehensive examination of cash transactions for the entire year because of the lack of internal control resulting from one individual, the treasurer, reconciling daily cash receipts, making deposits to the bank account, preparing checks and being a co-signer of checks, making the bank reconciliation, and having control over all books and records. The following audit procedures were adopted:

1. All checks issued during the year were examined as to date, payee, amount, signatures, endorsements, and cancellation by the bank. All check numbers were accounted for and voided checks were inspected. Notes were made of unusual checks and supporting evidence examined later.

2. Deposits as recorded in the cash book for the year were traced to the record of their deposit on the bank statements. The amounts shown by the cash register tapes were traced to their daily entry in the cash book for two months.

3. All of the cash columns and crossfootings in the cash book were added for the entire year, and all other columns in the cash book were footed for two months during the year.

4. All postings to the cash on hand and cash in bank accounts in the general ledger were checked. The opening balances were compared with the audit report for the previous year. The accounts were footed and the balances compared with the bank reconciliation and count of cash.

5. We prepared our own bank reconciliation and obtained direct written confirmation from the bank regarding the corporation's balance at June 30.

6. At the close of business on June 30, we counted the cash on hand and petty cash. Particular attention was paid to the composition of the undeposited cash receipts on hand to determine that none of the checks were old checks which might have been held for some time. The total of the cash on hand was compared with balance shown on the cash register tape which was reconciled with the copies of the counter cash sales and collections tickets.

7. The cash in the imprest petty cash fund and the unreplenished receipts were listed indicating the dates upon which the disbursements were made. In this case the disbursements, which had been made after the June 30 replenishment check was drawn, were so small that no audit adjustment was considered necessary. We examined the receipts supporting the petty cash disbursements for one month paying particular attention to the dates and the appearance of authenticity. This was a difficult task since the receipts, most of which were freight invoices, were filed with the invoices for the merchandise purchased.

Approximately fifteen per cent of the total audit time was required to audit the cash accounts, and the auditor was assured that all recorded cash receipts and disbursements had been properly accounted for.

U. S. TREASURY NOTES

There had been no change in this account during the year. The U. S. Treasury Notes were inspected after the balance sheet date and the serial numbers compared with those shown in the auditor's working papers of the preceding year to assure that no substitutions had been made. The interest accrued during the year was computed and an adjusting journal entry prepared.

NOTES RECEIVABLE

Notes receivable did not appear in the accounts during the year under review. However, notes received from one customer during the year had been discounted at the client's bank immediately and the transaction recorded in the cash book as a debit to cash and credit to accounts receivable.

The details of the unpaid notes as to amounts and due dates were confirmed by the bank directly to the auditor who disclosed the corporation's contingent liability in a note on the balance sheet.

ACCOUNTS RECEIVABLE

Charges and credits to individual customers' accounts are machine posted in one operation to the ledger cards and monthly statement forms from the charge sales tickets and credit memorandums and from the received-on-account journal. The customers' accounts are "controlled" by a summary account in the general ledger. A clerk posts the usual transactions to accounts receivable; but unusual postings, such as the write-off of uncollectible accounts or any postings from the cash book, are made by the treasurer.

The following procedures were applied in the verification of accounts receivable:

1. Negative confirmation stickers were attached to the statements at June 25 and mailed to the customer by the auditor in envelopes bearing his return address. The sticker requested the customer to notify the auditor giving details of differences if the statement was not correct. Only a few replies concerning minor differences were received, and these were satisfactorily accounted for. Copies of the statements, detached at the time of mailing, and the delinquent accounts in the hands of attorneys to whom statements were not mailed were totaled and compared with the amount appearing on the general ledger control.

2. The copies of the statements were kept by the auditor until after June 30 and compared with the ledger accounts. At the same time the accounts were analyzed according to age as of June 30.

3. A reconciliation of the June 25 general ledger control balance with the June 30 control balance was prepared by adding the charge sales and subtracting collections on account as shown by the cash register tapes for the five days.

4. The delinquent accounts as shown by the aging schedule were reviewed with the president and treasurer, and it was ascertained that the reserve for bad debts appeared sufficient. Delinquent accounts in the hands of attorneys were verified by examination of the corporation's file of correspondence with the attorneys.

5. The reserve for bad debts was analyzed, and the accounts charged off were listed and reviewed with the president.

6. All journal entries to the general ledger control were scrutinized,and where necessary, approval for the entries obtained from the president.

7. Accounts receivable having credit balances representing overpayments and credits for returned merchandise,were segregated and shown under current liabilities on the balance sheet.

These procedures consumed approximately eighteen per cent of the time applied to the entire audit.

MERCHANDISE INVENTORY

The inventory at June 30 was a very significant asset since it represented almost fifty per cent of the total assets and over sixty per cent of the current assets. The management informed us that inventory was to be taken in the usual manner commencing on Thursday, June 29, and would be completed on Sunday, July 2. The business was closed on July 1 and 2. On Thursday and Friday a few employees were allowed to commence counting the items which were stored in other buildings and not expected to be moved prior to July 3. Also, some of the small, difficult-to-count, and relatively immaterial items were counted. Throughout the inventory-taking it was observed that the president was directing the inventory crews and keeping careful check on the results. From Friday night until the physical inventory was completed Saturday night, practically all of the employees were engaged in this operation.

The auditor personally counted the automobile grille guards on consignment at the close of business June 30 and signed and mailed special inventory forms to the consignor at the request of the management. Later, a statement through June 30 from the consignor for the grille guards sold was compared with the amount recorded as payable to the manufacturer on the client's books and found in agreement.

It should be remembered that an accurate inventory is the company's responsibility. The independent auditor's responsibility is to satisfy himself as to the credibility of the management's representations by investigating the care and accuracy of the count, the propriety of pricing methods and bases, and the accuracy of the extensions and footings. On this engagement the following tests and procedures were adopted:

1. On July 3, with all of the inventory pages in hand, the auditor tested the inventory count. Numerous items having small value were checked, but particular attention was paid to locating items having large dollar value and counting them. Items in hidden corners and out of the way places were also counted and located on

the inventory as a check that no merchandise had been overlooked. Approximately sixty per cent of the total inventory value was tested.

2. While testing the count, the president pointed out obsolete and slow-moving merchandise for which due allowance was to be made in pricing.

3. Prior to returning the inventory pages to the management for pricing, extending, and addition, the auditor listed the major items which had been counted, listed items from each page which had not been tested, and made notations of incomplete pages. The auditor traced these items to the completed inventory at a later date in order to assure himself that the quantities had not been changed nor other items added.

4. After the pricing, extending, and footing of the inventory was completed, sufficient tests of the prices were made by comparison with price lists and invoices to satisfy the auditor that the inventory was priced at the lower of cost or market on the first-in, first-out method which was consistent with the preceding year. It was also noted that obsolete or slow-moving merchandise was valued at lower than cost by the management since the company was already selling it at a figure lower than cost.

5. Extensions of each of the larger amounts were tested and all extensions were scanned.

6. Each page of the inventory was added and the total of all the pages was compared with the company's total.

7. The necessary journal entry to adjust the inventory account in the general ledger was made.

The inventory procedures required approximately twenty per cent of the total audit time.

PREPAID EXPENSES

A schedule of prepaid insurance and insurance coverage was prepared by the auditor from information obtained by inspection of the insurance policies. The following data concerning each policy was included in the schedule:

1. Policy number
2. Name of the insurance company
3. Coverage
4. Coinsurance clause (if any)
5. Effective date
6. Expiration date
7. Premium
8. Monthly premium
9. Months unexpired
10. Unexpired portion of premium at June 30

The premiums shown on the schedule as applicable to the year under review were compared with the entries in the insurance and prepaid insurance accounts to determine that all policies and endorsements had been examined. Notation of any refunds were made and traced to the cash book. Particular note was made that no coverage was afforded for stock at locations other than where the inventory had been tested and that coverage was not afforded any asset not recorded on the books. The adequacy and changes in insurance coverage were discussed with the officers. A small adjustment to prepaid insurance was made, and the total of the monthly premiums given to the treasurer for use as a monthly adjusting entry unless a significant change occurred in the next year.

Prepaid taxes and licenses were verified when the taxes and licenses account was analyzed.

Verification of prepaid expenses took approximately one per cent of the time required for the entire examination.

DUE FROM EMPLOYEES

This account represented loans to employees. Since the amounts were insignificant, they were not verified beyond a listing of the amount loaned to each employee which was later approved by the president.

CASH SURRENDER VALUE OF LIFE INSURANCE

The life insurance policies were inspected and a schedule prepared showing the amount of insurance on the life of each officer. It was particularly noted that the corporation was the beneficiary. The insurance agent had furnished the corporation with written details as to the cash surrender value of the insurance policies as of June 30, and the auditor had the opportunity to discuss the policies with the insurance agent during the course of the examination. The insurance company's figures were the basis for a journal entry adjusting the cash surrender value of life insurance to record the increase during the year.

FIXED ASSETS

The fixed asset accounts, after deducting the related reserve accounts, comprised approximately eighteen per cent of total assets. The assets included were land, buildings, store and office furniture and fixtures, and delivery equipment. Analyses of these accounts were prepared showing the balances at the beginning of the year, the sales and retirements during the year, and the balances at the end of the year.

There was no change in the land and buildings accounts. Their cost had been verified in prior years by the purchase contract, cancelled checks, the minutes of the board of directors, copies of the deeds of trust, and the lawyers' title insurance policy. It had been ascertained that in apportioning part of the total cost to land the ratio of the assessed valuation of land for real estate tax purposes to the total assessed valuation had been used, this being one of the generally accepted methods.

All invoices supporting additions to furniture and fixtures and delivery equipment were examined. It was determined that the trade-ins of an automobile and truck and the profit on sale of a Toledo scale had been properly recorded and that the fixed asset and related depreciation reserves had been properly adjusted to reflect these disposals. The titles to all automobiles and trucks were examined and compared with those shown on the depreciation schedule.

An analysis of the repairs and maintenance account was prepared and the paid invoices examined for items exceeding $40.00. None was found which should have been capitalized.

The depreciation schedule is carried forward from the auditor's working papers from one year to the next. The rates of depreciation are the same as those used for Federal income tax purposes. After depreciation for the year was computed, a journal entry was made to adjust depreciation expense for the year and the related reserve accounts on the corporation's books.

The verification of fixed assets and the computation of depreciation required approximately five per cent of the total audit time.

ACCOUNTS PAYABLE - TRADE CREDITORS

The date of the invoice, name of the creditor, and amount of the invoice are entered in the purchase journal only for merchandise and only after receipt of the merchandise. Postings are made from the purchase journal to the subsidiary accounts payable ledger. Expenses are recorded when payment is made, usually in the month following that in which the expenses are incurred.

Accounts payable were substantiated as follows:

1. A list of merchandise creditors was prepared from the accounts payable ledger and the total compared with the control account in the general ledger. Creditors' statements and invoices were compared with the list. Explanations of past due amounts were obtained from the management.

2. The liability for merchandise shipped F. O. B. shipping point prior to July 1 had been included in accounts payable. To assure that a proper cut-off with regards to inventory and accounts payable had been made; the dates of receipt of merchandise, which had been written on the invoices, were noted. The merchandise not received until July was traced to a special list of merchandise in transit prepared by the company and added to the physical inventory.

3. Invoices entered in the purchase journal subsequent to the balance sheet date were reviewed for possible unrecorded liabilities.

4. July payments as recorded in the cash book were compared with the list of accounts payable at June 30. No questionable payments posted to the accounts payable debit column were found. A list was prepared of the items charged to expense and asset accounts in July and the invoices were examined. A journal entry was made to record the June charges and the corresponding liability.

5. Debit balances in accounts payable representing amounts due from suppliers for merchandise returned, price adjustments, etc., were segregated and shown on the balance sheet under current assets.

Verification of accounts payable consumed approximately eleven per cent of the time required for the entire examination.

MORTGAGE PAYABLE

This liability, which was incurred when the land and buildings were purchased in a prior year, was confirmed by direct communication with the insurance company holding the note payable secured by a deed of trust on the land and buildings. The auditor prepared a letter, which was signed by the president, stating the terms of the deed of trust and the unpaid balance as shown by the corporation's books. It further requested that a reply stating that the information was correct be directed to the auditor on an additional copy of the letter enclosed for the convenience of the insurance company.

The portion of the installment payments to be made applicable to principal during the coming year were deducted on the balance sheet and included under current liabilities in accordance with generally accepted practice.

The accrued interest was computed and compared with the amount already shown on the books. It was found by inspection of the interest expense account that the only interest paid during the year was on the mortgage.

OTHER LIABILITIES

Credits to the employees' withholding tax account were compared with the amounts reported to the Collector of Internal Revenue. Debits were traced to the cash book and indirectly the cancelled checks since all payments were evidenced by cancelled checks which had been inspected.

Accrued salaries for the payroll week ended June 30 had not been recorded on the books until paid July 1. The payroll summary sheet for the week was used as the basis to record the accrued salaries by a journal entry. The payroll summary for the week was compared with the amounts actually paid July 1.

A journal entry was also prepared to record the accrued bonus declared by the directors at a June meeting, as evidenced by the corporation's minute book.

Accrued payroll taxes on the balance sheet included employees' and employer's old-age benefits taxes, and state and federal unemployment compensation taxes. These taxes were verified by a detailed reconciliation commencing with the total salaries and wages as shown by the books and deducting amounts over $3,000.00 paid employees, as determined by inspection of the employees' individual earnings book, to arrive at the taxable payroll. The appropriate tax rates were applied to determine the payroll tax expense for the year from which amounts paid during the year, as evidenced by the cancelled checks, were deducted to arrive at the unpaid or accrued amounts. The computed accrual was compared with the book figures which agreed with the amounts actually paid in July. The minor difference in the computed accrual was due to fractions when deducting the employees' share of old-age benefits tax from salaries and wages. The computed payroll tax expense for the year was compared with the amount shown in the analysis of the taxes and licenses account which had been prepared by the auditor.

The city property tax, which was assessed on the basis of a personal property return as of January 1, and filed prior to May 1, was computed and accrued. This tax was a liability at June 30 although not due until the following December 31.

The federal and state income taxes were accrued after the auditor had prepared the corporation's income tax returns.

The procedures appearing under this section took approximately six per cent of the total time of which five per cent applied to the preparation of income tax returns.

CAPITAL

No changes occurred in the capital stock account during the year under review. However, the open stubs in the stock certificate book were listed and compared with the preceding year's list to determine that no transfers had been made. It was noted that revenue stamps were properly attached to the stubs.

That no change had occurred in the earned surplus account during the year was determined by comparison with the audit report for the preceding year. The profit for the year under review was not transferred to earned surplus until the necessary adjustments were given to the company and made after completion of the examination. Review of the minutes had disclosed that no dividends had been declared during the year.

COSTS AND EXPENSES OF OPERATIONS

Recorded expenses for the year under review were compared with the corresponding expenses for the preceding year. Important differences were investigated. For example, the increase in cash discounts allowed was out of proportion to the increase in sales. Investigation revealed that the two per cent discount allowed for payment by the tenth of the following month was not shown on the statements or invoices, and that during the year more customers had discovered that the company would allow the discount if it were claimed. In addition, the discounts allowed column was scrutinized and a list of the larger discounts prepared and the president's approval obtained.

The gross profit rate was compared with the preceding year and found to be almost the same. If there had been a significant variation, investigation as to the reason would have been necessary.

All of the expense accounts were scrutinized as to the source and amount of the postings, and unusually large monthly expenses were investigated. The following expense accounts were analyzed:

1. Contributions and donations
2. General expense
3. Officers' salaries
4. Office supplies and expense
5. Professional fees
6. Repairs and maintenance
7. Taxes and licenses

Contributions and donations were verified by properly endorsed cancelled checks. The invoices were examined for purchased items exceeding a cost of $50.00 included in general expense, office supplies and expense, and repairs and maintenance in order to substantiate both the purchases and the distribution to these expense accounts rather than fixed assets. Officers' salaries were segregated from the salaries and wages account and verified by comparison with the amounts authorized by the board of directors as shown by the minutes. Since attorneys' fees could be an indication that a company was involved in litigation, the statements supporting charges to professional fees were examined. All of the tax bills or receipts were examined to assure that a proper classification of taxes on the income tax returns would be made and that no nondeductible items such as penalties or fines would be included.

As a further test of purchases and expenses all invoices filed in the letters "R" and "S" were inspected and traced to the purchase journal or cash book where the amount was ticked with a colored pencil. The purchase journal and cash book were then scrutinized to see that there were no missing invoices in the letters tested. Whenever invoices were inspected during the audit, the following items were noted:

1. Date of invoice
2. That the invoice appeared to be properly a liability of the corporation
3. That there was indication of receipt of the material
4. That prices, extensions, and footings had been checked
5. That allowable discounts had been taken
6. That the proper account had been charged the proper amount

The procedures with regard to verification of costs and expenses of operations required approximately six per cent of the audit time.

In addition many of the procedures carried out in connection with the examination of balance sheet accounts were closely related to cost of sales and operating expenses. For example, many of the procedures with regard to the inventory and accounts payable were directly concerned with whether certain purchases and expenses were properly included in the current year. The examination of paid checks afforded an opportunity to observe their distribution to expense accounts, and further evidence was secured where questionable items or unusual distributions were noted. The provision for bad debts for the year was verified when the analysis of the reserve for bad debts was prepared. Another illustration of procedures relating to both balance sheet and expense accounts was the comparison of computed payroll taxes with the actual payroll taxes charged to expense during the year. The payroll taxes were computed in connection with the verification of the accrued liability.

OTHER PROCEDURES

Several procedures and matters not previously covered deserve mentioning. The general journal entries were scrutinized and the auditor was satisfied that all were proper. It was noted that the necessary reversing entries at the beginning of the year had been made. The beginning balances in the asset, liability, and capital accounts were compared with the audit report or work papers of the previous year at the time the accounts were analyzed.

A journal entry was prepared to record commissions received in July which were applicable to June.

Officers' expense accounts for one month were added and compared with the entry in the cash book. Each expense account was signed by the officer reimbursed for the travel or trade expenses.

No special procedures with regard to payrolls were deemed necessary for the following reasons. The salaries and wages account had been reconciled with the payroll tax returns. All salaries and wages were paid by checks which had been examined. Any unusual names or amounts would have been noted by the auditor. Furthermore, the officers signing the checks would have questioned any material error in the amounts paid.

A trial balance was taken of the general ledger on a work sheet to which the adjusting entries were posted. After the work sheet was extended and footed and the income taxes computed, the financial statements were prepared and the report was written. The supervising partner reviewed the report in detail with the accountant who had performed the audit.

Completion of the work sheet and preparation of the financial statements and audit report required twelve per cent of total time.

CLIENT'S WRITTEN REPRESENTATIONS

It is a general practice to obtain written representations from the client to eliminate the possibility of misunderstandings which occur in oral representations; to impress upon the management that it has the primary responsibility for the financial statements; and to secure their active cooperation. Such a statement does not relieve the auditor of his responsibility in any way.

On this engagement the auditor obtained a letter from the corporation, signed by the president, which made the following assertions:

Accounts Receivable:

Accounts Receivable aggregating $55,000.00 represent accounts due from debtors of the corporation resulting from transaction in the normal and regular course of business; there are no consignment accounts included therein; none of the accounts has been pledged or hypothecated; and ample provision has been made for bad and doubtful accounts, by actually charging off such accounts or by establishing a sufficient reserve.

Inventory:

Inventory totaling $100,000.00, has been taken, counted, priced, and valued by competent employees of the corporation, as of the above date, provision being made for obsolete or slow-moving merchandise; there is not included therein any consigned goods, the property of others, or any merchandise that has not been set up in the books; and none of the inventory has been pledged or hypothecated. Inventory consists of merchandise for resale and is valued at the lower of cost or market.

Liabilities - Direct:

All Direct Liabilities of the corporation for merchandise received, for expenses incurred, for fixed or capital assets purchased or acquired, for money borrowed, and for any other transactions prior to the close of business on the date above stated, have been entered on the books.

Liabilities - Contingent:

At June 30, 1950, the corporation was contingently liable for notes receivable discounted in the amount of $5,000.00. At June 30, 1950, the corporation was not contingently liable in any other manner. There was no contingent liability for additional notes receivable, sold or discounted; suits pending; guarantor or endorser; pending additional income tax assessments; or any other contingent liabilities.

Purchases and Sales Commitments:

The corporation was not on June 30, 1950, a party to any unfilled contracts for the purchase or sale of any merchandise or products at prices differing from current market quotations or for purchases in excess of normal requirements.

CONCLUSION

Upon completion of the examination, the auditors were satisfied that the audit had been performed in accordance with generally accepted auditing standards; that it included all procedures considered necessary; that the corporation's balance sheet and profit and loss statement presented fairly the financial position at the close of the fiscal year and the results of operations for the year; and that the corporation had applied generally accepted accounting principles on a basis consistent with that of the preceding year. The certified public accountants were therefore in a position to give a short-form certificate of the type recommended by the American Institute of Accountants without any qualification.

A long-form report was prepared which may be illustrated by a list of the contents as shown by the index of the report.

CERTIFICATE

COMMENTS:

Financial Position

Comments on Balance Sheet Items

Results of Operations

Application of Funds

Insurance Coverage

Scope of Examination

EXHIBITS

"A"	Balance Sheet
"B"	Profit and Loss Statement

Under the heading "Financial Position", a summarized comparison was made of the balance sheet at June 30, 1950, with the balance sheet at June 30, 1949, showing the increases or decreases in the assets, liabilities, working capital, and capital. "Comments on Balance Sheet Items" included a more comprehensive description of the various items than is possible or desirable on a balance sheet. Under the heading "Results of Operations", a summary was made of the current year's results and compared with those of the preceding year. A detailed comparison of expenses and other deductions was also made. The "Application of Funds" section of the report showed the sources of new funds and their application during the year. "Insurance Coverage" included a summary of the types of insurance and the coverage afforded as shown by the corporation's insurance policies. Under the heading "Scope of Examination", a brief statement of specific auditing procedures followed was made. Such a statement was considered necessary since readers of the report, particularly creditors, are frequently not familiar with generally accepted auditing standards and procedures and would not otherwise have any idea of the extent of the examination.

Five copies of the audit report, signed by the supervising partner, were delivered to the client.

BIBLIOGRAPHY

BOOKS

Bell, William H., and Johns, Ralph S., _Auditing_. New York: Prentice-Hall, Inc., 1946.

Carey, John L., _Professional Ethics of Public Accounting_. New York: American Institute of Accountants, 1946.

Finney, H. A., _Principles of Accounting - Intermediate_, 3rd Ed. New York: Prentice-Hall, Inc., 1946.

PAMPHLETS

American Institute of Accountants, _By-Laws...Rules of Professional Conduct_, Revised December 19, 1950.

American Institute of Accountants, _Examination of Financial Statements by Independent Public Accountants_, January, 1936.

Committee on Accounting Procedure of the American Institute of Accountants, "Accounting for Intangible Assets," _Accounting Research Bulletin No. 24_, December, 1944.

Committee on Accounting Procedure of the American Institute of Accountants, "Current Assets and Current Liabilities-Working Capital," _Accounting Research Bulletin No. 30_, August, 1947.

Committee on Auditing Procedure of the American Institute of Accountants, Case Studies in Auditing Procedure.

No. 1. A Loading and Hauling Equipment Manufacturer, 1947.
No. 2. A Newspaper Publisher, 1947.
No. 3. A Department Store, 1947.
No. 4. A Public Utility, 1947.
No. 5. A Corn Processing Company, 1947.
No. 6. A Management Investment Company of the Open End Type, 1947.
No. 7. A Grain Company, 1949.
No. 8. A Steel Fabricating Company - A Small Restaurant, 1950.
No. 9. A Wholesale Distributor of Newspapers and Magazines, 1951.

Committee on Auditing Procedure of the American Institute of Accountants, Internal Control - Elements of A Coordinated System and its Importance to Management and the Independent Public Accountant, 1949.

Committee on Auditing Procedure of the American Institute of Accountants, Statements on Auditing Procedure.

No. 1. Extensions of Auditing Procedure, October, 1939.
No. 2. The Auditor's Opinion on the Basis of A Restricted Examination, December, 1939.
No. 3. Inventories and Receivables of Department Stores, Instalment Houses, Chain Stores, and Other Retailers, February, 1950.
No. 4. Clients' Written Representations Regarding Inventories, Liabilities and Other Matters, March, 1941.
No. 5. The Revised S. E. C. Rule on "Accountants' Certificates," February, 1941.
No. 6. The Revised S. E. C. Rule on "Accountants' Certificates" (continued), March, 1941.
No. 7. Contingent Liability under Policies with Mutual Insurance Companies, March, 1941.
No. 8. Interim Financial Statements and the Auditor's Report Thereon, September, 1941.
No.10. Auditing under Wartime Conditions, June, 1942.
No.11. The Auditor's Opinion on the Basis of a Restricted Examination (No. 2), September, 1942.
No.12. Amendment to Extensions of Auditing Procedure, October, 1942.
No.13. The Auditor's Opinion on the Basis of a Restricted Examination (No.3) - Face-Amount Certificate Companies, December, 1942.

No.14. Confirmation of Public Utility Accounts Receivable, December, 1942.
No.15. Disclosure of the Effect of Wartime Uncertainties on Financial Statements, December, 1942.
No.16. Case Studies on Inventories, December, 1942.
No.17. Physical Inventories in Wartime, December, 1942.
No.18. Confirmation of Receivables from the Government, January, 1943.
No.19. Confirmation of Receivables (Positive and Negative Methods), November, 1943.
No.20. Termination of Fixed-Price Supply Contracts, December, 1943.
No.21. Wartime Government Regulations, July, 1944.
No.22. References to the Independent Accountant in Securities Registrations, May, 1945.
No.23. Clarification of Accountant's Report when Opinion is Omitted (Revised), December, 1949.
No.24. Revision in Short-Form Accountant's Report or Certificate, October, 1948.

Committee on Auditing Procedure of the American Institute of Accountants, Tentative Statement of Auditing Standards - Their Generally Accepted Significance and Scope, October, 1947.

Research Department of the American Institute of Accountants, Audits By Certified Public Accountants, May, 1950.

Securities and Exchange Commission, Accounting Series Release No. 21, February 5, 1941.

PERIODICALS

Byerly, F. P., "Formulation of Accounting Principles or Conventions", The Journal of Accountancy, LXIV (August, 1937), 93-99.

Carey, John L., "Editorial", The Journal of Accountancy, LXVIII (December, 1939), 361-364.

Calkins, Frank S., "What Are Generally Accepted Accounting Principles?," The Virginia Accountant, IV (January, 1951), 4-16.

McLaren, Norman L, "The Influence of Federal Taxation upon Accountants," The Journal of Accountancy, LXIV (December, 1937), 426-439.

"Message from the President of the United States," The Journal of Accountancy, LXIV (November, 1937) 331-332.

Montgomery, Robert H., "What Have We Done, and How?," The Journal of Accountancy, LXIV (November, 1937), 333-348.

VITA

The author was born in Blackstone, Virginia, on February 8, 1923, the son of Mr. and Mrs. Lawrence C. Sullivan. He was educated in the Blackstone public schools, receiving his diploma from Blackstone High School in June, 1940.

He entered Washington and Lee University in September, 1940, and received his Bachelor of Science degree with a major in Business Administration in August, 1943.

On September 1, 1943, he entered the Naval Reserve Midshipman School at Northwestern University in Chicago, Illinois, and received his commission as Ensign in April, 1944. He served in the Atlantic and Mediterranean theaters during World War II, and was released to inactive duty with the rank of Lieutenant (jg), U.S.N.R., in June, 1946.

He immediately entered the University of Richmond to take additional accounting classes. In September, 1946, he entered the graduate school of the University of Richmond as a student in business administration with a major in accounting and served as an accounting instructor until February, 1947.

He entered public accounting as a career and has been employed by a firm of certified public accountants in Richmond, Virginia, since June, 1947. After meeting the requirements of the Commonwealth of Virginia, he received his certified public accountant's certificate in November, 1949. He is a member of the Virginia Society of Public Accountants and the American Institute of Accountants.

He is now a candidate for the degree of Master of Science in Business Administration in August, 1951.