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Duties of junior and senior accountants: supplement to the CPA handbook;

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DUTIES OF JUNIOR AND SENIOR ACCOUNTANTS

SUPPLEMENT TO CPA HANDBOOK

AMERICAN INSTITUTE OF ACCOUNTANTS

DUTIES OF JUNIOR and SENIOR ACCOUNTANTS

Supplement to the
CPA Handbook

DUTIES

of

JUNIOR AND SENIOR

ACCOUNTANTS

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Volume 1

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DUTIES OF JUNIOR AND SENIOR ACCOUNTANTS

Supplement to the

CPA HANDBOOK

Edited by
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PREFACE

THE CPA HANDBOOK is intended as a reference book for public accountants, their staff members, and students who are interested in public accounting. The Committee on CPA Handbook felt that the inclusion of material on the duties of junior accountants and on the duties of senior accountants would add to the general usefulness of the book. In outlining it, Chapters 26 and 27 were planned to cover those areas.

However, due to the amount of material to be included, it has been decided that Chapters 26 and 27 should be published separately as a Supplement and also that it will be made available for separate distribution.

A previous book on "Duties Of The Senior Accountant" by F. W. Thornton was published in 1932. A book on "Duties Of The Junior Accountant" was first written by W. B. Reynolds and F. W. Thornton and revised in 1933 by A. B. Cipriani. Developments in the practice of public accounting and in education and training of accountants since those books were written have made certain portions of them obsolete. The present authors, therefore, have used a different approach to their subjects than that in the original volumes which dealt with those subjects.

It is hoped that this volume will be of particular interest and help to students and staff members who have not progressed to the stage of supervisor. Not only should students and beginning accountants benefit from the material presented in Duties of the Junior, but also they should find the material on the senior's work to be helpful in giving them an understanding of the purpose and end result of the work in which they are engaged. The Appendix presents a general explanation of audits and auditing procedure. Possibly most readers will benefit by studying it prior to reading the various chapters.

As is pointed out in the Preface to Volume I of the CPA Handbook, "The contents, except for that reproduced from previous Institute publications, have not been approved by the Institute or by any of its committees. Users of the Handbook should remain aware of the personal nature of the views expressed, which may or may not coincide with the views and practices of a majority of the Institute membership. To make the material more useful, in many cases a variety of procedures has been given, frequently along with the author's personal interpretation and preference."

Special recognition is due for the contribution to this Supplement, as well as to the entire Handbook, made by the consultants, by committee members, and by John L. Carey, Louis Sigaud, Agnes Moger and other members of the staff of the Institute.

ROBERT L. KANE, JR.

New York
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Duties of the Junior Accountant

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CHAPTER 1

Introduction

The duties of a junior accountant have never been and probably cannot be defined as a series of specific tasks. On the job the junior accountant accepts whatever assignments his supervising accountant gives him; in the office he likewise follows the instructions of the staff manager and does whatever work he is requested to do. This covers a wide variety of tasks. Also, the fact that the term "junior accountant" includes new recruits who have never worked on a set of books and have never been in a client's office as well as men who have had a year or more of experience in the field makes it all the more difficult to describe the duties assigned to junior accountants as a group. Specific assignments given to junior accountants range all the way from performance of a single step in an audit program under close supervision, to the complete execution of the audit of a department or branch of a client company. Thus the work in some cases borders on the clerical; in other instances it calls for experience, initiative and judgment.

General Scope of Duties

Someone has said that the duties of a junior accountant are "to do whatever his senior tells him to do," the senior being his immediate supervisor on field assignments. This comes very close to being the truth but is unlikely to be of much assistance to someone wanting to prepare himself in advance for the tasks he will be assigned to perform.

The duties of the junior accountant might be summarized in another expression which at first appears equally indefinite but which will give a somewhat better opportunity for subdivision into the specific duties that devolve upon beginners in the field of public accounting. The duty of a junior accountant is "to get ahead in the profession." This brief phrase has the advantage, first, of pointing out the professional nature of the work with which the young accountant is concerned; second, of indicating that he is expected to develop and to progress, for no man will be carried on a staff as a junior accountant indefinitely; and third, of permitting subdivision into more specific duties, all of which are aimed at accomplishing the primary objective of progress in the profession.

As a profession, public accounting makes demands on its practitioners above and beyond the mere satisfactory accomplishment of assigned tasks. The accountant deals with people almost as much as he deals with records and financial data. Part of his task is to enlist the co-operation of those with whom he works so that his own task can be completed efficiently and with as little disruption of the established routine of the client's office procedures as possible. He must learn to work not only with fellow staff members but also with the employees of the client. Not only must he work with them; he must create in them the conviction that he is a competent, reliable, professional person, a credit to his firm and to the accounting profession. Any failure to do that will work to the detriment of his employers' practice as well as his own advancement.

As a new and rapidly growing profession, public accounting offers opportunities for advancement scarcely excelled in any field or occupation. The top positions in most of the public accounting firms in this country are occupied by men who came into the field with nothing more than their own native abilities, a reasonably sound educational background and a desire to get ahead by their own efforts. Because the profession is still growing there are equally good opportunities today. Of course such opportunities require effort on the part of anyone who seeks to enjoy them. No one stands still in public accounting. Either he grows with the profession or he falls behind. Satisfactory completion of the job at hand is seldom enough; the accountant must do well that which is assigned to him and at the same time must be preparing constantly for the next job that he may be called on to perform. During the pressure of a busy season additional engagements and unexpected problems on old engagements call for shifting between assignments and the assumption of increased responsibilities by some in order that the work may go forward and adequate service be furnished to clients. The junior accountant who can assume increased responsibilities and advanced duties assures himself of special attention and consideration for advancement. The man who is unable to cope with anything more than the immediate task assigned has but limited usefulness to his firm, so he neither receives nor can he take advantage of the opportunities that are so often present.

With these thoughts in mind, a somewhat more expanded description of the duties of a junior accountant might be presented for further discussion as follows:

1. To acquire proficiency in the performance of his assigned tasks. This includes a sound understanding of accounting terms and auditing techniques, skill in the performance of work assigned, and an alertness for any weaknesses or deficiencies in the techniques as applied in practice.
2. To develop what may be called a professional bearing and attitude toward his work. This includes the development of traits of personality that will enable him to get along with those with whom he works, as well as traits of

character that stamp him as a competent practitioner holding to high standards in the performance of his work.

3. To prepare himself for advancement. This requires keeping abreast of current developments in auditing and accounting, preparing for advanced duties through self-study, formal classes, and intelligent questions and alertness on the job, and satisfying any technical requirements established by his firm or by the profession.

Nature of An Audit

Most of the work assigned to junior accountants is related to the examination of the financial statements of client companies preparatory to the issuance of an opinion on those statements by the auditor — or, as it is more commonly termed, making audits. Juniors are usually assigned to this type of work; first, because it makes up the bulk of the work done by most public accounting firms; second, because it requires the performance of a considerable amount of clerical or detail work that can be done by beginners; and third, because most junior accountants are not qualified for more specialized work such as systems or tax assignments.

Independent public accountants examine the financial statements of business enterprises so that they may express an opinion as to the reliability of the statements. Their opinion as independent experts in accounting and auditing assures those who use the information contained in financial statements that the statements present fairly the results of operations and the financial position of the company issuing them. In effect the auditor first satisfies himself as to the reliability of the financial statements and then expresses a written opinion that he has made an examination of the statements and that he is satisfied as to their reasonable accuracy and conformance to generally accepted principles of accounting.

The Auditor's Opinion

The auditor can express an opinion as to reasonable accuracy only. He can state that, *in his opinion,* the financial statements "present fairly"; he cannot state that they are correct or absolutely accurate. This follows from the fact that accounting itself is far from an exact science and makes significant use of estimates and judgments. Depreciation, depletion, allowances for uncollectible accounts, provisions for taxes, and many similar items are at best informed judgments as to what those items will ultimately prove to be. No one is in a position to state categorically what they should be in any given case.

There is another reason why *reasonable* accuracy is all that can be assured. Of necessity, the work of an auditor is based on tests and samples.

That is, he rarely examines every transaction; instead, he tests or examines a portion of the transactions and, based on the results of the tests, concludes either that the data are reasonably free from substantial error or that additional work must be done because substantial errors are found. This reliance on tests and samples is possible because most business firms have adopted various measures directed at the elimination of mistakes. Through a system of checks on the work of individuals, companies have established systems of internal control over their operations. The system of internal control within the company is evaluated carefully by the auditor before he determines the extent of his own work. If the opportunities for errors are slight, his work can be reduced accordingly; if they are great, then his tests and samples must be proportionally larger.

Over the years auditors have found that the use of tests and samples has been entirely effective. The possibility of using a sampling procedure has made annual audits possible where they otherwise would have been prohibitively costly. Under ordinary circumstances an audit team of two or three men can review in a period of three or four weeks the work of a 10-man or 20-man accounting department for a year by judicious use of sampling techniques. If it were necessary to review every individual transaction, an audit staff almost as large as the accounting staff and working for almost as long would be necessary. Obviously this would be too costly for business in general to bear.

In reporting on financial statements which he has examined, an auditor must pass on the fairness and acceptability of the accounting principles followed by his client in preparing the statements. This means that everyone on an audit team, junior accountants as well as those in charge, must have a sound understanding of generally accepted principles and practice. The junior accountant is not likely to be entrusted with making the final decision as to the acceptability of the accounting principles followed, but he is expected to note any peculiar practices and any deviations from generally accepted principles and to call them to the attention of the senior accountant in charge of the examination.

A general description of the function of the independent public accountant and an outline of the nature of his work is given in "Audits by Certified Public Accountants" which is reproduced in the appendix. Juniors should become thoroughly familar with this booklet since it will assist them in obtaining a comprehensive view of the auditor's function and of his methods.

Obtaining Evidence

The junior should recognize that there is nothing at all mysterious about the conduct of an audit. Auditors have available to them certain techniques or tools. Each of these is relatively simple and straightforward.

By applying them in an integrated program, the auditor stands a good chance of uncovering any material errors, whether in amounts, in classification, in description, in disclosure, or otherwise, that may exist in the financial statements or in the supporting records. There is no sixth sense that enables an experienced auditor to "smell out" such mistakes. He discovers them, if they exist, by the careful application of accepted verification techniques. This is not to say that a "hunch" may not lead to discovery of mistakes. Some people do have hunches and accurate ones too. But the playing of hunches is not restricted to auditors and in many cases what appears to be a hunch is a reasonable conclusion arrived at after giving consideration to the results obtained by performing accepted audit procedures.

An audit is a matter of studying such evidence as is available in order to establish whether the financial statements present fairly the facts of the situation. Only after carefully accumulating legitimate audit evidence can an auditor review the accounting principles followed and convince himself, as a professional man, that the statements do portray reasonably the operations and financial position of a company. Further, if any question arises as to his work, the evidence he has compiled must be sufficient to satisfy the auditing standards accepted by the profession. Casual opinions will not serve as evidence; real proof obtained by applying generally accepted procedures is required.

In building up evidence as to the reliability of financial statements and underlying records a considerable amount of detail work must be performed. This work is commonly assigned to the junior accountants on the audit staff. Because of the clerical nature of some of this work, and because part of it is frequently monotonous and often uninspiring, there is a tendency sometimes to view it with distaste or to take it lightly. Often it is referred to as "routine," thereby implying that it requires no more than a portion of the attention of the person doing the task. This is an implication and a tendency that must be avoided at all costs. Four points relating to the importance of detail work should be remembered:

1. If it were not essential to the achievement of the audit objective it would be eliminated. Time is of the essence in the performance of an audit examination both because of its direct effect on the cost of the examination and because of the press of other work on accountants. Most audit engagements have been reduced to essentials. If detail work is included as a part of the audit program it is there because experienced auditors consider it of importance.
2. Because of the reliance on tests and samples, detail work must be performed with care. If a test consists of one-tenth of the transactions of a certain type, the possibility of discovering any errors in the total group of transactions has necessarily been reduced to some extent. Any carelessness on the part of the person examining the sample reduces that possibility even further.
3. Errors discovered during the performance of detail work should be brought

to the attention of the accountant in charge of the engagement. Because of the use of tests and samples the significance of an error may be greater than it otherwise would be. The accountant in charge is responsible for making any necessary changes in the program and should be given ample opportunity to evaluate the significance of errors in time to make such changes in the program as appear desirable.

4. Under no circumstances should the junior accountant either increase or decrease the amount of detailed work without the approval of the accountant in charge. Program planning and modification are beyond the scope of the junior accountant's duties. Of course he must be alert throughout the performance of his work to any deficiencies or weaknesses in the program and it is entirely within his province to suggest changes to the senior accountant. Working as he is with the detailed operation of the accounting system, he is frequently in the best possible position to recommend changes in the audit program and therefore should consider it one of his responsibilities to do so. His responsibility is limited to suggestion, however, and he must not take it upon himself to change the program unless such a change has been authorized by his superior.

CHAPTER 2

Work Papers and Audit Techniques

Audit Work Papers

During an audit engagement an auditor follows certain procedures directed at determining whether or not the financial statements of the client company are acceptable. At the same time he collects information to be used in the preparation of his audit report at the close of the engagement. To assist in carrying out audit procedures in a systematic manner, to have a record of the work he has performed, and to accumulate the information he will need for report writing, he prepares audit work papers. These constitute his principal record of work actually done on the engagement; therefore, they must be complete and self-explanatory in every respect.

General Requirements of Work Papers

A general rule of work paper practice and of report writing is that any assertion of fact made in the report must be supported adequately in the working papers. Furthermore, the working papers stand as a record of the work done in verifying the client's financial statements. Any question that arises as to whether or not the examination was made in accordance with generally accepted auditing standards or as to whether or not it included all procedures required in the circumstances must be answered by reference to the working papers. Therefore, any omission from the work papers of information regarding auditing techniques applied, questions asked, explanations received, or of any work done in connection with the audit may be extremely serious. "If it is worth doing, it is worth including in the working papers," is a good rule for a junior accountant to follow.

Working papers are the primary basis on which senior and supervising accountants review and evaluate the work of their assistants. From this standpoint they are of first importance to juniors. If a junior accountant makes a favorable impression on his superiors it will most likely be through the preparation of satisfactory working papers. A good job on his part saves the time of his superiors in their review of his work, makes it unnecessary for them to ask him a great many questions, and saves him the embarrassment of trying to remember what he really did in regard to a certain item weeks or months earlier. To a considerable extent the new man in auditing stands or falls on his ability to produce satisfactory working papers.

Types of Working Papers

Included within a standard set of audit work papers will be:

1. A draft of the final audit report.
2. A review of the system of internal control.
3. An audit program.
4. A general ledger trial balance.
5. A list of adjusting journal entries.
6. Account analyses, supported by schedules, reconciliations and the like.
7. Miscellaneous notes, comments, excerpts from important documents such as contracts, bond indentures, et cetera, and excerpts from the minutes of Board of Directors and other important meetings.

A junior accountant must become familiar with each of these types of working papers and must be able to prepare and handle them readily. However, most of his work, at least until he acquires some experience, will be concerned with either following the detailed audit program prepared by the senior accountant or with constructing relatively simple working sheets to indicate the method of verification of specific account balances or to show the data used in arriving at account balances. Illustrations of such work sheets are shown as Figures 1 to 12 and describe the auditing techniques to which they are related. Practice varies somewhat from one accounting firm to another but the general rules for the preparation of working papers remain the same. Hence it seems best at this point to discuss fundamental requirements rather than specific forms.

Rules for Preparation

In preparing working papers one should remember that it is the application of verification procedures that makes an audit. Therefore, each working paper should provide not only for analysis or summarization of data making up the item but also should indicate the audit steps performed in the attempt to determine the reliability of the information as recorded.

Several simple rules of working paper practice should be observed. Each work sheet should be complete and understandable in itself. This rule is directed at saving the time of the reviewer and at insuring that work sheets contain sufficient information to constitute effective evidence of the work done. To be complete and understandable the work sheet should have a complete title consisting of the name of the company under examination, the title of the account analyzed or of the test being applied, the source of the data used, and the date or period covered by the test. Any audit procedures applied should be described in such detail that their nature and the extent of their application is apparent. For example, if a list of invoices is prepared and then the invoices are tested for their validity and propriety of entry, some indication should be given as to which of them were actually examined and what the results of the examination were. This is done by placing a distinctive tick mark on the working sheet after the amount for each invoice examined and by explaining the significance of that tick mark in a note at the bottom or the side of the page.

Each work sheet should be signed or initialed by every accountant working on it and the date of his work should be indicated. This is important in fixing the responsibility for work in case questions are raised later. It also is helpful in showing the sequence in which work was done and the date of completion.

Working sheets should be neat, legible, and orderly in appearance. It is best to avoid all except commonly understood abbreviations. Generalities and unsupported conclusions should be avoided and all comments and exceptions should be factual. Final disposition of all exceptions and questions should be stated. Many junior accountants get the impression that sloppy work sheet practice is an indication of sophistication and assurance on the part of the one doing the work. Nothing is further from the truth. The fact is that every work sheet must be reviewed by a superior whose time is far more valuable than that of the junior accountant. Neat, legible work lends itself to review much more readily than careless work and is far more likely to save the reviewer extra and valuable time. In addition, it is more likely to leave him with a favorable impression of the one who did the work.

All work sheets should be indexed and related work sheets should be carefully cross-referenced. Various methods of indexing are in use, ranging from rather simple straight-numbering systems to more complex decimal or combined letter and number systems. If the firm for which he works has a standard system for indexing its working papers the junior accountant will be expected to learn and to use that system. Otherwise he can follow whatever system his senior requires. The purpose of indexing is to make the finding of data in the papers easy and to show the inter-relationship of related working papers. Account analyses are usually keyed to the general ledger trial balance which, among other uses, may serve as an index to the working papers supporting the amounts from which the financial statements are prepared.

The inter-relationship of working papers may be illustrated with the following example. If in making an analysis of the balance of the accounts receivable account it is determined that certain accounts must be written off as uncollectible and charged against the "provision for doubtful accounts" (or the "reserve for bad debts," as it is still commonly called), a cross-reference should be made on the accounts receivable analysis indicating the other work sheet concerned so that the reviewer can follow the entry into the analysis of the reserve for bad debts. Likewise, a word of explanation should be included on the reserve for bad debts analysis indicating that the entry ties into the accounts receivable work sheet. Thus the reviewer, or anyone else who has occasion to look at the working papers, has a complete explanation of the adjustment and of the work sheets to which he should refer if he wants to determine how it has been taken into consideration.

Use of Tick Marks

To show the type of procedure which has been applied to data in the working papers, it is customary to place distinctive tick marks close to the figure or information in question. These marks then are indexed elsewhere on the work sheet, together with an explanation of their meaning. This practice is illustrated in some of the work sheets presented as Figures 1 to 12.

Some accountants prefer to use certain tick marks uniformly throughout an engagement. That is, a certain tick mark always means the same thing wherever it is used. It may mean that the item has been vouched, or that a column has been footed, or that it agrees with the client's records, or some other similar fact. When this is the practice an index of the tick marks used, together with an explanation of their meaning, should be included in the front of the working paper file for use by anyone referring to the papers. Another, and perhaps more common, practice is to permit each auditor to use such tick marks as he finds convenient at any time during the examination and then to require him to explain the tick marks he has used on each work sheet in a note or explanation included on the work sheet. This has the advantage of permitting certain tick marks to be used over again so that a long list of distinctive marks is unnecessary and of making it unnecessary for everyone on the job to memorize the standard meaning of the marks. It also makes the work of the reviewer easier since he has before him on each work sheet an explanation of each mark used. The junior accountant should ascertain the procedure to be followed before commencing work.

In most cases it is desirable to use colored pencils for tick marks because it causes them to stand out on the work sheet in such a way that they are found more easily. Since the fact of verification is usually the most important information on the working paper this has the advantage of making that information stand out.

No attempt will be made here to illustrate standard or model forms of work sheets. Various examples, Figures 1 to 12, have been given to illustrate how certain audit techniques are applied and to indicate acceptable work sheet practice. More complete treatises on accountants' working papers should be referred to for the solution of special problems.

Audit Techniques

To a considerable extent, the work assigned to junior accountants consists of the application of some of the basic auditing techniques used on every engagement. This is not to say that junior accountants do nothing beyond the work described in the following paragraphs. As suggested previously, an experienced junior accountant may be given assignments requiring the exercise of considerable judgment and the assumption of real responsibility. However there are certain verification methods with which a junior accountant must be familiar. He will find that most of his technical duties, both in the early stages of his work as an assistant and later in more responsible positions, involve the application of these techniques in one way or another. Hence it becomes important that he know them thoroughly — their nature, usefulness, and limitations — if he is to use them effectively. Incidentally, in learning them he also is preparing himself for advancement, for it is in the appropriate use of these techniques in audit program planning that the skilled auditor can be distinguished most easily from the unskilled.

No authoritative list of basic audit techniques has yet appeared, and it is not the purpose of this book to present such a list. Nevertheless, some can be listed and the following should certainly be included among those techniques which a junior accountant will find useful throughout his career in auditing:

1. Vouching, or the verification of entries by examination of the original documents on which they are based.
2. Recomputation of arithmetical calculations to determine their accuracy.
3. Retracing bookkeeping procedures.
4. Physical examination and count.
5. Confirmation.
6. Scanning.

The explanations in the next three chapters of these techniques in certain described situations are illustrative and not all-inclusive. The same techniques may be used for many other purposes than those described, and it would be unnecessarily repetitive and almost impossible to state them all. Other techniques are used in audit examinations, but those discussed here are the ones most commonly assigned to junior accountants.

CHAPTER 3

Vouching and Recomputing

Vouching

The expression "vouching" is used to describe the procedure of examining the documentary evidence on which an entry in either a book of original entry or a ledger account is based. In modern business almost every transaction is evidenced by some kind of a business paper – a sales ticket, a receipt, a cancelled check, a contract, or some other document. Entries in the books of original entry are made either from the original or from copies of the documents concerned. Therefore, in determining whether such a transaction actually took place and also whether it was entered correctly an auditor examines the documentary evidence of the transaction.

This is a very common and extensively used technique. It is applied in two somewhat different ways: (1) it is used to verify entries in a book of original entry for a selected test period, (2) it is used to verify entries in specific ledger accounts. For example, an auditor must give some attention to the authenticity of cash disbursement transactions as shown by the books for the period under examination. To do this, he will investigate entries in the check register for a selected period by examining the cancelled checks returned by the bank and by comparing them with the entries in the check register. On the other hand, in verifying the balance of the furniture and fixtures account he may call for the invoices supporting each debit to that account so that he may determine whether or not they are appropriate additions to that fixed asset account. Thus he will use the vouching technique either to satisfy himself that entries in the books of original entry are satisfactory or to obtain information about the entries in selected accounts.

Requirements of Vouching

Included within the idea of verifying entries by examination of supporting documents are various component steps; it is not merely a matter of comparing an amount on a document with an amount in a journal or ledger. Attention must be given to each of the following matters if the procedure is to be valid:

1. Is the document itself genuine?
2. Is the transaction pertinent to this company?
3. Is the transaction a legitimate one in view of the nature of the company's operations and activities?

4. Does the document carry such approvals or signatures as are required under the system of internal control supposedly in operation?
5. Does the entry appear to be an appropriate analysis of the transaction in terms of debits and credits?
6. Are such mechanical details as the date, amount and names of outside parties entered correctly?

Not until he has answered all these questions to his own satisfaction can an auditor accept the record of a transaction as being adequately supported by the documents presented to him.

Determining the authenticity of a document such as a vendor's invoice is often an extremely difficult matter and obviously an auditor cannot spend a great deal of time checking out many individual transactions. However, he should be alert to the general possibility of counterfeit documents at all times and in doubtful cases should make some investigation of their propriety.

In some cases it may be appropriate to look up in the telephone book or some other directory the names of new or unknown companies with whom there have been business transactions to discover if they do actually exist.

He may verify a transaction further by examining into preceding and succeeding transactions related to it. For example, a purchase invoice for a supplier might be verified further by actual examination of the merchandise received, by reference to approved receiving room reports, freight bills or the like.

The auditor should make certain that the transaction relates to the company under examination. Sometimes in processing hundreds of invoices or other documents a company will approve invoices received through the mail in error and actually addressed to other companies with a similar name. Needless to say, an auditor is expected to find any such errors that fall within the sample tested.

The importance of internal control to the performance of an audit program has been mentioned. One of the purposes of examining documents is to discover whether the internal control procedures that were *supposed* to be carried out in the processing of those documents have actually been followed. Thus, before examining checks, the junior accountant must inform himself (usually by reference to the review of internal control prepared by the senior accountant) as to how many signatures are required and exactly who is authorized to sign checks. Further, it is desirable that he familiarize himself with the signatures of those who are authorized to sign in order that he will have a fair chance of detecting any forged signatures. In like manner, if he were vouching the entries in a purchase book or in a voucher register he would examine the approvals on a purchase invoice for receipt of the merchandise, approval of prices, verification of extensions and totals, approval of terms, and approval for payment.

Applicability of Vouching

Vouching is one of the most useful techniques available to auditors and is used in one form or another throughout an audit engagement. As an indication of its general applicability and of the documentary evidence most commonly examined by junior accountants the following summary of procedures, though incomplete, may be helpful:

1. To support entries in ledger accounts (generally asset or expense accounts).
   Procedure — Refer to original purchase invoices appropriately approved and supported by receiving reports, purchase orders, and shipping documents (or to copies of contracts, correspondence, et cetera, if invoices are not available or appropriate).
2. To support entries in books of original entry.
   a. Cash disbursements book or check register.

   Procedure — Refer to paid checks returned by the bank.

   b. Sales book or sales record.

   Procedure — Refer to duplicate copies of sales invoices (original would be sent to customer), supported by shipping documents if possible. In some cases, cash register tapes may be the only available record of sales transactions and, if the internal control is organized as it should be, these may be entirely satisfactory.

   c. Voucher register, invoice register, or purchases book.

   Procedure — Refer to original purchase invoices, supported by receiving reports and copies of purchase orders.

   d. Cash receipts book.

   Procedure — Refer to remittance advices, if received, or to original listing of receipts prepared by mail clerk or cashier.

   e. Payroll disbursements as recorded in payroll summary.

   Procedures — Refer to paid checks returned by bank in support of amounts in net pay column. Refer to employee time cards or timekeeper's record for hours worked, to union contracts or wage authorization slips for rates, to union agreements for union dues withheld, and to authorizations from the employee for deductions for hospitalization and the like.

   f. Petty cash disbursements as recorded in a petty cash book or in reimbursement vouchers.

   Procedure — Refer to petty cash vouchers with supporting expense invoices.

Work Paper Record of Vouching

When documents have been examined in support of book entries some record must be made in the working papers as evidence that the work has been performed. In many cases the audit program calling for the vouching will provide a place for the junior accountant to sign with his initials for the work done. In other cases, especially in reviewing the entries in a given ledger account, he must note on the work sheet containing the account analysis exactly what documents he reviewed and whether or not he was satisfied that they support the entries in the account.

Obtaining Documents for Vouching

Obtaining invoices, checks or other documents for review is sometimes a problem. In most cases the senior accountant will make arrangements to provide the junior with the papers to be examined or will give him specific instructions for obtaining them. It is usually unsatisfactory for a junior accountant to go searching for papers in the client's files unless he has been given specific permission to do so. Many file clerks are extremely particular as to the manner in which their files are kept and do not relish a stranger having unsupervised access to them. For this reason it is best for the junior to go a little slow at first until he is certain that he either does or does not have free access to the client's files. On some engagements the client will place a file clerk at the disposal of the audit staff to obtain and to refile any documents they require. This is an ideal situation but it should not be expected in every case. To order a client's employee to bring some documents to his desk may be the surest way for an auditor to lose the goodwill and co-operation of the client's staff with whom he must work.

One other point about obtaining documents for examination should be observed. It is generally unwise to indicate in any way to the client's employees the extent of the tests and samples to be examined. If one calls for the sales invoices for the months of December and July, he gives to an alert employee a strong indication of the period being tested and over the course of two or three successive audits may give away the pattern followed by the senior in spreading his tests over the year. A request for the sales invoices for the entire year or a question as to where they may be found so that he may select those he desires is much less likely to give an inquisitive employee information he should not have.

Recomputation of Arithmetical Calculations

Bookkeeping and accounting employ simple arithmetic in a great variety of ways. Columnar books of original entry are totaled, ledger accounts are totaled and the balances determined, inventory quantities are multiplied by prices to get the extended amounts which must then be added to obtain the inventory total, depreciation and depletion provisions and allowances for doubtful accounts must be computed, and such agreements as profit-sharing bonus plans require computation. One of the facts to be learned by a junior accountant is that wherever there is an arithmetical computation there is a possibility of an error. Thus, the great number of calculations performed by an accounting department during the course of its work for the year represent, to the auditor, a great number of potential mistakes which must be given some attention if he is to reasonably satisfy himself that material errors have not been made.

Of course, here again the procedure is applied on a test basis. It is seldom necessary, for example, to foot all books of original entry for the year. With a reasonably effective system of internal control in operation in the client's office this task may be reduced to checking the footings for one or two or perhaps three months. In like manner, only a portion of the inventory extensions are proved by recomputation and only some of the inventory page totals are verified.

It is sometimes a difficult matter for a junior accountant to convince himself that the total at the end of a long column of figures is likely to be incorrect, especially if that column has been totaled on an adding machine. Incorrect footings, however, constitute one of the simplest and oldest methods of covering a shortage or of making facts appear other than what they are. There is an appearance of accuracy to an adding machine tape but a dishonest employee could very easily list the required items on the tape and then roll the tape sufficiently far forward to miss the place where the total is to show. Then he can enter other amounts in the machine, either plus or minus, roll the tape back to the place for the total and obtain exactly the result he desires. Hence the fixed rule: "Never accept a client's adding machine tape." More than one junior has been embarrassed to find a member of the client's bookkeeping department watching him incredulously as he re-adds the list of the accounts receivable balances supplied to him. Nevertheless, the possibility for error exists and the rule of never accepting a total, or the result of any other computation for that matter, is a sound one. The same rule applies to listings and totals by mechanical accounting equipment. As pointed out previously, this does not mean that all totals are recomputed; it means only that until the auditor has at least tested the computations concerned he is not entitled to rely on their results.

Types of Arithmetical Verification

The verification of arithmetical computations might be subdivided into absolute verification and approximate verification. Many figures must be proved to the penny. For example, at some time during the course of the examination the balances of all general ledger accounts should be proved. This proof must be absolute, that is, the balance must be recomputed completely. In testing inventory extensions, on the other hand, it is unnecessary to prove them to the penny. It is seldom possible to eliminate all chance of error anyway; all that an auditor can do is to satisfy himself that no material errors have been made in arriving at the final figure. Hence he may rely on what is called "sight-testing" for the verification of inventory extensions. Sight-testing consists of making a rought mental calculation of the result obtained by multiplying the quantity by the price, as opposed to making a precise calculation on a machine or with pencil and paper. For example, a quantity of 50 units at

$1.13 should be a little over $55.00, a quantity of 23,000 at $2.98 should be close to $69,000, and so on. Sight-testing permits a greater number of items to be examined in a given length of time and, in the case of inventory extensions, gives reasonable accuracy. It should be particularly effective in discovering such errors as misplaced decimal points, a relatively common form of mistake and one which can result in errors which are material in amount.

Another example of approximate verification may be found in testing the footings of inventory sheets or of books of original entry such as a voucher or invoice register. It is usually unnecessary to prove the footings to the penny. Rather it is common practice to omit the cents and perhaps even the first two dollar columns so that the footing commences with the hundreds column. This often reduces the time required considerably and yet gives an adequate proof of the totals. In some cases the totals of the omitted columns can be approximated by considering the number of lines on the page and the unit of the largest omitted column, tens, hundreds, et cetera. This is particularly helpful where a great number of similar pages must be footed. Generally the auditor cannot afford the time to search for trivial errors. However he must always be alert for errors which are material in amount.

When assigned to prove footings and extensions, the junior should always be careful to obtain specific instructions, not only as to the records and periods to be tested but also as to the extent of the checking required, whether absolute or approximate.

Two points which may give a new junior accountant trouble are worth mentioning at this point. The first has to do with the proof of the forwardings in a columnar record. If one is assigned to foot a columnar record of several pages, it is not enough to prove the footings of each page. The total carried forward from one page to the next also must be traced carefully as carrying forward an incorrect total can have the same effect as the incorrect footing of one or more pages.

The second relates to insuring that the record to be checked is footed completely. For example, the program may call for checking the sales book footings. The sales book may be a summary record in which is entered only the total amount of sales for each day. A subsidiary record or records may list the individual sales transactions and arrive at totals which are then entered in the sales book. Whenever the junior finds that the record he has been assigned to test is itself a summary record of some kind he should bring this fact to the attention of the senior accountant and inquire whether he should foot the underlying records as well.

CHAPTER 4

Retracing Entries, Inspecting and Counting

Retracing Bookkeeping Procedures

During the completion of the ordinary bookkeeping cycle, certain of the steps taken by the bookkeeper or the accounting department of a company may be performed incorrectly so that errors result. Therefore some of these steps must be retraced by the independent accountant, again on a test basis, so that he may satisfy himself as to whether errors were or were not made. Among these bookkeeping steps are:

1. Posting from books of original entry to ledgers.
2. Preparation of trial balances, both of the general ledger and of subsidiary ledgers.
3. Preparation of bank reconciliations.

A junior accountant probably will be instructed to determine the accuracy with which each of these steps has been carried out by the client's accounting department. He must know not only how to retrace the procedure but also the types of errors most likely to be found under each procedure.

Tracing Postings

An error in posting may be made by entering an amount in the wrong account, by entering an incorrect amount, or by entering no amount where one should be recorded. Thus, from the standpoint of concealing a shortage or an error, posting offers opportunities similar to those offered by incorrect footings. The accountant charged with the duty of checking postings must be on the alert for either intentional or unintentional errors. What may appear to be an inadvertent error in posting may actually be an effort to cover a shortage or defalcation. Any errors discovered should be brought to the attention of the senior accountant for his decision as to their significance.

Tracing postings from books of original entry to ledger accounts at one time made up a larger proportion of the detail work on an audit engagement than it now does. The analysis of account balances and the subsequent vouching of entries in these accounts effectively establishes the accuracy of postings and has made extensive tests of postings unnecessary.

The tracing of postings may be undertaken as either a one-man or a two-man job. If the amount of work involved is considerable, the use of two men sometimes will halve the time required and at the same time permit a more effective proof. When two men work together on such an assignment it is important that they understand one another completely as to the manner of calling amounts, the order in which the facts to be proved are to be called, and the indication to be given when an amount has been traced satisfactorily. Some firms have established rules for such matters; others permit the men concerned to work out their own procedures. In any case the following facts must be included in the work:

1. The name of the account.
2. The date of the transaction.
3. Nature of the entry as a debit or credit.
4. The amount.
5. The page and code of the book of original entry from which the posting came.

While this may appear to be a purely mechanical procedure, the accountants involved are expected to do more than merely follow the entry from the book of original entry to the ledger account. They also must concern themselves with the nature of the transaction that is to be traced into the ledger accounts. If they fail at first to understand the transaction or its analysis into debits and credits, they should satisfy themselves as to its propriety before continuing. To be completely satisfied as to the accounts to which amounts are posted the junior accountants doing this type of work must obtain a copy of the company's chart of accounts and familiarize themselves with the account titles sufficiently to know that they are being charged or credited in accordance with the established procedure.

Review of Trial Balances

Any trial balances prepared by the client's employees and submitted to the auditor must be proved by the auditor before he can accept them. This generally involves comparing each item in the trial balance with the appropriate ledger account balance to make sure that both the account title and the balance have been recorded in the trial balance correctly. When this has been done the trial balance must be footed either to prove the equality of the debits and credits or, if the trial balance is that of a subsidiary ledger, to match the total with the balance of the controlling account in the general ledger.

In some cases the trial balance of a subsidiary ledger may be nothing more than an adding machine tape. This is often true of accounts receivable trial balances prepared by members of the bookkeeping department. This fact should not bother the accountant particularly. He can still check them back to the subsidiary ledger accounts even though no account names are given, because the order of the amounts on the tape should be the same as those in the ledger.

The senior accountant usually prepares the general ledger trial balance because it gives him an opportunity to become familiar with the various accounts in the ledger. If an assistant prepares it, he should ascertain the form or ruling desired by the senior. Some accountants take off a straight two-column trial balance with totals for the entire ledger; others use a single-column trial balance that arrives at separate totals for the assets, for the liabilities, and for such profit-and-loss account groups as they desire. Examples of the two most common arrangements are illustrated in Figures 1 and 2.

When the amounts in a trial balance are compared with the balances shown in the ledger accounts, questions may arise as to the amount of work that should be done in verifying the balances. The extent of work to be done in proving the validity of the individual account balances varies with the circumstances and should be established by the senior accountant rather than by the junior. However, the junior should be constantly alert for unusual balances and for unusual entries in the accounts which might require additional investigation.

Bank Reconciliations

As part of its regular bookkeeping routine the accounting department of a business should prepare reconciliations for all bank accounts monthly. From the standpoint of the accounting department a bank reconciliation is proof that the record of cash has been kept so as to arrive at a balance of cash on deposit that agrees with the bank record. Failure to bring the bank reconciliation to balance indicates that errors have been made.

The auditor likewise must prepare a bank reconciliation at least at the balance sheet date in order to assure himself that no errors have been made. If the client has not yet prepared a bank reconciliation, the auditor will obtain the bank statement with cancelled checks and other necessary data and do so. If the client has already made such a reconciliation at the balance sheet date, the auditor will check out the client's reconciliation so carefully as, in effect, to make his own independent reconciliation. This will later be supplemented by other procedures.

From the auditor's standpoint a count of the company's cash would be desirable to satisfy him that the amount of cash claimed is actually present. However, since the cash is on deposit, a count is impossible; hence he resorts to reconciling the book balance of cash with the bank's statement of what is on deposit as a substitute for an actual count. If the figures don't reconcile the company does not have the exact amount of cash it claims to have. For this reason a bank reconciliation is an important verification procedure and one that should be performed with care. Every amount used in the reconciliation should be given close attention.

Preparation of a bank reconciliation requires that the bank statement be obtained together with the paid checks returned by the bank for the period ended on the reconciliation date. The returned checks should be compared with the entries in the check register for the period and with the outstanding checks listed in the previous bank reconciliation so that a list of checks outstanding at the reconciliation date may be prepared. The deposits per bank statement must be compared with the cash receipts record for the period so that the amount of any deposits in transit may be determined. If any bank debit or credit memoranda are included with the bank statement, these also must be given consideration as additional reconciling items. Most auditors work from the balance shown in the bank statement to the balance shown in the client's books, taking into account outstanding checks, deposits in transit, and any other reconciling items. (See Figure 3 for bank reconciliation.)

Use of "Cut-Off" Bank Statement

A bank reconciliation has three major weaknesses which require that additional procedures be followed before the auditor can rely on the apparent agreement of the book balance with the bank balance. First, the list of outstanding checks is prepared from the client's cash disbursements book which may be in error as to any one or all of the checks listed as outstanding. Second, the deposits in transit are taken from the client's cash receipts book which likewise may be in error. Third, checks may have been drawn on the bank balance before the reconciliation date and not recorded in the books.

Because of these weaknesses it is standard practice to support the reconciliation by a "cut-off" bank statement. The auditor requests the client to ask his bank for a special bank statement prepared as of a date at least ten to fifteen days after the reconciliation date. The auditor must get this statement directly from the bank so that no interested employee may have access to it. All, or most, of the checks listed as outstanding at the reconciliation date probably will be returned with this statement. The auditor thus is able to examine those checks and to discover for himself whether they were correctly recorded in the cash disbursements book and in the bank reconciliation. Also, any deposit in transit should have reached the bank within the first one or two days after the reconciliation date and can be traced to the "cut-off" bank statement. Finally, any unrecorded checks should have cleared the bank and would be returned with the bank statement as of the cut-off date.

The auditor examines all returned checks for propriety and may trace them into the cash disbursements book if they appear in any way unusual. Special attention is given to checks made out to the company under examination, to cash, to bearer or to an individual. Bank endorsements are examined for checks dated and entered the first few days of the following period. Such checks may have been cashed at some bank other than the one on which they were drawn before the end of the period, even before the date they carry, because the cashing party knew they would not reach the drawee bank before that date. Thus they could have been used to provide cash to cover a shortage. The date of the bank endorsement indicates the date on which the check was cashed and this may be more important to an auditor than the date of the check.

When a cut-off bank statement has been obtained and used as described in support of the bank reconciliation, the reconciliation itself becomes a more reliable proof of the cash in bank.

Bank Confirmation

In addition to securing a cut-off bank statement auditors customarily obtain a bank confirmation of the amount on deposit on the reconciliation date by letter directly from the bank. (See opposite page). This is particularly desirable if the client has had access to the bank statement before the auditor uses it, which is likely since the client's employees will generally prepare their regular monthly bank reconciliation without waiting for the auditor. In any case the direct confirmation gives the auditor greater assurance that the bank balance with which he reconciled the book balance is valid.

Review of Client's Reconciliations

In addition to preparing bank reconciliations at the balance-sheet date, the junior accountant is frequently instructed to review bank reconciliations as prepared by the client at other dates during the year. In reviewing a reconciliation, much less is expected than when the auditor is instructed to prepare a reconciliation for the working papers. The arithmetical accuracy of the reconciliation should be proved, including the total of the outstanding checks. The balance per bank statement should be checked back to the statement and the balance per books compared with the ledger account. All other reconciling items should be scrutinized carefully for the propriety with which they are handled. Any large, unusual items such as outstanding checks that appear in several successive reconciliations should be investigated by reference to the checks themselves. In general the junior accountant doing the reviewing should be alert to any possibility of the reconciliation having been manipulated to obtain an apparent support of the book balance when no such support actually exists.

Reconciliation of Cash Transactions Per Bank and Per Books

The purpose of a bank reconciliation is to determine whether the book balance of cash on deposit is satisfactorily supported by the bank's statement of the cash on deposit. However there is another aspect of the

______________19____

Dear Sirs:

We shall be obliged if you will kindly complete the attached report and mail it, in the enclosed addressed envelope, direct to the accountant named below.

Yours truly,

____

By____________________
Authorized Signature

DUPLICATE
To be retained by Bank

STANDARD BANK CONFIRMATION FORM-1940
Approved 1940 by
AMERICAN INSTITUTE OF ACCOUNTANTS
NATIONAL ASSOCIATION OF BANK AUDITORS
AND COMPTROLLERS

Report from

(Bank)____________________

____

____

Name of accountant

STANDARD BANK CONFIRMATION FORM-1940
Approved 1940 by
AMERICAN INSTITUTE OF ACCOUNTANTS
NATIONAL ASSOCIATION OF BANK AUDITORS
AND COMPTROLLERS

This report covers all branches of the bank unless specifically stated__________

Dear Sirs:

1. We hereby report that at the close of business on________________19____our records showed the following balance(s) to the credit of____________________

AMOUNT	DESIGNATION OF ACCOUNT	REMARKS	
		IS BALANCE SUBJECT TO WITHDRAWAL BY CHECK	DOES ACCOUNT BEAR INTEREST? GIVE RATE
$			

2. We further report that the above mentioned depositor was directly liable to us in respect of loans, acceptances, etc., at the close of business on that date in the total amount of $____________, as follows:

AMOUNT	DATE OF LOAN, ETC.	DUE DATE	INTEREST		DESCRIPTION OF LIABILITY, COLLATERAL, LIENS, ENDORSERS, ETC.
			RATE	PAID TO	
$					

3. Said depositor was contingently liable as endorser of notes discounted and/or as guarantor at the close of business on that date in the total amount of $____________, as below:

AMOUNT	NAME OF MAKER	DATE OF NOTE	DUE DATE	REMARKS
$				

4. Other direct or contingent liabilities, open letters of credit, and relative collateral, were

Except as stated above, according to our records, the said depositor was in no way obligated to us.

Yours truly,

(Bank)____________________

Date________________19____ By____________________
Authorized Signature

verification of cash that deserves some attention. An auditor is interested not only in verifying the amount of cash which the client claims is on deposit but also in whether all the cash which should be on deposit or on hand is accounted for. To illustrate: a company may show a general ledger cash account balance of $80,000. An auditor's first concern will be to determine if the company does actually have $80,000. Secondly, he will concern himself with determining whether the company should have cash in excess of $80,000, and whether any cash has been intercepted or improperly converted to the personal use of an employee or officer.

Several of the tests described so far are useful in aiding the auditor to discover attempts to conceal shortages of cash. Another procedure commonly used is the reconciliation of the cash transactions as shown in the books with the cash transactions as shown by the bank statement. Since most companies make disbursements only by check and deposit all receipts intact in the bank, failure of receipts per books to reconcile with deposits as shown by the bank statement or disbursements per books to reconcile with charges as shown in the bank statement is an indication that something is amiss. If, for example, the cash receipts as shown by the company's books are larger than the cash deposited as shown in the bank statement there is a strong implication, if there are no deposits in transit, that cash receipts have been intercepted by someone before deposit. On the other hand any excess of bank deposits over receipts per books would suggest that someone had deposited cash not received or recorded in the ordinary course of business, perhaps from unrecorded loans or to cover a previous shortage in anticipation of a review of the bank reconciliation at the end of the period. Differences between the totals of book and bank disbursements likewise indicate that either there have been unrecorded disbursements on the one hand, or on the other an attempt to depress the cash account balance by overstating disbursements on the books.

Two different methods of showing the reconciliation of receipts and disbursements per books and per bank are used. In one method, a simple calculation working from the receipts per books to the deposits per bank is worked out together with a similar calculation for disbursements as follows:

Cash deposited per bank statement	$112,780
Less deposits in transit at the beginning of the period	8,250
	104,530
Add deposits in transit at the end of the period	7,214
Cash receipts per books	$111,744

Any undeposited cash receipts on hand at either the beginning or end of the month should be treated as deposits in transit.

For disbursements the calculation would appear somewhat as follows:

Checks paid per bank statement		$ 98,214
Less		
Outstanding checks at the beginning of the period	$16,715	
Bank charges deducted by the bank this period but not yet entered on books	36	16,751
		81,463
Add		
Outstanding checks at the end of the period	18,912	
Bank charges deducted by the bank in the previous period and entered on the books this period	27	18,939
Cash disbursements per books		$100,402

Another form of work sheet is often used to accomplish this same purpose of determining whether receipts and disbursements per books and per bank can be reconciled. It has the advantage of tying in this reconciliation of transactions for the period with the bank reconciliations at both the beginning and the end of the period, thus giving a complete reconciliation of book and bank balances as well as of transactions.

An illustration of such a reconciliation follows:

	Balance 11/30	Receipts	Disbursements	Balance 12/31
Per bank statement	$42,715	$112,780	$ 98,214	$57,281
Reconciling items:				
Deposits in transit				
11/30	8,250	8,250*		
12/31		7,214		7,214
Outstanding checks				
11/30	16,715*		16,715*	
12/31			18,912	18,912*
Bank charges				
November	27		27	
December			36*	36
Per books	$34,277	$111,744	$100,402	$45,619

* Denotes deductions.

This particular type of work sheet or reconciliation is sometimes called a "proof of cash," which is certainly a misnomer. It is an extremely useful procedure but it does not of itself "prove" the cash. Only if various supplementary verification procedures are applied, such as the footing of the cash receipts and disbursements books for the period involved, the obtaining and use of a cut-off bank statement to support the ending reconciliation, and the careful verification of each figure used, is such a work sheet reliable. Without these supporting procedures it has limited usefulness; combined with them, it serves to give strong assurance that no unrecorded cash transactions have been entered into during the period. (See Figure 4.)

Physical Examination and Count

In their examinations of the reliability of financial statements, auditors do more than merely refer to records and documentary evidence supporting those records. In many instances they examine the actual asset that the financial statement item represents. For example, if called on to verify the balance of a petty cash account, an auditor would expect cash or cash items (checks, properly approved petty cash vouchers, et cetera) to be on hand in an amount equal to the account balance. To assure himself that such is the case the auditor would want to see and to count the cash making up the fund. This same procedure may be followed with respect to such other tangible assets as inventories, securities and perhaps additions to fixed asset accounts.

The purpose of this technique is to prove the existence and the quantity of the thing under examination. Obviously the primary usefulness of the technique will be with respect to tangible assets and to those assets, such as securities and evidences of debt, for which the owner does possess some tangible evidence of ownership.

Requirements of Physical Examination

Within the idea of physical examination as a verification technique are included several subsidiary ideas. Each of these must be given adequate consideration and attention if the technique is to be applied successfully and if its limitations are to be understood. One who is charged with the task of physically examining an asset must:

1. Satisfy himself as to the existence of the thing to be examined.
2. Identify that which he examines.
3. Determine whether or not it is in a satisfactory condition.
4. Determine the quantity.

A few words about each of these may be helpful.

Physical existence is a fact that would appear to be so simple to prove as to constitute no real problem whatever. "If seeing is believing" then all the auditor must do to satisfy himself of the existence of the property is to see it. Yet this is not always a simple matter. For various reasons satisfactory determination of existence is sometimes more difficult than might appear. First, there is the practice of packaging various assets. One may see a package but can he tell without opening the package what is contained within it? Whether the "package" is a roll of coins in the petty cash drawer or a box in the warehouse there is a possibility that it may not contain that which it is said to contain. Second is the practice of stacking or piling bales or boxes in large quantities. There is then a question of whether or not the stack is solid. Instead of being a solid pile as it appears, does it contain a "hollow square" or other vacant space? Finally, the use of tests and samples by an auditor in applying physical examination as a verification technique requires that care be exercised in selecting the tests to make sure that the scope of examination is adequate. For example, one might do a very good job of making test counts of raw materials inventory, but if he made no effort to test-count the work-in-process inventory his verification would be deficient.

Identification is a problem closely related to determination of existence. If one is unable to identify that which he is supposed to examine, how can he be sure he has examined it? Thus attention to the description of the item examined is essential. The names or descriptions of securities must be determined carefully, the bin tags or other descriptions of items in an inventory must be noted, and any additions to fixed assets must meet with the description given on the invoice. During a busy season a junior accountant may take part in the examination of a wide variety of companies.

Dealers in grain, manufacturers of radio parts, lumber companies, textile mills, and others may have inventories to be examined. In each of these the problem of various grades within each classification also may be a matter of importance. Only in rare cases can one be so familiar with the materials to be examined that he can distinguish among several grades.

Courts have long held that an auditor is not an appraiser nor a valuer of merchandise. Hence he is not responsible for appraising the value of the goods in inventory. On the other hand, he is interested in arriving at a conclusion as to the reliability of the client's inventory figure and can scarcely do so without giving reasonable attention to the descriptions of the items included. This requires extreme care on the part of the accountant in order that improper descriptions of the items examined may not result in incorrect inventory figures.

Condition is another variable. No items should be included at full cost if they are not in a useful and usable condition. This applies more to inventories than to other items to which the examination technique is applied.

Throughout his examination the auditor must be alert to shop-worn, damaged or obsolete merchandise. Occasional questions directed to the employees who regularly handle the merchandise may be helpful although the auditor must be careful not to appear to be quizzing them unduly.

Obsolete merchandise sometimes can be recognized because of its location in the storeroom, because it is obviously an out-of-date item, or because it is so marked. In other cases the item may be in the best of condition, well packaged, and with no indication whatever as to its obsoleteness. Of course, physical examination is only one of the means whereby the obsolete nature of merchandise is determined. Other tests, for example the review of detailed inventory records for activity of the individual items in the inventory, are used to supplement physical examination.

Ascertainment of quantity is relatively easy in most cases. Occasionally, however, it becomes a serious problem. Quantity of work-in-process is sometimes difficult to determine. The quantity of goods stored in piles or in other "bulk" form cannot be counted in the usual manner. Tremendous quantities of small parts may make counting impracticable although the value of the items may be substantial. Weighing the entire quantity and then multiplying the total weight by the known quantity per pound may be satisfactory in such a situation. In other cases an estimate may be the solution. As with other doubtful matters, a junior accountant should always bring such situations to the attention of his senior or supervisor and request instructions. Needless to say, he should do this only if the item is of enough importance to require such attention.

The application of physical examination varies somewhat with the thing to be examined as do the problems encountered in applying the examination technique. Some of the points to be considered in examining cash, securities and inventories are discussed in the following sections.

Cash Counts

Junior accountants are frequently assigned to count petty cash and other funds and to count undeposited cash receipts. Certain requirements must be fulfilled in making such counts if they are to be satisfactory. First, all cash and cash items must be counted simultaneously. Second, they should be counted in the presence of the custodian. Third, a receipt should be obtained from the custodian on completion of the count and return of the fund. Fourth, the work sheet record of the count must be adequate to permit investigation of any unusual or questionable items. Fifth, unusual items must be thoroughly investigated and satisfactorily explained.

Simultaneous count of cash funds is necessary in order to eliminate the possibility of amounts being transferred from one fund to another to conceal a shortage. In counting three funds, for example, the junior must be sure that he is not counting the same cash more than once. This necessary control of all cash until counting is completed can be obtained by bringing all funds to a single location for counting where they are under the view and supervision of the auditor until he has completed his examination, by assigning sufficient men to the counting task to cover all funds at the same time, or by sealing with an initialed sticker any cash drawers or boxes not in view until the auditor can get to them. In some situations funds are active throughout the day, which circumstance may require a count either before the business day begins or after it ends. With a little planning, simultaneous count can nearly always be obtained with no real difficulty.

Securities, notes receivable and similar valuables should be counted at the same time cash is counted because they can be used as a basis for obtaining a temporary loan to cover a cash shortage. Hence, any negotiable papers are considered as cash equivalents and are counted simultaneously with the cash.

Cash funds or undeposited receipts are commonly the responsibility of a specific employee of the client. The junior accountant assigned to count a fund should make sure that the custodian of that fund is present throughout the count. If the custodian is permitted to leave and a shortage is discovered during his absence, the junior may find himself accused by the custodian of having caused the shortage. Such an embarrassing predicament can be avoided by requesting that the custodian remain until the count has been completed or, if he insists on leaving, by requesting him to lock up his fund until he returns at which time the count will be completed.

It is common practice to obtain a statement on the working sheet from the custodian of the fund to the effect that the fund was counted, the total determined and the fund returned to him. Some accounting firms object to this because they feel it implies that the custodian relinquished control of the fund and was not present during the count, an undesirable situation as explained above. Careful wording of the statement to be signed by the custodian, however, appears to meet this objection. A phrasing frequently used runs as follows:

> This fund was counted in my presence by a representative of Smith and Jones and returned to me intact.
>
> *Signature of custodian*

This wording appears to meet the objections commonly raised and at the same time gives the accountant a release and a signed agreement as to the fund total determined by the count.

An illustration of a work sheet record of a cash count together with the notes explaining questionable items is shown in Figure 5. Currency, coins, vouchers, cashed checks, I.O.U.'s and the like should all be listed for the review of the senior accountant. Any items other than cash or regular petty cash disbursement vouchers should be questioned. Any petty cash vouchers included in the fund at the time of count should be examined carefully for authenticity since a fraudulent voucher could easily be introduced to cover a shortage. The approval of someone superior to the fund custodian should be obtained for any cashed checks or advances. If there is any real question as to the validity of checks in the fund, the custodian should be requested either to turn them over to the general cashier for reimbursement or to take them to a bank for cashing in the presence of the auditor. This is seldom necessary and should be done only with the senior accountant's approval.

The presence of rolled coins in a fund raises the question of how many rolls, if any, should be broken to insure that they are really filled with coins of the denomination stated. Normally rolls are not broken but if it is considered desirable to do so only one or two rolls, selected at random, should be opened unless there is an extremely large amount of rolled coin on hand. A number of other rolls of the same denomination may be picked up and weighed individually in the hand to detect variations caused by insertion of material other than the proper coins.

The total of the fund as determined by count should be compared immediately with the appropriate ledger account balance so that any differences may be reported to the senior accountant and investigated further.

Examination of Securities

The examination of securities may be made against a list provided by the client or may require that the auditor prepare his own list from the securities examined. In either case all details of the security should be carefully determined: name of issuing company, description of security, established interest or dividend rates, par or stated values of stock or denomination of bonds, number of units, and proper naming of or endorsement to the client company.

The count of securities may be a major task if the company under examination is a dealer in securities or if it has extensive investments for a retirement trust fund or other purposes. In such cases it is customary to make the count on a work sheet that is merely a list of the securities examined. For most manufacturing or merchandising companies, however, the number of securities will be small. If so, it is customary to prepare a work sheet that permits tracing through all security transactions for the year. The count of securities can be incorporated readily into such a work sheet and the junior should inquire of the senior in advance of making the count the precise type of working schedule required. Figure 6 is an illustration of a common style of work sheet for securities. The way in which the count has been worked in should be given attention.

Physical Examination of Inventories

Since the physical examination of inventories became a requirement of any examination made in accordance with generally accepted auditing standards, it has become an important part of the work assigned to junior accountants. In most cases the observance of physical inventory taking requires two separate activities on the part of the accountant doing the observing. First, he is expected to observe the procedures and the care with which the client's employees take inventory; second, he is expected to make certain test counts of inventory quantities himself.

In order to make appropriate working paper comments pertinent to his observations of the company's inventory procedure it is necessary that the junior accountant be familiar with the requirements of good inventory-taking procedure in general and with that of the client in particular. Many companies provide their employees with written instructions covering inventory procedures. In advance of the inventory date the junior accountant should obtain, through his senior, a copy of the inventory instructions. By studying them he is in a position to know what is required of the company employees and whether, in general, the procedure is adequate.

On the inventory date he must do a certain amount of moving from department to department and from storeroom to storeroom watching the care and efficiency with which the inventory crew performs its work. At the close of the day he should summarize briefly his conclusions as to the effectiveness of the inventory-taking procedure.

At the same time that he is watching the methods followed by the inventory crew he should make and record in his working papers a certain number of inventory counts of his own. Since these will later be traced into the company's inventory summary, it is important that they be in good order and described clearly. In making test counts it is generally most satisfactory to follow behind an inventory count crew. This gives the auditor the benefit of their count, so that he can immediately check his own count against theirs, and also the benefit of their inventory description on the count tag. Thus he can make a work sheet record of the description, tag number, and count. (Figure 7 is an example of such a work sheet.)

Making a test count requires that the auditor actually count the items in the bin, pile or stack. If he finds that his count does not agree with that of the count crew he should count again; and, if unable to account for the difference, he should call it to the attention of the inventory supervisor. He is not particularly interested in reporting isolated minor errors made by the inventory crew; he is far more interested in seeing that they arrive at a correct inventory result. Hence, any errors which they can correct on the spot should be called to their attention.

It is expected that occasional errors will be made by a count crew and discovered by the auditor. The existence of very many errors, however, indicates either an unawareness of the importance of their task, an ignorance of their duties, or complete carelessness on their part. This should be called to the attention of the senior immediately so that remedial steps may be taken before the inventory procedure is completed.

In deciding which items are to be counted for his tests the junior accountant will do well to give special attention to those which have greatest value. This is not always easy to determine but in most cases will give little difficulty. Even the casual acquaintance with the inventory obtained by observing the work of the count crew should be enough to indicate which items in general are most valuable. Also an effort should be made to get wide coverage of locations, that is, something from every department and storeroom, and of all lines of merchandise and types of inventory. If the company has raw materials, finished goods and work in process, tests should be made of each. If the company handles several different types of merchandise, again the test counts should attempt to reach some of each type.

On a large inventory assignment it is likely that the senior will work out such problems in advance and assign his assistants to different parts of the work so as to get representative tests. On a small job it may be left to the junior accountant to work this out for himself.

The possibilities of empty containers and of "hollow squares" in the material to be counted are always present and must be given consideration by the junior accountant. Three general methods of satisfying himself on this score can be and should be used in most instances. First, he should make every effort to determine through his own contact with the inventory whether such possibilities do exist. He can occasionally move or lift a container, climb to the top of large piles, investigate passageways between stacks, and the like. Second, he can ask an occasional question of the employees in that department as to how long the material has been there, what is included, how often it is restacked, et cetera. The answers to such questions may be the best clues to something out of the ordinary. Finally, by observance of what may be called the inventory situation he can tell a good deal about the possibilities for such misrepresentation. For example, in a busy storeroom from which items are being drawn for shipment or use at all times and into which new shipments are coming, there is little likelihood that either empty containers or improperly piled stacks will be found. They would interfere too much with regular operations and would require the collusion of too many employees. On the other hand, in a storeroom from which amounts are not being requisitioned regularly, such as a warehouse with only one custodian in charge, there is much more opportunity for something to be amiss. The junior accountant should always be alert to such possibilities.

When the accountant is dubious concerning the inventory items in stock he can request that packages or crates be opened for examination and that piles be moved sufficiently to assure him that no vacancies are concealed within. However, this is generally viewed as an imposition by the employees of the company and may result in considerable bad feeling. As with other such questionable alternatives, before making extensive requests of the client's staff it is best to obtain the opinion of the senior whose experience is greater and who is the one finally responsible to his firm for the extent of the examination.

As the auditor is not expected to be a valuer or an appraiser he is relieved from a task which might be almost impossible to perform — that of determining the grade and quality of everything he examines. However he is expected to determine whether the items are in a useful or "merchantable" condition. Inventory items which have been damaged by exposure to the weather, those which have been injured because of faulty storage or handling, and those which have become obsolete should be detected during the physical examination of the inventory and later priced accordingly. In some cases this is a simple matter as the client will have such merchandise separated from the regular goods and perhaps even marked. In other cases it is almost impossible to discover that items are obsolete or defective merely by looking at them. It is comforting in this respect to remember that other procedures such as a review of detailed inventory cards is very helpful in locating obsolete or slow-moving merchandise.

CHAPTER 5

Confirming and Scanning

Confirmation

Another basic verification technique which commonly falls to the lot of junior accountants is that of confirming certain facts by correspondence. To confirm means to obtain a written statement, usually from some one outside the enterprise, on some fact of importance to the auditor and on which that person is qualified to make a statement. The balance of cash in a bank account is confirmed by the bank as is the existence of bank loans and any contingent liabilities for guarantees or endorsements. The amounts owed to the company by its customers on open accounts or on notes are confirmed by obtaining statements from them as to the amounts of their debts. Amounts owed to others can likewise be verified by requesting each creditor to state the amount of the obligation. Frequently the best verification of title to property is a letter from the company's attorneys. Thus the confirmation procedure has wide usefulness and is generally considered to be an extremely reliable method of verification.

Control Over Confirmations

Perhaps the most important feature of the confirmation procedure for the junior accountant is the necessity for maintaining control over the confirmation requests and the replies thereto. If at any time there is an opportunity for the confirmation to get into the hands of anyone who might falsify an answer, destroy a confirmation that provided information not in agreement with the books, or in any other way manipulate the confirmation replies, the procedure has failed. If the evidence obtained is to be reliable, no tampering with the results may be permitted.

A confirmation is obtained in reply to a request. In most cases the request should come from the company under examination. Actually there is no reason why the one of whom the confirmation is requested should bother to answer to anyone other than the company concerned. Thus it is standard practice for the confirmation request to be prepared or at least signed by an official of the company under examination. Even when printed forms are used by the auditor he should have the form prepared in such a way that the request is made by the company rather than by the auditor himself. This means that confirmations, once prepared, must be turned over to the company for signature (unless, of course, they are printed forms bearing the client's name).

Another fact makes control difficult. In many cases the company under examination will actually prepare the confirmation requests together with the envelopes in which they are to be mailed. The auditor will merely indicate which accounts receivable are to be confirmed, and the company officials will have one of the employees type the necessary information on the forms provided. Again this requires that the confirmations be under control of the company for a period. If adequate control is to be maintained by the auditor the following steps are therefore necessary:

1. After the confirmation requests have been prepared or signed by the client company they must be returned to the auditor for final review and mailing. At this time the junior should make certain that all confirmations are accounted for. Any missing confirmation requests should be reported to the senior immediately.
2. The auditor must place the requests in the envelopes, after he has assured himself that they are in order as requested, and should seal the envelopes and place them in the United States post office receptacle himself. Under no conditions should he turn them back to any member of the client's staff for mailing.
3. The envelopes in which the requests are mailed must contain the auditor's address as the return address so that he may learn of any nondelivery.
4. The addressed envelope, enclosed for the convenience of the party of whom the confirmation is requested, should be addressed to the auditor at his own office, post office box, or place of residence if he is on an assignment away from home.

Only if these precautions are taken is the auditor entitled to rely on the replies received. None of these are particularly difficult, but all must be carefully observed. They are applicable whether the confirmations are of accounts receivable balances, bank balances, or any other data of interest to the auditor.

Circularization of Accounts Receivable

The largest single application of the confirmation technique on most engagements is in the circularization of accounts receivable. This duty is frequently turned over to a junior accountant and is therefore one with which he must be familiar. In addition to the control over confirmations described previously, two other points must be given consideration. One has to do with selecting the accounts to which requests for confirmation will be sent; the other deals with the investigation of unsatisfactory replies or failures to reply.

The expression "confirm a representative portion of the accounts receivable" is a common one in audit programs. The emphasis is on the phrase "representative portion." This implies that some large balances, some small balances, some from various ledgers if more than one ledger is used, some from each geographical or other divisions if there are such divisions, and some credit balances, if there are any, ordinarily should be selected. The intent is to insure that no segment or division of the accounts is overlooked. In addition, the sample confirmed should be adequate in total dollars. Therefore, it is customary to include all or most of the large account balances as well as a reasonable number of the smaller balances. In many cases it is possible to get a high proportion of the total dollars of accounts receivable confirmed by taking only a small proportion of the total number of accounts if the accounts to be confirmed are carefully selected.

Types of Accounts Receivable Confirmation

Two types of accounts receivable confirmation requests are used, the positive and the negative. A positive confirmation requests the individual addressed to reply whether or not the amount indicated is correct.

A typical positive confirmation request is shown below:

DEAR SIRS:

Will you please advise our auditors, WAKE & FIELD, Certified Public Accountants, on the attached form, of the correctness of the balance in your account as shown by our books at the date and in the amount stated below, or of any exception you may take thereto. A stamped and addressed envelope for your reply is enclosed.

____

To

(This is merely a request for confirmation, not for remittance.)

- -

MESSRS. WAKE & FIELD
One North La Salle Street — No. ____________
Chicago, Illinois

We (I) confirm the correctness of a debit balance of $__________ in our (my) account on the books of ______________________________ as of ______________________ 19_____, with the exceptions, if any, stated below.

Signed ______________________________

By ______________________________

Exceptions
(please state differences in detail, giving all pertinent dates and amounts):

____

____

(Use other side if necessary)

A negative confirmation requests a reply only if the amount indicated is incorrect, as shown in the following typical example of a negative confirmation:

> IMPORTANT
>
> Please examine the enclosed statement carefully and, if the amount of your account is incorrect, advise our auditors, Wake & Field, One North LaSalle St., Chicago, Ill., using the enclosed envelope (no postage required). If correct, no advice is necessary.
>
> *(This Is a Routine Step In Our Annual Audit)*

Negative confirmations are especially useful in cases where the nature or number of accounts to be confirmed makes positive confirmation difficult. The positive confirmation of course gives better evidence as to the validity of the account balance as the auditor is provided with a definite statement regarding the correctness or incorrectness of the amount. A negative confirmation is one of implication only, since the auditor receives no answer if the amount is correct. Actually the failure to receive a reply may be due to other reasons than the correctness of the amount. The recipient's failure to co-operate, his oversight, nondelivery of the request or a variety of other reasons might account for the lack of a reply to a negative confirmation. The auditor should not use the negative form if he has reason to believe (as in the case of government agencies) that it will be ignored.

Positive confirmation forms are generally used where account balances are relatively large and relatively few in number. Negative-type requests are most useful in situations where there are a great many accounts of small amount. They should be supplemented by positive-type confirmations on at least a small scale if at all practicable.

Additional Work on Accounts Receivable Confirmations

A careful record should be kept of all positive confirmation requests sent out so that they can be adequately followed up if not returned. As confirmations come back they must be examined for any exceptions or differences. Those that agree with the records are immediately filed with the working papers as evidence. Those that disagree in any way must be investigated further. Generally these are accumulated and all discussed with some member of the client's staff at one time. In each case the reason for the difference must be determined and the necessity for an adjustment considered. Reasons given must be recorded in the working papers together with the fact of the exception. Sometimes the explanations are noted on the reverse side of the confirmation form. Needless to say, all differences must be either explained sufficiently or adjusted.

A positive confirmation request that is not returned always presents a problem. A question is raised in the mind of the auditor as to whether or not that account is correct and whether it exists at all. This he attempts to determine either by tracing subsequent cash receipts on that account through the cash receipts book and into bank deposits to satisfy himself that the balance was real and collectible or, if no remittances have been received, by referring back to the sales invoice supported by shipping documents and the like to discover whether or not the sales transaction was a real one. In many cases a second confirmation request or a telephone call is used. If a reply is still not received the alternative steps mentioned are generally necessary.

It should be remembered that the complete confirmation procedure includes these last two steps: the investigation of any reported differences or exceptions and the investigation of confirmations requested but not returned. A typical work paper schedule of accounts receivable confirmation is shown in Figure 8.

Scanning

Scanning is the process of carefully scrutinizing a ledger account, a journal entry, or any other record or part of a record for questionable, unusual, or improper items. A good auditor applies this technique constantly in his work because he is always alert to the possibilities of items or entries that are incorrect. For example, the general ledger cash account in a system making use of columnar books of original entry usually has but twelve postings during the year on the debit side, each of them from the cash receipts book. On the credit side should be twelve postings from the cash disbursements record. An alert auditor, in scanning this account, should note any additional items on either side and should investigate them. Likewise, a posting from some source other than the two mentioned would merit attention.

The ability to scan accounts effectively implies a sound knowledge of bookkeeping and accounting and some acquaintance with the business under examination. It is acquired with experience but is not the inevitable result of experience. Many auditors labor for years without ever developing alertness to unusual situations and entries. No auditing technique is less tangible and almost none is more useful. The junior accountant should constantly strive to develop the habit of watching for any amounts that appear unusual, that is, either larger or smaller than similar items, for any entries that do not appear to be entirely in keeping with the ordinary course of accounting transactions, and for any apparent violation of bookkeeping practice. Experience is helpful but alertness and application are more important. If the junior possesses the latter two qualities, experience will then be of real benefit in improving the ability to do a good job of scanning.

It should be apparent that scanning is seldom applied except in connection with some other technique. The accountant should be scanning constantly the records with which he is working. Only if he is, can he expect to pick up the unusual entries or items that may lead to the discovery of important errors.

CHAPTER 6

Applications of Audit Techniques

The verification techniques described in the preceding chapters are those with which a junior accountant must be familiar inasmuch as he uses them frequently in his audit work. However they are not always applied as directly as implied in the discussion so far. In many cases a variation of one of these techniques is used; in other instances two or more are combined to make up a specific test. Nevertheless these variations and combinations do get back to the basic techniques in almost every case. Accordingly, if a junior is familiar with the requirements of each technique he can apply it appropriately in a variety of situations.

Some of the modifications or combinations of the basic techniques are applied to work so frequently assigned to junior accountants that they deserve attention at this point. The following paragraphs will review them with the objective of acquainting the junior accountant with terms commonly used in the field and of indicating further the usefulness of auditing techniques in general. It should be remembered that these are really nothing more than special applications of the basic techniques with which the junior accountant should be familiar.

Comparing Details per Cash Receipts Book with Duplicate Deposit Tickets

If the client's procedures are such that one individual has access to cash received on account and also controls the accounts receivable ledgers, it may be possible for him to practice a type of defalcation commonly known as "lapping." Lapping is used in intercepting amounts received from customers and converting them to personal use. To cover the resulting shortage, amounts received from other customers are used to apply on the accounts of those whose remittances were taken. Later, amounts from still other customers are credited to the accounts of those whose credits were misapplied to cover the original shortage and so on. If the guilty party is careful to cover his shortages promptly with no more than a few days "lap" in giving credit for amounts received, it is possible that he can cover his shortage indefinitely with little danger of complaint from the customers.

The method followed in covering a shortage by lapping together with an indication of how that coverage may be brought to light is illustrated in the following tabulation:

Date	Remittances Received		Amount Misappropriated	Entries in Cash Receipts		Cash Deposited	
6/28	*A*	$ 200	$200				
	B	600		*B*	$ 600	*B*	$ 600
		$ 800	$200		$ 600		$ 600
6/29				*A*	$ 200		
	C	$ 200				*C*	$ 200
	D	500		*D*	500	*D*	500
	E	300		*E*	300	*E*	300
		$1,000			$1,000		$1,000
6/30				*C*	$ 200		
	F	$ 150	$150				
	G	400		*G*	400	*G*	$ 400
	H	200				*H*	200
		$ 750	$150		$ 600		$ 600
7/1				*F*	$ 150		
				H	200		
	I	$ 350				I	$ 350
	J	700		*J*	700	*J*	700
		$1,050			$1,050		$1,050

On June 28 a remittance from *A* in the amount of $200 was received and misappropriated. This shortage was covered the following day by applying against *A*'s account a $200 remittance received from *C*. This left a balance in *C*'s account which was $200 in excess of what it should have been. On the following day, June 30, this was covered by crediting *C* for a $200 payment received from *H*. On the same day an additional collection of $150 from *F* was misappropriated. The total shortage at that time was $350. This was covered July 1 by applying a remittance of $350 from *I* against the accounts of *F* and *H*. In this way the shortage was covered promptly the following day in each case. Thus the time lag between remittance by a customer and the credit to his account may be so short that suspicion on the part of the customer is not likely. Any question raised by a customer because his personal records do not agree with a statement of his account received from the company could be answered as being only a slight delay in the bookkeeping.

It should be noted that for each day the total of the cash receipts book agrees with the total of the amount deposited so that any comparison of receipts per books with deposits per bank that relies on totals would fail to uncover the defalcation. If, however, the details of the items entered in the cash receipts books are compared with the items listed for deposit on the deposit ticket, differences do appear. In preparing a deposit ticket a person must list the specific items deposited so that the bank teller can check the various items against the deposit ticket. Thus the deposit ticket shows the items actually deposited whether entered in the cash receipts record or not. The cash receipts record, on the other hand, shows the receipts in the way the party guilty of the defalcation wants them shown.

As a matter of common practice, audit programs will include provision for comparing the details of the items in the cash receipts book with the details of the items listed on duplicate deposit tickets for a period of about five days on each side of the year-end date. Since shortages must be covered immediately to avoid questioning by the customers concerned, this brief period is considered long enough to locate any lapping of collections taking place at the year-end. Other periods during the year are sometimes tested.

Unfortunately, duplicate deposit tickets are not necessarily reliable. The guilty party could prepare a deposit ticket listing the exact items deposited so that no question would be raised by the bank. He could then destroy the duplicate and prepare another one agreeing exactly with the cash book entries. For this reason auditors commonly send copies of the deposit tickets for the days they are testing directly to the bank with the request that the bank validate the deposit ticket in detail and return it directly to the auditor for his use in comparing with the cash receipts record. Even this is not completely satisfactory as banks frequently do no more than compare the total of the deposit ticket sent in by the auditor with the total of the deposit ticket in their files, which of course is insufficient for the auditor's purpose. Hence, if there is a real suspicion of lapping, care should be exercised to assure that the bank does verify the details of the duplicate deposit tickets on which the test is based.

Lapping is accomplished more easily if the party concerned has both currency and check receipts available to him. This makes it possible for him to take any amount he desires from the currency receipts and then to cover it by manipulation of the credit entry for both the currency and check receipts. It also can be accomplished if he receives only check receipts providing he can make arrangements to cash the checks made payable to the company. In either case the procedure applied by the auditor is the same but where only currency is received this test would not be effective.

Comparison of Receipts and Deposits on a Daily Basis

The importance of reconciling receipts and disbursements as shown in the bank statement with the receipts and disbursements as shown by the books is discussed in an earlier section. This procedure is useful in pointing out any differences between disbursements per books and per bank and between receipts per books and per bank for the month or period selected for the test. It would not show, for example, any withholding of receipts from deposits for a period within the month if the shortage were made good before the end of the month. Since many concerns include in their provisions for internal control a requirement that all cash received must be deposited intact the day it is received, some attention should be given to ascertaining whether that practice has been adhered to.

A very simple test is to list the total cash receipts for each business day within the month from the cash receipts record. In an adjoining column the deposits according to the bank statement also are listed day by day. Any failure to deposit receipts promptly is quickly brought to light. The following illustrates the method to be followed:

Date	*Receipts per Cash Book*	*Deposits per Bank*
Dec. 1	$1,200	$1,350
2	900	1,200
3	1,500	900
5	1,275	1,500
6	1,900	1,275

The lag of one day between receipts and deposits is to be expected as it is impossible to make deposits of all cash received on a given day before the end of that day. Any lag of more than one day should be viewed with suspicion and reported to the senior accountant.

Price Test of Inventories

In addition to observing physical inventory taking and making test counts, a junior accountant is often asked to make a "price test of inventory items." This consists of determining that items in the inventory have been priced on a basis satisfactory for balance-sheet purposes. The primary basis for pricing inventories is cost, but this basis frequently is modified if the market price of the items in the inventory is below cost. The "lower of cost or market" rule has become the generally accepted basis for pricing inventories for financial statement purposes. (For the meaning of this term "lower of cost or market" and further details as to its application, see Accounting Research Bulletin No. 29 of the American Institute of Accountants.)

At one time the lower of cost or market test was applied to each item in the inventory so that the final figure was made up of the lower of cost or market for each individual item included. This practice has been modified so that it is now acceptable to apply the lower of cost or market rule to major sections of the inventory or, in some instances, to the inventory as a whole if done consistently. This modification does not in any way make it unnecessary to test individual prices. In order to determine to what extent, if any, market is below cost for the inventory as a whole it is necessary to determine both cost and market (if different) for all components of the inventory total. Thus the test of detail prices is still important.

This test is commonly applied by selecting from the client company's inventory a representative sample of the inventory items, including as many of the more significant items as possible. The description, quantity, price and extension as indicated by the inventory listing are all copied on a work sheet as illustrated in Figure 9. By reference to recent purchase invoices for quantities usually purchased, to catalogs or price lists, to published quotations, or to confirmations from the suppliers if necessary, the current replacement market prices are determined. The quantity is then extended at the current market price and the difference between the current market price and cost is entered in a final column.

The pricing of an inventory to recognize obsolescence or physical deterioration is a different matter. In such cases the pricing should not exceed the realizable value less costs of selling and delivery. Unless sale has taken place by the time the audit work is undertaken so that such amounts are known, the pricing may be difficult and may present a problem which should be referred to the senior if the amounts are material.

Purchases and Sales Cutoff

In taking and pricing a physical inventory, there is always a possibility that the purchase and sales accounts will not be appropriately coordinated with the inventory procedures. For example, goods may have been received close to the end of the year and may have been uncrated and included along with other items in the physical count of goods on hand so that they are a part of the ending inventory figure. The invoice for these goods might not arrive until some time after the goods themselves. In such a situation it is possible for the invoice to be recorded as a purchase in the following year although the material was considered to be a part of inventory at the end of the year under examination. This will result in an understatement of the cost of goods sold and a consequent overstatement of net income for the year in which the items were included in inventory. Conversely, the invoice might have been received and recorded as a purchase although the merchandise in question was not received until after the inventory was taken and therefore was not included in the inventory. The same type of problem exists in regard to sales. Products not yet shipped at inventory time might be included in the inventory although the sale had already been recorded, or goods actually shipped and not in inventory might not have been billed to the customer.

To discover whether errors of this nature have been made it is customary to test the company's cutoff of purchases and sales. From the purchases book a list is prepared of the significant purchase invoices for the last few days of the period under examination and for the first few days of the following period. By reference to the purchase invoices, the terms of the transaction are found so that the ownership of the merchandise in question on the audit date is determined. By reference to receiving room reports or by whatever other means may be available, the location of the goods on the inventory date is determined. With this information at hand the auditor reviews each invoice with the following questions in mind:

1. Was it included in inventory?
2. Should it have been included in inventory?
3. Is any adjustment of inventory necessary?
4. Was it included in purchases for the year?
5. Should it have been included in purchases?
6. Is any adjustment of purchases necessary?

If the inventory figure has not yet been recorded by adjusting or closing entry, it may be corrected for any errors prior to its entry. If it has been entered, adjusting entries will be necessary.

A test of the sales cutoff is performed in much the same way. A number of sales invoices both before and after the audit date are listed, the terms of sale are determined from sales invoices, and the location of and title to the goods on the inventory date are determined from related shipping documents.

An illustration of a work sheet showing the test of the purchases cutoff is in Figure 10. Careful attention to the individual items included on the illustrated work sheet will indicate the manner in which the purchases and inventory figures are correlated.

Search for Unrecorded Liabilities

Another test commonly assigned to junior accountants is the search for unrecorded liabilities or, as it is sometimes called, the search for out-of-period items. This test is designed to discover any liabilities existent on the audit date that were not recorded at that time and that were not discovered by the test of the purchases cutoff. Invoices for purchases, public utility bills and similar items that were actually obligations on the balance-sheet date may have been omitted, inadvertently or otherwise, at that time and entered at a later date. The search for unrecorded liabilities is an attempt to discover such omissions.

The test is made effective by the fact that to protect its credit rating a company must pay all such obligations within a reasonable period. Inasmuch as an audit is seldom completed until at least a month after the close of the period under examination, and frequently considerably later than that, most of the unrecorded debts at the balance-sheet date will either have been paid by the time the audit is completed or at least will have been entered and approved for payment. Thus the search for unrecorded liabilities consists principally of reviewing the invoices paid or approved for payment from the end of the period under examination to the date the audit is completed with the intent to discover any such items that should have been included as liabilities on the audit date but which were not included.

If the company utilizes a voucher system, all the items in the paid and unpaid voucher files should be examined carefully. If some variation of the voucher system or some other method of controlling accounts payable is used the search for unrecorded liabilities must be modified accordingly. In most cases the senior accountant in charge will instruct the junior clearly enough so that no confusion exists in regard to the records or files to be examined. In any event, the junior should make every effort to include all possibilities within his search, including items paid and items approved and not yet paid. This may require study of the cash disbursements record as well as the purchases book, invoice register or voucher register.

In studying the invoices and other evidences of liability, the junior accountant should have in mind the question: Was this an obligation on the balance-sheet date? He should observe the terms of the invoice and the date of the related receiving report for merchandise purchases because these two elements establish the ownership of the merchandise and, therefore, the existence of liability for the purchase price. For utility bills, the period covered by the bill will indicate the time at which the liability accrued.

When a liability as of the balance-sheet date is found the accountant must then determine whether or not it was recorded as such at the audit date. This may be determined by the voucher or invoice number if they are numbered consecutively as entered. Otherwise it may be necessary to trace the invoice into the purchases book, invoice register or voucher register to determine when it was entered. Accruals of expenses must also be considered since many companies accrue certain expenses in advance of receiving an invoice. A list of all unrecorded liabilities should be prepared and submitted to the in-charge accountant for his decision as to whether adjustment should or should not be made. Since the search for unrecorded liabilities is related closely to the test of the purchases cutoff, care must be taken to avoid duplication of adjustments.

There are a number of other tests for determining that unrecorded liabilities exist (such as reviewing expense accounts, reading corporate minutes, inspecting correspondence with the company's attorneys, et cetera), but these are usually done by the senior accountant or by the junior under the specific direction of the senior as to method and extent of procedure.

Aging Accounts Receivable

As part of the review of collectibility of the accounts receivable, a task generally performed by the in-charge accountant, it is helpful to have an aging schedule which is an aged accounts receivable trial balance. In many cases the client's staff will prepare such a trial balance and make a copy available to the auditor. In other cases the auditors will be required to prepare their own schedule. In either case the junior accountant must know how to age accounts receivable properly for he may be called on either to prepare the schedule, if the client does not provide one, or to test the aging shown in the client's trial balance if such a schedule has been provided.

The purpose in aging accounts receivable is to determine which of the various charges to each account are unpaid at the date of the schedule and the length of time for which they have been outstanding. The older the unsettled items the more likely they are to be uncollectible; therefore, the greater the amount of attention they should receive from the auditor when he passes on the adequacy of the provision for uncollectible accounts. It is not unusual to find old and questionable items in accounts which otherwise are current and considered good. Because of dissatisfaction with a shipment or for some other reason a customer may have no intention of paying for the disputed item and it is therefore an uncollectible amount.

To determine which charges to an account receivable are included in the account balance requires that remittances received be matched with charges to the account. Any unmatched charges are the open items which make up the account balance.

Often the credit and collection department of the company under examination will already have matched remittances with charges because they too are interested in any old unsettled items. Frequently this is done by coding charges and remittances with a letter or number in the margin. In other cases the auditor will have to work it out himself. In matching remittances with charges the following rules are considered valid:

1. The customer is entitled to state which charges are to be paid by any remittance he makes.
2. If the customer neglects to indicate the charges he intends to pay with a remittance, the creditor is entitled to allocate the remittance as he sees fit.
3. If neither the customer nor the creditor has so indicated, courts have usually held that the intention was to pay the oldest items first.

The following three accounts are presented to illustrate the general procedure followed in aging accounts and to show how a schedule is prepared to summarize the aging:

Abbott				*Adkins*				*Admiral*			
Debit		*Credit*		*Debit*		*Credit*		*Debit*		*Credit*	
4/1	500	4/28	500	2/5	200	3/15	200	12/20	300		
6/12	700	7/10	600	7/15	350	8/1	350	3/17	400	3/31	400
10/3	300	11/4	300	11/12	475	12/10	200	5/28	700	11/1	800
12/15	800							10/16	800		

AGING SCHEDULE

Account	*Balance*	*Under 30 days*	*30 to 60 days*	*60 to 90 days*	*Over 90 days*
Abbott	$ 900	$ 800			$100
Adkins	275		$275		
Admiral	1,000	300			700
	$2,175	$1,100	$275	0	$800

Verification of Payroll Transactions

Junior accountants are frequently assigned to the task of testing payroll transactions. For this reason, and because it is a good illustration of how basic audit techniques are combined to do a single verification job, it deserves consideration here.

The basic record of payroll transactions in a small organization is generally the payroll itself. On it are listed the name of each employee, the hours he has worked, his rate of pay, the total dollars earned, the deductions from gross pay for social security and Federal income taxes withheld, any union dues collected by the company from the employees, hospitalization or other insurance deductions, and the like; and the net pay in a final column. Check numbers are entered as checks are issued for the net amounts. Thus the payroll is the basis for computing the pay of each employee and also serves as a check register of payroll disbursements. As might be expected it is also the basis for the auditor's tests which include the following:

1. Footing and cross-footing the payroll to make sure that the totals have been determined accurately. This is necessary so that the total amount of cash charged for payroll purposes is not excessive. Because of the number of payroll checks and the frequency with which they must be issued it is difficult to have as effective internal control over their issuance as over other cash disbursements. For that reason it is customary to establish a payroll bank account on which payroll checks are drawn. Each pay day there is deposited in this account only enough cash to cover the net pay, which is the sum of all the checks to be issued on that day. Under this procedure only as much goes into the payroll account as is needed. The internal control consists of making available to the person signing pay checks only the exact amount needed (with perhaps a small fixed amount in excess thereof always kept in the payroll account as a minimum imprest amount to prevent overdrawing because of

an error in preparing a check). If the payroll has been overfooted, a greater amount than indicated will be deposited in the payroll bank account and will be available to the one signing paychecks.

2. Vouching the hours worked by reference to approved time-clock records, timekeepers' reports, or other satisfactory evidence.
3. Vouching the rate of pay by reference to wage authorization slips in the employees' personnel files, to union contracts, or to other reliable authorizations.
4. Testing the amounts entered in the gross pay column by multiplying hours by rates of pay.
5. Scanning deductions for reasonableness and investigation of doubtful items for propriety. The greatest possibility of error here is that in order to favor an employee no deduction might be entered where one should be. In scanning the payroll deductions the auditor should be alert for the omission for one employee of deductions of a type commonly entered for other employees.
6. Vouching amounts in the net pay column by test examination of returned payroll checks. Special attention should be given to endorsements, to agreement of the name on the checks with the names listed in the payroll, and of course to any checks apparently not made payable to employees.
7. Testing the subsidiary payroll records such as the employee's earnings record required by the social security tax laws. Every name on one or more selected payrolls should be traced to employee earning records and the entries in the earnings records for that payroll examined for propriety. The test should then continue from the employee earning records into copies of social security tax reports. The fact that a name is listed on a social security tax report is not conclusive evidence that such a person actually exists and works for the company, but it is reasonable evidence and should be obtained if available.
8. Scanning the journal or voucher register entries recording the payroll for propriety to assure that the liability for amounts withheld have been recorded properly and to determine that appropriate expense or cost accounts have been charged.
9. Reconciling the payroll bank account to assure that there is no attempt to cover errors through a forced reconciliation.

Account Analysis and Verification

After a junior accountant has demonstrated an ability to accomplish quickly and effectively the various routine tasks assigned to him, he will be asked to make analyses of various accounts or of groups of accounts. An account analysis consists of a work sheet showing the various items that compose the account balance. By itself the analysis does little more than present information as to the nature of the charges and credits to the account. Once the analysis has been prepared it is customary to verify the various entries to the account by whatever means appear most suitable. In some cases the individual entries are proved by vouching, in other cases the account balance or portions of the balance are established as reliable through application of the confirmation procedure. Thus account analysis, to be effective, must be accompanied by one or several of the basic verification techniques.

In preparing the account analysis it is desirable for the junior accountant to determine, either by reference to the prior year's working papers or by questioning the senior accountant, the extent of information desired in the analysis. Some accountants wish detailed descriptions of the charges and credits to the account included in the work sheet; others are content with little more than the amount and the voucher reference. In the case of small clients with inadequate records, fairly complete information is generally desirable.

The ledger account itself is the basis for the analysis and, if detailed items are posted to it, may give almost all the information necessary. In some cases accounts receive only summary postings from a voucher or invoice register. In such cases it may be necessary to work back from the ledger accounts to the books of original entry to ascertain the individual items that make up the monthly charges or credits to the account.

In analyzing an account it is not always necessary to list every entry in detail. Some accounts receive a few relatively important entries each month together with a good many small items, sometimes so small as to be insignificant even in the aggregate. In such cases it is customary to list only the material items in detail with perhaps a few of the smaller items. The remainder of the insignificant items are lumped together with some such description as:

Remaining July charges, all of $25 or less $425

This procedure makes it possible to compare the account balance as shown by the analysis with the trial balance and with related schedules without the necessity of tracing every entry.

Related accounts are best verified together. A fixed asset account and the related account for accrued depreciation, together with the related depreciation expense account, make a natural grouping and should be analyzed together. Indeed it is difficult to do a satisfactory job on any one of the three without giving some attention to the others. To make this group complete the account for repairs and maintenance to that particular fixed asset should usually be added. It is seldom the task of a junior accountant to decide which accounts should be attacked as a group. Sometimes, however, a senior will take it for granted that his assistant, if assigned the fixed asset accounts, will also analyze and verify the related depreciation and repair accounts.

It is therefore desirable that the junior give some consideration to related accounts, and if his instructions are not specific he should inquire of the accountant in charge as to whether he is expected to audit the related accounts. The natural groupings of accounts for verification purposes are not difficult to discover. See Figures 11 and 12 for examples of analyses and of cross-checks of items from one analysis to another.

Variety of Applications of Audit Techniques

It has not been the intent of this section on audit techniques to cover all possible applications with which the junior should be familiar. Neither has the description been exhaustive in covering the procedures applicable to the various audit problems presented. Audit engagements differ one from another. The records kept by various clients differ, the internal control systems differ, the materiality of the amounts differ, the scope of audit engagements may differ, and the programs followed by the accountants in charge may vary. The problem is always one of obtaining an adequate amount of evidence as to the reliability of the financial statements and of ascertaining their conformance with accepted principles of accounting. Frequently there are alternate methods by which some evidence may be obtained and situations where the amount of evidence needed is different than in other cases. Auditing does not consist of blindly following through a series of steps or of applying certain techniques. Rather it requires the use of judgment in efficiently and adequately learning enough about the financial statements to permit the expression of an opinion or to determine that no opinion can be expressed about them.

The junior should keep in mind constantly the basic purpose of all the work being done. Only by doing that can he proceed in an intelligent manner in the tasks assigned to him. He should not change the procedure without permission of his supervisor, but he should be alert to the possibility of saving time or of obtaining better evidence by some change in procedure and he should not hesitate in suggesting well thought-out changes to his superior.

CHAPTER 7

Professional Requirements

As a young man bidding for a place in a young and growing profession, a junior accountant must not only acquire technical skill in the performance of his present duties, but he also must recognize his responsibilities as a professional man. He must attempt to develop what may be described as a professional attitude and bearing. To do this he must have some understanding of the nature of accounting as a profession and a genuine awareness of the importance of maintaining proper relations with those persons with whom he works.

Public accounting has one field of effort that is peculiarly its own: the examination of the financial statements of business companies in order that an opinion as to their dependability may be expressed. This is the field of auditing in which a junior accountant finds most of his work. In performing this function of examination of financial statements, public accounting performs an important social service. Modern business operates largely on a credit basis. The granting of credit requires that the grantor have some knowledge of the financial position and operating success of the one requesting credit. Therefore he calls for copies of financial statements. But financial statements are prepared by the company that issues them so there is always a possibility that there may be errors in accounting principles or judgment, or other errors in their presentation of the information required by the prospective credit grantor. Out of this set of circumstances grows the work of the independent public accountant. As an independent expert on both accounting and the verification of accounting data, he examines the financial statements issued by business companies and then states whether, in his opinion, they are or are not reliable. An independent accountant's opinion gives the reader of the statements the assurance he needs — assurance that the statements have been examined by an independent expert who is willing to state, on the basis of his examination, that they present fairly the financial condition and results of operations of the reporting company. This is an essential service in a credit economy such as ours.

The same necessity for reliable financial information is felt by corporate stockholders, many of whom are absentee owners. As assurance of the propriety of the financial reports of management, the stockholders, who are in no other way able to verify the financial representations made to them, rely upon the reports of independent public accountants.

One of the outstanding characteristics of an accountant's professional position is that of independence. He is an independent contractor, not an employee. In accepting an audit engagement he reserves the right to make an examination by methods and to the extent he sees fit. He does not follow detailed instructions of his client. Although he is paid for his work by the client company, he has certain responsibilities to anyone who reads and relies on his report. Accordingly he must consider more than merely the interests of his client in performing his examination and in writing his report. He must cultivate an independence of thought and of viewpoint calculated to serve fairly both his client and those who might read the report.

Because of this rather peculiar position two characteristics are essential if an accountant or a firm of accountants is to be successful. Integrity and alertness are the foundations for a good professional reputation. The need for integrity is rather obvious. Unless the auditor does a sound task of verification, unless his opinion is reliable, creditors and stockholders will soon refuse to accept his report as an indication that financial statements are dependable. Once it is discovered that his work is something less than necessary or that his opinion is carelessly given, an accountant loses not only prestige but clients as well. Integrity is an essential.

The importance of alertness is something quite different. It has to do with the service an accountant can render his client above and beyond a bare statement of opinion as to the reliability of the financial statements. During the course of an audit engagement an auditor learns a good deal about his client's accounting methods, office procedures and business practices. Couple this with the thought that an accountant is an expert on accounting methods and procedures and has, through his work with a wide variety of clients, acquired considerable experience in business and financial practices and it should be obvious that he may be in a position to make valuable suggestions for improvements of one kind or another.

An accountant is rarely an expert in all business problems. However, he is an expert on certain problems of business related to accounting, internal control procedures, taxation, and the like. Throughout the course of his examination he should be constantly alert to the possibility of suggesting improvements in the client's methods and procedures. Public accounting, as any other field, is competitive. If a business man has a choice between two firms, one of which will give him an opinion on the financial statements and no more whereas the second can be counted on to recommend improvements in his system of internal control and is also able to talk with him intelligently on his business problems, it is almost certain that he will engage the latter. Alertness to all possibilities of service to the client is always important.

In addition to the field of verification in which the public accountant specializes, his work more or less laps over into related fields of the organization of business operations and transactions, office procedures and methods, taxation and regulatory problems, and finance. An accountant must have some acquaintance with each of these areas if he is to recognize and be in a position to take advantage of opportunities to serve his clients.

A junior accountant is not expected to become an expert in either the field of verification or in the other areas of service to his employer's clients overnight. He is expected to see the over-all problems of the profession and to prepare himself for both present duties and future opportunities. To the extent that he does protect his employer's reputation for integrity and shows alertness by suggesting to his senior any opportunities for additional service, he will indicate that he has some of the essential characteristics for success and, as a result, he will be given additional responsibilities and commensurate advancement.

Professional Bearing

A junior accountant represents his employer. Any impression he leaves with the client works to the benefit or detriment of his firm. This is a simple fact which he must never forget. An independent public accountant should be a serious, competent, reliable, professional man. That is the impression he wishes to make on his clients and on others; that is the impression a junior accountant likewise should try to create. It is not necessary to rebuild one's personality. All that is required is an awareness of the fact that as a representative of a firm of public accountants he is looked on as being a professional person. This requires him to be conscious at all times of the opinions others form of him and of his work.

Clothes do not make the man it is true, yet there is much to be said for quiet, conservative dress. Somehow a loud shirt and a "race-track" suit do little to inspire a feeling of confidence. A junior accountant is expected to appear as would any other responsible young business man. A clean hat, neat business suits, harmonizing ties and socks are expected. These are little things; yet they do have an effect in the impression they make on the client's employees. This in turn has a direct bearing on the co-operation the accountant gets from them on the job. For example, the junior accountant whose sporty attire is the joke of an office in which he is working is very likely to find himself and his work something of a joke as well. Serious questions will be given light answers; his time will be taken with the humorous efforts of various members of the office force; and in general his work will be less effective.

In the close confines of an office made more crowded because of the presence of the auditors, annoying personal habits or mannerisms must be guarded against. Humming or whistling while one works, unnecessary coughing or clearing of the throat, tapping with a pencil while considering a problem, any or all of which may be done quite unconsciously, may be extremely irritating to others and should be avoided.

Sometimes seemingly unimportant matters such as removing one's suitcoat or smoking in an office are frowned on by the client. It is best to inquire of the supervising accountant as to the policy to be followed. Needless to say, such practices as leaving the client's office before the closing hour or returning late from lunch should be avoided.

Relations with Client's Staff

From the standpoint of a client's bookkeeper or accounting department, the auditors are always something of a nuisance. They ask many questions, want the records that are needed for the regular accounting work, take up desk space, ask for documents that may be difficult to find, and in general, upset the normal office routine. This point of view indicates why the junior should be as considerate as possible of those with whom he works in the client's office. Insofar as possible any friction should be avoided; an attitude of considerate co-operation on the part of the auditor is the best way of avoiding unnecessary difficulties.

The junior accountant should always remember that he is the outsider. Although his work is of first importance to him, it is not so important to the members of the accounting department with whom he is working, and unless he is able to enlist their help when he needs it successful completion of the examination may be far more difficult than it otherwise would be. The following suggestions are offered with this thought in mind.

A sincere effort should be made to "work around" the needs of the accounting department staff in regard to books or records required both for auditing purposes and for the regular bookkeeping work. Advance inquiry as to the accounting department program plus care in arranging the junior's own work generally can result in making the client's books and records available to its accounting staff as needed and not interfere with the efficient completion of the audit work.

An overly critical attitude on the part of the outside accountants is certain to be resented by those who have kept the books and records concerned. The auditor must adopt an extremely liberal attitude toward peculiar or "pet" methods of bookkeeping. Many competent bookkeepers have never had the advantages of advanced education in accounting. They merely follow the methods and procedures which have been satisfactory in the past. Any criticism of such methods probably will be ill received. One of the advantages of experience is that one learns that methods of bookkeeping are not as important as results, and that many methods which are somewhat unorthodox, to say the least, yield satisfactory results.

From time to time methods and practices will be found that are faulty or perhaps even incorrect. The appropriate procedure for a junior accountant in such cases is to obtain a full description of the practice and to include that description together with his criticisms of it in working papers to be presented to the senior. He should be extremely careful not to voice his criticisms either directly or indirectly to members of the accounting department concerned. If the senior feels that the criticism and suggested improvements are appropriate he will convey them to the proper member of the client's organization in the best method possible. This is his responsibility, not that of one of his assistants.

An unintentional mistake sometimes made by junior accountants is to open files, look into drawers, or rummage about in vaults which are actually none of their concern. The impression of undue curiosity should be avoided. If the junior has a legitimate question about a matter, he should certainly stay with it until he has a satisfactory answer. On the other hand, unless the matter is of legitimate concern in the course of the examination he will do well to avoid it. Personnel files, payroll data, and similar information of a confidential nature should be requested or taken advantage of only as necessary.

In working with such records the junior should treat as confidential all information the client wishes kept confidential. Payroll records should never be left unattended on a desk. Any other material of a confidential nature should be either returned or locked up over the noon hour or when not required for actual use. It is a good procedure to inquire of the person from whom materials of this nature are obtained whether or not they should be treated as highly confidential in regard to the office staff and as to whether he prefers that they be used only in some private office.

In making use of adding machines, calculating machines and other devices in the client's office, the auditor should be certain to refrain from borrowing without permission equipment which is needed by someone else who may look upon it as personal property. This is similar to the matter of not conflicting with the client's employees over books and records. Another matter of perhaps less importance also should be observed. It is best for the auditor never to use an office machine unless he is completely familiar with it. Not only is there the possibility that improper operation may do it some harm, but also there is the possibility of appearing hopelessly incompetent. The classic example of such a situation is the junior accountant who once attempted to use a check protector as an adding machine. A less extreme situation is found sometimes in the amateurish attempts of some juniors to use a 10-key adding machine designed for rapid touch-system use. There is no objection to the use of machines if they actually expedite the work one has to do. But if one is not familiar with the device more time may be spent in attempting to learn its operations than would be taken if the job had been done another way. In addition the accountant leaves the impression that he is incompetent in what, to the office staff, may be a very elementary ability, and that he is not above practicing on the client's time.

Special care should be exercised in the use of the client's files and other records. It is well to inquire in advance as to the procedure to be followed in obtaining materials and in returning them to the files. File clerks refer to an item out of place as an item lost and if the auditors have used the files freely they will likely be blamed for months afterward for any document that cannot be located. In making tick marks on documents or in the client's journals and ledgers care should likewise be used. Many bookkeepers do not appreciate heavy, colored pencil marks in the records which they have kept neatly and accurately. Actually, little is gained by marking up the client's records in any case and such marks may serve as a clue to the amount of work done. Some accounting firms never mark any of the client's records or documents. If some kind of mark is to be made a small dot or inconspicuous tick mark in a location on the page which is significant to the auditor is far more desirable than a large check for all to see and to duplicate if they desire.

As a professional accountant the junior should avoid any appearance of being overly friendly. This does not mean that he must be aloof or unfriendly. A dignified friendliness with the client's staff is desirable. Anything more than this should be avoided. Special favors by staff members and the sort of intimacy that might conceivably obligate the auditor should be cleared with the senior before acceptance. Independence at all levels is necessary if the audit examination is to be valid, and it is incumbent upon a junior accountant to refrain from any activities or relationships that might impair his own independence from those whose work he is to verify.

In other words, general alertness, consideration of others, and a realization of his position as a professional accountant are required of a junior accountant at all times and especially while in the office of a client.

Relations with Fellow Staff Members

In commencing work in a new organization a junior is very likely to feel that he is in competition with others who came into the organization at about the same time he did. To a considerable extent this is true in public accounting as it is in other fields. A junior accountant is in competition with other junior accountants. There is a difference in the nature of the competition, however, that should be kept in mind. In many types of employment several people are all working toward the same position, a position which only one of them can hold. Only one of the competing workers can succeed; the others will be unsuccessful. This is seldom true in public accounting. Because the profession is still young and growing rapidly there are opportunities for advancement for all who are qualified. Rather than "Which one of several should get this one position?" the question is more likely to be "How many of our juniors are ready to do semi-senior work this year?"

For this reason there is little competition of an intense variety on the staff of a public accounting firm. There is much more of a team spirit. On any single engagement the men assigned work together to accomplish the task. As a group, the entire staff works together to build the best reputation possible for the firm. In this way they help the firm and help assure themselves of a sound future. This feeling of working together rather than against one another has other beneficial aspects. Interesting experiences can be shared to the benefit of all. Joint study of working-paper files during unassigned time can be mutually helpful. Joint preparation for professional examinations may strengthen the chances of all. Certainly much can be said in favor of the feeling of mutual and unconflicting progress to be found within the staff of an accounting firm.

CHAPTER 8

Preparation for the Future

In the preceding chapters the nature of the technical tasks that are assigned to the junior accountant immediately following his employment have been discussed and the characteristics of the professional bearing that he is expected to develop likewise have been given attention. These are essentials for success in the profession of accounting. But more than these are necessary if the junior accountant is to take advantage of the opportunities for advancement that will inevitably come his way. The ambitious junior must be looking ahead constantly to the assignments he will receive in the future. He must appraise himself critically and realistically with questions like these: Do I or do I not have the technical skill, the knowledge, and the judgment required for anticipated assignments? If not, how can I go about preparing myself most effectively?

These questions indicate the procedure to be followed if advancement is truly desired. Promotion does not come with years of service in public accounting; it follows the demonstration of ability to perform advanced assignments and to discharge additional responsibilities satisfactorily. Because accounting is growing and expanding, opportunities are ever present, but unless the junior is ready for them they will be lost. He must produce to progress.

Preparation for advancement may follow any one or all of several possibilities to be discussed in the following paragraphs. Included are:

1. Individual study.
2. On-the-job training.
3. Formal schooling on a part-time basis.

Individual Study

During their first year or so of employment, most junior accountants will have a certain amount of what is known as "unassigned time," that is, time when they are required to be at the office but during which they have no specific duties to perform. Their employers expect that such time will not be wasted but rather will be used in preparing for future tasks. In many cases no specific directions for study are given by the firm, the choice of method and subject being left to the individual.

Unassigned time at the office is likely to be more advantageous for study purposes than free time away from the office because of the materials available for study. The firm's files of audit working papers are ready at hand and available to a man while he is in the office; they are not available to him once he has left for the day. By obtaining and carefully studying a set of audit working papers a junior accountant can do much to acquaint himself with firm practice with respect to working papers and in regard to preparing audit programs. There is no better study material anywhere than a set of actual audit working papers indicating what the auditors did on that assignment, how they did it, and, when coupled with the review of internal control, the reasons why they felt their work was necessary. The junior accountant who fails to draw on his firm's working paper files for study material is missing a great opportunity.

More can be learned from working papers than the procedures and practices applied on a single engagement. A junior can usually obtain permission to draw out a series of working paper files, each of them representing a different industry and different audit problems, until he has not only thoroughly acquainted himself with the firm's audit practice but also has given himself valuable education on the subject of variations in audit programs made necessary by differences among industries and companies.

Another extremely important subject for study in firms which have them is the accounting manual, technical procedure manual, or whatever title is given to the book of instructions for staff auditors. This will have been compiled by experienced auditors who have drawn on their years of activity in the field to develop standards of practice for the firm. The junior should study the firm publication carefully in order that he may be familiar with what is considered by his employers to be desirable practice. Any matters that are not clear to him should be noted and put in the form of questions to seniors or experienced members of the staff until he is satisfied that he understands not only the "how" but also the "why" behind all firm practice.

At this point it should be emphasized that a failure to ask questions on points which are not understood is a serious weakness and may well prove a bar to progress. No member of an accounting firm staff expects a junior to have answers to every question that might arise. Indeed not many of the staff members of considerably higher rank have all the answers. It is never an indication of ignorance nor of lack of ability to ask a significant question. The man who asks no questions is either so conceited that he feels that he knows everything already, so uninterested in his work that he has no desire to learn more about it, or afraid that he will appear uninformed if he asks the advice of others. None of these attitudes is a healthy one for a junior accountant. It is expected that he will find the use of new terms, the application of unusual procedures, and the necessity for certain audit steps, all somewhat puzzling. It also is expected that he will have sufficient initiative and desire to ask questions of those who can give him an informed answer.

There are two kinds of questions, of course. The junior should not become a nuisance by asking every question he can think of. Many matters can be understood by giving them a little serious reflection. This the junior accountant is expected to do. When he is unable to answer the question for himself out of his own limited experience and education, then and then only should he put the question to others.

Professional magazines, accounting and auditing textbooks, handbooks of various types, the publications of the American Institute of Accountants, and works on the special problems of various industries and types of business also provide material for individual study. One of the facts a junior must face is that no matter how extensive his formal education has been prior to entering the field of public accounting he has little more than a background for additional learning. He must become familiar with the latest developments in the fields of accounting, auditing, and taxation, and must exert every effort to keep abreast of them at all times. This is not to say that he must be an expert in every specialized field within the general area of accounting. He should, however, have sufficient acquaintance with new developments to know when to call on specialists within his firm for help with problems.

The publications of the American Institute of Accountants and of his local state society of certified public accountants are invaluable in this respect. A careful scanning of each new issue should be a "must" for every active accountant. The authoritative pronouncements of committees of the American Institute of Accountants and the American Accounting Association, the accounting releases of the Securities and Exchange Commission, the texts of pertinent legal decisions, new government regulations and other important developments of that type are all reported within the covers of the leading accounting periodicals. Hence these publications perform a valuable service in bringing together for easy reference the current materials of most importance to practicing accountants.

Various tax handbooks, systems handbooks, and the like are helpful in summarizing the principal problems with which the accountant may be expected to deal in these fields. As such, they are a valuable type of ready reference and are particularly helpful in enabling him to discover those books or articles that cover more fully the specific point which may be of immediate interest. The particular usefulness of a handbook is that it gives some information on a wide range of subjects; it does not usually give thorough or exhaustive coverage on all of the subjects included.

Personal Library

Every junior accountant who intends to make a career for himself in accounting should begin to build up a small personal library. This need not be extensive for it will be found that a relatively few items are sufficient to obtain reasonably complete coverage of the fields in which he will be most interested. He might well begin with a subscription to the official periodicals of the outstanding professional accounting organizations. Nonperiodical publications by these societies should be added as they are released. Reports or releases by the leading committees of the American Institute of Accountants and the American Accounting Association should certainly be included. The accounting releases of the Securities and Exchange Commission can be obtained from the United States Government printing office at small cost and should be a part of a basic library.

Next he should give attention to the various fields with which he will find himself working and attempt to add one or two outstanding works in each such field. Personal opinion as to the relative desirability of competing works varies considerably. The junior should make inquiry of former teachers and of experienced accountants with whom he works, and should check with libraries where copies can be obtained for study and comparison before final choices are made.

Books are likely to fall under one of two heads: either they are written as textbooks for use in college courses or they are written on a higher professional level for use by men actually in the field. It is extremely difficult for a single volume to serve both of these requirements with any degree of success. In selecting books the accountant should first determine the type of book he needs. If he is attempting to fill in a deficiency in his former education, he may do well to select a college level textbook that can be used for a first coverage of the material. If he has completed a college course covering that material, on the other hand, he will gain little by merely working through another college-type textbook. It seems more advantageous under such conditions to add a more mature work such as would be useful to someone in the field already possessed of some knowledge of the subject. In developing a personal library intended to have lasting usefulness he will find the second type of book to be more appropriate. This is especially true if he already has his college texts as a nucleus around which to build.

The following subjects or areas of interest probably should be represented in a personal library by at least one worthwhile and authoritative book:

1. General auditing.
2. Federal income tax (a copy of the Internal Revenue Code and the Regulations should be supported by a ready reference or tax service of some kind).

3. General accounting.
4. Systems design and installation.
5. Specialized accounting systems.
6. Report writing.
7. Business law.

Most public accounting firms have libraries available to staff members. These should be relied on for matters in which extensive research facilities are required. All that should be expected of the junior's own personal library is that it have ready information on those subjects on which help is most likely required; it should not be expected to give exhaustive treatment on all subjects.

Self Review

One of the tasks an experienced accountant is called on to perform is that of reviewing the work of others. When he reaches the point at which his own work indicates an awareness of auditing technique and procedures sufficient to qualify him for advancement, he will be given an opportunity to review and then to supervise the work of others. Ability to review conscientiously and effectively without undue loss of time is a necessity and such an ability should be cultivated early.

As a junior completes working paper assignments on his first engagements he turns those papers in to the senior accountant on the job for review. If the junior, after completing the work and immediately before turning it in, tries to put himself in the position of the senior accountant and subjects his own working papers to a careful review he will at once begin to lay the foundations for development of a review technique and at the same time will find himself producing more satisfactory working papers.

Review consists of reading a work sheet critically in an effort to determine whether:

1. It is complete.
2. It is self-explanatory.
3. Its relationship to other work sheets is clear.
4. Its contribution to the over-all verification is apparent.
5. Any questions raised by the performance of that procedure have been answered.

The reviewer, once he has accepted the work sheet as satisfactory, indicated by his own initials below those of the man performing the original work, accepts responsibility for that work. He has scrutinized it carefully and is satisfied that it is complete, understandable, and that no additional questions have been raised. He accepts as satisfactory both the extent of the work done and the method of doing it, and further accepts the working papers as adequate evidence of both.

In reviewing his own work before submitting it to his senior, a junior accountant should attempt to look at it from the standpoint of the senior. Would he be willing to accept that work as complete and satisfactory in every way if he had not prepared it himself? Is it completely understandable to someone who has had no previous acquaintance with the records on which it is based? Does it answer all questions likely to be raised in the mind of an experienced auditor by the facts as stated? These are the sort of questions to be answered. Unless they can be answered in the affirmative the work needs additional time and attention. By training himself to review impersonally his own work, a junior accountant is constructively preparing himself for future responsibilities and at the same time giving himself important discipline in the art of working-paper preparation.

Communication

Included in a program of self-study should be a conscientious effort to improve the ability of expression, both orally and in writing. Those who hire college graduates, including public accounting firms, list as their first criticism of the men they employ an inability to express themselves well. This ranges from the use of incorrect grammar and inadequate vocabulary to a failure to achieve persuasiveness in the presentation of basically sound ideas.

The subject of rhetoric does not seem to have much appeal, but it is a subject that must receive earnest attention from the junior if he is to succeed in professional work. Accounting is not a matter of work sheets, figures, financial statements, ledgers, and nothing more. Accounting is a matter of ideas and ideas must be expressed. Accountants do a great deal of work with figures and with forms of one kind or another but they also must work with ideas. The comments at the bottom of a work sheet describing the work done or suggesting the need for additional verification, explanations of peculiar or complicated transactions, footnotes explaining the significance of contract provisions or of litigation in progress, suggestions for the improvement of internal control measures, and a host of other thoughts must be well presented to be useful.

The accountant does not need a command of the language to say that he has footed the cash book as instructed. On the other hand, no one wants to foot cash books forever. Advancement will require the ability to discuss matters with officials of the client company and with partners of the public accounting firm. It stands to reason that the firm will not permit itself to be represented by someone who cannot carry on an intelligent and grammatically correct conversation.

As an audit examination progresses matters are often uncovered which should be brought to the attention of the client. The common practice is for the one who discovers the need for the communication to write it up in the form of a letter from the accounting firm to the client. This letter is then submitted to the partner in charge of the engagement who revises it as he considers necessary, has it typed, and then signs the final copy. A failure to be able to write such letters satisfactorily will do as much to hold a man back from promotion as will any other deficiency.

Finally there is the preparation of long-form audit reports. A junior accountant is unlikely to be expected to prepare these until he has gained a considerable amount of experience, but inevitably the time will come when he is called on to draft such a report. A command of rhetoric is essential if the job is to be well done, if it is to be a credit to the firm and to the man who wrote it. By exercising care in writing work sheet notes and comments he prepares himself for the time when he is called on for more formal writing.

Three factors contribute to success in accounting. First, the accountant must be a competent technician with a sound knowledge of accounting and auditing; second, he must have ideas, he must see the opportunity for suggestions and know what suggestions to make; third, he must be able to convey his suggestions, his ideas, in a helpful and convincing manner. Although there may be a lack of opportunity in public accounting for men who are nothing more than technicians, there will always be opportunities for men with ideas and the ability to express those ideas.

On-the-Job Training

Probably the best and perhaps the most intangible training open to a junior accountant is that which he receives while actively working on audit engagements. The instructions of his superiors as to the method to be followed in performing a given test, their criticisms of his work when he turns it in, the experience of working with the client's books, ledgers, and business papers, all go together to make him better equipped to do his next job more efficiently and with the need for less supervision. As with other training methods, on-the-job experience is beneficial to the extent that the individual makes the most of his opportunities. If he is content merely to go along trying to get by with the work before him, many of the advantages of his work will be lost. If, on the other hand, he is curious about the work of others and of the place his own task fills in the over-all scheme he can do much to improve his knowledge and his usefulness as an auditor.

An ideal situation from the staff training point of view would find a junior accountant on the job with a senior accountant who felt keenly his responsibility to increase the knowledge of the junior and who had all the time necessary to give detailed instructions, to point out weaknesses in the junior's work, to discuss alternative procedures, and to stimulate the junior's imagination with a variety of questions. But such ideal situations are extremely uncommon. In many if not a majority of the cases in practice, the junior is not alone on the job with the senior accountant. Also there are complicating problems to take up the time of the senior, and the necessity for completing the assignment within a given date makes anything but full attention to completing the job difficult. The responsibility of getting something out of each new assignment therefore falls on the junior accountant. Certainly he should be the one person most interested.

Getting the most out of each assignment requires that the junior make a sincere effort to understand the way in which his part of the work fits in with the rest of the examination. At first his assignments will be simple and of a routine nature and he will be more concerned with the "why" behind the work he is to do than with how it fits in with other work. Later he will be given more advanced work such as the complete program for a given account or group of accounts. By critically examining the segment of the audit program he is asked to perform and by further inquiry, first of himself and later of others if he is unable to answer the question out of his own knowledge, he can begin to develop an ability to prepare audit programs, to see the necessity for supporting certain techniques with others, and to get the over-all picture of the audit problem.

He also must ask questions. Any point that puzzles him after he has given it serious consideration should be asked of the senior accountant or of any other accountant on the job who may be able to help him. Obviously there is a time and place for all questions. He should not interrupt the senior accountant during a discussion with one of the company's officers. Neither should he annoy a senior working on some difficult problem unless the question is absolutely necessary. Yet there are times on every engagement when questions are appropriate and it is then they should be asked. It is a good practice to prepare a list of questions and troublesome points to be put to the senior accountant as opportunity permits. Frequently the answers to some of them will be found in later work on the same job. Those that are not so answered should be asked of someone who can answer them. Most senior accountants make a practice of giving their assistants an opportunity to ask questions from time to time. If the senior neglects to do this the junior should not hesitate to mention that he has several problems to which he would like a solution if the senior can spare time.

Formal Classes

Two types of formal classes may be open to junior accountants. The firm itself may have a staff training program of one sort or another.

Needless to say, staff training should be taken seriously and every effort made to benefit from it. Such work may be found to be on an advanced level as compared to the work in college. Also it will reflect actual audit situations and conditions more realistically because of the materials available to auditing firms.

If the accountant is located in a large city or even a smaller town in which a college or university is located, he will frequently find an opportunity to take additional courses. Generally these must be taken at night in order not to interfere with regular work.

Such courses have both advantages and disadvantages. They are particularly helpful if the individual feels that his accounting education has been unsatisfactory in any respect and he wishes to correct the deficiency, If, for example, he has had no work in the field of income taxation or in governmental accounting he can register in such a course in an approved night school and add that material to his fund of accounting knowledge. Such courses are difficult in that he must fit them in after a full day of work when he is likely to be somewhat tired already. Problem and reading assignments must be attended to in the reduced amount of free time that he has after he takes on a full-time job and in general such a procedure is likely to be a burden. There is another distinct hazard that should be recognized. In public accounting the individual must take such assignments as come his way and work always takes precedence over after-hours activities such as school. Thus if he is assigned to an out-of-town engagement or to night work it will of necessity disrupt his school work. More than one young accountant has found it impossible to carry on with the after-hours academic schedule he has prescribed for himself because he was unable to be present at sufficient class meetings.

Many accounting firms definitely take into account any known program of study on the part of their staff men in working out personnel assignments. However in the press of busy season work the demands of clients must come first and it is sometimes impossible to keep everyone in town who wants to stay in town for purposes of furthering his education, as important as that may be.

Some people tend to rely on formal classes to give them the discipline and the program they need to keep them studying. If they have classes to meet and assignments to turn in to an instructor at a set time, they can hold themselves to their task. Without such an incentive they find it difficult to refrain from passing up their studies for more enjoyable forms of recreation. This is a tendency a junior accountant should certainly discourage in himself. The self-discipline required to hold to a course of study either with or without required class meetings is something that should be developed. Considerable self-discipline is needed to get ahead in any profession and accounting is certainly no exception. Good work habits are essential. Throughout his career an accountant finds it necessary to choose between reading technical literature and choosing more entertaining activities. If he permits himself to rely on the directions of an instructor in his early years he may find it impossible to discipline himself adequately in later years. Registration in night school classes is desirable for a junior if he gets real benefit from the classroom discussion and from the teacher's contribution. It is seldom desirable if its only purpose is to keep him from "playing hookey" from himself.

If a junior accountant has completed the usual college education he should be sufficiently mature to be able to study technical writing, whether textbook or other, by himself. He should be able to lay out a course of study for himself and to complete it successfully without attending classes merely for disciplinary purposes.

Certified Public Accountant Certificate

At some time during his first five years in public accounting an accountant is expected to pass the certified public accountant examination and thus to qualify for that certificate. Some firms have a requirement that no member of their staff can reach a certain rank (senior accountant in most cases) until they have done so. Whether their firm requires it or not, junior accountants will do well to bend every effort toward obtaining this certificate early in their careers, for several reasons. First, it carries considerable prestige with the employees of clients. It is always less satisfactory to give a negative answer to the inevitable question, "Are you a CPA?" than it is to give an affirmative one. Second, an accountant is very likely to have greater facility in problem solution and examination writing shortly after he has completed his college work than he will have, say, ten to fifteen years later. Third, he will find that demands on his free time, the time available for study, will increase as he grows older and as his responsibilities both at home and at work increase.

While some able accountants do not possess the coveted CPA certificate, and this in no way detracts from their ability to do a good job, it may militate against them professionally in a variety of ways. Most of them regret that they did not take the time and effort when they were young men to clear this hurdle in their paths.

The CPA examination is a difficult one it is true, and ranks with any professional entrance examination. Yet there is no reason why any young accountant of normal intelligence and ability cannot prepare himself adequately for successful completion of this test. Materials in the form of well-written textbooks and previous examinations with sample solutions are available for study. Attention to these, plus experience with field conditions, should be sufficient to enable any accountant to attempt the examination with a satisfactory chance for success.

Preparation for the Examination

In preparing for the examination the accountant should give first attention to any weaknesses in his own educational background. The field of accounting is indeed a large one but it can be subdivided into a limited number of areas. These are:

1. Auditing.
2. Accounting theory.
3. General accounting problems such as those having to do with transaction analysis, business practices, and interpretation of data.
4. Specialized accounting problems such as:
   a. Consolidated statements.
   b. Partnership accounting problems.
   c. Problems in accounting for net worth.
   d. Foreign exchange.
   e. Specialized statements such as a statement of affairs, statement of realization and liquidation, et cetera.
5. Cost accounting.
6. Governmental accounting.
7. Federal income taxes.

The serious student should review his past education and his present knowledge with a view toward discovering any weaknesses. If he feels deficient in any of these areas, or in business law which also is included in the examination, that weakness should be given first attention. A text or other book covering the material should be obtained and studied until the weakness is eliminated. In many places coaching courses are available in the evenings. These offer certain advantages but in the absence of such courses, the junior should be able to prepare on his own.

Once he is reasonably satisfied with his over-all educational background for the examination he should obtain copies of the official American Institute of Accountants examinations for at least the last five years. These can be purchased from the Institute in book form, together with unofficial solutions if desired, and are also reproduced in leading accounting periodicals. These examination questions provide some of the most useful review materials. They should be worked completely under conditions as close to those of the actual examination as possible.

The student should attempt to solve each problem within the time allotted, in good form, and without reference to books or other materials. The time to be spent on each problem can be approximated by spreading the total time allowed for a section of the examination over the problems in that section in proportion to the number of points for each problem. If possible, he should write an entire section of the examination at one sitting so that he becomes accustomed to proceeding from one problem to another without any loss of time or the necessity for a "break."

At first attempts at the solution of actual examination problems may be discouraging. Points will be found on which the student is not sure of himself. Questionable alternatives and apparently ambiguous statements will appear. These will encourage him to fall back on textbooks and other reference materials and, in some cases, to refer immediately to the published solution. Such tendencies should be avoided. The candidate must learn to work solely with the problems at hand, independent of any aids at all. It is best to work right on through the problem to some sort of solution although it may be inadequate or even incorrect. Only after he has done all that he can with a problem should he turn to the solution and then only for the purpose of grading his own efforts. He should never use a published solution for a lead as to how to attack a new problem.

First attempts may be discouraging indeed, but if the accountant carries on seriously trying to work problems on his own, he will find that his skill and ability at problem solution improve rapidly. Obviously, any serious deficiencies as to knowledge of subject matter should be remedied. If he finds that cost-accounting problems are especially troublesome, for example, he should take time to review that material before returning to problem work. As he gradually supplies such deficiencies in his background and acquires practice in solving CPA problems, they will bother him less and less.

The same kind of attention should be given to the theory, auditing and business law sections of the examination. These generally consist of questions rather than problems. In many cases this makes the preparation of an acceptable solution all the more difficult. There is a tendency on the part of accounting students to neglect the development of abilities to express themselves clearly and concisely in well-constructed sentences. In the examination this is equally important with the ability to set up work sheet problem solutions. Thus in preparation for the examination it should be given equal attention and as much time.

As the student completes his review and approaches the date of the examination he should spend more time in writing actual examinations under approximate examination conditions. If possible, one or more full days should be spent in this way. The two and one-half days spent in the examination room is a strenuous and tiring experience, particularly so for anyone who is not accustomed to working long hours under such conditions. To prepare in advance in much the same way that an athlete conditions himself for a contest is highly desirable. Depending on the individual, it may be desirable to ease off studying some time before the examination and get in a little relaxation and recreation in order to go into the test with a clear mind.

Suggestions for Writing the Examination

In the examination room a few simple precautions may help considerably in saving time and in getting the most points possible out of the questions given. First, the candidate should never begin writing on any problem until he has determined the requirements of that problem. This is an obviously sound procedure but is frequently overlooked. Until he has read the problem requirements he cannot begin to develop the required solution and any writing or time spent may be entirely wasted.

Second, it is a good practice for him to look over the entire examination before beginning work on any single problem. In this way he has an idea of what to expect and can judge better the relative difficulty and time to be allotted to individual problems. Third, he should work the most simple problems first. This has a psychological advantage but, more than that, it permits him to get the points he is sure of into his solution. Sometimes a man begins on the most difficult problems and finds it hard to leave them unfinished, or else forgets to keep careful count of his time so that the examination period ends before he has written solutions to the problems which would have given him no difficulty at all.

Fourth, he should apportion the total time for the examination over the problems assigned roughly in proportion to the points allocated to each, and then spend no more than that amount of time on each problem until each has been given satisfactory attention. Any time saved by working some problems in less than the expected period may then be spent on those which gave difficulty. The candidate should never make the mistake of getting so tied up in one problem, no matter how long, that he fails to work on other problems that would give him no real trouble.

Fifth, when unable to complete a problem or the answer to a question to which he knows the solution, he should take at least a few minutes of the allotted time to set forth in an outline description the procedure that would be followed in completing it. Graders will give credit for whatever knowledge is exhibited in the solution and although an outline is far from a complete solution it may well be worth enough points to make a difference between a passing and a failing grade.

Conclusion

As in other professions, the individuals found in public accounting display a wide variety of temperaments and personal attributes. Professional work at the higher levels is not stereotyped nor are the individuals in the profession all of a like pattern. Not only is there room for individuality but the development of such individuality is a by-product of the responsibility assumed and of the judgments which must be made in the work. The junior is a beginner who is seeking to become a full-fledged member of the profession. There should be no such thing as a permanent junior. The junior is a learner, as are the men in all ranks in an accounting firm, and as he learns he advances. As he advances, the responsibilities imposed on him assure him the opportunity to expand his knowledge and to develop as an individual. The successful public accountant is a man with breadth of interests. Every junior would do well to devote some attention and considerable thought to the obligations of all citizens, and of professional men in particular, to their community.

It is impossible to discuss in the limited space available here all the duties that a junior accountant may be called on to perform. As has been pointed out previously, the work of a junior varies as he progresses and acquires experience and skill. It will also vary somewhat with the practices of the firm by which he is employed and certainly will change from job to job. The intention here has been to present a discussion of some of the fundamentals which a junior accountant must understand thoroughly if he is to develop and progress as an accountant. As such, these pages should be taken as a guide and little more. In many cases much more will be required of the junior accountant, especially as he progresses toward the position of a semi-senior or senior. Once he feels that he has mastered the material presented here, he must pass on to the more advanced work discussed in other books on accounting and auditing.

ILLUSTRATIVE WORK SHEETS, FIGURES 1 TO 12

Figure 1

Prep. by W.K.B.
Date 1/28/52
Reviewed L.S.

Cluff and Evans, Inc.
General Ledger Trial Balance
December 31, 1951

	Worksheet No.	12/31/50 Per Audit Debit	12/31/50 Per Audit Credit	12/31/51 Per Books Debit	12/31/51 Per Books Credit	Adjustments Debit	Adjustments Credit	12/31/51 Per Audit Debit	12/31/51 Per Audit Credit	Profit & Loss Expense	Profit & Loss Income	Balance Sheet Assets	Balance Sheet Liability
Petty cash	A	270 00		500 00			① 312 00	188 00				188 00	
Cash	B	28871 00		32411 00				32411 00				32411 00	
Accounts receivable	C	104218 00		116783 00			② 2785 00	113998 00				113998 00	
Estimated uncollectible accounts	D		8720 00		9083 00	③ 2785 00	④ 2150 00		8448 00				8448 00
Machinery	↑ I	187324 00		198416 00				198416 00				198416 00	
Accrued depreciation, machinery	↓		83291 00		95874 00				95874 00				95874 00
Goodwill	N	80000 00		80000 00				80000 00				80000 00	
Accounts payable	AA		65382 00		72823 00		⑰ 2765 00		75588 00				75588 00
Notes payable	BB		25000 00		40000 00				40000 00				40000 00
Earned surplus	MM		48119 00		65119 00				65119 00				65119 00
Sales			1250870 00		1475212 00		③ 2785 00		1477997 00		1477997 00		
Cost of materials used		287416 00		312788 00		⑰ 2765 00		315553 00		315553 00			
Direct labor		205588 00		230672 00				230672 00		230672 00			
Indirect labor		46212 00		51318 00				51318 00		51318 00			
Depreciation of building	J	17688 00		17688 00				17688 00		17688 00			
Factory supplies		7812 00		6903 00				6903 00		6903 00			
Sales salaries		63749 00		70212 00				70212 00		70212 00			
Miscellaneous office expense		4987 00		5136 00				5136 00		5136 00			
Dividends received	F		4000 00		4300 00				4300 00		4300 00		
Interest income	E		968 00		612 00		⑤ 150 00		762 00		762 00		
Interest expense	BB	3000 00		4200 00				4200 00		4200 00			
Provision for Fed. income taxes	HH	32000 00				㉒ 43000 00		43000 00		43000 00			
		2107381 00	2107381 00	2406478 00	2406478 00	89416 00	89416 00	2408647 00	2408647 00	1437881 00	1483059 00		
Net income for the year										45178 00			45178 00
										1483059 00	1483059 00	1147681 00	1147681 00

Figure 2

Prep. by W.K.B.
Date 1/28/52
Reviewed L.S.

Cluff and Evans Inc.
General Ledger Trial Balance
December 31, 1951

	Worksheet Number	12/31/50 Per Audit	12/31/51 Per Books	Adjustments Debit	Adjustments Credit	Per Audit
Assets						
Petty cash	1	270 00	500 00		① 312 00	188 00
Cash	2	28871 00	32411 00			32411 00
Accounts receivable	3	104218 00	116783 00		③ 2785 00	113998 00
Estimated uncollectible accounts	4	8720 00	9083 00	③ 2785 00	④ 2150 00	8448 00
Machinery	11	187324 00	198416 00			198416 00
Accrued depreciation, machinery	↓	83291 00	95874 00			95874 00
Goodwill	19	80000 00	80000 00			80000 00
Total assets		765848 00	810746 00			812327 00
Liabilities						
Accounts payable	20	65382 00	72823 00		⑰ 2765 00	75588 00
Notes payable	21	25000 00	40000 00			40000 00
Earned surplus	35	48119 00	65119 00			65119 00
Net income for the year		33995 00	95487 00	62487 00	12178.0	45178 00
Total liabilities		765848 00	810746 00	89416 00	89416 00	812327 00
Income + Expense						
Sales	41	1250870 00	1475212 00		③ 2785 00	1477997 00
Cost of materials used		287416 00	312788 00	⑰ 2765 00		315553 00
Direct labor		205588 00	230672 00			230672 00
Indirect labor		46212 00	51318 00			51318 00
Depreciation of building	10	17688 00	17688 00			17688 00
Factory supplies		7812 00	6903 00			6903 00
		916347 00	1104467 00			1107211 00
Gross profit on sales		334523 00	370745 00			370786 00
Sales salaries		63749 00	70212 00			70212 00
Miscellaneous office expense		4987 00	5136 00			5136 00
		270496 00	275970 00			283470 00
Net profit on operations		64027 00	94775 00			87316 00
Dividends received	6	4000 00	4300 00			4300 00
Interest income	5	968 00	612 00		⑤ 150 00	762 00
		68995 00	99687 00			92378 00
Interest expense	21	3000 00	4200 00			4200 00
Net income before Fed. income taxes		65995 00	95487 00			88178 00
Provision for Fed. income taxes	27	32000 00		㉒ 43000 00		43000 00
Net income		33995 00	95487 00	62487 00	12178 00	45178 00

Figure 3

Prep. by W.X.B.
Date 1/4/52
Reviewed L.S.

Major Manufacturing Company
Bank Reconciliation - 1st National Bank
December 31, 1951

Balance per bank statement			42481 69 c
Less outstanding checks			
#5547	7/3/51	87 65 ②	
5617	7/18/51	15 10 ②	
7128	12/30/51	312 28 ч	
7129	12/30/51	2618 00 ч	
7130	12/31/51	423 83 ч	
7131	12/31/51	212 50 ч	
7132	12/31/51	2700 00 ч	
7133	12/31/51	1846 10 ч	
7134	12/31/51	500 00 ч	
7135	12/31/51	419 71 ч	9135 17
			33346 52
Add:			
Deposit in transit 12/31/51			7210 81 ť
December bank charges			12 50 ⱳ
R.C. Edwards Co. check returned N.S.F.			430 00 ① ⱳ
Balance per general ledger			40999 83
Less:			
A.J.E. ③ to record December bank charges		12 50	
A.J.E. ④ to record R.C. Edwards Co. N.S.F. check		430 00	442 50
Balance per audit			40557 33

c Confirmation attached
ⱳ Bank debit memo examined; appears proper
ч Returned with cut-off statement 1/18/52; payee, signatures, endorsements and amounts examined; appear proper.
ť Recorded by bank 1/2/52 per cut-off statement
① Charged back to accounts receivable. N.S.F. check received on this account in November also per Mr. Landgren, credit manager. Allowance for uncollectibles sufficient to cover this and other items. See Analysis #6.
② Stop payment order given to bank 1/10/52; to be credited to Miscellaneous income in January, 1952.

2-B

Figure 4

Prep. by W. K. B.
Date 1/4/52
Reviewed L.S.

Major Manufacturing Company
Proof of Cash Transactions
December, 1951

	Balance 11/30/51	Receipts	Disbursements	Balance 12/31/51
Per bank statement	47117 64 ✓	108976 48 ✓	113612 43 ✓	42481 69 ✓c
Deposits in transit				
November 30	8791 12 ✛	(8791 12)		
December 31		7210 81		7210 81 ✛
Outstanding Checks				
November 30	(12348 70) ⊗		(12348 70)	
December 31			9135 17	(9135 17) ✗✗
Bank Charges				
November	16 75 ^		16 75	
December			(12 50)	12 50 ^
N.S.F. check - December			(430 00)	430 00 ^
	43576 81	107396 17	109973 15	40999 83
Excess of bank receipts and disbursements over book amounts.		(400 00) ③	(400 00) ③	
Balance per books	43576 81 ^	106996 17 ^ ①	109573 15 ^ ②	40999 83 ^
Less A.J.E. #② to record bank charges for December and N.S.F. check.				442 50
Balance per audit				40557 33

✓ Taken from bank statement
c Confirmed
^ Per general ledger cash account; footed and balance proved
① Cash receipts book footed
② Cash disbursements book footed
✗✗ See list of outstanding checks for details
⊗ Per company 11/30/51 bank reconciliation; list footed
✛ Traced into subsequent bank statement
∧ Bank debit memos examined
③ Error by bank; account debited in error and offsetting credit made to correct. See bank statement for explanation.

2-E

Figure 5

Prep. by W.K.R.
Date 1/2/52
Reviewed L.S.

Major Manufacturing Company
Count of Petty Cash
December 31, 1951

Bills					
$10	15			150 00	
$5	7			35 00	
$1	11			11 00	
Coin-rolls					
Halves	2	@	$10 00	20 00	
Quarters	3	@	10 00	30 00	
Dimes	1	@	5 00	5 00	
Coin-loose					
Halves	7			3 50	
Quarters	16			4 00	
Dimes	21			2 10	
Nickels	14			70	
Pennies	27			27	261 57

Vouchers				
Bigtown Daily News	12/20/51	Ad for Office Boy	3 50 n	
Standard Stationery Shop	12/21/51	Office Supplies	18 55 n	
Beaver Trucking Co.	12/27/51	Freight in	28 38 n	
J. R. Wright	12/30/51	Supper Money-overtime	2 00 n✓	
R. A. Kelly	12/30/51	" " "	2 00 n✓	
W. E. Morrell	12/30/51	" " "	2 00 n✓	
Jane Gonzales	12/30/51	" " "	2 00 n✓	58 43
Checks				
C. Harker, 12/27/51, payable to "Cash"				30 00 #
Total per count and balance per general ledger 12/31/51				350 00

THIS FUND WAS COUNTED IN MY PRESENCE BY A REPRESENTATIVE OF WAKE AND FIEND AND RETURNED TO ME INTACT. L. M. Henderson

n Vouchers examined - all approved and appear to be in order.
✓ Overtime due to year-end accounting work per J. R. Wright, chief accountant.
Harker is sales manager. Check was approved for cashing by Garth Hanson, office manager. Company policy not in favor of cashing personal checks but exceptions made occasionally.

See A.J.E. #1 to clear fund of non-cash items. - R.K.M.

1

Figure 6

Prep. by W.K.B.
Date 10/1/51
Reviewed R.S.

Various Products Corporation
Investments
September 30, 1951

Bonds		Units / Par or Face	Investments #12: Per Audit 9/30/50	Premium Amortized	Purchased	Sold	Balance 9/30/51	Market Value 9/30/51	Accrued Interest: Per Audit 9/30/50	Purchased	Earned	Collected	Balance 9/30/51
Firestone Tire and Rubber, Debenture 3½, 1961	May & Nov.	5 / 1000 00	5060 04	6 67		7/13 5053 37	—0—		62 50		118 75	11/30 75 00; 5/1 75 00; 7/13 31 25	
G. N. Railway, Gen. Mtge. 5½, Series C, 1973	Jan. & July	10 / 1000 00	11714 74	134 21			11580 53	11750 00	125 00		500 00	1/1 250 00; 7/1 250 00	125 00
North States Power (Minn), 1st Mtge. 2¾, 1974	Feb. & Aug.	5 / 1000 00	4912 50			7/17 4912 50	—0—		22 92		108 86	2/1 68 75; 7/17 63 03	
Quaker Oats, Debentures, 2⅝, 1964	Jan. & July	7 / 1000 00	6947 50				6947 50	6956 25	45 94		183 74	1/1 91 87; 7/1 91 87	45 94
			28634 78	140 88		9965 87	18528 03	18706 25	256 36		911 35	996 77	170 94

To Account #86-12 - Interest Income - Anal. (43)

T.B.

Stocks	Units / Par or Face	Per Audit 9/30/50	Premium Amortized	Purchased	Sold	Balance 9/30/51	Market Value 9/30/51	Dividends Paid
Allis Chalmers Mfg. Co., Common	100 / None	6275 00				6275 00	9650 00	12/22 175 00; 3/31 75 00; 6/30 75 00; 9/29 100 00
Celotex Corporation, 5% Pfd.	50 / 20 00	1037 50				1037 50	825 00	10/31 12 50; 1/31 12 50; 4/30 12 50; 7/31 12 50
Glidden Company, Common	60 / None	1095 00			8/18 1095 00	—0—		10/1 30 00; 1/2 45 00; 4/2 30 00; 7/2 30 00
International Harvester, 7% Pfd.	50 / 100 00			7/2 8000 00		8000 00	8162 50	9/1 87 50
		8407 50		8000 00	1095 00	15312 50	18637 50	
		37042 28	140 88	8000 00	11060 87	33840 53	37343 75	697 50

To Account #86.12 Interest Income Anal. (43)

T.B. T.B.

Gain or Loss on Sale of Securities - #86.12

	Date Sold	Book Value	Sales Price	Gain or Loss
Firestone Tire & Rubber	7/13/51	5053 37	5062 50	9 13
Northern States Power	7/17/51	4912 50	4650 00	(262 50)
Glidden Company	8/18/51	1095 00	2880 00	1785 00
		11060 87	12592 50	1531 63

T.B.

^ Per 9/30/50 work papers
✓ Certificates examined in presence of Emer Broadfent 10/14/51; no access to safety deposit box 9/30/51 - 10/14/51 per confirmation attached.
★ Approved per Board of Directors' minutes - see Permanent File, Anal. (M)
n Broker's advice examined; entry appears proper.
≠ Calculation verified
r Traced to cash receipts and duplicate deposit tickets.
x Plus accrued interest

Client amortizes premiums on investments but not discounts. Market in excess of cost, no adjustment needed. (7)

Figure 7

Prep. by W.K.B.
Date 12/31/51
Reviewed R.S.

Minor Grocery Supply Company
Test Counts of Inventory
December 31, 1951

Inventory Tag No.	Description		Location		Count Per Tag		Count Per Audit	
73	Spam	24-12 oz. cases	Room	4	77		77	γ
76	Prem	24-12 oz. cases	"	4	84		84	γ
79	Treet	24-12 oz. cases	"	4	63		63	γ
80	Tuna Fish - Starkist solid	48 - ½ #	"	4	110		110	γ
124	Tuna Fish - Starkist solid	48 - ½ #	"	4	78		78	γ
125	Salmon - Libby Red Alaska	48 - ½ # flat	"	4	48		48	γ
130	Salmon - Libby Red Alaska	48 - Tall	"	4	46		46	γ
308	Pineapple - Libby sliced	48 - 12	"	2	212	66 / 146	212	γ
312	Pineapple - Libby sliced	24 - 2	"	2	187		187	γ
317	Pineapple - Libby crushed	48 - 12	"	2	116		116	γ
482	Dreft - Giant	9	"	2	172	60 / 112	172	γ
483	Tide	60 regular	"	2	86		86	γ
489	Tide	24 large	"	2	112		112	γ
490	Fab	24 large	"	2	210		210	γ
491	Ivory Flakes	24 large	"	2	189	34 / 155	189	γ

Count per audit agrees with company count in all cases. At our request count on tag no. 312 was rechecked by count crew and changed from 167 to 187.

γ Traced to inventory sheets - R.K.M.

5-D-8

Figure 8

Prep. by W. K. B.
Date 1/18/52
Reviewed LS

Major Manufacturing Company
Accounts Receivable Confirmations
December 31, 1951

Customer	Address	Confirm. No.	Account Balance 12/31/51	Amount Confirmed	Exception Taken	Remarks
Wallens Stores, Inc.	Grand Forks, N. Dak.	63	457 00 ✱			
Webster's, Inc.	Boise, Idaho	64	823 00	823 00 c		
Western Supply Stores	Des Plaines, Illinois	65	1875 00	1500 00 c	375 00	Credit requested 12/31/51 - Granted 1/3/52 per credit memo 491
Woods and Company	Fort Wayne, Indiana	66	1356 00	1356 00 c		
Wullits Dept Store	Decatur, Illinois	67	1090 00	1090 00 c		
Total This sheet			5601 00	4769 00	375 00	
" page 1			27880 00	24720 00	815 00	
" page 2			32416 00	26425 00	1320 00	
" page 3			23950 00	20640 00	614 00	
			89847 00	76554 00	3124 00	

Summary	Number of Confirmations	Dollars	% of Total Accounts Receivable	% of Confirmations Sent
Total Accounts receivable	481	157084 00	100.00	
Total confirmations requested	67	89847 00	57.00	100.00
Confirmations returned	54	76554 00	48.00	85.00
Confirmations returned with exceptions				
Exceptions cleared	6	2549 00	1.60	2.90
Adjustment required - A.J.E. 8	2	575 00	.30	.64
Confirmations not returned	13	10269.00	6.50	11.40

✱ Cash receipts subsequent to 12/31/51 traced into cash receipts book and duplicate deposit tickets.
c See confirmation attached.

3-C-4

Figure 9

Prep. by W.K.B.
Date 1/10/52
Reviewed L.S.

Minor Grocery Supply Company
Inventory Price Test
December 31, 1951

Description		Supplier	Per Company Quantity	Per Company Price	Per Company Extension	Per Audit Price	Per Audit Extension	(Over) Under Market
Swift Chopped Ham	24-12z	Swift & Co.	43	10 90	468 70	10 90 n	468 70	
Swift Corn Beef	24-12z	" "	31	9 70	300 70	9 70 n	300 70	
Swift Lunch Tongue	24-12z	" "	47	11 10	521 70	11 47 n	539 09	17 39
Broadcast sliced dried beef	24-5z	Illinois Meat Co.	62	12 20	756 40	12 20 n	756 40	
Libby Red Alaska Salmon	48 Tall	Libby, McNeill & Libby	40	30 00	1200 00	29 75 n	1190 00	(10 00)
Happyvale Pink Salmon	48 Tall	" " "	46	24 98	1149 08	24 98 #	1149 08	
Brookdale Chum	48 T	" " "	27	20 70	558 90	21 02 n	567 54	8 64
Peaches, Libby Halves	24-2½	" " "	86	6 50	559 00	6 63 n	570 18	11 18
Peaches, Libby Sliced	48-8z	" " "	90	5 12	460 80	5 12 n	460 80	
Pears, Libby Halves	24-2½	" " "	112	9 15	1024 80	9 28 n	1039 36	14 56
Pears, Rosedale Halves	24-2½	" " "	88	7 75	682 00	7 88 #	693 44	11 44
Campbell's Soups, Cream of Mushroom,	case	Campbell's Soup Co.	46	6 75	310 50	6 75 n	310 50	
Campbell's Soups, Cream of Chicken,	case	" " "	38	6 75	256 50	6 75 n	256 50	
Spry	36-1lb.	Lever Bros.	70	12 70	889 00	12 87 n	900 90	11 90
Spry	12-3lb.	" "	62	12 15	753 30	12 15 n	753 30	
Crisco	36-1lb.	Proctor & Gamble	58	12 70	736 60	12 87 n	746 46	9 86
Crisco	12-3lb.	" "	81	12 15	984 15	12 15 n	984 15	
					11612 13		11687 10	74 97

n Price per recent supplier's invoice for approximately same quantity.
\# Per supplier's price list; no recent invoice available

5-E

Prep. by W. K. B.
Date 1/6/52
Reviewed L.S.

Major Manufacturing Company
Purchases Cut-Off
December 31, 1951

Supplier	Item Purchased	Invoice Date	F.O.B. Terms	Entered In Invoice Register	Date of Receiving Report	Invoice Amount	12/31/51 Adjustment Required: Purchases Debit	Purchases Credit	Inventory Increase	Inventory Decrease
Remington Supply House	Raw Materials	12/23/51	S.P.	12/26/51	12/25/51	864.50				
Simmons Parts Co.	Purchased Parts	12/20/51	Dest.	12/26/51	12/25/51	228.90				
John Landgren, Inc.	Raw Materials	12/25/51	Dest.	12/26/51	12/28/51	1712.31				
Grayline Electric Company	" "	12/25/51	Dest.	12/27/51	12/27/51	1424.40				
Fargo Auto Parts	Purchased Parts	12/26/51	S.P.	12/27/51	12/27/51	671.00				
E. R. Billings & Sons	Raw Materials	12/26/51	S.P.	12/27/51	12/28/51	2200.00				
Morrell Mfg. Co.	Purchased Parts	12/22/51	S.P.	12/27/51	12/26/51	912.83				
Simmons Parts Co.	" "	12/23/51	Dest.	12/28/51	12/28/51	372.40				
Fiber Box Company	Packing	12/26/51	Dest.	12/28/51	1/2/52	1188.10		1188.10		
Harker Incorporated	Raw Materials	12/28/51	Dest.	12/31/51	1/2/52	2234.16		2234.16		
Grayline Electric Company	" "	12/29/51	Dest.	12/31/51	1/2/52	188.50		188.50		
Northern Power Company	Light & Power	12/20/51	—	12/31/51	—	117.80				
Fanning Foundries, Inc.	Raw Materials	12/27/51	Dest.	12/31/51	12/31/51	2034.10				
Anderson Metal Products	" "	12/28/51	S.P.	1/2/52	1/3/52	950.75	950.75		950.75	
Kuehne & Co.	" "	1/2/52	Dest.	1/2/52	1/3/52	405.10				
Simmons Parts Co.	Purchased Parts	12/27/51	Dest.	1/2/52	12/31/51	878.40	878.40			
Henderson & Henderson	Raw Materials	12/31/51	S.P.	1/2/52	1/2/52	265.00	265.00		265.00	
Ashmeade Products Co.	" "	12/31/51	Dest.	1/3/52	1/3/52	740.00				
Grayline Electric Co.	" "	12/31/51	Dest.	1/3/52	1/5/52	1085.09				
The McClellan Company	" "	1/2/52	Dest.	1/3/52	1/4/52	1300.00				
Moffett Mfg. Co.	Purchased Parts	12/30/51	S.P.	1/4/52	1/3/52	763.81	763.81		763.81	
E. R. Billings & Sons	Raw Materials	1/2/52	S.P.	1/4/52	1/4/52	4100.00				
John Landgren, Inc.	" "	1/2/52	Dest.	1/4/52	1/4/52	945.50				
Fanning Foundries, Inc.	" "	1/2/52	Dest.	1/5/52	1/5/52	1708.00				
Henderson & Henderson	" "	1/3/52	S.P.	1/5/52	1/5/52	386.00				
							2857.96	3610.76	1979.56	-0-

See A.J.E.'s 12 & 13

All purchase invoices in excess of $100 each recorded in Invoice Register from 12/26/51 – 1/5/52 inclusive were examined as above. Physical inventory was taken 1/1/52 and all goods on hand at that time were counted and included in inventory figure.

5-C

Figure 11

Prep. by W.K.B.
Date 1/14/52
Reviewed L.S.

Major Manufacturing Company
Factory Machinery
1951

Balance per audit 12/31/50					26530 40
Additions					
2/17/51	Parker and White	Machine Lathe	2-134	788 50 ∧	
2/21/51	Work order # 318	Installation costs	J 283	85 75 ✓	
3/7/51	Parker and White	Punch press	3-74	1170 00 ∧	
5/25/51	Larabee Corp.	Spindle drill	5-145	940 00 ∧	
8/8/51	A & B Machine Tool Co.	Repairs to lathe #17	8-25	65 00 ≠	
11/13/51	Sleight & Co.	Buffing Machine	11-11D	467 50 ∧	
12/19/51	Parker and White	High Speed grinder	12-114	815 00 ∧	4331 75
					30862 15
Retirements					
6/24/51	Drill press # 4 - scrapped		J 2164	830 00 +	
9/30/51	Lathes 8, 11, & 15 sold to Moffett Manufacturing Company		J 2 196	2775 00 +	3605 00
Balance per general ledger 12/31/51					27257 15
Less A.J.E. (19) to reclassify repairs capitalized in error.					65 00
Balance per audit 12/31/51					27192 15
					T.B.

∧ Voucher with supporting invoice examined; appears proper addition to fixed assets.

✓ Work order supported by time clock cards and material requisitions examined; appears proper.

\+ Journal voucher examined; traced to subsidiary property ledgers. Retirement entry appears in order.

≠ Repair charge; should not have been capitalized.

(11)

Figure 12
Prep. by H.H.
Date 1/14/52
Reviewed R.S.

Major Manufacturing Company
Allowance for Depreciation
Factory Machinery
1951

Balance per audit 12/31/50		11750 12
Less depreciation on assets retired - see Anal (11):		
6/24/51 Drill press #4, fully depreciated	830 00 n	
9/30/51 Lathes		
#8 - 8 years at 10% on cost of $900	720 00 n	
#11 - 7 years at 10% on cost of $925	647 50 n	
#15 - 5 years at 10% on cost of $950	475 00 n	2672 50
		9077 62
Add depreciation for the year:		
10% # on assets used for the entire year		
10% of (26,530.40 - 3,605.00 = 22,925.40)	2292 54 ✓	
5% # on assets used for part of year		
5% of (4,331.75 + 3,605.00 - 65.00 = 7,871.75)	393 59 ✓	2686 13
Balance per audit 12/31/51		11763 75
Balance per general ledger 12/31/51		11867 00
Discrepancy (5% of 65.00 repair capitalized in error = $3.25, see Anal. (11). Arithmetical error of 100.00 located in client's computations.) - AJE. #20		103 25

n Traced to subsidiary property ledger.
Same rates as last year; approved by I.R.A. in 1948.
✓ Calculation proved

Depreciation - Factory Machinery

Depreciation for the year, per audit - as above	2686 13
Balance of depreciation account, per general ledger 12/31/51	2789 38
A.J.E. #20 (see above)	103 25

(11-A)

Duties of the Senior Accountant

BY JOHN C. MARTIN

CHAPTER 9

General Responsibilities

The senior accountant is one skilled in technical knowledge and qualified by experience to take charge of the field work of a medium-sized or large audit engagement.

The senior normally has educational and experience qualifications equivalent to the level of the CPA examination. In fact, many firms require that staff men possess a CPA certificate before they are advanced to senior or even to semi-senior status. Normally a senior has been promoted from a semi-senior after having served as a junior and is thereby well grounded in the methods of the firm. The senior is usually required to have a college degree, although in some cases a staff member may develop into a capable senior with less formal education if he has considerable aptitude for the work and his staff training and experience are adequate.

The senior's education should include specialized subjects as well as those usually classified as "accounting." Taxes, budget preparation and control, government accounting procedure, economics, commercial law, finance, and English are taught in accounting colleges. They should be included in the senior's education whether or not he has obtained a college degree.

The semi-senior, as the name implies, is a step between the junior and senior. He is usually assigned to take charge of a small engagement or to assist a senior who is in charge of a larger examination.

Professional Qualifications

The capable senior should have, in some degree at least, all of the following professional qualifications:

1. Full basic knowledge of accounting principles and auditing standards.
2. Technical skill in application of these principles and standards.
3. Sound judgment and common sense in the application of that judgment.
4. Several years' experience in public accounting.
5. Knowledge of modern business organization, finance, and operations, and of sound accounting practice. With this background, he approaches an engagement intelligently, is able to detect possible weaknesses of internal control or accounting procedure, and is qualified to make recommendations for improvements.
6. The quality of leadership and ability to organize and direct the work of others.

7. Ability to speak and write effectively.
8. Initiative and perseverance.
9. Alertness to recognize unusual matters.
10. Aptitude for auditing and accounting.

Personal Characteristics

The senior should possess the following essential personal characteristics:

1. Integrity and moral courage.
2. Ability to meet people intelligently and effectively.
3. Tact.
4. Courtesy.
5. Knowledge of human nature with the ability to see good qualities of persons disagreeable to him and to resist being swayed by agreeable or forceful personalities into errors of judgment.
6. Pleasant personality.
7. Self-assurance.
8. Self-discipline.
9. Good personal habits.
10. Good appearance.
11. Loyalty.

Place in Staff

The senior's place in the staff of an accounting firm will depend on the size of the firm and of the staff. In a very small firm, he may be a partner and the staff may consist entirely of juniors. In a medium-sized organization, he will likely work under the direct supervision of a partner. In a large organization, with few partners, he may work under the supervision of another staff member who is variously termed "manager," "supervisor," or "principal." Herein, we will term the immediate superior of the senior as "principal" which will designate either the partner or another staff member.

The "supervising senior" or "manager" has usually been promoted from the senior staff because of outstanding ability, skill, and judgment. He is responsible to the partners and keeps in personal touch with them and with the policies of the firm. In relation to his assignments, he acts in a capacity similar to that of a partner with respect to responsibility and authority. He may supervise several examinations being conducted by seniors concurrently, or he may take personal charge of a large engagement.

He reviews and approves working papers and reports and so relieves the partners of a portion of that work, also, he usually conducts the conferences with the client. The supervising senior would not ordinarily be found in a small firm except when the supervision required exceeds the capacity of the limited number of partners.

The Auditing Practice Forum in *The Journal of Accountancy*, September 1947,[1] states that the senior accountant is graded as follows: "size and difficulty of the engagements completed; quality of the work done; number of assistants effectively employed; frequency and extent of supervision required; time consumed and co-operation in firm matters such as adaptability to changes in personnel assignments, adherence to time budgets, and compliance with promised delivery dates for reports."

In addition to these, the senior is graded by the quality of his staff relations.

Responsibilities toward Firm

Ralph B. Mayo, in an article entitled "Problems of a Medium-Sized Public Accounting Office" published in 1946,[2] wrote: "No accounting office is any better than the quality of its personnel." The senior is the custodian of the reputation of his firm in every engagement. He can discharge this responsibility only by observing high professional standards in his work and accomplishment.

The senior should be loyal to his principals, to the accounting firm, and to its policies. He should have pride in the firm and in the knowledge that he is an essential part of the organization. He should promote its development in every way possible and inspire his associates with the same spirit of loyalty and co-operation which he possesses.

The senior should be self-reliant, with an aim to perform his duties efficiently, and with as little supervision as possible. At the same time, he should be willing to accept the advice and decisions of his superiors.

The duties of the senior in relation to the audit engagement will be outlined later. In addition, the senior can do much to avoid idle time during the lighter months of the year. At such times, he may well look ahead to coming audits and arrange for the preparation of skeleton exhibits and schedules, having the previous year's amounts inserted in comparative statements to save time in later pressure periods. Working papers and schedules can be set up, audit programs revised, and much of the preliminary work done in advance of the busy season. Unassigned time will be well spent in study of his own reports, with a view toward improvement; or those of other engagements with which he is unfamiliar, with a view toward broadening his knowledge.

The senior should be willing to devote personal time to the study of technical subjects and to keep up to date in professional matters. His education is never completed, and he should seek to broaden it in classical as well as in technical fields.

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[1] See references on pages 116-17.

Responsibilities toward Associates

The senior accountant represents the firm in his relations with his assistants while in the field and, as such, is responsible for their work and their conduct. He should become acquainted with the technical abilities of his associates, be interested in their progress and promote co-operation among them. He should be willing to assist them beyond the ordinary requirements of the engagement, helping them to learn and so to advance.

The accounting firm rates the senior in part by the effect he has on his associates. The man who brings out the best in his assistants, who works with them in harmony, is particularly valuable. Occasionally a senior is retained because of other qualities although his staff relations are known to be unpleasant, but promotions usually go to those whose staff relations, as well as technical ability, are good.

Responsibilities toward Profession

It can also be said that no profession is any better than its members. The American Institute of Accountants, through its committees and publications, is striving in conjunction with other professional organization to raise the standards of the accounting profession and of its members. The senior accountant represents his profession in his relations with the client, its employees, and the public with which he has contact. He should, therefore, keep informed on the recommendations for improvement made by the spokesmen of his profession, and conform to the high standards of accounting principles and auditing practice which have been set. He would do well to study the leaders of his profession and emulate the qualities which have made them successful.

He should maintain membership in professional societies for which he is eligible, such as the American Institute of Accountants, local chapters of state societies of certified public accountants, the American Accounting Association, the Institute of Internal Auditors, the National Association of Cost Accountants, and the Controllers' Institute of America. He may have attained membership during college days in the national accounting fraternity, Beta Alpha Psi, an organization for men and women accounting students with high scholastic achievements. The senior accountant will gain by association with members of these groups and by participation in their activities.

Responsibilities toward Clients

The accountant has many responsibilities toward his clients, most of which stem directly from his special confidential relation to them. Care should be taken that information which he has obtained relative to business activities, operations, or office procedures of a client is not divulged improperly. Although the auditor has taken the precaution to obtain the names of employees trusted by the client to answer routine questions, he should be careful not to impart to them any information which they do not already have. The affairs, operations, or procedures of one client should not be discussed with another client or with the public, no matter how unimportant the subject matter may appear to be.

The accountant is required to give the client all helpful information which he obtains during the examination and to safeguard the interests of the client in every way possible. His aim should be to perform the examination efficiently with a minimum of cost to the client.

The accounting firm may be held legally liable to the client for negligence in an audit examination if loss is sustained by the company or its stockholders by reason of deception or errors which were not uncovered and disclosed. Negligence in this case is construed as (1) failure to do what a reasonable or prudent person would do in the circumstances or (2) performing a positive act which such a person would not have done. The legal defense of a negligence suit would require proof that reasonable skill was exercised although the facts in question were not discovered. It is not a defense that the auditor was ignorant of his responsibility or not qualified for his position of trust.

The financial statements are the primary responsibility of the client since they are based upon financial data which he has recorded. However, the accounting firm, by rendering an opinion on the statements, is responsible for:

1. Adherence of the statements to generally accepted accounting principles.
2. Disclosure of any material fact which affects the statements.

The auditing staff should handle the client's records with care, return them as soon as possible and, under usual conditions, not remove them from the office. Office rules of the client should be observed, with respect to hours, smoking, dress and other matters.

Responsibilities toward Third Parties

The accountant, by his independence from management, is in a sense a representative of the public in each audit engagement. He is morally responsible to the public for conducting his examination in accordance with professional standards and making a full disclosure of his findings.

There may also be a legal liability to third parties. There have been court cases in which third parties claimed injury when gross negligence was attributed to the auditor, because of the misstatement or omission of an essential fact in financial statements on which an opinion was expressed, or when the auditor failed to uncover a major embezzlement or other deception.

The accountant is liable to investors, as third parties, under the Federal Securities Acts administered by the Securities and Exchange Commission. In this instance, the investor must show loss occasioned by a misrepresentation in the registration statement of the subject company filed with the Commission as a requisite for sale of the security on a stock exchange or outside of the state of origin. In this case, there may be a defense that due professional care has been exercised in the audit examination and in the preparation of the report. Responsibility of the accountant with respect to securities registrations is extensive, and every senior accountant should be familiar with the governing regulations.

The American Institute of Accountants, in Statement No. 23 of its committee on auditing procedure,[3] points out the moral responsibility of the accountant, even though no legal liability may attach. This statement has to do with statements associated with an accountant's name, on which an opinion cannot be expressed because of the omission of generally accepted auditing procedures. The accountant is required to state clearly the responsibility which he is willing to assume with respect to every financial statement which bears his name. Reasons for the qualification of the accountant's opinion, or the denial of an opinion, must be stated clearly in order that third parties may not rely upon the statements merely by reason of their association with his name.

Although these responsibilities rest with the accounting firm, the senior accountant has the immediate responsibility to his firm for the examination and the disclosures required.

CHAPTER 10

Responsibility for Planning

The senior accountant does not have the same duties in every examination. His responsibility will vary with the size of the engagement somewhat as follows:

1. In a small engagement, he may conduct the examination alone or with the help of one assistant.
2. In a medium-sized engagement, he may be the senior-in-charge with several assistants.
3. In a large engagement, he will have more assistants, possibly including other seniors. He may conduct the examination under the direct supervision of a principal or he may be in full charge.
4. He may supervise several small engagements being conducted concurrently by semi-seniors or juniors.

For the purpose of these comments it is assumed that the engagement is one which requires the services of several assistants and that the senior accountant is in charge of the examination except for consultation on unusual matters and for a final review by the principal.

Starting the Examination

In current practice a good portion of a large examination is conducted at intervals during the year. Often accounts receivable are confirmed and inventories are examined at other than the balance sheet date. For additional interim work which may be done, see Chapter 14 of the CPA Handbook, and two recent articles which appeared in *The Journal of Accountancy*.[4,5] For simplicity, this practice is ignored herein in favor of the assumption that the examination is made in a continuous process at the year end. The differences between this and interim work are not significant.

There are several types of audits, although the general audit, frequently referred to as a regular annual audit, is the one usually connected with the term. This consists of an examination of the financial position and a review of the operations. The "detailed audit" is seldom used because of its prohibitive cost to the client, except possibly in cases of the examination of the cash transactions of charitable organizations. Even then, the examination of receipts beyond those recorded may be impracticable, and the evidence supporting disbursements, other than cancelled checks, is usually sampled.

There are special purpose examinations in which the auditor is expected to examine only matters which are related to the designated purpose. There are examinations which are limited in respect to auditing procedures relative to accounts receivable, inventories, or other important items in which it is understood that the auditor will not be in a position to express an opinion on the financial statements. There also is a so-called "tax audit" in which the auditor is expected to make adjustments and analyses of matters needed for tax returns, but in which there is no attempt to apply auditing procedures to the accounts.

This discussion embraces only the general audit wherein the auditing procedures are sufficient in scope to permit the accounting firm to express an opinion on the statements.

The senior-in-charge is not always responsible for the initial phases of an examination. The preparation of the audit program, preliminary review of internal control and the preliminary arrangements are often made by his principal. These matters are discussed in connection with the duties of the senior accountant since frequently he aids in their preparation and in many cases he has responsibility for them.

Review of Internal Control

Chapter 16 of the CPA Handbook is devoted to a discussion of internal control. However, a brief discussion of the topic is presented here because of the senior's responsibility for the review of internal control.

The committee on auditing procedure, American Institute of Accountants, in its Statement No. 24, "Revision in Short-Form Accountant's Report or Certificate" [6] gives a brief summary of the meaning of the term "generally accepted auditing standards" to which the accountant refers in his opinion on financial statements. In the section entitled "Standards of Field Work," the following statement appears: "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."

Characteristics of Internal Control

Internal control supplements and extends the personal supervision of owners in a small business enterprise, and in a large business it must largely take the place of such supervision. It is a plan of organization and procedures adopted within a business to safeguard the assets, check the reliability of the records, and promote operational efficiency. A proper system reduces the possibility that errors or fraud will remain long undetected. Characteristics include:

1. Separation of functions — separated responsibility for: (a) initiation and authorization; (b) recording; and (c) custody. This is possible only in a large organization, properly departmentalized. In a medium-sized business it may be accomplished by segregation of duties whereby: (a) no one person will have complete charge of a business transaction; (b) no one person or department will control the accounting records relating to that department: and (c) work of one person checks that of another without duplication of work.
2. Fixed responsibilities — responsibilities are fixed by clear lines of authority.
3. Personnel control — employees are carefully selected, trained commensurate with their responsibility, adequately compensated, and bonded.

Purpose of Review

Review of internal control is not a substitute for an audit. Rather it provides:

1. A basis for judgment of the reliability and adequacy of accounting records.
2. Knowledge of the extent of protection against fraud or other irregularity.
3. Information needed in determining the weight which can be attached to the system of internal control as an aid in selecting auditing procedures and determining the extent of the tests to be made.

When Review is Made

The initial review of the system of internal control is normally made early in the field examination, either during the interim examination or as a special phase performed in an early stage of the field work. However, many of the subsequent audit procedures supplement the initial work done and aid in establishing the degree of control and the manner in which the system operates.

One of the greatest services which an accounting firm can render a client is the recommendation of changes which will strengthen its system of internal control. Recommendations are best made in writing, supplemented by conference between principal, senior, and the client.

How Review is Made

There is no rigid formula for the review of internal control. In each case, it must be fitted to the circumstances of the engagement. Initially it is accomplished by direct inquiry, supplemented by a review of the chart of accounts, organizational charts, if any, and the accounting manual, for determination of accounting procedures and the division of responsibility. In a small or medium-sized engagement where little control exists the review is less formal.

Many accounting firms have a printed internal control questionnaire for use of their staff. Occasionally the questionnaire is submitted to the client to be filled in and returned prior to the examination. Examples of questionnaires are given in Case Studies in Internal Control 1 and 2,[7,8] published by the American Institute of Accountants, as well as in two recently published books.[9,10] The danger in having a questionnaire is that it will be used mechanically and that proper judgment may not be exercised. It has the advantage of acting as a reminder list to insure inclusion of all important phases. Small accounting firms often rely entirely on a reminder list as a guide to seniors in reviewing controls.

It is necessary to observe and test the extent to which the controls are actually operated. Questionnaires usually provide space for the auditor's verification, whether by observation or test. In any case, some written record should be made indicating the tests by which the auditor is assured that the system is in operation and effective. Because of the time involved it may not be possible to observe all control features each year except those which relate to accounting records and procedures. Others can be spread over a period of several years.

Reliance on Internal Auditors

Where there is an internal audit staff and program, greater reliance can be placed on the records. A review of the internal audit program and the working papers of the internal auditor is of great importance in evaluating the effectiveness of the client's accounting records and procedures. Auditing procedures of the accounting firm may be considerably reduced as a result of such a survey. Many auditors accept some supervised participation of the internal auditors in their examination, thereby considerably reducing the time required for the audit examination.

Control in a Small Business

In a small business with few employees it is not practicable to segregate accounting functions to provide satisfactory internal control. However, even in a business where there is only one accounting employee there can be a few elementary controls, including the following:

1. Double entry bookkeeping.
2. Control accounts for accounts receivable and payable.
3. Bonding of employees.
4. Periodic vacations.
5. Daily deposits of cash intact.
6. Prenumbered checks and, if applicable, invoices.
7. Periodic physical inventories.

If the proprietor participates in the operations to any extent, he will know what the transactions and results should be, and this in itself is a control. He may also exercise a measure of control if he performs a few simple tasks such as:

1. Opening the mail, and noting the remittances received.
2. Signing checks and at the same time inspecting the invoices being paid, and stamping them with a paid stamp.
3. Inspecting cancelled checks returned by the bank and reviewing the bank reconciliation.

If there is more than one employee, the work might be so arranged that the person keeping the general ledger and accounts receivable ledger would not have access to the cash or merchandise inventory.

Reliance on Internal Control

There is no control which is not susceptible to manipulation by collusion of employees or even by cleverly laid plans of one working alone. Internal control can only reduce the possibility of such manipulations. The auditor must always be alert to detect and recognize irregularities which may conceal a fraud. Neither can internal control wholly prevent or always detect the manipulation of records by management to mislead creditors or stockholders as to the financial position or operations of the business.

Development of Audit Program

Audit programs are discussed in general and are illustrated in Chapter 14. However, in many firms, the senior who is to be in charge of the field work on an engagement is responsible for preparing the audit program. This program may then be reviewed and approved by a supervisor, manager, or partner. The following discussion is intended as a general guide for the senior.

Types of Audit Program

Formal audit programs are of two types, predetermined and progressive. Many accounting firms have a predetermined audit program in printed form in which all auditing procedures are outlined, although it is recognized that all procedures are not required in every examination. The program is the basis for the assignment of work. It is divided into sections and the pertinent section given to the assistant as work is assigned. Such a program will require considerable alteration in the small engagement where there is little if any internal control, the client's accounting staff is unskilled, and many errors are encountered.

The progressive type of audit program is an outline of the general scope, character, and limitations of the examination. Details are sketched in as dependable information is obtained and the reliability of the records is judged. This type of program gives a great deal more discretion to the senior-in-charge in developing the detailed program as the audit progresses. It has the advantage of requiring him to exercise judgment in determining what audit procedures are necessary, and the extent to which they should be applied to the particular examination. This type of program lends itself to the small engagement where conditions vary from year to year as the client's employees are changed.

The work sheet for each type of audit program should include the following essentials:

1. Adequate space for additional items.
2. Space for initials and notations of the assistant completing.
3. Space for dates and times of beginning and completing, and time consumed.

The policies of accounting firms differ in the authority given the senior to revise the predetermined audit program or to depart from procedures of a previous year on a progressive-type program. He is usually allowed to make minor revisions, but is required to confer with the principal before any major changes are made.

Informal audit programs are not uncommon in small accounting firms. The senior is familiar with the client's business and with the policies of the accounting firm, which enables him to judge the procedures which will fit the situation. He may make the examination alone and will not need a formal program, or he may have only one assistant who is instructed orally. In situations of this kind where there is no written audit program, notations are usually made in the working papers as to the amount of work completed. However, a written audit program takes little more time to prepare than these notations.

Preparatory Review

Before the audit program is prepared, the senior accountant should become familiar with the engagement by a review of the following:

1. Previous reports, trial balances, and working papers, including the audit program for the preceding year or years.
2. The legal entity of the client (its corporate structure, partnership agreement or ownership).
3. The organization of the client (principal employees and their duties), obtained from the client's organizational chart, or briefed in the working papers.
4. The books and accounting records maintained, accounting machines, perpetual inventory records, cost system, voucher system, payroll procedures, and so forth, obtained from the client's accounting manual, or compiled for the working papers prior to the field work.
5. Accounting procedures, obtained from the client's accounting manual or in connection with the review of internal control.
6. The effectiveness of internal control, as developed by inquiry or questionnaire in preliminary work.

7. Peculiarities of the industry or trade, how the business is conducted, products, markets, financial policies, and so forth as developed through preliminary conferences with the client or with the principal.
8. The type of report desired, when due, and special data which may be required in the report.
9. Permanent files of minutes, capital changes, surplus analyses, and other data.

From this background, the senior will be in a position to decide, with the help of the principal, the audit program to be developed.

Planning Tests

The audit program, outlining the planned procedures of examination, should not be considered a formula of examination. It can only be a guide and should be subject to revisions as the results of the tests disclose the need for more or less or different work than originally planned.

The objective is always to make an adequate examination and not to complete a fixed audit program. The judgment of the senior as to the legitimacy of the facts and the propriety of the accounting for them is more desirable than assuring the mechanical accuracy of the records. It is important that amounts be stated fairly, without the necessity in all circumstances of stating them precisely. The purpose of the tests is to determine the general reliability of the records as a basis for forming an opinion.

The extent of the tests is dependent on judgment of the procedures required for a fair sampling. A thorough verification of a small number of transactions is better than a perfunctory inspection of many. Materiality of the amounts involved and the relative risk of the existence of errors or other irregularities are factors. Stronger grounds are required to support an opinion on material items than on small, relatively unimportant amounts. Procedures may be reduced for items in which there is little likelihood of material error or where a possible error, if detected, would not change the opinion. The urge of some managements to overstate the profits in periods of recession and to understate them in periods of prosperity is another factor. Certain minimum tests of footings, postings, and mathematical accuracy of general ledger accounts are necessary. If these tests disclose material errors, further tests are indicated. The judgment of the senior as to the additional work required is an important part of his responsibility.

Advantages and Disadvantages of Audit Program

The advantages of a written audit program include the following:

1. It acts as a check against the possibility of omitting procedures.
2. It lends itself readily to a division of work.
3. It provides an orderly routine and thereby saves time.

4. It provides a running record of matters completed for use during the examination and for later reference.
5. It facilitates review of the working papers.
6. It acts as a guide for succeeding years.
7. It affords some evidence in the event of a dispute as to work performed.

The following disadvantages are frequently cited:

1. There is danger that the examination will be limited to the outlined procedures, whereas other procedures may be indicated in cases where internal control is weak or material errors are discovered.
2. Unnecessary work may be done in cases where internal control is strong or when errors are not material in amount or importance.

Audit Techniques

This discussion is not concerned with audit procedures; however, a statement of the audit techniques and illustrations of their application may be interesting.

Audit Technique	*Illustration*
1. Observation	Such as accounting procedures and methods
2. Tests	Of transactions, particularly those which will disclose accounting policy
3. Inspection	Of cash, securities, inventories, and documents
4. Confirmation	Of bank balances, receivables and payables
5. Inquiry	Of management and employees
6. Computations	Of prepayments, accruals
7. Sampling (on the assumption that a representative sample will indicate the quality of the whole)	Of accounting records Of account analyses
8. Investigation	Of irregularities, deviations from customary accounting procedures or internal control
9. Scrutiny	Such as the accuracy of the cut off of closed ledger accounts
10. Evaluation	Adequacy of provision for losses on receivable or depreciation
11. Post balance sheet date procedures	Obtaining and reconciling bank statements at a post balance sheet date. Testing and evaluating the effect of entries subsequent to the balance sheet date to determine their effect on the financial statements and the need for disclosures

The senior should know well the full application of these techniques and should determine at the outset how well his assistants know them and how much assistance and supervision will be required.

Small Concern

In cases where the concern under examination is small and there is little if any internal control the senior may be compelled to review the entries in considerable detail. This would include checking more footings and postings. In this circumstance many firms require that footings be tested for all ledger accounts which are not analyzed. In general, the extent of the tests and sampling should not be disclosed to the client or employees. This is particularly true in small concerns with little internal control, for employees may obtain a clue which will enable them to circumvent the auditor by a planned deception outside the scope of examination.

Arrangement of Work

The senior ordinarily is responsible for planning the details of the conduct of the engagement. He must assign the assistants to particular tasks in such a way as to avoid lost time and confusion in finishing the engagement.

Planning Staff Needs

The number of staff members required on an engagement is governed by several factors:

1. Number of records available simultaneously.
2. Extent of allotted working space.
3. Time allowed for the examination, including consideration of when it is to begin and the due date of the report, as compared to the estimated time required.
4. The ability of assistants available.
5. The need to provide diversified training for staff men.

Often it is advisable to begin with fewer assistants and obtain more later, as required. Sometimes a junior may be requisitioned for a short period to perform a specific task, as it develops. Likewise, some may be released before the conclusion of the engagement.

Time can be saved by assigning men to the work for which they are best adapted. An experienced man should be assigned to take charge of the examination of branches or subsidiaries in other locations. Much time can be lost by inexperienced assistants who are not properly supervised.

Planning Work

Working papers should be headed and skeleton exhibits and schedules should be prepared in advance of the field work. The field work should be planned with a view to keeping assistants busy throughout the period required for the engagement. If there is joint work to be done, it should be arranged in the early stages so that later, when the senior-in-charge and other assistants are busy, there will be work for the junior.

The order of work is often dependent on the convenience of the client, the availability of the records, or the expected absence of officials. The accounting executive should be consulted for this information at the earliest opportunity, particularly as to records which may be examined only during limited periods. It is embarrassing to plan work for the concluding stages of an engagement and find it is held up because the records are not available at that time.

Frequently the first thing scheduled is the count of cash and inspection of securities which are in the office. This is particularly true in the case of banks and investment brokers where immediate physical control of these assets is essential. Intercompany or branch accounts should be reconciled early. There is an advantage in doing other routine work early to determine whether additional procedures are required. Among these are a review of the cost accounts and tests of footings and postings for a short period.

After this early work, the senior is in a better position to budget the time, for he has then gained a knowledge of the condition of the client's records and of the ability of his assistants.

In a small engagement, the records are often found to be in a poor condition. If the general ledger is not in balance or subsidiary accounts are not in balance with controls, it may be expedient to withdraw until the books are ready. The expense to the client is usually considered too great to permit the auditors to help employees with mechanical errors, unless it is requested by the management, and the examination takes longer when the auditor is hindered by extensive usage of the records by employees. It also may be advisable to withdraw if numerous clerical errors are uncovered, and the client wishes his staff to make the necessary corrections. The senior is usually required to consult his office about such a decision.

Overtime work for assistants is usually limited by the policies of the firm. The senior should not schedule overtime work if contrary to policy, except in emergencies and then only with permission. Proper planning will reduce the occurrence of such emergencies.

Before the examination begins, the senior should be sure that he has the names of the officials and key employees with whom he will come in contact. He also should be fortified by knowledge of the economic status of the client and its trade or industry. He should be certain that all working papers which may be required are taken to the client's office, as well as stationery and supplies.

CHAPTER 11

Conduct of an Audit

Basically, the task of the senior-in-charge is to conduct the field examination with professional competence and in accordance with the policies of his firm. It begins with planning the audit program, and laying out and assigning work to produce the maximum of accomplishment with the minimum of time expended.

Proper supervision of the engagement is the next essential. The senior must assure himself that the procedures planned in the audit program are followed and that his assistants are alert to recognize and report irregularities. An important phase of supervision is the field training of juniors, which will be discussed later herein.

The exercise of good judgment is another essential. The judgment of the senior applied to accounting and auditing practices, and to accounting principles, spells the success of the engagement. The junior is expected to refer all matter requiring decision to the senior-in-charge. The senior makes the decision after all facts are brought out by discussion with the junior and any required investigation is made. If the decision is major, the senior may consult with his principal and so avoid wasted time in later revisions where contrary views are held by the principal. If the matter is not of far-reaching consequence, the decisions made can be reviewed with the principal at the conclusion of the engagement.

Explanations of more than minor importance will be obtained from the client by the senior-in-charge. Possibly, minor questions may be addressed to employees but explanations of accounting principles and policies should be obtained from the accounting executive and major questions or errors referred to him.

The senior is responsible for the control of the working papers during the examination to see that they do not fall into the hands of unauthorized persons and to see that they are properly filed and indexed for ready reference.

Getting Assistants Started

As soon as the staff arrives at the client's office, the senior will assign assistants to various phases of the examination as planned. He will advise them of procedures to be followed and of the form and content of the working papers to be prepared. Experienced men will be assigned to tasks which will not require immediate supervision, leaving the senior time to direct the less experienced men.

He will show the junior how to approach his assignment, possibly working with him until the pattern of examination is developed and the character of the data is established. He then is in a better position to instruct the assistant on what irregularities may be expected, the data which are acceptable, and what should be questioned.

If there is a predetermined audit program, the senior will give each assistant the section applicable to his assignment. If there is internal control connected with the work assigned to the assistant, the senior will give him the indicated section of the internal control outline or questionnaire with instructions to observe whether or not the indicated control is being exercised.

Throughout the examination, the senior should satisfy himself by observation that his instructions are being followed and that the work is being done properly.

Survey of Trial Balance

The senior accountant usually begins his own part of the examination with the trial balance. If it is prepared by the client or an assistant, the senior will devote some time to reviewing the trial balance. He will check it back to the ledger accounts, scanning the accounts to observe the sources of entries and to detect unusual entries.

There are many advantages to the senior in this early survey, including the following:

1. He will become familiar with the accounts and how they are operated.
2. He will obtain an over-all picture of the accounting system and the operation of the business.
3. He will select any accounts which need special attention.
4. He will note the nature of closed accounts which also may require attention.
5. He will observe large or significant fluctuations.
6. By comparing opening balances with the previous report, he will observe whether adjustments made in the preceding examination have been recorded.
7. He will acquire information early which may influence a revision in the audit program.
8. By analysis of comparative figures, ratios, the relationship of inventories to cost of sales, et cetera, he may raise questions early in the examination which will require discussions with the client.

Checking and Reviewing

As completed working paper schedules are received from his assistants, they should be reviewed promptly by the senior. He should determine whether they are prepared in a workman-like manner, in conformity with the methods of the firm, and whether they disclose an adequate examination. Are they properly headed and signed by the assistant? Is there one sheet to each class of information or topic? Is the source of information noted, and the oral information obtained included? What differences are noted and are the reasons given? Are corrections indicated? Is the total in agreement with the trial balance? Does the content of the account indicate consistency? Are there errors in accounting principle involved which may have been overlooked by the junior? Have the procedures indicated in the audit program been followed?

The second step in reviewing work in progress is investigation by the senior. The best approach is to discuss the schedule with the junior, asking questions concerning the work done and his findings. If the junior is unable to answer all questions it is possible that his work does not meet with requirements and further examination is indicated. Special attention should be given to questions and explanatory comments found on the work sheet to determine what further action may be required. If irregularities are indicated they should be thoroughly investigated to see if they actually exist and, if so, whether they are clerical errors or whether there is an implication of deception or fraud.

The last step in review is to dispose of the questions which have been raised. If investigation indicates that adjustments are required, the adjusting entries should be made and posted to the trial balance working sheets. The policy of the firm may require that a major adjustment will first be taken up with the principal for approval. Either the senior or his principal should discuss the adjustments with the accounting executive of the client, explaning the errors or principles which are involved. The books can be adjusted only with the approval of the client, since financial reports are primarily the representations of the company and not of the auditor. If required adjustments cannot be made because of the client's objection, the senior should evaluate their effect on the financial statements. It may be necessary to identify or classify the account in the statements so that the facts are clearly indicated. In the event of a serious misstatement, disclosure should be made in the report indicating the effect on the statements. A qualified opinion on the financial statements may possibly be required, or the effect may be so serious as to render any opinion worthless.

Details Usually Done by the Senior

The details which should be done by the senior-in-charge are those which require special judgment and technical knowledge. In most cases, they will include the following:

1. Examination of the corporate structure — the Articles of Incorporation and amendments, by-laws, and minutes of stockholders' and directors' meetings.

2. Examination of capital stock and retained earnings accounts.
3. Examination of contracts, leases, bond indentures, and other documents.
4. Evaluation of the collectibility of accounts receivable, the sufficiency of the provision for loss, the propriety of charge-offs, and the control exercised over accounts which have been written off; also following up exceptions in important verification letters for both notes and accounts receivable.
5. Examination of the basis of valuation of the inventories, the method of handling and valuing returned sales, possibilities of obsolescence, the reasonableness of quantities, and similar factors.
6. Determination of the propriety of the additions to the plant and equipment accounts, the basis of valuation, and the consistency and propriety of the provision for depreciation. (The senior should visit the plant with an operating officer at some time during the examination; he will thereby acquire information on policies of renewals, additions, and disposals, and perhaps gain knowledge as to the adequacy of depreciation policies.)
7. Analysis and evaluation of the restrictions in the bond indentures or credit contracts, such as restrictions on working capital, dividend declarations or officers' salaries and review of accounts for the premium or discount on the bond issues, and for sinking funds.
8. Determination of what contingent liabilities may exist, by review of the minutes, discussions with the client, and correspondence with legal counsel; investigation of the arrangements with financial companies with respect to discounted notes or accounts and obtaining confirmations from them.
9. Investigation of bonus arrangements, if any, to see whether they are properly administered and whether the related liabilities are recorded. The minutes usually provide evidence of the general plan.
10. Scrutiny of the journal entries made by the client to determine the sufficiency of the supporting evidence and the propriety of the entries.
11. Survey of the insurance coverage in relation to the asset values.
12. If Federal income tax returns are to be prepared by the accounting firm, preparation or supervision of the preparation of the returns. If returns are not to be prepared, the basis and computation of amounts accrued for income taxes must be examined.
13. Preparation or review of all important reconciliations.

In all engagements, the senior will do the accounting work on the examination, as distinguished from auditing. He will be especially alert to discover errors of principle.

In a small or medium-sized examination, the senior-in-charge will do a fair amount of actual auditing in addition to the tasks outlined. In a large examination, many of these tasks will be delegated to another senior who assists in the examination, and the senior-in-charge will devote his time wholly to supervision.

Action Where Fraud is Discovered

The usual audit cannot be relied upon to uncover minor defalcations, and such is not its purpose. The accountant relies primarily upon effective internal control for the prevention and detection of misappropriations or irregularities. Defalcations are not encountered frequently, but enough cases come to light each year to warn the accountant to be alert for their existence.

Fraud is commonly defined as a false representation of fact, made with the intent to deceive another, so that he will act upon it to his legal injury. As applied to accounting, it has two phases:

1. Falsification of records to cover misappropriation of money or other property.
2. Falsification of records for the purpose of misstating the financial position or operations.

If fraud exists in the accounting records in such form as to be disclosed during the course of an audit, it will first appear as some kind of irregularity. Consequently it is the duty of the senior accountant to investigate all abnormalities. Upon examination, the irregularities may be determined to be unintentional errors, resulting from carelessness or inadequate knowledge of accounting principles or of their application. If so, there is no fraud present, because the primary requisite for fraud is the intent of the perpetrator. As an error, the irregularity can be corrected by the senior as a part of routine audit adjustments.

However, if the investigation indicates the likelihood of fraud the senior should report the matter to his principal at once. There is no universal practice in the handling of suspected fraud. Some firms instruct the senior to pursue the investigation until a conclusion is reached, after which the client is informed, usually by the principal. Other firms report the matter to the management immediately with the statement that irregularities were discovered which may possibly point to a defalcation and that a further investigation is indicated. It seems desirable that the client be notified just as soon as it can be determined that there is a reasonable basis for suspecting the existence of fraud. Since judgment becomes so important in deciding whether there is or is not a reasonable basis for suspecting fraud, the senior and his principal should ordinarily both have an opportunity to study the conditions which give rise to the suspicion of possible fraud. Frequently there may be some question as to which individual in the client's organization should be notified, and this too requires the exercise of judgment. Regardless of the evidence uncovered no charges should be made against an employee, but the facts should be stated to the client. The client may authorize the auditor to extend his auditing procedures or he may conduct his own investigation under the direction of the auditor. In any case, it is advisable to have the client obtain any desired explanations from the employee at this point.

Relatively few cases of the second type of fraud, involving manipulations of accounts by management to misstate financial matters, are encountered. In smaller businesses, with an uninformed accounting staff, many errors of accounting principle are found, some of which grossly misstate the financial statements. There is no fraud when there is no intent to deceive. Management is usually willing to accept the recommended corrections after the principles are explained.

Ordinary audit procedures cannot be expected to uncover carefully planned deceptions such as forgery of the records or widespread collusion. However, if the senior accountant suspects this type of fraud, he should report his suspicions to his principal at once. The principal may decide that audit procedures should be extended until the suspicion is removed or confirmed. Even in cases where fraud is fairly evident the principal will not approach the client or client's officer with an accusation but will tactfully obtain explanations and encourage him to state his position. It may be found that an apparently unusual situation has a satisfactory explanation.

If fraudulent intent by the client is established, the principal may find it expedient to withdraw from the engagement. The extended procedures which would be required to express an opinion on the statements after such a situation is uncovered would be costly to the client, and the moral risk would be great to the accountant.

Assembling Working Papers

After working papers are received and examined by the senior, he will index and file them according to the methods usual in his firm. Supporting papers, such as bank confirmations, are attached to the corresponding schedules.

Many firms use the trial balance as the index. The account analyses and schedules are numbered in accordance with the client's account numbers and are filed in numerical order, corresponding to the order of the trial balance. A supplementary index is maintained for other papers. This is a practical method for small accounting firms.

Another index used frequently is an alphabetical classification following the sequence of items in the balance sheet. Items which combine on the balance sheet are given a connected index classification; for instance, A-1 and A-2 might be used for separate cash accounts which, combined, equal the cash amount on the balance sheet. Under this system, the working trial balance is properly inscribed with the account identification.

Large accounting offices have their own standard methods of indexing whereby any staff member can locate schedules in any set of working papers of the firm.

During the examination, the working paper schedules should be assembled in folders conforming to the classification. When the examination is completed, they should be bound in loose-leaf binders. These may be simple, with heavy cardboard backs for protection, perhaps using the backs of working paper pads for the purpose, and the papers are held together with fasteners. If sufficiently bulky, there should be separators and index tabs.

It is helpful to have a separate file folder for assembling information pertinent to the report. This folder is also used for other information useful to the client which is to be the subject matter of a supplementary letter.

Final Check and Review

As the engagement approaches conclusion, a final check should be made by the senior to see that all work has been completed satisfactorily. The audit program should be inspected to make sure that all procedures have been initialed as completed. The working paper schedules should be inspected again to see that all notations are clear, that all questions raised have been settled, that all adjustments made in the schedules are posted to the working trial balance, and that the corresponding balances are in agreement.

The adjusting entries should be inspected and traced into the working trial balance to determine that all have been included. The senior should be sure that the adjusted working trial balance is in balance. These checks, if made carefully, should reduce the possibility of clerical errors in the report.

The working papers should be reviewed also to see that they supply the foundation of the report by providing all facts and conclusions which will go into the explanatory comments, footnotes, and the financial statements themselves. The senior should make a searching analysis of the facts which have been developed. Do the working papers explain satisfactorily a wide fluctuation which may have occurred in either assets or liabilities? Is there a reasonable relationship between the sales and receivables, inventories, and sales commissions paid? Is the relationship comparable with previous years or, if not, is the reason for the variation shown in the working papers? Are the past due accounts receivable, as shown by the aging schedule, comparable with previous years and, if not, have the variances been satisfactorily explained? Do the operating accounts bear a comparable relation to volume of sales and output? Analyses of this type applied to the working papers should reduce the possibility of overlooking the essentials of the examination and will provide a basis for intelligent comments in the report.

A final check and review should be made to be sure that all information required for development of analyses and schedules in the report has been assembled. The senior now is ready to integrate the working papers into the financial statements and the report.

Accountants usually advocate the preparation of the audit report in the client's office, where additional information can be obtained without embarrassment. In examination of small businesses, where working space in the client's office is limited and there is lack of privacy, it is often found convenient to return to the office for preparation of the report. This has an advantage in the flexibility which it provides in handling staff members. Often office workers or juniors who have not had much field work can be utilized in making mathematical calculations or checking, thereby releasing experienced men for new assignments. Other assistants can be released from time to time as the report exhibits and schedules for which they are responsible are completed.

Before leaving the client's office, the senior should be sure that no loose ends remain; that all papers have been returned to the client; and that all books and files are left in good condition.

CHAPTER 12

Completing an Engagement

The audit report will ordinarily be the subject of agreements between the principal and the client and the seniors responsibility will be limited accordingly. Such agreements, or understandings, should have established general plans regarding the following:

1. General scope of examination.
2. Form of opinion.
3. General type of report.

Drafting the Report

Having completed the field audit, the senior will have accumulated in his working papers the evidence to support his compliance with the proper scope of examination and the justification for the intended opinion. He will have accumulated, by audit and inquiry, information for the specific content and presentation of the financial statements, comments and notes and is in a position to proceed with the preparation of the report.

Exhibits and Schedules

The skeleton of the major financial statements or exhibits will have been set up in advance of the examination in the general form acceptable to the client and the firm, which the senior has adapted to the circumstances. He may then assign certain of the exhibits and the supporting schedules to experienced assistants, who will work under his close supervision.

After completion, the senior should review the statements thoroughly in the following respects:

1. Trace all amounts from the trial balance into the financial statements, making sure that any combination of accounts into one figure in the statements is proper.
2. Determine that the nature of each account is indicated clearly by the title.
3. Check all cross references to see that they are in agreement.
4. Determine that the presentation clearly reflects the facts.
5. Have all mathematics rechecked.

Notes and Comments

There are two forms of audit reports, the long and the short forms. Ordinarily, the primary report is in long form and the short form report, if required, is supplementary, possibly published for stockholders or others. Small businesses are not likely to need a short form report. Some large businesses may want only that form. In the short form report, disclosures required for compliance with professional standards are made in the form of notes to the financial statements. In the long form report financial matters are discussed, import of the statements is outlined, and the required disclosures may be made in the text matter of the report. The financial statements should contain references to the explanations in the comments, specifically if necessary, but usually by a general notation that the comments are an integral part of the statements.

The senior, through his own contacts during the examination and those of his principal, has acquired knowledge of the scope of the report which the client requires. He has been accumulating information which he believes will be useful to the client. One of the greatest services which the accountant may render the small businessman is to furnish comprehensive financial data not supplied by the client's own limited accounting staff.

At the start, the senior should be sure that the report is addressed in accordance with directions from his principal, and in a style conforming to the firm's policy, and that names are correctly spelled. The most important things should be stated first to arouse immediate interest of the reader. A condensed comparison of the operations of the year with the preceding year conveys information which is usually found to be of greatest importance to management. A condensed comparison of financial position at the balance sheet date with that of the previous year end gives an over-all picture of the effect of the operations. A summary of the financial operations for the year, stated in terms of working capital, gives a picture of where the working capital came from and what was done with it. An analysis of the variations in net profit may provide the clue that management needs to interpret the results of the operations and provide a guide to the formulation of policies for the ensuing year. Pertinent ratios and percentages usually aid in interpretation of the facts.

The language of the report should be simple and concise, free from unusual words and technical terms. In practice it is found that many small businessmen are unable to recognize the underlying facts disclosed in the financial statements and analyses. In this case the comments should interpret the financial data and clearly state the inferences which may be drawn from the comparisons.

In writing the comments the senior may be guided in general by the client's reaction to the report for the previous year. However, it is sometimes better to write the current report without reference to any other, thereby achieving a fresh viewpoint. After the first draft is completed, the previous report will serve as a check to avoid omission of anything of importance and as a basis for revisions and improvements.

Many accounting firms have style manuals or report manuals to guide staff accountants in writing reports, the objective being uniformity in style and appearance. The senior should have full familiarity with such requirements and should observe them at all times.

Opinion

The opinion to be expressed in the report is that of the accounting firm and not that of the senior-in-charge. The senior's responsibility is limited to disclosures of the scope of his examination; of the reliance he believes can be placed on the client's financial records and their compliance with generally accepted accounting principles; and disclosure of all facts which have a bearing on the opinion to be expressed. It is the principal's responsibility to determine that the working papers support the conclusions of the senior and if so whether the facts permit the expression of an unqualified opinion or require a qualification or perhaps the disclaimer of an opinion. If an unqualified opinion cannot be expressed the reasons should be stated clearly. The policies of the accounting firm may permit the senior to prepare a draft of the opinion which he believes is justified. The principal then can either accept this draft or make such revisions as his judgment dictates.

Discussion with Client

Many accounting firms have found that it is a good policy to submit the rough draft of the report to the client, and in some instances this duty is delegated to the senior-in-charge. In discussing the report, the senior explains all points not understood by the client and endeavors to meet any objections which the client may have regarding presentation. As a result comments are often clarified or rearrangements made which will be mutually satisfactory without sacrificing the standard of disclosure. Sometimes it is found that certain subject matter has little value to the client and can be omitted, condensed or its position in the report changed. In this manner the interest of the client in the report is retained for the presentation of matters which are valuable to him and not lost prematurely by inclusion of subjects which are not. In any case, harmonious relations may be strengthened when the client is given an opportunity to voice an opinion on the content of the report.

The senior should not be swayed by the objection of the client to disclosures which he is required to make in the discharge of his firm's responsibility to third parties. Instead he should exercise all of his powers of persuasion to convince the client of the necessity for their inclusion in the report. If he is unable to do so, he should refer the matter to the principal.

Principles of Statement Presentation

The American Institute of Accountants has adopted rules of professional conduct in its by-laws which govern its members. Among other things "a member may be held guilty of an act discreditable to the profession" if he fails to disclose a material fact which is necessary to make financial statements not misleading; if he fails to report any material misstatement in the financial report; if he is grossly negligent in the conduct of his examination or in his report; or if he gives an opinion on statements as to which he has failed to acquire sufficient information or if his exceptions are sufficiently material to negative an opinion; or if he fails to direct attention to any material departure from generally accepted accounting principles.

Although these rules apply to members of the Institute and are imposed on the accounting firm, they should be adopted by the senior accountant as a responsibility throughout the engagement.

Basic accounting principles applicable to financial statements are too voluminous to be summarized here. The following listing is primarily for illustration of these principles with all of which the senior should be conversant:

1. Assets should not ordinarily be stated in excess of cost.
2. Assets and liabilities should not be offset, except in the case of certain United States securities held for the purpose of paying Federal income taxes.
3. The basis of inventory valuation should be disclosed in the balance sheet or in the notes.
4. The portion of assets charged to expense, such as provision for loss from uncollectible accounts, or wear and exhaustion of building and equipment should be shown as a deduction from the assets.
5. Descriptions of the maturities and other important provisions of long-term liabilities should be shown in the balance sheet or in the notes.
6. Restrictions on retained earnings, working capital or financial operations in the bond indentures or preferred stock should be disclosed.
7. Reserves for any purpose (other than to provide for known liabilities of definite or indefinite amount, which should be designated liabilities) should be created from retained earnings (earned surplus) and returned intact when no longer required. Such reserves should be presented in the equity section of the balance sheet as appropriated retained earnings.
8. Premium paid on reacquired stock should be charged to paid-in surplus in the amount per share included therein and the balance applied to reduce retained earnings.
9. The net income should be stated clearly, without inclusion of appropriations to general purpose reserves or of material extraordinary nonoperating items, which are properly carried directly to retained earnings.

10. Long-term leases and purchase-lease agreements should be disclosed.
11. Disclosure should be made of the effect on the financial statements of a difference between tax accounting and financial recording, if the effect is material.

Disclosure of Material Events Occurring up to Time of Report

Often events occurring after the balance sheet date have a bearing on the financial position of the client, the effect of which cannot be incorporated in the financial statements. If these events are extraordinary or material, they should be disclosed in the notes to the financial statements or in the comments in the audit report. Disclosures are usually made of items such as the following:

1. Reorganizations, mergers, and sale or retirement of substantial amounts of capital stock.
2. Suspension of operations by a strike, fire, or other casualty; or an uninsured loss.
3. Plant expansion commitments.
4. New long-term financing, refinancing under different terms, or the payment of long-term debt.
5. Legal action — judgments rendered or new litigation begun.
6. Purchase or sale of substantial amounts of investments; extreme market fluctuations of investments.
7. Purchase, sale, or liquidation of a subsidiary.
8. Change in accounting methods, such as adoption of a new method of pricing inventories.
9. New long term leases.
10. Contracts entered into which place restrictions on the retained income or working capital.
11. Stock or other options given, received, or exercised.
12. Pension plans adopted or modified.

The senior-in-charge should scrutinize the records and minutes for the period following the balance sheet date and up to the completion of the examination for evidence of such events, and should also seek information orally regarding them. He should make provision in the financial statements for losses, such as bankruptcy of a customer from whom substantial amounts are due, or for newly ascertained liabilities such as Federal income tax assessments or retroactive wage increases. Full disclosure should be made of all other extraordinary events for which no provision can be made. Many accounting firms have had the experience of rewriting audit reports which are ready for delivery, in order to include such disclosures.

In the case of financial statements filed with the Securities and Exchange Commission, in connection with the registration of securities, the accountant is responsible for disclosure of material events occurring after financial statements are filed and up to the effective date of the registration.

Typing Instructions

It is common practice among accounting firms to submit typing and other instructions with the report. A facing sheet with spaces for at least the following data is commonly used:

1. Date of the balance sheet.
2. Number of copies required.
3. Binding instructions.
4. By whom prepared.
5. Date of completion.
6. Approval by principal.
7. Date of approval.
8. Due date.
9. Delivery instructions.
10. When and how delivered.

The basic information is usually provided by the senior, with the approval and delivery indicated by others.

Discussion and Review by Principal

Discussion of the audit engagement between the senior accountant and his principal will follow the line of the senior's responsibility toward the engagement. If the senior is experienced, has good judgment, and his work has been found reliable he may be permitted to conduct the examination without supervision except for the final review. If the senior is less experienced or if the engagement presents exceptional problems, he may be closely supervised throughout the examination and his authority may be limited. The degree of supervision also will govern the discussions required with his principal.

Matters to be Discussed

In general it is customary for the senior to consult with a superior in the following instances:

1. When it appears desirable to modify or expand audit procedures because the tests which were planned are deemed either excessive or inadequate.
2. Upon discovery of irregularities of material amounts which may have an implication or suspicion of fraud, either by defalcations of employees or manipulations of management.
3. When differences of opinion arise with the client on material issues.

If the senior conducts the examination without supervision, he may be required to refer other problems to his principal for decision. He also may be expected to consult his principal on the proposed adjusting entries before they are made. If he is permitted to make such decisions during the examination, they will be discussed with the principal during the final review.

The senior usually keeps his principal advised of the progress of the engagement and the problems which are encountered. He should ask for conferences with his principal whenever any situation arises on which he feels the need of advice. After the completion of the examination the principal will review the working papers to see that the audit program has been followed and that the work has been done properly.

Review by Principal

The accounting firm can assume responsibility for financial statements only after a critical review of the working papers and the financial statements. The principal conducting the initial review may be the supervising senior but a partner will always be responsible for the final review.

The staff organization varies in accounting firms and with it the review procedures. It is a fundamental objective of review that the work of each person will be checked by another. If the financial statements are prepared from the working papers by an assistant and the senior checks all figures from one to the other, there will be little reason for another person to recheck them. The mathematical accuracy of the reports may be checked by a machine operator or a junior. The principal in this circumstance will confine his attention to auditing procedures, accounting principles, and the conclusions to be drawn.

There is no standard or formula of review. It is governed by the circumstances of each examination. The reliability of the senior and the complexities of the business are taken into consideration by the principal in judging the extent of review procedures necessary to enable him to approve the statements. In all cases there should be satisfactory evidence as to the following:

1. The adequacy of the audit procedures to establish the reliability of the client's accounting records and to bring to light errors of principle and practice.
2. The propriety of the adjusting entries made.
3. The soundness of the judgment displayed by the senior in decisions made.
4. The adequacy of the disclosures in the text, statements and opinion.
5. The compliance of the presentation of the financial statements with standards of the profession.
6. The clarity and sufficiency of the notes to the financial statements and the comments in the long-form report.

In some cases the reviewer inspects and initials every working paper schedule and traces the total into the working trial balance. He may read the excerpts from the minutes for pertinent information. He will usually make a critical analysis of the statements and of the facts developed. He will question the senior concerning the items and satisfy himself that due care has been exercised in the performance of the examination and in the preparation of the report.

By the thoroughness of the review, the principal effects an internal check for the accounting firm, satisfies himself that there are no material misstatements in the report, and helps to further the training of the senior.

When the senior presents the audit report and working papers to the principal for review he should have a memorandum of the points which he thinks need the attention of the principal. He should be prepared to explain his ideas, the problems which he has encountered, his solutions to them, and any uncertainties which he may have. He should be sufficiently familiar with the facts to be able to answer questions as to profits, trends, and office practices of the client without referring to the working papers.

Individuals working as senior accountants do not always have the ability to express themselves clearly, accurately and readably in writing, but such individuals will not be really well qualified senior accountants unless they can acquire this very important ability. Because of this lack of ability it may be necessary for the principal to make considerable revision in the text of the report to present the ideas more clearly or concisely. Even in cases where major revisions of reports are required later, it is desirable that the report be written by the senior rather than by one who is not connected with the examination. The senior has knowledge of the client and his business and is in possession of information which will make the report vital to both. Continuous preparation of reports will cultivate the senior's writing ability, especially if he makes it a point to understand the changes in his work that are made by the reviewer.

Report on Work of Assistants

The senior-in-charge is expected to rate assistants assigned to him, in a periodic report to his firm . The report may be given orally or in writing, sometimes in the form of answers to a questionnaire. The senior should be fair in his appraisal, making sure that his criticism is constructive and objective. The rating should cover the technical knowledge and ability of the assistant as well as his personal qualifications, such as tact, willingness to take instructions, and conduct in the client's office. Any special abilities should be stressed. The senior will render service to his firm and his assistants alike if he makes recommendations concerning further training needed by a junior to meet the requirements of the firm. The ability to correctly appraise his assistants is a valuable trait in a senior.

Adding Data to the Permanent File

Accounting firms maintain a permanent file for each client, in which is accumulated continuing data needed for reference in later years. This permanent file would normally include such items as the following:

1. Account schedules for:
   a. Property and equipment
   b. Depreciation
   c. Intangible assets — patents, copyrights, formula, leaseholds, and goodwill
   d. Amortization schedules for intangibles of limited life
   e. Permanent investments; subsidiaries
   f. Long-term liabilities
   g. Bond discount or premium amortization schedules
   h. Capital stock, paid-in capital, retained earnings, or proprietorship accounts
2. Corporate data (or corresponding data for a partnership):
   a. Articles of incorporation, amendments, correct name of the company, and incorporation date
   b. Classes and provisions of capital stock
   c. Corporate minutes
3. Bond indenture provisions, including sinking fund data, restrictions on dividends, and similar items.
4. Contracts, deeds, leases, labor contracts, pension plans and other important legal documents.
5. Tax return data, such as surplus reconciliations, depreciation on cost bases and similar data.
6. Insurance coverages.
7. Accounting manual of client, chart of accounts, data on accounting records and accounting procedures.
8. Organizational and personnel charts (where maintained).
9. Internal control outline or questionnaire for several years.
10. Audit program for several years.

The senior should give particular attention to the accounts carried in the permanent file, in view of the permanence and importance of their content. If details are assigned to an assistant, there should be close supervision.

The client is usually willing to furnish copies of legal papers, indentures, contracts, and similar records for the auditor's files. Where copies are not available the senior should make excerpts of pertinent points which relate to the client's finances. If the client has an accounting manual, or an organizational chart, the senior should secure an up-to-date copy. If not, he should secure or prepare a chart of accounts and a list of accounting records and procedures for this file.

The corporate minutes should be reviewed by the senior-in-charge, preferably early in the engagement, for information as to new and unusual matters, such as financing, commitments and litigation, and as to dividend action and disbursement authorization. They furnish the evidence of authority for important transactions and enable the auditor to judge the propriety of the entries by which they are recorded. The senior should make excerpts of the minutes which relate to these and other financial matters such as plant expansion, treasury stock transactions, bonus and pension plans, and so on. The notes should be clear, concise, and comprehensive. Important resolutions and actions of far-reaching effect should be copied verbatim in order that the intent may be clear.

Failure to have access to the corporate minutes is a matter for exception to the opinion of the auditor on the financial statements.

CHAPTER 13

Additional Responsibilities

The responsibilities of a senior accountant are not rigidly fixed. They vary with the firm for which he works because of variations in organization; they vary with the engagement to which he is assigned; and also they vary with his status in his firm. A senior may be placed in charge of some engagements, but may be working under a more experienced senior or a supervisor on other engagements.

Responsibility When in Full Charge of an Engagement

The duties and responsibilities of the senior accountant which have been described in these pages are those of a senior who is in charge of an engagement. In this capacity, he is the executive in the field and as such he is responsible to his firm for the assistants assigned to him.

This responsibility extends to the conduct of the assistants in the client's office as well as to supervision of their work. In the unusual event of the insubordination or misconduct of an assistant, the senior will send him back to the home office at the earliest moment possible, without creating a disturbance.

The senior should comply with the policies of his firm in all respects and should be watchful that they are also observed by his assistants. He should keep his office advised of the progress of the engagement and the approximate date on which assistants will be released for new assignments.

On out-of-town engagements, the senior has charge of travel arrangements, transportation, hotel, and meals. Living quarters provided should be commensurate with the dignity of the firm. Since these expenses will usually be billed to the client, the senior should avoid extravagance which may prove embarrassing to his firm. Frequently, the senior pays most of the bills himself and can keep expenses within reasonable bounds. Expense accounts of assistants should be approved by the senior before submission to the firm. In the event that expenses are on a per diem basis, the senior should see that the staff members are not required to accept living arangements which exceed the allowance and should not permit them to choose those which would be demeaning.

Responsibility When in Charge of a Phase

The senior is often assigned to a larger engagement in the capacity of a semi-senior, working under the direction of the senior-in-charge. He is given responsibility for only a phase of the audit, and in that area he acts in the same capacity as the senior in charge of the entire engagement. An assignment of this sort is good training for a new senior and is valuable to the senior-in-charge, since less supervision is required.

The senior in charge of one phase of the engagement should be fully aware of what the job calls for and where he fits into the over-all examination. His responsibilities will normally include the following:

1. Following the audit program assigned to him, or initiating suggestions for modification or expansion which he believes proper.
2. Watching for matters which should be called to the attention of the senior-in-charge, such as irregularities, errors in accounting principle or application, and so on.
3. Supervising and on-the-job training of assistants assigned to him.
4. Reviewing the working paper schedules prepared by assistants, before they are turned over to the senior-in-charge.
5. Preparing adjusting entries required.

In addition, he may be assigned important tasks which were described previously as being done only by the senior-in-charge.

Work details usually assigned to a senior or semi-senior include these:

1. Scrutinizing asset and liability accounts to see if related income or expense accounts tie in.
2. Investigating minor irregularities such as posting errors, checks unsigned or endorsements missing, and similar matters.
3. Following up exceptions in verification letters.
4. Auditing prepayments.
5. Examining notes receivable and confirming notes payable.
6. Inspecting securities and valuable documents.
7. Confirming mortgage or bond indebtedness.
8. Examining charges or credits in appropriated earnings accounts.
9. Examining retained earnings and paid-in or other capital in excess of that assigned to the capital stock.
10. Reviewing shareholders' lists, dividends, and important capital stock changes.

Training of Juniors

The senior should always bear in mind that he is responsible for the field training of the juniors assigned to him. This duty is overlooked easily in the pressure of an examination when the senior's time is taken up with seemingly more important matters. He should realize that his own position with his firm is strengthened when he contributes materially to the training of his assistants. Training will take several forms such as instruction, supervision, demonstration, encouragement, criticism, and advice.

Instructions should be given on the procedures to be taken, how to approach the work, how much to do, what to look for, and how to do it. Instructions on irregularities will cover what kind to expect, how to recognize them, and which should be reported to the senior immediately. Instructions should be given on the form and content of the working paper schedules, the notations to be made as to the source of the information, the oral information obtained and from whom it was obtained. The senior should instruct the junior in the characteristics and peculiarities of the trade or industry under examination.

Supervision will include observation that all instructions are being carried out and that work is being performed competently and without loss of time. In the case of a new junior the senior may work with him, demonstrating the procedures and methods. If there is doubt as to the junior's understanding, the senior may recheck his work to the original records until he is satisfied that nothing is being overlooked, thereby developing the judgment of the junior.

Explanations should be made regarding the purpose and value of the junior's work and where it fits into the over-all scheme. The senior should explain the decisions which are made, the reasons for them and their effects on the statements. He should encourage the junior to ask questions and discuss with him the questions raised. He should encourage any special aptitudes which the junior may have and give him an opportunity to exercise them. He should rotate the juniors in jobs to provide them with well-rounded experience.

The conscientious senior will give constructive criticism to the junior, explaining how his work can be improved, where his conduct is weak, what policies of the firm he is violating and what type of study will benefit him. The senior should always be helpful and tactful in his relations with his assistants.

Relations with Clients

Since the senior may be the person with whom the client is in contact more than any other representative of the firm, his relations with the client may be extremely important to the firm and finally to him. If he is in charge of an engagement, his work is made easier or more difficult if he obtains or fails to obtain, the respect and co-operation of the client.

Services to be Rendered

The services rendered by the independent auditor vary with the size and organization of the client's business. In all cases where the examination is sufficient in scope to permit the expression of an opinion, the financial statements are given a degree of reliability which is important to clients, large or small. The large business with a competent accounting staff may be helped by suggestions for strengthening internal control or increasing the efficiency of accounting procedures. Such a client, being further from employees and operations, also may benefit from the knowledge that an independent authority is satisfied that its transactions are properly recorded and that its financial and operating policies are being executed properly. To the small business, the auditor in addition provides some protection against fraudulent practices, acting to some degree in place of internal control which is not otherwise practicable. The accounting firm usually furnishes the small organization with an interpretation of its financial position and operations which it does not receive from its limited accounting staff.

In an examination which is limited in scope by the client, the auditor provides assurances of the authenticity and reliability of the statements within the limits of the examination. The client in this case normally has little need of the statements for credit purposes and is satisfied that accounts not examined are reasonably correct. Care should be taken that a client of this category does not place reliance on the statements beyond the point at which the auditor ceases to assume responsibility.

Conferences

Important conferences with the client are usually handled by the partner or a supervising senior. Sometimes the senior in charge participates in conferences, and less frequently he is allowed to handle them alone. He is normally expected to handle the routine contacts during an examination.

Preliminary Conferences

Before the engagement begins, the principal will make the preliminary arrangements either in informal conversations or in a formal conference. At this time, arrangements will be made as to the type of service to be rendered, date the examination will begin, date the report is required, working space available, condition of the records, and other factors. If the client wishes to cut down the cost of the audit by having some of the work done by his staff[11] such arrangements will be made at this time. Among other things, the client's staff may prepare the trial balance, schedules aging the accounts receivable, insurance schedules, copies of reconcilements, and possibly assemble vouchers supporting the additions to property and equipment. Much time can be saved on an examination if this is done.

Conferences During the Examination

At the outset of the examination, after assistants are started, the senior ordinarily seeks an interview with officers or key personnel of the company with the object of obtaining information which will guide him in the examination. He should encourage officials to talk about the business, obtaining their views on the operations, and learning their plans for the future. After the trial balance has been surveyed and information has been extracted from the corporate minutes, he will take advantage of the first opportunity to discuss the indicated questions regarding matters therein.

Later, as questions are raised during the examination concerning any irregularities, or material errors or matters which are not clear from the records, further conferences will be held. It is not good practice to carry each question to an official as it arises, but rather to accumulate such matters until an opportunity is presented. The senior should be very sure of his ground before bringing errors to the attention of the client, and be tactful in his presentation, to avoid creating antagonism. Explanations are more reliable when obtained amicably than in a tense atmosphere. If there is a difference of opinion on accounting principles, the senior should explain his position as clearly as possible; then if he does not readily convince the client he should allow the matter to drop, referring it to his principal to handle.

Any important information obtained during the examination should be disclosed to the client and nothing withheld which would be of help to him. Major irregularities or fraud discovered, weaknesses in internal control or in the accounting system which might occasion losses, or suggestions for improving the system should be written and then presented in person with explanations. Normally, this is done by the principal with the senior present, but sometimes it is handled alone by a senior who is qualified for such an assignment.

As previously indicated, the report is usually discussed with the client in preliminary draft. If the senior handles this conference, he should make sure that the findings of the examination and the adjustments made are fully understood. The position of the accounting firm should be clarified with respect to any exceptions which they are obliged to take in the opinion.

Attitudes

An important requirement in dealing with the client or his representatives is the exercise of tactfulness, saying or doing what is appropriate without giving offense. Friction should never be allowed to develop. If in the discussion of unpleasant subjects, the client becomes angry or unreasonable, the senior should courteously suggest that the matter be deferred until they both have time to think further about the matter. He may then refer the matter to his principal with a full statement of the position taken by the client.

The senior should cultivate the goodwill of the officials and employees, for the examination will proceed with greater celerity with their full co-operation. He should have enough knowledge of human nature to be able to meet each person with the attitude best suited to him. He should be friendly and respectful with all, but not intimate. He should not fraternize in any way with the employees or officials of the client. He should be sure that arbitrary demands are not made by his assistants. He should be careful that his staff does not impede the work of the office by using records when they are needed by employees or by retaining records longer than necessary. The senior and his staff, although alert to discover fraud, should never display a suspicious attitude toward either the client or his employees.

The senior should bear himself with assurance and confidence, without being overbearing. He should be willing to listen to suggestions but not to accept unjustified criticism. He should bear in mind that, as a representative of his firm, he should be respectful to others and in turn expect respect for himself and the accounting firm which he represents.

Responsibility for Professional Standards

The CPA who is practicing as an independent public accountant is held to a high standard of professional conduct. Staff members, and especially those occupying a position of responsibility such as that of a senior, must be aware of those professional standards. The profession has accepted a code of ethics for its general guidance. Every senior should be aware of the ethical standards of the profession. As to auditing engagements, the profession has equally important standards which must be observed and with which the senior must be conversant. Many firms supply each senior with a copy of publications such as the Tentative Statement of Auditing Standards, the Codification of Statements on Auditing Procedures (both of these publications are reprinted in full as Appendixes A and B of Chapter 13 of the CPA Handbook) and similar current publications. Even though they may not be supplied to individual seniors, these publications are generally available and should be in each senior's library.

Not only must the senior be aware of the standards accepted by the profession, but he must apply them in his work. To meet his responsibility he must continually keep abreast of current developments in auditing and in accounting. He must make certain that he is technically qualified to meet his responsibilities.

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Appendix

AUDITS BY CERTIFIED PUBLIC ACCOUNTANTS

. . . . THEIR NATURE AND SIGNIFICANCE

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AMERICAN INSTITUTE OF ACCOUNTANTS

OUTLINE OF APPENDIX

Section I. FINANCIAL STATEMENTS

Financial Statements Reflect Judgment as Well as Facts (Balance Sheet, Income Statement, Consolidated Statements); Judgment is Guided by Accounting Principles; Company Has Primary Responsibility for Financial Statements.

Section II. THE CPA'S REPORT

The CPA Expresses an Opinion; The Opinion May Be Expressed in a Short-Form Report; The Opinion May be Expressed in a Long-Form Report; The CPA's Report May Be Qualified; The CPA May Disclaim An Opinion.

Section III. AUDITING PHILOSOPHY

Audits are Not Uniform; The CPA Usually Relies Upon Tests; The CPA Often Performs Part of the Audit During the Year; The CPA Is Guided by Auditing Standards (Personal Standards, Standards of Field Work, Standards of Reporting).

Section IV. AUDITING PROCEDURES

Audit Techniques; Auditing Procedures Often Employed (Cash; Notes Receivable; Accounts Receivable; Inventory; Investments; Property; Intangible Assets; Deferred Charges and Prepaid Expenses; Other Assets; Liabilities; Estimated Future Liabilities and Appropriations of Retained Income — Reserves, Capital Stock; Other Capital Items — Capital Surplus — and Retained Income — Earned Surplus, Income and Expense Accounts; Consolidated Statements).

AUDITS BY CERTIFIED PUBLIC ACCOUNTANTS

Preface

This pamphlet has been prepared by the research department of the American Institute of Accountants to fill the need expressed by credit grantors, teachers, and others concerned with the work of the certified public accountant for a brief, but reasonably complete, statement setting forth in general terms what the CPA does in order that he may express an opinion on financial statements. It discusses some of the characteristics of financial statements and explains the significance of the CPA's report. Auditing procedures frequently employed by CPAs are described in some detail, but they are not a checklist of procedures applicable in a particular audit.

Together with *Statements on Auditing Procedure, Case Studies in Auditing Procedure, Tentative Statement of Auditing Standards* and *Accounting Research Bulletins,* this pamphlet supplants the earlier pamphlet, *Examination of Financial Statements by Independent Public Accountants,* published by the American Institute of Accountants in 1936 and now out of print. It is hoped this pamphlet will help those who are not familiar with the process of auditing gain a better understanding of the Certified Public Accountant's work and his responsibilities.

CARMAN G. BLOUGH, *Director of Research*
AMERICAN INSTITUTE OF ACCOUNTANTS

May 1950

Appendix

AUDITS BY CERTIFIED PUBLIC ACCOUNTANTS

Introduction

A certified public accountant's opinion as to the fairness of financial statements is important to all who use such statements. The opinion states whether or not the certified public accountant considers the financial position of the company and the results of its operations to be presented fairly in conformity with generally accepted accounting principles applied on a consistent basis.

Despite the reliance which is placed upon the opinion of a certified public accountant, few people outside the accounting profession understand how he reaches it. Many believe there is something mysterious about the process. The principal purpose of this pamphlet is to help those who have had little or no accounting training gain a better understanding of how the certified public accountant makes an audit. It discusses the nature and characteristics of financial statements, noting particularly their limitations, and outlines the certified public accountant's responsibilities in reporting upon them. Many of the procedures frequently employed in carrying out those responsibilities are described in general terms.

Principal Uses of Pamphlet

Particular attention has been given to the need expressed by bankers and other credit grantors for a summary of the basic considerations usually involved in making audits of small and medium-sized manufacturing or mercantile companies. Accordingly, this pamphlet is concerned primarily with the certified public accountant's work in connection with *audited* financial statements submitted to bankers or other credit grantors of such companies.

This pamphlet should also be helpful to users of financial statements generally. Teachers of auditing, and those concerned with staff training in public accounting firms might advantageously employ it as an introduction to the series of *Case Studies in Auditing Procedure* which the committee on auditing procedure of the American Institute of Accountants is currently sponsoring.

While not intended as a statement of "minimum procedures" for conducting an audit or as a "standard audit program," the procedures outlined in this pamphlet are all applied in actual practice, though they will seldom, if ever, all be applied in the same engagement. Accounting practitioners, too, may therefore find the discussions suggestive of some of the procedures which might be applicable in a particular audit.

Auditing Services

The type of work discussed in this pamphlet is the *examination,* or *audit* as it is commonly called, which the certified public accountant makes as a basis for an opinion on the fairness with which financial position and results of operations are presented. That type of work consists of a searching, analytical review of the books, vouchers, and other evidence supporting the information set forth in the financial statements, and contemplates the preparation of a written report in which the certified public accountant states his findings. In the course of his audit, he employs a variety of techniques and tests, selecting the procedures which in his judgment and experience are best suited to each engagement.

Other Services

In addition to conducting audits, many certified public accountants perform professional services and report on matters related more to their capacity as expert accountants than to their capacity as auditors. For example, they may be engaged to prepare financial statements from the books with little or no audit verification. They may be engaged to make analyses of certain accounts, or to make special studies. Certified public accountants often render expert advice on such matters as accounting methods and procedures, tax accounting, reports to governmental agencies, and general business matters.

Those services are of great value to the business community and require a high degree of professional skill. In performing them the certified public accountant may employ some auditing procedures, but not usually to a sufficient extent to provide an informed opinion as to the fairness of any general financial statements that may be included in his report.

The Opinion

Depending upon the circumstances, the certified public accountant (1) expresses an unqualified opinion, (2) expresses a qualified opinion, or (3) disclaims an opinion on the statements taken as a whole. Thus, when a certified public accountant finds he cannot express an unqualified opinion, he weighs the qualifications or exceptions he considers necessary with respect to his opinion to determine their significance. If they are not such as to destroy the significance of an opinion with respect to the statements taken as a whole, he renders a properly qualified opinion. If the exceptions are so material as to negative an opinion on the statements taken as a whole, he is under obligation to disclaim such an opinion, giving his reasons why. His disclaimer of opinion is indicated either by a specific statement in his report to the effect that an opinion cannot be expressed, or, if no report accompanies financial statements with which his name is associated, by a note, such as *Prepared from the Books without Audit,* on the face of each statement. Since the degree of responsibility the certified public accountant takes for financial statements varies with the circumstances of each audit, it is important to read his report carefully.

CPA Requirements

Users of financial statements look to the certified public accountant's report in determining the credibility of financial statements because they know it presents the conclusions of an independent expert in accounting and auditing. Certified public accountants must demonstrate their high professional qualifications to state boards of accountancy before receiving their certificates, and must observe strict standards in the performance of their work. The right to use the title Certified Public Accountant, or CPA, is granted by each state and territory, and by the District of Columbia, only to persons who, with minor special exceptions, present satisfactory evidence as to their character, training, and experience, and who pass an examination to test their knowledge of the matters with which they will be called upon to deal. In many states anyone can practice as a *public* accountant. Some states require public accountants to be registered. However, in the great majority of states, only *certified* public accountants have passed a written examination given under state supervision.

Professional Societies

A number of organizations have been formed to further the development of the accounting profession; principally, the American Institute of Accountants, which is the national organization of certified public accountants, and numerous state societies, some with local chapters. These organizations are constantly engaged in the study of various phases of the certified public accountant's work. Through their efforts to maintain high ethical and professional standards, they have contributed greatly to the development of the concepts discussed in the succeeding sections of this pamphlet.

Section I: FINANCIAL STATEMENTS

Financial statements ordinarily consist of a balance sheet, an income statement, a statement of retained income (earned surplus), and footnotes. If appropriate, they are accompanied by schedules showing the details of various items on the statements.

The purpose of the balance sheet is to present a summary of the assets, liabilities, and capital of a company as of a specified date. The income statement summarizes the results of operations for a period, often the year ending on the date of the balance sheet. The statement of retained income sets forth increases or reductions during the period in the undistributed earnings of the business. Footnotes are often provided to explain items more fully than is possible in the captions. They are considered an integral part of the financial statements.

Financial Statements Reflect Judgment as well as Facts

Perhaps no class of information is so imperfectly appraised by its readers as that contained in financial statements. Many regard the statements as mathematically accurate presentations of financial facts. Others regard them with complete skepticism.

Actually, the values of most items in financial statements cannot be measured exactly. By their nature, many of the amounts shown have to be approximations and represent the best estimates which those responsible for the statement can make. The items which, in part at least, are subject to approximation are among the most important in the financial statements. Despite these limitations, however, financial statements serve their purposes well. They merit acceptance and confidence as the fairest presentation of the financial position and operating results of a business which it has been possible to devise.

The reasons approximations often have to be made may be easier to understand if some examples of items which cannot be measured exactly — items as to which judgment is an important factor — are considered.

Balance Sheet

The item, accounts receivable, is an example. The total of customers' accounts can be stated with approximate accuracy, but provision for the uncollectible element in these accounts is a matter of estimate based on experience and on the best information available. At times such estimates will prove wide of the mark, but usually they are such as to permit a "fair" value to be shown on the balance sheet.

Fixed assets also present problems. Though it is usually practicable to state the initial cost of items included under fixed assets, judgment often enters into a decision as to whether subsequent expenditures, such as for new parts or modifications, should be classified as costs of fixed assets to be written off over a period of years, or whether they should be absorbed at once as expenses of the current period.

The decision in such cases affects both the balance sheet and the income statement. Failure to capitalize additions to fixed assets results in understatement of income in the period of expenditure, and corresponding overstatement in subsequent years. Capitalizing expenditures representing maintenance or repairs has a contrary effect.

Moreover, accounting for fixed assets requires judgment in estimating suitable charges to income for depreciation. Here the probable useful life of the asset and the likelihood of obsolescence must be considered. Any significant failure in determining the proper provision for depreciation affects the fairness of the income statement as well as the net amount at which fixed assets are carried on the balance sheet.

Inventories are another item requiring the exercise of judgment. The value of no item in financial statements is so little susceptible to exact statement as inventories. Estimates as to condition, salability, and even market value, may vary greatly. The convention of "cost or market, whichever lower" may be applied in a variety of manners to produce quite different results. Even the count or measurement of items in the inventory cannot always be exact.

Income Statement

Financial statements are usually prepared on an accrual basis. That means the income statement includes, to the extent possible, all income of a business applicable to the period covered, regardless of whether or not such income is fully represented by cash received in the same period. In similar manner, the statement includes, to the extent practicable, all costs and expenses applicable to the period.

Those objectives cannot be achieved by simply adding up the cash receipts and disbursements for the period. For instance, income is in some cases applicable to periods other than that in which the sale is made and the proceeds received, the reason being that full performance is not then completed. An example of this is the receipt of payment for goods or services which are to be delivered in the future. By the same token, amounts paid out today may be applicable not only to current operations, but also to those of several years to come. That is the reason for writing fixed assets off over their useful life. On the other hand, costs incurred today may not be paid for until some future time. Such is the case when goods or services received today are to be paid for at a later date.

The preparation of the incoming statement thus involves one of the basic objectives of accounting — the matching of costs and expenses against income. In great measure, this is relatively simple but as to many items the problem cannot be solved by formula, and allocation of income or expenses between periods must rest on judgment.

Consolidated Statements

Many business organizations prepare financial statements showing the financial position and results of operations of the parent company and its subsidiaries as though they were a single business entity. These are called consolidated statements and usually include only those subsidiaries over which the parent company has control. As a general criterion, the existence of control over a subsidiary is determined by whether the parent company has more than 50% of the voting control, thereby giving it the power to direct, or to cause the direction of, the management and policies of the subsidiary.

Even though the power to control a subsidiary is present, consideration is also given to whether its inclusion or exclusion in the consolidated statements will fairly and realistically present the financial position and results of operations of the group of companies. The decision to include or exclude certain subsidiaries often requires the exercise of judgment; as, for example, when legal or geographical considerations affect the extent of the control exercised or when the operations of some subsidiaries are not similar or complementary to the operations of the consolidated group.

Although consolidated financial statements serve a very useful purpose, they have important limitations which require consideration. For example, the status of bondholders and other creditors and the respective assets against which their claims rank in priority will not usually be shown. Thus, consolidated statements may be inadequate for certain purposes unless accompanied by additional statements or footnotes. However, when substantially all the securities of a subsidiary are owned by the parent company and the subsidiary is, in effect, an operating division of an integrated business, the individual income and surplus statements of the parent company alone, or of the subsidiaries, would not ordinarily be significant. On the other hand, disclosure of the parent company's equity in the aggregate earnings or losses of unconsolidated subsidiaries is usually regarded as significant information in connection with financial statements. The equity of minority stockholders — i.e., those outside the group — in the earnings, capital stock, and surplus of subsidiary companies included in consolidated statements, is generally stated separately.

Consolidated statements are intended to show the position and results of operations on the basis of considering the entire consolidated group as a single unit. Hence, intercompany sales and intercompany profits not realized by means of sales outside the group are usually eliminated in consolidation. However, practical considerations may at times necessitate minor deviations from this rule.

The examples cited illustrate only a few of the areas in which judgment enters into the recording of business transactions and the preparation of financial statements.

Judgment Is Guided by Accounting Principles

One might question the usefulness of statements whose fairness rests so heavily upon judgment rather than upon demonstrated fact. But as against such doubts it should be borne in mind that the judgment employed is an informed one. It is concerned with actualties and does not descend to mere imagination. The statements reflect the considered judgment of prudent businessmen as to the proper interpretation of all the pertinent information relating to the transactions involved.

Furthermore, broad principles, known as generally accepted accounting principles, serve as guides in making accounting decisions. Those principles have been developed over the years as a result of study and experience in presenting useful financial information. They comprise a body of accounting conventions for dealing with problems such as those described. When financial statements are prepared in conformity with those principles, and are checked by CPAs, they almost always present financial facts fairly, even though approximations and estimates have been necessary.

It is not the purpose of this pamphlet to deal with accounting principles as such. Many excellent books are available to those who wish to pursue the subject further, and a series of *Accounting Research Bulletins* dealing with the application of those principles to a variety of specific problems has been issued by the committee on accounting procedure of the American Institute of Accountants.

Company Has Primary Responsibility for Financial Statements

There is one further point that should be understood before considering the following sections of this pamphlet. Financial statements are primarily the statements and representations of the company. The fact that they have been examined and reported upon by a CPA does not shift the company's responsibility for the fairness of the information presented.

The transactions with which the accounting records are concerned, and the recording of those transactions in the books, are matters within the direct or primary knowledge and control of the company. While the CPA may supervise the keeping of the records, and often prepare the financial statements, his knowledge of the transactions is a secondary one. Thus, even though the financial statements may reflect the influence of the CPA, the company in presenting them to others must be considered to have accepted, and adopted, the CPA's recommendations. The company cannot be excused for presenting statements which it knows to be false or misleading any more than can the CPA.

Section II: THE CPA's REPORT

The characteristics of the CPA's report depend upon the purpose for which the examination was undertaken. However, all reports based on audits whose objective is an opinion on the fairness of financial statements have characteristics in common. They include a description of the work done by the CPA and present his findings. In some instances, they include qualifications of the opinion, or an assertion that an opinion cannot be given. In such cases, an explanation of the conditions which make these necessary is included in the report. The CPA's representations are confined to and expressed in his report. It is essential, therefore, that users of financial statements read the CPA's report carefully to be fully informed as to the views the CPA holds regarding the fairness of the statements.

The report may take varying forms. In some cases, a detailed, or long-form, report is submitted. In other cases, the report is limited to a concise statement of the scope of the examination and the related opinion of the CPA concerning the financial statements. This is referred to as the short-form report.

Not infrequently, both types of reports are submitted: the long-form report being principally for the information of the management, or a small group of creditors; the short-form report being used in connection with financial statements submitted by the company to those whose concern is primarily with the over-all picture rather than with the details of the audit or the management of the business. The short-form report is customarily used in reporting upon financial statements to be published in reports to stockholders. Regardless of form, however, the CPA is careful to word his reports so that readers will not be led to place greater reliance upon them than is intended.

The CPA Expresses an Opinion

A word of caution is appropriate at this point. For many years, it was customary to introduce the CPA's opinion with the phrase "We certify that . . . " It is quite natural, therefore, that the opinion came to be known as a "certificate" — for the same reason, it became customary to say that the CPA "certified" financial statements. Nevertheless, the CPA's conclusions are essentially matters of opinion rather than of fact.

His opinion is an expression of personal judgment. In recognition of this, it is now customary to use the phrase "In our opinion," to introduce the conclusions set forth in the CPA's report as to the fairness of financial statements.

The opinion of a CPA is not comparable to the certificate of a weighmaster who certifies as to the weight of a load of goods. As explained, financial data often cannot be gauged by precise standards. The CPA is not an insurer. He cannot guarantee that the figures presented in financial statements are literally correct. It is not possible to certify the accuracy of management's judgment or estimates, but the opinion of an independent expert, skilled in analyzing and appraising the grounds upon which such decisions are made, is valuable to those who lack the opportunity, the time, or the training to make such an investigation themselves.

Since he must assume responsibility for his opinions, it is proper that the CPA should be the sole judge of his ability to express them. If, in his judgment, it is necessary or desirable to include explanations of his findings or to take exception to some aspect of the financial statements, those matters are usually included in a separate paragraph of the report. The CPA is responsible for reporting any exceptions clearly and unequivocally, whether they involve the scope of the audit work, particular items in the financial statements, the soundness of the company's accounting practices (as regards either the books or the financial statements) or lack of consistency in the application of accounting practices.

It bears repetition that the financial statements, with all supplemental descriptive and explanatory data, including footnotes, are regarded as representations of the company. It is upon all these representations that the CPA exercises his independent, considered judgment and renders his opinion. If explanations are essential or desirable, and they are not incorporated in the statements in a manner he considers satisfactory, he makes appropriate explanations in his report.

The Opinion May Be Expressed in a Short-Form Report

The short-form type of report, which outlines in general terms the scope of the examination made and states concisely the CPA's opinion regarding the fairness of the financial statements, is usually adequate for the needs of those who seek assurance primarily as to the over-all fairness of the presentation of a company's financial position and the results of its operations. The following wording of a short-form report, recommended by the committee on auditing procedure of the American Institute of Accountants in 1948, is typical:

"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."[1]

The first paragraph sets forth the CPA's representations regarding the scope of his audit. It represents that the audit met the profession's standards for competence and workmanship. It also points out that, in observing generally accepted auditing standards, the CPA made all the tests and employed all other procedures which he considered necessary in the circumstances for an informed, professional opinion regarding the financial statements. A major portion of this pamphlet is devoted to explaining the CPA's approach to an examination and to outlining the ways in which he selects and applies auditing procedures.

The second paragraph deals with the CPA's findings. As noted previously, the CPA expresses an *opinion*. He does not *guarantee* that the statements are correct. He states that in his best judgment, based upon a careful audit, the financial statements set forth all the information necessary to present fairly the company's financial position and the results of its operations. He states further that, in his opinion, the statements are presented in conformity with generally accepted accounting principles, which were mentioned briefly in the early part of this pamphlet, and that those principles have been applied on a basis consistent with that of the preceding year.

The expression "presents fairly" should be noted particularly, because it constitutes the essence of the CPA's opinion. It indicates the belief that, although the amounts shown in the statements may not represent exactness, they are near enough to actuality (under generally accepted accounting principles) to be accepted as correct for practical purposes. Further, it stresses the CPA's belief that the method of presentation — that is, the arrangement of the items — is such as to give a truthful over-all picture of financial position and results of operations.

While this form of report has been recommended as a standard, it is not prescribed or recommended for invariable use. It is adaptable to the needs of the particular case. For example, the CPA may consider it desirable to expand the report to include a brief explanation of certain auditing procedures he has employed, or has not employed, or of certain

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1 Statements on Auditing Procedure No. 24, *Revision in Short-Form Accountant's Report or Certificate.*

accounting practices followed by the company. He may wish to include information which he believes is not adequately explained in the financial statements. As has been indicated, he may in some cases consider it necessary to qualify his opinion in certain respects, or to disclaim any opinion as to the over-all fairness of the financial statements. Variations from the standard wording should be carefully considered by users of the statements. They may be important.

The Opinion May Be Expressed in a Long-Form Report

The long-form report customarily outlines in some detail the work done and the CPA's conclusions regarding the more important matters. It usually includes comments on the company's operations and comparisons with previous periods. It may include a wide variety of information, such as statistics on changes in financial or working capital position, agings of receivables and payables, an application of funds statement, a summary of insurance coverage as taken from policies submitted for examination, and other information which may be appropriate in the particular circumstances.

It is not uncommon to find the wording of the short-form report, previously quoted, incorporated in the long-form report. Recommendations on internal control and accounting procedures are frequently submitted in a separate memorandum.

The long-form report is generally intended primarily for the use of management and, for that reason, may not accompany financial statements presented to outsiders. However, it is frequently submitted by the company to bankers and other credit grantors upon request. Credit grantors often find either the long-form report presented for management purposes, or a similar report designed specifically for their needs, to be of great value.

The CPA's Report May Be Qualified

Depending upon his findings, the CPA may express an unqualified opinion as to the over-all fairness of the presentation of the financial data; he may express an opinion qualified in some respects; or he may feel that no opinion is justified under the circumstances.

If he is completely satisfied that the financial statements present fairly the financial position and results of operations, the CPA usually expresses an unqualified opinion to that effect. The short-form report previously quoted is an example of an unqualified report. When the CPA has not been completely satisfied on some point, or when he feels that some part of the financial position or results is not fairly presented, but under the circumstances the matter in question is not of sufficient significance to prohibit the expression of an opinion on the statements taken as a whole, he may express a qualified opinion, indicating the nature of the reservation or exception.

In general, the necessity for expressing a qualified opinion occurs when the CPA has not been able to make an examination sufficiently complete to warrant the expression of an unqualified opinion or when he has found violations of accepted accounting principles which the company is unwilling to correct. When either of these situations exists, the CPA weighs their significance and importance. If the statements read in the light of his qualifications permit a reasonable appraisal of the financial position and results of operations, he expresses a qualified opinion.

It is not possible to prepare standard wording for use in expressing a qualified opinion; the circumstances calling for qualified opinions are far too numerous and varied and must be dealt with as they arise. However, the following examples illustrate the manner in which they appear in CPAs' reports. The first example shows wording that might be used when certain auditing procedures normally considered necessary were omitted. The second involves an exception to the company's accounting practices. The third concerns a reservation because of uncertainty as to a contingent liability. The fourth illustrates an exception with respect to consistency in the application of accounting principles:

(I)

"Records supporting the changes in the inventories at one of the divisions between the date of the last physical inventory, October 31, 19__, and the end of the company's accounting year, December 31, 19__, were not completed and in proper order for satisfactory examination. The auditing tests and observations made by us indicate the possibility that a further reduction might have been found necessary. This reduction would not, in our opinion, exceed $____.

"In our opinion, subject to the exception with respect to inventories explained above, ..."

(II)

"In our opinion, except that no provision was made for net losses, estimated to be approximately $____, on purchase commitments, ..."

(III)

"In our opinion, except as to such adjustments as may result from final determination of taxes on income, ..."

(IV)

"As stated in the notes to the financial statements, the company changed its method 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 income 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."

The CPA May Disclaim an Opinion

The CPA refrains from expressing either an unqualified opinion or one that is qualified when, because of limitations on the scope of his audit or departures from generally accepted accounting principles, his exceptions or reservations would be such as to destroy the significance of the opinion on the statements taken as a whole. In such cases, the CPA is obliged to indicate that he is not in a position to express an opinion on the over-all fairness of the financial statements and to give his reasons why. He may, if he considers it appropriate, express an opinion limited to those parts of the financial statements with which he is satisfied. When he does so, however, he first makes it absolutely clear that he is not expressing an opinion on the over-all fairness of the financial statements.[2]

As in the case of qualified opinions, it is not possible to suggest any standard wording that would be applicable generally for the disclaimer of an opinion. However, the following paragraph illustrates the type of language that might be incorporated in the CPA's 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."

It should be remembered that the CPA is not in a position to force his client to authorize a satisfactory audit. If the client is unwilling to have the CPA make an examination of sufficient scope to justify expressing an opinion on the over-all fairness of the financial statements, the CPA must state clearly in his report the limitations of his audit and the degree of responsibility which its scope justifies.

Section III: AUDITING PHILOSOPHY

The general misunderstanding as to the real significance of financial statements also extends to the audit of those statements by CPAs. People who mistakenly suppose that statements represent financial facts expressed in exact figures quite naturally assume that an audit of such statements can be nothing but an exact and complete verification of the figures on the statements.

Objectives of Audit

The objectives of an audit require no such lengthy and microscopic scrutiny. What they do require is sufficient examination of the state-

[2] Statements on Auditing Procedure No. 23 (Revised), *Clarification of Accountant's Report when Opinion Is Omitted.*

ments and supporting records, and sufficient study of the company's accounting practices, to place the CPA in a position to express an informed opinion upon the general fairness of the statements. An examination for that purpose does not ordinarily require an exhaustive investigation of details of the company's operations.

The soundness of accounting judgments and estimates depends upon the integrity and competence of those who make them and upon their adherence to generally accepted accounting principles. It is for an independent review of the reasonableness of both management's and employees' decisions regarding these questions, even more than for tests of the mathematical accuracy of the accounting data, that an unbiased, objective audit, as provided by CPAs, is desirable. The objectives of an audit, in modern practice, are much broader in scope than the discovery of mathematical errors or the detection of defalcations or fraud.

Of course, the testing of the accounting records and supporting information is important — in fact, it is a necessary part of the process of forming an opinion regarding the soundness of the management's accounting decisions and the integrity of the accounts. Moreover, while the usual audit which is undertaken to enable the CPA to express an opinion on the financial statements may not be relied upon to disclose minor defalcations or fraud, it is incumbent upon the CPA to be alert to the possibilities of irregularities and to inform the management about weaknesses in internal control which come to his attention and which conceivably could permit such irregularities to remain undisclosed.

CPA's Approach to Audit

CPAs satisfy themselves as to the general fairness of financial statements:

1. By a general review of the accounts and records and comparison of the figures shown on the statements with the sources from which they are drawn.
2. By a study of the accounting procedures regularly followed by the company and consideration of any departures from those practices.
3. By independent sampling tests (through inspection, correspondence, or other means) of the existence of assets.
4. By the application of various audit tests to determine, so far as reasonably possible, that all liabilities are reflected in the balance sheet in actual or approximate amounts.
5. By analyses, tests, and over-all review of the income and expense accounts.
6. By test-procedures designed to determine the authenticity and general correctness of the accounts on which the statements are based.

Audits Are Not Uniform

Each audit discloses circumstances which require differences to a greater or lesser degree in the auditing procedures that should be employed, the manner in which they should be used, and the extent to which they should be applied. Among the reasons for these differences in requirements are that: (1) significant variations exist in the nature and scope of the operations of companies in different industrial or commercial groups, or even of companies within the same group or classification; (2) the degree of effectiveness of the internal control varies among companies; (3) even within a single company the operating and accounting problems frequently change from year to year; and (4) the amount of detail to be included in the financial statements varies. In new engagements, there may be the additional problem of making an appropriate review of the important transactions of prior years and determining the nature and extent of the accounting procedures and internal control in effect.

These differences make it apparent that it is impossible to lay down specific procedures which could be applied satisfactorily in all cases. Often there is a choice of procedures, any of which would be satisfactory in a given situation. Here, as elsewhere in accounting and auditing, there must be an exercise of judgment based upon experience and upon a clear view of the objective of providing a sound basis for an informed, professional opinion.

The CPA Usually Relies Upon Tests

In most audits, investigation of every transaction would not only be excessively costly — it is also unnecessary. The CPA bases his examination upon tests of the records and upon inspection of selected transactions.

The extent of testing in any audit is decided by the CPA in the light of his best independent judgment as to the amount required to constitute a fair sampling of the record being tested. In deciding upon the character of the tests to be made, and the extent to which they should be applied, one of the most important factors taken into consideration is the system of internal control. When evidence exists that the system is effective, the CPA properly concludes that the accounting records and supporting data have a higher degree of dependability than would otherwise be the case, and limits his testing accordingly. However, when his investigation shows that the system has points of weakness, he extends the scope of his testing. If the internal control is considered grossly inadequate or ineffective, he may feel compelled to review the entries in considerable detail before he can express an informed opinion on the financial statements.

Other factors which enter into the planning of tests include the materiality of the item to be tested and the relative risk of the existence of irregularities. Thus, for example, where office supplies are a relatively minor item on the financial statements, they would not usually be investigated extensively. On the other hand, certain kinds of assets, such as cash, marketable securities, negotiable papers, et cetera, are obviously of such a nature that the risk of irregularities is relatively greater. The CPA usually requires more conclusive evidence for items of that type than for others, even though they may not be as material in relation to the over-all picture as some items regarding which less exhaustive tests are suitable.

The CPA must defer final determination of his procedures until he has a dependable understanding of the available evidence and has judged its reliability. Although he may prepare a tentative program of procedures to be employed in a particular audit, using as a basis the results of his preliminary investigations, he must at all times be prepared to revise the program if in the course of his work he finds that changes are necessary.

The CPA Often Performs Part of the Audit During the Year

The CPA frequently performs much of his audit work prior to the close of the annual period. For example, he may make interim or periodic audits for the purpose of reporting on financial statements for portions of the year. If the CPA intends to express an opinion regarding the over-all fairness of the interim financial statements, he observes the same standards and the same care in the selection and application of his auditing procedures as he would with respect to annual statements.[3] However, the closer contact and greater familiarity with the business gained by periodic interim examinations may make it unnecessary to carry through in as complete detail for the interim periods all of the procedures customarily applied to the year-end statements.

CPAs often carry out important phases of their audit work as of an interim date even though they will render a report only with respect to year-end financial statements. The choice of the procedures employed, and the extent to which they are applied at such interim dates, depend very largely upon the company's internal control. For that reason, a considerable part of the interim work may first be directed to determining the effectiveness of the company's system of internal control. If the internal control is effective, a major portion of the work on inventories, plant accounts, cash and receivables, for example, may in many cases be accomplished more satisfactorily during the year than is possible after the close of the year. Some of the work must of necessity be held over until the later date, and the CPA reviews the transactions taking place during the intervening period to assure himself that nothing out of the ordinary has occurred.

The practice of doing much of the audit work during the year is of advantage to the company as well as to the CPA. One of the most im-

[3] Statements on Auditing Procedure No. 8, *Interim Financial Statements and the Auditor's Report Thereon.*

portant advantages is that the CPA can familiarize himself with the operations of the company at an earlier date. This enables him to bring any undesirable features of the company's accounting practices to the management's attention promptly for remedial action. Moreover, by doing much of the detailed work at a time when the pressure for issuing the financial statements is not so great, the CPA is generally able to work with less inconvenience to the company's staff.

The CPA Is Guided by Auditing Standards

It is apparent that to weigh the reasonableness of management's accounting decisions and to express an informed, professional opinion regarding them, the CPA himself must exercise sound judgment. This responsibility demands the highest standards of competence and integrity.

Various professional organizations, such as the American Institute of Accountants, as well as state societies of certified public accountants, and state and Federal governmental bodies, over the years have developed, clarified, and vitalized standards which guide CPAs in their work.[4]

These standards are the underlying principles of auditing which govern the nature and extent of the evidence to be obtained by means of auditing procedures. They are broad in scope and concern both the CPA's personal qualifications and the quality of his work. Whereas auditing procedures must be varied to meet the requirements of the particular engagement, standards to be observed in selecting and applying the procedures are the same in all circumstances.

Personal Standards

Generally accepted auditing standards require the CPA to be proficient in accounting and auditing; he must have the training and experience necessary to perform any engagement he undertakes in a professional manner.

The most widely recognized evidence that a person has attained this standard of competence is his possession of the right to call himself a Certified Public Accountant. As stated previously, this right is granted by each state to any person who can demonstrate that he possesses the requisite character, education, and training, and can pass a professional examination.

Practically all states use examinations prepared by the American Institute of Accountants to test the applicant's mastery of his subject. To pass these examinations the applicant must have completed a rigorous course of training involving instruction in the theory and practice of accounting,

[4] See *Auditing Standards — Their Generally Accepted Significance and Scope.* — Special report by committee on auditing procedure (American Institute of Accountants, 1947).

auditing and commercial law, and must have acquired experience in dealing with practical accounting problems. After becoming a CPA, the practicing auditor must continue to keep abreast of current developments in accounting and auditing techniques.

Independence, both historically and philosophically, is the foundation of the public accounting profession. The CPA must not only possess extensive technical skill; he must also maintain the highest standards of honest, objective judgment and consideration. Independence is one of his most important personal qualifications.

Independence is an attitude of mind much deeper than the surface display of visible standards. The standards may change or become more exacting, but the quality itself remains unchanged. Rules of conduct cannot of themselves, therefore, assure independence. They can, however, provide objective standards to guide the CPA in all his professional endeavors.

The rules of professional conduct adopted by the American Institute of Accountants [5] and by the various state societies of certified public accountants are designed to maintain the high standards of independence which the work of the CPA requires. Typically, the rules provide penalties for false and misleading statements, and prohibit contingent fees, financial interest in clients' affairs, occupations incompatible with public accounting, commissions, brokerage, and fee splitting — all intended to avoid even the possible appearance that the CPA's judgment may have been wrongly influenced.

The CPA's personal standards also demand the exercise of due professional care in the performance of his work. Due care involves not only the employment of procedures which are proper under the circumstances of a case, but also the proper application and co-ordination of the procedures employed. He must observe due care both in his field work and in reporting his findings.

Standards of Field Work

To meet generally accepted auditing standards regarding the performance of his field work, the CPA's work must be adequately planned and his assistants, if any, must be properly supervised. Proper planning is an essential prerequisite of good audit work. It is particularly important in connection with the auditing of inventories and is indispensable to the achievement of satisfactory co-ordination in auditing procedures. Closely related to proper planning is the necessity for critical review by the accounting firm's supervisory personnel of the work and decisions of those whose skill and experience are less extensive.

[5] These are discussed at some length in *Professional Ethics of Public Accounting* by John L. Carey (American Institute of Accountants, 1946).

Professional standards of field work also require the CPA to make a proper study of the existing internal control and to evaluate its effectiveness by positive tests designed to demonstrate its substance as well as its form.[6] The adequacy of the system of internal control, which from the CPA's viewpoint concerns primarily the measures adopted by the business to safeguard its assets and to check the reliability and accuracy of its accounting data, is of vital importance in the selection and application of appropriate audit procedures.

Standards of Reporting

In his report, the CPA states whether the financial statements are presented in accordance with generally accepted accounting principles and whether the principles have been consistently observed during the current period in relation to the preceding period. The CPA's responsibility relates not only to the propriety of that which is set forth, but also to the inclusion of such additional information as may be necessary to make the statements not misleading. If disclosures in the financial statements relating to items of material importance are not reasonably adequate, he clarifies these matters in his report.[7]

Section IV: AUDITING PROCEDURES

The preceding discussion was directed primarily to the broader considerations involved in an audit — what was called the philosophy of auditing. The rest of this pamphlet deals with some of the ways in which the philosophy may be reflected in the selection and application of auditing procedures.[8] The discussion is of necessity very general because, as already explained, auditing procedures must vary with the circumstances. More detailed and comprehensive illustrations of the application of auditing procedures are presented in the series of *Case Studies in Auditing Procedure,* issued by the committee on auditing procedure of the American Institute of Accountants. Each of those case studies describes the auditing procedures which were actually followed in a particular case.

[6] *Internal Control — Elements of a Co-ordinated System and its Importance to Management and the Independent Public Accountant* — Special report by committee on auditing procedure (American Institute of Accountants, 1949). The committee is also sponsoring a series of three *Case Studies in Internal Control* to illustrate the manner in which accountants reviewed internal control and applied their findings in actual engagements.

[7] A summary of references to disclosure in various Institute publications appeared in the August 1948 issue of *The Journal of Accountancy* as "Disclosure in Financial Statements — Codification of Institute Pronouncements," pp. 112-118.

[8] Certain aspects of this subject are discussed in the series of *Statements an Auditing Procedure* issued by the committee on auditing procedure of the American Institute of Accountants.

Audit Techniques

Although the nature of the techniques employed by CPAs should be readily apparent from the discussion of procedures which follows, a brief description of them, in general terms, may be helpful.

Analysis and Review: The principal means by which the CPA forms his opinion as to the fairness of financial statements is through careful analysis and critical review of the data presented, with a view to appraising whether they appear to be reasonable and reliable. This process is applied not only to the company's data, but also to data accumulated by the CPA himself in the course of his audit. One way this is accomplished is by the comparison of balances in the trial balance at the balance-sheet date with those in the trial balance at the end of the previous comparable period, noting for investigation any items which appear to be out of line with previous experience. Another comparison is that of the gross profit percentage during the current period with the corresponding percentages in previous periods. A somewhat different approach is to break down the detail of individual accounts so that any unusual items requiring special investigation may be identified or so that the more significant transactions in the account may be selected for investigation as a part of the testing program.

Observation: The CPA should, of course, be observant at all times. However, the term "observation," as used in auditing, refers to the practice of being present to observe the manner in which various procedures of the company are being performed by its employees. In particular, it is used in reference to the CPA's attendance at the counting of the inventory. In the course of his audit, the CPA may also observe the company's procedures in the handling of cash and in the operation of other phases of its system of internal control.

Inspection: A large part of the CPA's work involves the inspection of physical assets, and of documents and other evidence supporting the figures in the accounting records. This process includes such procedures as counting cash on hand, testing inventory counts and visiting plants to gain general familiarity with the company's facilities and operations. It also includes such steps as examining invoices, checks, and other documents supporting entries in the books, and reading the minutes of stockholders' and directors' meetings for information on actions authorized by those groups.

Confirmation: In numerous phases of the audit, the CPA obtains confirmation of items shown on the records by advice directly from the individual or company in a position to verify such items. For example, the CPA generally obtains reports as to the balances in the bank accounts at the balance-sheet date directly from the banks in which the company's funds are deposited. Confirmation requests are similarly sent to customers of the company on a test basis. In this way, the CPA receives confirmation of certain information from persons or businesses that are independent of the company under examination. Requests for confirmation are mailed personally by the CPA in envelopes bearing his return address and are usually accompanied by a return envelope addressed to the CPA.

Inquiry: The CPA generally secures considerable information by discussing with officers and employees of the company various questions that arise during the audit. These inquiries generally involve points which are not completely clear from the records, matters of general company policy, or such items as contingent liabilities regarding which information can often be supplied only by the management. Not infrequently, the more important of these explanations are reduced to writing in a statement signed by responsible officers of the company.[9]

Computation: The CPA also does a considerable amount of work independently testing arithmetical calculations and computing such figures as depreciation, interest accrued, amortization of bond discount, tax liabilities, et cetera.

Auditing Procedures Often Employed

Some of the procedures often employed by CPAs in the audits of small or medium-sized companies engaged in industry or trading are described in the following pages. The procedures are discussed in relation to the principal items usually appearing in financial statements of corporations. However, the general approach would be the same in the case of a partnership or proprietorship.

It should be understood that the procedures would seldom be performed in the order presented here. In practice the procedures are coordinated to deal with related items (e.g., sales and receivables).

It is not considered practicable to present in this pamphlet descriptions of procedures as they might be employed in the audits of large business units because of the complexities of their operations and accounting procedures. Nor are the special problems that arise in certain audits such as those of insurance companies, brokerage concerns, banks and trust companies, municipalities, clubs, hospitals, colleges and universities, or other nonprofit enterprises, considered here. However, the broad objectives and the basic considerations involved in such audits are the same as those involved in the audits of manufacturing and mercantile organizations.

In the case of certain items in the financial statements, the CPA makes an extensive investigation. In other instances, he proceeds only far enough to satisfy himself that the items cannot be incorrect to any great extent. As explained earlier, the materiality of the item and the risk of

[9] Statements on Auditing Procedure No. 4, *Clients' Written Representations Regarding Inventories, Liabilities and Other Matters.*

its being incorrectly stated in the particular instance, together with the effectiveness of the company's system of internal control, enter into his decision as to how far he should go in verifying each item on the financial statements. It should be remembered that the CPA cannot achieve absolute certainty. To approach it would require verification of every transaction — a process which would generally be far more expensive than the result would justify.

Many of the procedures described are applicable in most audits. Others are not always applicable. Still others, not discussed here, are necessary at times. Accordingly, in reading the following pages, it is important to bear in mind that, as stated before, each audit must be designed to fit the particular circumstances. The discussion which follows does not constitute a "standard audit program." It does not describe a "typical audit." This pamphlet does not tell a person how to make an audit; nor does it present a yardstick for weighing the adequacy of an audit. It is the CPA's responsibility, and his alone, to determine what procedures are necessary and how extensively they shall be applied in a particular audit.

Cash

Cash includes such items as amounts on deposit in banks, undeposited receipts, change and other working funds, and petty cash funds. Because of the relative ease with which errors or irregularities can occur in the handling and recording of cash, an effective system of internal control over the handling and recording of cash is of the utmost importance.

The CPA's examination of cash is designed to afford a reasonable basis for his opinion that cash, as stated on the balance sheet, is available without restriction, or with restrictions as indicated. The detection of embezzlement or kindred frauds was once a primary purpose of an examination by a CPA but, as the size of business organizations and the number of transactions have increased, with consequent improvement in internal controls, this purpose has become less important and the usual examination is no longer designed primarily to disclose such irregularities. The present-day aim of auditing procedures for cash is comparable to those for the examination of other assets — to state the amount fairly but not necessarily precisely.

In small or medium-sized companies, the circumstances do not always permit the development of as effective a system of internal control as is obtainable in large business units. It follows that the audits of many smaller business units require relatively more extensive application of auditing procedures.

Cash in Banks

Each bank with which the company does business is asked to confirm the balances in the company's bank accounts at the balance-sheet date.

A special confirmation form has been developed to assist the banks in answering these requests.[10] In addition to asking for confirmation of balances in the accounts, the request form provides for information regarding such important matters as restrictions on withdrawal of funds, direct or contingent liabilities to the bank, such as loans or discounted notes, and any of the company's assets held as collateral.

Balances of cash on deposit as reported by banks, seldom agree with the corresponding balances recorded in the company's records because of such items as checks issued by the company that have not been paid by the banks, or deposits in transit. To satisfy himself that these reconciling items are in order, the CPA usually compares them with the books and with bank statements and canceled checks received by him directly from the bank subsequent to the date of the reconcilation. If the bank statements are not received directly from the bank, the CPA usually proves them by ascertaining that the total of the opening balance and deposits, according to the bank statement, less the sum of the accompanying checks, equals the closing balance shown on the bank statement. In the case of large deposits in transit, authenticated deposit slips are usually obtained from the banks and compared with the books, item by item.

Cash on Hand

In satisfying himself as to cash on hand, the CPA usually counts it, making sure that no item such as vouchers for disbursements of significant amounts made prior to the balance-sheet date, or checks which do not appear to be readily collectible, are included in the cash funds. He also satisfies himself that the amounts of all cash funds, as determined by his counts, are in agreement with the books, and that all receipts produced as a part of the cash balance have been entered in the cash book prior to the close of the period. Where the company has a number of small petty cash accounts, it may not be necessary to count them all. In such cases, the CPA frequently requests confirmations of the amounts from the custodians of the funds.

The CPA, in counting cash, takes precautions against temporary substitution from other funds or from other sources. To accomplish this, he may secure control over the other funds and negotiable assets until the count is completed. Control may be obtained in many cases by providing that no one may have access to the items unless accompanied by the CPA, or by sealing the containers in which the items are kept.

Cash Transactions

To satisfy himself that cash receipts and disbursements have been correctly recorded, the CPA usually selects a sample period or periods for

[10] Standard Bank Confirmation Form — 1940, available from American Institute of Accountants.

checking cash transactions in detail. The procedures applied generally include examination of checks issued by the company during the sample period, and paid by the bank, to see that they appear to be bona fide checks issued for bona fide business purposes to bona fide payees, and comparison of the checks with the cash disbursements records and with supporting evidence. Receipts, as shown by the cash receipts records, are traced to the bank statements, to duplicate deposit slips, or to other documents which support the records of the disposition made of them. As an over-all check, to be sure that all recorded receipts and disbursements have been accounted for, total cash receipts and disbursements, as shown by the company's records, may be reconciled with total deposits and withdrawals during the sample period, as shown by the bank statements.

CPAs usually obtain bank statements covering a short period immediately following the balance-sheet date to examine returned checks for evidence of post-dating or failure to enter withdrawals in the cash records for the period ended on the balance-sheet date. These "cut-off" statements also enable the CPA to trace deposits in transit at that time to the bank statements and to satisfy himself as to whether any items have been returned. The bank statements are usually obtained by the CPA directly from the bank. If they are not, the CPA proves them in the manner previously outlined.

Notes Receivable

The business under review may have several different types of notes receivable among its assets. It may have notes receivable, including installment notes, arising out of its regular business with its customers. There may be notes receivable from affiliated concerns or from stockholders, directors, officers, or employees. There may also be notes receivable arising from other transactions outside the ordinary business of the company. Some of these notes may have been discounted, in which case the company may have a contingent liability.

The objectives of the CPA in auditing notes receivable are to satisfy himself that the items making up the amounts on the balance sheet are genuine and that they are stated at amounts they may reasonably be expected to realize. He also satisfies himself that they are properly classified on the balance sheet, with the different types shown separately, if significant, and that none has been pledged, sold, assigned, or discounted, except as disclosed in the statements.

Notes on hand are usually examined and the details compared with the company's records. Any evidence of collateral may also be examined to determine whether the collateral appears adequate or whether provision should be made for possible loss.

It is generally accepted auditing procedure, where practicable and reasonable, to ask the makers of the notes to confirm the balances payable and the collateral pledged, if any.[11] If the notes are numerous, the confirmation procedure may be performed on a test basis. Replies to these confirmation requests are checked to the records and any differences are investigated. As was indicated under "Cash," the bank confirmation form provides for information as to notes discounted with banks. When notes are in the hands of attorneys or others for collection, confirmation that the notes are being held for the account of the company is usually requested.

The CPA customarily reviews the records of notes receivable and analyzes the accounts to satisfy himself that the notes are being recorded properly. In addition to comparing the results of his count and the confirmations with the records, this analysis and review may also include consideration on a test basis of whether collections of principal and interest during the period under review have been recorded properly, and whether any notes have been sold, assigned, or discounted.

Accounts Receivable

Accounts receivable, like notes receivable, may arise from various types of transactions and, as in the case of notes receivable, the CPA's objective is to satisfy himself that they are presented fairly in appropriate detail. Since accounts receivable are generally related closely to sales, the CPA's audit of accounts receivable often plays an important part in his audit of income.

General

Unless the accounts receivable are few in number, the records of individual accounts are usually kept in a separate ledger, or ledgers, the total balances of which are "controlled" by summary accounts in the general ledger. It is customary, therefore, to obtain trial balances (a listing of balances) of the accounts in the subsidiary ledgers, making sure that the details on the trial balances are in agreement with the balances in the individual accounts and that the totals are in agreement with the general ledger.

The accounts may, at the same time, be scrutinized for unusually large items, or for items which for other reasons appear to require special investigation. If there are significant credit balances in any individual

[11] Statements on Auditing Procedure No. 1, *Extensions of Auditing Procedure.* (American Institute of Accountants, 1939.)

accounts, they are investigated to see if they should be reclassified as liabilities for balance-sheet purposes.

Past-Due Items

The trial balances of accounts receivable, in addition to showing the balance due on each account, are often prepared so as to show the "aging" of the individual accounts. For example, the balance of each account may be analyzed to show the portion of the balance that is current and the portions that are thirty days, sixty days, ninety days, and over ninety days, past due. The calculation of this schedule is tested by comparison with the customer's accounts to assure its correctness, if the CPA has not prepared it himself.

Steps are also taken to see that adequate provision is made for material items which are in dispute, or which may not for other reasons be collected in full. For example, a customer may be making regular payments on his current account while old items in dispute are carried forward. It is customary to pay particular heed to the possible existence of such items when comparing the trial balance with the individual accounts. The aging schedule provides considerable assistance in this respect because it so readily directs attention to items past due.

The CPA usually discusses with the credit department, or with some responsible officer, disputed items and accounts and notes that are past due. On the basis of this discussion, and such other investigations of correspondence, loss experience, et cetera, as are deemed necessary to form an opinion regarding the collectibilty of the accounts and notes, the CPA satisfies himself as to whether sufficient allowance for probable losses from doubtful accounts and notes has been made. In the balance sheet, these estimates of possible losses are usually shown as deductions from the corresponding assets, or from the total of the receivables to which they relate if the estimates are combined in a single amount.

Allowances to Customers

The CPA customarily investigates the company's practice regarding the granting of trade discounts, cash discounts, and freight allowances. He may also make inquiries as to the existence of customers' claims for reduction in prices and for allowances on account of defective material or special quantity discounts. Recognition of such items in the financial statements is similar to that given estimates of bad debt losses, though it is not customary to disclose them separately.

Goods Consigned Out

If the company consigns goods to customers or agents or holds goods under orders from customers for future delivery, title not having passed to the customers, the CPA makes inquiries and reviews the records to satisfy himself that such items have not been improperly included in accounts receivable. They are ordinarily carried in the inventory at the inventory price.

Confirmation

As with notes receivable, accepted practice requires the CPA to obtain confirmation of a representative portion of the balances of accounts receivable by communicating directly with the debtors wherever practicable and reasonable, and where the aggregate amount of accounts receivable represents a significant portion of the current assets or the total assets of the company.[12] Experience has demonstrated that this procedure is generally practicable and reasonable and is the most satisfactory method of substantiating receivables. It should be noted, however, that the principal purposes of such confirmations are to establish the genuineness of the receivables, the proper recording of receipts and the accuracy of the balances, and to test the internal control, rather than to determine the debtor's credit worthiness.

The method, the extent, and the time of confirming receivables in each engagement, and whether all receivables, or a part of them, should be confirmed, are determined by the CPA in the light of the particular circumstances. In general, there are two methods: the positive method and the negative method.

Method of Confirmation

When the postive method is used, the debtor is asked to reply directly to the CPA, stating whether the balance shown by the request is correct and, if not, the balance he considers correct. He is also asked to furnish information which may be of assistance in locating any difference. Under the negative method, the debtor is asked to reply only if the balance is incorrect.[13] The confirmation request is often in the form of a special letter, or of a sticker attached to the regular periodic statement, or it may be imprinted on the statement by a rubber stamp.

Extent of Confirmation

In addition to applying his judgment as to the method of confirming accounts receivable, the CPA must also decide whether under the circumstances a limited test will be satisfactory, or whether requests should be made for confirmation of a relatively large number, or even all, of the

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12 Statements on Auditing Procedure No. 1, *Extensions of Auditing Procedure.*

13 Statements on Auditing Procedure No. 19, *Confirmation of Receivables (Postive and Negative Methods).*

accounts. In reaching a decision, he takes into consideration such factors as the type of business and the effectiveness of the internal control.

Some companies, such as public utilities and department stores, have a large number of accounts with small individual balances. Other companies have a much smaller number of accounts but individual balances may be large. If the company has a large number of accounts with small balances, and the internal control is good, the likelihood that the receivables may be materially misstated is slight. The CPA may, therefore, request confirmations for only a relatively small proportion of the accounts. It is not uncommon to use the negative method in such cases.[14] On the other hand, if the company has a smaller number of accounts, but with large individual balances, it is customary to confirm a relatively larger proportion of the accounts and to use the positive method.

It is often desirable to use both methods of confirmation in the same audit, confirming the more important accounts by the positive method and the remainder by the negative method.

Checking Results

Even when the positive method is adopted, it is usually impossible to secure responses to all requests. The percentage of replies varies considerably according to the type of customer with which the organization deals. The CPA must, therefore, decide whether the nature and extent of the response, taken in conjunction with his other auditing procedures, constitute a satisfactory basis for his opinion as to the receivables. Generally, the CPA reaches a decision in this respect by comparing the aggregate dollar amount confirmed with the aggregate dollar amount for which confirmations were requested, taking into account also the nature of the replies and the situations disclosed. If the CPA does not consider the results satisfactory, he pursues the matter further, either by communicating again with those who have not replied or by adopting alternative procedures, to satisfy himself that accounts with respect to which replies have not been received are in order.

When the internal control and other conditions warrant, the confirmation of accounts receivable and the general review of the accounts receivable records are frequently done as of an interim date.

Confirmation Omitted

Although confirmation of accounts receivable is generally practicable and reasonable, circumstances occasionally arise under which it is not.

[14] Statements on Auditing Procedure No. 3, *Inventories and Receivables of Department Stores, Installment Houses, Chain Stores and Other Retailers,* and No. 14, *Confirmation of Public Utility Accounts Receivable.*

The CPA may be able, in some cases, to satisfy himself by other, special auditing procedures which are substantially the equivalent of confirmation in the circumstances. If unable to do so, and the amount involved is sufficiently material, he must refrain from expressing an opinion. In any case, the fact that receivables were not confirmed must, if they are material, be disclosed in his report even though he has satisfied himself sufficiently by other auditing procedures.[15]

Inventory

Inventory consists of goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies).[16]

The CPA's procedures are designed to satisfy him that the amounts set forth by the company as inventory represent actual inventory, that they are presented with reasonable accuracy and in accordance with generally accepted accounting principles consistently applied, and that the bases of stating the inventory, as well as the pledge or assignment of any inventory, are properly disclosed. These objectives require the CPA to investigate the care and accuracy with which the company has counted the inventory, the methods and bases adopted by the company in pricing it, and the substantial correctness of the company's mathematical computations.

Observation

To satisfy himself that the counting of the inventory is done carefully and accurately, and also to gain general familiarity with the inventory, the CPA is required by generally accepted auditing practice to be present at the inventory-taking to observe the effectiveness of the count procedures when it is practicable and reasonable to do so and the amount of the inventory is significant.[17] Although the CPA may review and approve the instructions for taking the inventory, and may test the count of some items, it is the company's responsibility to make the count satisfactorily. The CPA's purpose in observing the count is to satisfy himself that the company is discharging that responsibility. It should be clearly understood that the CPA does not hold himself out as an appraiser, valuer, or

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15 Statements on Auditing Procedure No. 12, *Amendment to Extensions of Auditing Procedure.*

16 Accounting Research Bulletin No. 29, *Inventory Pricing,* and No. 30, *Current Assets and Current Liabilities — Working Capital.*

17 Statements on Auditing Procedure No. 1, *Extensions of Auditing Procedure,* and No. 16, *Case Studies on Inventories.*

expert in materials. He does not "take," "determine," or "supervise" the inventory.

Although many companies count the inventory at, or very close to, the end of the accounting period, it is not uncommon to do this at other dates. For example, some companies maintain a book (or card) record of the inventory on hand from day to day, called a perpetual inventory record. These companies sometimes check these book records by comparing actual counts of individual items with the records, adjusting the records for the differences disclosed, on a continuous basis throughout the year. They may not count the whole inventory at any one time. Other companies take the whole inventory at one time, but at a date other than the balance-sheet date.

Planning Observation

It is apparent that the CPA must plan his audit program carefully if he is to perform his procedures in connection with the inventory count efficiently and satisfactorily. In particular, this involves careful study of the company's inventory-taking instructions to its employees. When the counts are made during the year, it also involves proper consideration of the effectiveness of the book or perpetual inventory records and of the system of internal control to determine whether the CPA may plan to rely upon a general review of the records for transactions taking place between the dates when he observes the counting and the close of the period under review.

Outside Custodians

In addition to the stocks of inventory on their own premises, companies may also have inventories in public warehouses or with other outside custodians. Under these circumstances, the CPA usually requests confirmation of the nature and amounts of the inventory from the outside custodians. If the amounts involved represent a significant proportion of the current assets or of the total assets of the company, supplemental inquires may be made. At times, it may be necessary to make test counts of such inventories as well as those on the company's premises.

Observations Omitted

Although observation of physical stock-taking is a generally accepted auditing procedure, it is occasionally impracticable or unreasonable to perform it. The question then arises whether the CPA can give an informed opinion on the financial statements. In some rare cases, he may be able to adopt other, special auditing procedures which he feels give sufficient assurance as to the reliability of the inventory amounts to permit the expression of an opinion. If not, and the amounts involved are material, he must refrain from expressing an opinion. However, regardless of whether or not he has satisfied himself by other auditing procedures, the CPA must explain in his report that the counting of the inventory was not observed.[18]

Inventory Pricing

Although the procedures by which the CPA satisfies himself as to the fairness of the count are important, they are but one part of his audit of the inventories. He also satisfies himself that the methods of pricing, or stating, the inventory are in accordance with generally accepted accounting principles and that the practices in this respect have been adequately disclosed in the financial statements and have been observed consistently.

As a general rule, inventories are stated at the lower of cost or market. It should be borne in mind, however, that there are several different methods of determining "cost" of inventories, and the figure considered to be "market" varies with the particular circumstances. For example, the inventory *cost* may be determined by the "first-in, first-out" method, by the "last-in, first-out" method, by an averaging method, or by other acceptable methods. Similarly, *market* may, according to the circumstances, be considered to be the current replacement value of the inventory, the net amount that may reasonably be expected to be realized from the inventory in the normal course of business, or the net realizable amount reduced by an allowance for a normal profit margin.[19]

It is the CPA's duty to make sufficient tests to satisfy himself that the method, or combination of methods, used is being applied properly and consistently. To do this, it is generally necessary to make rather extensive tests of the inventory records. These tests may include comparisons of items counted with quantities shown on the records, inspection of purchase invoices, and verification of footings and extensions. They may also involve a general examination of the company's cost system, including a review of the allocation of overhead, as a check upon the pricing or valuing of inventories of work in process and finished goods.

Inventory Losses

Throughout his inventory examination the CPA is alert to see that adequate provision has been made for substantial losses on obsolete or damaged stock, discontinued products, or unsalable overruns and excess stock.

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[18] Statements on Auditing Procedure No. 12, *Amendment to Extensions of Auditing Procedure,* and No. 17, *Physical Inventories in Wartime.*

[19] Accounting Research Bulletin No. 29, *Inventory Pricing.*

He satisfies himself, usually by tests of shipping and other records, that a proper cut-off has been made so that goods, the title to which has passed to the customer, are excluded from the inventory and included in sales.

Tests of purchase invoices and receiving records may be made to see that, when title for goods has passed to the company, the related liability has been recorded. The CPA also satisfies himself that adequate provision has been made for indicated losses on purchase commitments and on uncompleted sales contracts, if material.

Consigned Goods Held

Goods *held* on consignment are excluded from the inventory. To prevent substitution and to account for reported quantities, the CPA generally applies to such goods the same auditing procedures, including observation of the count, as are used on inventories to which the company has title. He often requests confirmation of the nature and quantity of the consigned goods from the consignor.

Investments

Investments may be either temporary or long-term. Temporary investments include marketable securities in which surplus funds of the company available for current operations have been invested, such as bonds and stocks of other companies and government bonds. Long-term investments include those which have been made for the purpose of control, affiliation, or other continuing business advantage. They may, or may not, be marketable.

CPA's Objectives

In auditing the investment accounts, the CPA's objectives are to assure himself that the securities recorded actually exist and are, in fact, in the possession or under the positive control of the client and that their value is stated in accordance with generally accepted accounting principles.

Accordingly, the CPA satisfies himself that securities considered to be readily convertible into cash, and in which surplus funds of the company have been invested temporarily, are shown on the balance sheet under current assets. Where stocks and bonds represent control of or a material interest in other enterprises and have a significance to the company apart from their dividend or interest return, they are more in the nature of permanent investments and he sees that they are shown below the current assets in the balance sheet. His examination is also directed to ascertaining that securities which are not readily marketable are excluded from current assets and that the basis upon which investments are shown is stated in the financial statements.

He also investigates whether the value of securities included under current assets, when priced at market quotations, amounts to materially less than the total book value so that the amount of the shrinkage should be deducted in the financial statements. In any event, if book values are shown in the balance sheet, he sees that the total amount at market quotations is stated parenthetically.

As to noncurrent investments, if examination of available data, including market quotations or, in their absence, balance sheets and income accounts supplemented by information and explanations from responsible officials, indicates that there has been a substantial shrinkage since acquisition, he sees that appropriate deductions are made or that the facts are disclosed in the financial statements. If it can be determined that the shrinkage is permanent, he satisfies himself that adequate adjustment has been made.

Procedures

As in the case of cash, the CPA's principal reliance is upon inspection and confirmation. In examining or obtaining confirmation of stocks and registered bonds, the CPA makes sure that they are in the name of the company or endorsed so as to be transferable to the company, or that they are accompanied by powers of attorney. In the case of coupon bonds, the CPA may make tests of unmatured coupons to see whether any have been cut from the bonds.

The inspection of securities is often made at the time the cash is counted. If not, the securities may be kept under control until counted. Where mortgages are held, the CPA usually requests confirmation of balances, interest status, and other pertinent information from the debtor. If mortgaged property is insurable, the CPA may review the insurance coverage. If any securities are held by depositaries or others for safekeeping or as collateral, he satisfies himself that such holder is bona fide and usually requests the holder to confirm that the securities are being held for the company. Under certain conditions confirmations are requested both at the date of the cash count and as of the balance-sheet date, if these two dates do not coincide.

The CPA's investigations of the investment accounts also provide essential information regarding investment income and profits or losses on sales of investments. As a part of these investigations, he may, therefore, prepare an analysis of security and investment income accounts for the period. In order to satisfy himself that these transactions are properly recorded, he customarily reviews evidence, such as brokers' advices, regarding purchases and sales. He may also refer to security-reporting services, or other sources, and make computations to assure himself that all dividends and interest have been entered and are correctly reported in the financial statements.

Property

Property accounts include such items as land, buildings, and machinery and equipment. In auditing these accounts, the CPA's work consists largely of a review of the principles applied, an analysis of the property accounts, and tests of the supporting data.

His review of the accounting principles applied is directed to the company's accounting practices with respect to depreciation, betterments, additions, retirements, repairs and replacements, to determine that these practices are in accordance with generally accepted accounting principles which have been consistently applied. He sees that the basis of stating the property items is adequately disclosed; including disclosure of the date of appraisal and authority for the figures when appraisal figures are used.

Property Accounts

In his analysis of the property accounts, the CPA customarily pays particular attention to the changes during the period under review. These changes consist principally of additions or betterments and sales or retirements of property items. He relies to a large extent upon inspection of supporting documents, such as authorizations by the board of directors, work orders, vouchers, journal entries, etc., in assuring himself that these changes have been properly recorded. Although the CPA takes all reasonable steps to ascertain that title to property is in the name of the company and that pledges of property through mortgage or otherwise are stated, the verification of present title and search for encumbrances are legal matters not within his province.

As a part of his analysis of the property accounts, the CPA makes sufficient tests to satisfy himself that all major items charged to them were properly capitalizable and were not proper charges to expense. In the same manner, he investigates charges to expense to satisfy himself that items which should have been capitalized were not written off. He also reviews evidence in support of recorded property sales, abandonments, or other retirements. Special inquiry may be necessary when there are no detailed records.

If the company leases its premises, the CPA generally examines the leases, noting their terms, and reviews the company's records to satisfy himself that any asset for leaseholds, as well as leasehold improvements, are being written off over their useful life or over the term of the lease, whichever is appropriate, and that significant information regarding any long-term lease arrangements is adequately disclosed.

Depreciation

The CPA's review of the company's depreciation policies is generally made in conjunction with his examination of the property accounts. In this review he satisfies himself that a reasonable allowance for depreciation has been made during the period under review and that the total amount accumulated for depreciation is adequate on the basis of a reasonable and orderly depreciation policy.[20] This does not involve or contemplate engineering studies or efforts to determine independently the useful life of the plant items. The CPA also investigates charges against accumulated depreciation and satisfies himself that they are proper. In the case of companies having diminshing assets, such as oil companies, the CPA makes a similar review and analysis of the company's policies and records concerning depletion.

When the CPA is engaged in the audit of a company for the first time, it is usually necessary to make a historical review of the property accounts in order to obtain general information relative to the acquisition of the property and the company's policies in recording it.

Intangible Assets

Intangible assets include such items as patents, trademarks, franchises, and goodwill, shown separately on the balance sheet, if practicable.[21] In auditing these accounts the CPA generally reviews the accounting records and other evidence to determine the basis used and to ascertain that the company's policies as to carrying values and amortization are in accordance with generally accepted accounting principles consistently applied. In the course of his review, he may examine pertinent documents and inquire into royalty or other agreements related to the assets.

Deferred Charges and Prepair Expenses

Deferred charges include such items as bond discount, organization expense, and other deferred items which have not been completely amortized. Such items as unexpired insurance, taxes, royalties, and other prepaid expenses are frequently included among deferred charges, although many consider it preferable to include them among current assets when they will be charged to operations within a relatively short time.[22]

With respect to these items, the CPA customarily reviews the company's practices in amortizing them and examines such evidence as insurance policies, tax receipts, contracts and invoices, making whatever computations are necessary, to determine that the amounts carried forward are applicable to future periods. In his examination of the insurance policies, he usually makes a general review of the insurance coverage, but he does not hold himself out as an expert in insurance matters.

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[20] Accounting Research Bulletin No. 33, *Depreciation and High Costs.*

[21] Accounting Research Bulletin No. 24, *Accounting for Intangible Assets.*

[22] Accounting Research Bulletin No. 30, *Current Assets and Current Liabilities — Working Capital.*

Other Assets

"Other Assets" may include such items as noncurrent notes and accounts receivable, deposits of various kinds, special funds, et cetera. The CPA's responsibilities for these items are the same as for current items of similar classes. When the company carries life insurance policies of which it is the beneficiary, the CPA usually satisfies himself by reference to the policies, if an approximate figure is satisfactory, that the cash surrender value is correctly stated on the financial statements; and determines by correspondence with the insurance companies whether loans have been made on the policies.

Liabilities

The audit of liabilities is designed to establish, so far as possible, that all significant liabilities are included in the financial statements, that reasonable provision has been made for accrued liabilities, and that adequate disclosure has been made of the source or type of borrowing, of any assets pledged as security for the liabilities, and of liabilities to affiliated companies and to stockholders, directors, officers, and employees, if material. In general, all liabilities to banks, trustees, and mortgagees are confirmed by correspondence. An analysis of the interest accounts often provides information regarding interest-bearing liabilities.

Notes Payable

As explained in the discussion of cash procedures, the standard form of bank confirmation ordinarily used to confirm cash balances also provides for information as to notes payable and discounted notes held by banks.

If there are any other recorded notes payable, the CPA generally obtains confirmation of the details, including the collateral held, if any, directly from the holders of the notes. The information obtained from these confirmations is compared with the accounting records to see that they are in agreement. Canceled notes are usually inspected to see that notes paid during the period have been properly discharged and to provide evidence in support of payments recorded during the period. Formal agreements made in connection with borrowings are usually reviewed to ascertain restrictions on dividends, and such covenants as those involving financial position.

Accounts Payable

The CPA customarily reconciles open items on the voucher register, or balances of the individual accounts, with the control accounts for accounts payable to see that they are in agreement. An ageing of the accounts, similar to that discussed under Accounts Receivable, may also be prepared. It is usually advisable to test whether cash discounts are taken regularly.

Large accounts which do not represent recent items, and accounts which have been active during the period but show no balance at the date of examination, are generally investigated. Confirmation of such accounts is frequently requested from the creditors by correspondence, especially when the internal control is weak. The CPA may also test whether all accounts payable are included among the liabilities by examining vouchers and payments entered in the records subsequent to the balance-sheet date, unpaid invoices not yet entered, and regular monthly statements from creditors. Receiving records both before and after the closing date may be reviewed for that purpose and to make sure that the related liabilities are recorded in the proper periods.

The CPA may also examine the records regarding goods consigned to his client to ascertain that any liabilities for the sale of such goods have been set up.

Other Current Liabilities

Accruals are usually made for other liabilities such as interest, taxes, salaries and wages, commissions, legal expenses, damages, et cetera. The CPA examines the supporting evidence, obtaining confirmation where appropriate, and makes whatever computations are necessary to be satisfied that proper accruals of the liabilities for these items have been made.

Long-Term Liabilities

Long-term liabilities include those arising from the sale of long-term notes and from mortgages and bonds. In auditing these liabilities, the CPA satisfies himself that the amount of the liability is correctly stated on the balance sheet, and that the amount of bonds in treasury or sinking funds, rates of interest, and the dates of maturity or, in the case of serial bonds, the annual or periodic maturities, are properly shown. He customarily ascertains that serial bonds, notes and mortgage installments due within a relatively short period of time, usually twelve months, are disclosed separately and, if material, are included with the current liabilities.

He also assures himself that the amount of interest expense has been properly accrued.

It is customary to request confirmation of payments on principal during the period and the amount of the debt outstanding at the balance-sheet date by direct communication with banks, trustees, or mortgagees. Bonds redeemed during or prior to the period under review are generally examined or confirmed with the trustee to ascertain that they have been properly canceled. In addition, the CPA customarily reviews loan agreements to satisfy himself that the financial requirements of the agreements are being observed and to ascertain that the significant terms of the agreements, together with any default in the principal, interest, or sinking fund provisions are disclosed and that the amounts involved are stated.

Contingent Liabilities

Businesses frequently have potential liabilities the amounts of which cannot be determined with reasonable approximation at the time of the audit.

Such liabilities might arise in connection with income taxes, notes receivable discounted, endorsements and guarantees, judgments, unfulfilled contracts, damages, et cetera. It is the CPA's duty to give due consideration to the likelihood that such contingent liabilities may become actual obligations of the company and to see that their existence is suitably noted on the financial statements if it appears that the amounts involved are or may become significant.

To satisfy himself that all significant contingent liabilities have been given recognition, the CPA customarily investigates or inquires of the most authoritative sources available for such information — including revenue agents' reports, the company's legal counsel, the banks with which the company does business, and minutes of the meetings of directors and stockholders. As in the case of actual liabilities, he usually obtains from the management of the company a representation letter enumerating all significant items of this nature.

Estimated Future Liabilities and Appropriations of Retained Income (Reserves)[23]

These items include accounts established to indicate estimates of costs or losses which it is anticipated will have to be met in the future and restrictions on the distribution of earnings. The accounts may be set up by charges against current income or by appropriations of retained income (earned surplus) depending upon the nature of the item. In auditing these accounts, the CPA generally analyzes changes during the period and investigates significant items. He satisfies himself that the accounts are properly described on the balance sheet and are used only for *the* prescribed purposes. In reviewing the accounts, the CPA pays particular attention to the company's policies in setting them up and applying them, and satisfies himself as to whether these policies are in accordance with generally accepted accounting principles.[24]

[23] Accounting Research Bulletin No. 34, *Recommendation of Committee on Terminology — Use of Term "Reserve."*

[24] Accounting Research Bulletin No. 28, *Accounting Treatment of General Purpose Contingency Reserves,* and No. 31, *Inventory Reserves.*

Capital Stock

Capital stock may be of different types, such as various classes of preferred and common stock. The CPA's procedures are directed to assuring himself that each of these are adequately described and properly stated in the balance sheet. This includes seeing that the capital stock or stated capital is shown on the balance sheet in accordance with the statutes of the state in which the corporation is organized, the articles of incorporation and the corporation's minutes, and that each class of stock is stated separately on the balance sheet, showing the amounts authorized, issued and outstanding and the par value per share. If the stock has no par value, the stated or assigned value per share, if any, is shown. If preferred stock, the amount of preference upon involuntary liquidation is stated, and the redemption price may also be given.

The CPA ascertains that the total amount of dividends, or the dividends per share, on outstanding cumulative preferred stock in arrears is stated and, if the arrearage creates a right to elect directors, that suitable disclosure is made. He also sees that all dividends declared but not paid at the date of the balance sheet are included in the current liabilities.

Procedures

The amounts of capital stock outstanding are usually determined by direct confirmation from the registrar and transfer agent or by reference to the stock records and stock certificate books. Changes in the amounts of stock outstanding during the period are customarily investigated by reference to cash records, or to other records of the consideration involved, and by reviewing authorizations of the board of directors and the provisions of the corporation's charter and by-laws.

The CPA also makes inquiries regarding the existence of stock options, warrants, rights, conversion privileges, or sales of stock on special terms, to satisfy himself that they have been recorded according to the facts in conformity with generally accepted accounting principles, and that the significant details of such matters are set forth in the balance sheet or in the notes thereto. If stock has been subscribed on an installment plan, it is customary to investigate whether or not payments are in arrears. If special terms have been extended to any stockholder, the minutes of the board of directors are usually examined to see that such terms have been approved.

When corporations have reacquired their own stocks, the certificates are generally examined or confirmed, and, if the company maintains its own stock records, are compared with the stock certificate books. The CPA also satisfies himself that they are adequately reported in the financial statements; preferably as a deduction from the capital stock, from surplus, or from the total of the two, at either par or cost as the laws of the state of incorporation and other relevant circumstances require. In the rare instances when temporary holdings of such stock may appropriately be treated as assets, the CPA satisfies himself that the circumstances justify such treatment and that they are indicated in the caption or in a footnote to the balance sheet. In addition, he makes sufficient investigation to assure himself that dividends on such stock are not included in income.

Other Capital Items (Capital Surplus) and Retained Income (Earned Surplus) [25]

In his examination of these accounts, the CPA generally analyzes the changes during the period and satisfies himself that they reflect the application of generally accepted accounting principles, making careful distinctions between items that should be charged to current income, to retained income, or to paid-in or other types of capital.[26] A summary of the changes in each of these accounts during the period is generally shown, either on the balance sheet or in a separate statement. The CPA also ascertains that any restrictions upon the use of these accounts are disclosed.

At the time of a "first audit," it is the CPA's responsibility to satisfy himself by appropriate investigation of the records, and by inquiries, that the balances brought forward are correctly captioned.

Income and Expense Accounts

It is generally recognized today that information as to the earnings history of a company is of vital importance both to credit grantors and to investors, and that for most purposes a statement of income is at least as important as the balance sheet. In many respects the changes in the balance sheet from year to year are more significant than the balance sheets themselves.

As stated earlier, the question of how income and expenses shall be allocated to periodic income statements is one of the basic problems of accounting and requires the exercise of experienced judgment as to the proper interpretation of all the pertinent information relating to the transactions. Because of the important part which judgment plays in these accounting decisions and in the selection and application of auditing procedures for the examination of income and expense, it is impracticable to outline specific procedures that might often be applicable to

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[25] Accounting Research Bulletin No. 39, *Recommendation of Subcommittee on Terminology — Discontinuance of the Use of the Term "Surplus."*

[26] Accounting Research Bulletin No. 32, *Income and Earned Surplus,* and No. 35, *Presentation of Income and Earned Surplus.*

these accounts, such as was done with respect to the balance-sheet accounts.

General Approach

It is evident that the CPA must have a thorough understanding of the principles and classifications adopted by the company in order to use sound judgment as to the relative importance of the different items and the amount of testing needed. The extent of the testing also depends upon the effectiveness of the company's system of internal control. The tests are planned to be sufficient, when combined with information obtained in other phases of the audit, to satisfy the CPA to a reasonable extent that the transactions recorded are genuine, that they have been recorded properly, and that they have been properly classified and disclosed in the financial statements.

The CPA depends principally upon the results of careful review, tests, and analyses of the accounts with respect to items recorded during the period and upon comparison with previous periods. He usually tests the more material or extraordinary items by reference to such supporting evidence as payrolls, vouchers, journal entries, statistical data prepared by the company, copies of various kinds of agreements, budgets, and provisions of corporate minutes.

Co-ordinated with Balance-Sheet Procedures

Much of the work the CPA performs to satisfy himself as to the income and expense accounts is carried out in conjunction with his work on the balance-sheet accounts. For example, his work on sales may involve comparing sales data with the corresponding cash receipts or accounts receivable. His tests of purchases may often be co-ordinated with his tests of the cash disbursements or accounts payable records and his examination of the inventory.

Mention has been made of the necessity of assuring that proper cut-offs have been made of shipments and receipts of inventory items. Other items of income and expense, such as interest income, income from securities, interest expenses, depreciation, repairs and maintenance, taxes, amortization of deferred charges, and patents, et cetera, are likewise examined to a considerable extent in conjunction with the audit of the related asset and liability accounts.

Consolidated Statements

Consolidated financial statements present a number of auditing problems which do not arise when the audit of only one company is involved. The CPA reviews the consolidation policies followed and satisfies himself that proper recognition has been given to the business facts of the circumstances so that a fair presentation of the financial position and results of operations of the combined organizations is made.

The financial statements of subsidiaries, as well as of the parent company, are usually audited if the reporting CPA is to express an opinion on the consolidated statements. In some cases, the reporting CPA himself audits the financial statements of the subsidiaries. In other cases, the audits of some of the subsidiaries may be performed by other independent public accountants. Sometimes the accounts of relatively unimportant subsidiaries are included in the consolidation on the basis of unaudited book figures.

Consolidated Statements

So far as the audit work in connection with the consolidation of statements is concerned, the CPA's principal duty is to satisfy himself that proper adjustments have been made in combining them. These adjustments, or intercompany eliminations as they are usually called, are concerned principally with such matters as the elimination of the parent's investment accounts against the related equity accounts of the subsidiaries to be consolidated, and the elimination of intercompany transactions and intercompany profits. These are reviewed and checked to supporting data.

It is frequently desirable to audit the accounts of some of the subsidiaries as of a date prior to the close of the parent company's fiscal year. This is done so that the consolidated statements may be issued without undue delay, or so that the audit work may be spread effectively. When the subsidiaries are audited as of a prior date, it is usually necessary to review the records for the intervening period to ascertain that there have been no important transactions outside the ordinary course of business and that the financial position of the subsidiaries as of the consolidated balance-sheet date is not materially different from that at the date they were audited.

In the case of some subsidiaries, particularly foreign companies, it is frequently impossible to obtain the fiancial statements as of the date of the consolidated balance sheet in time for inclusion with the consolidated statements. It is customary to include the financial statements of such subsidiaries, if they are consolidated, as of earlier dates. The CPA is, therefore, careful to see that there have been no unusual transactions during the interim, that shipments and remittances within the consolidated group of companies up to the date of the consolidated balance sheet are taken into consideration, and that the operations of each company cover a full fiscal year. When foreign subsidiaries are included in the consolidated statements the CPA reviews the basis of conversion of foreign currencies to ascertain that it is proper and that the treatment of exchange adjustments is adequately disclosed.[27]

SUMMARY

As explained in the introduction to this pamphlet, many people hold mistaken beliefs as to the exactitude of financial statements and the responsibilities which CPAs assume in reporting upon them.

Financial statements are not completely factual. They reflect judgment as well as facts. It should not be assumed, however, that they are subject to the whims of those preparing them. Over the years, broad principles of accounting for financial transactions have been developed to guide the exercise of judgment in accounting matters. Those principles make possible the preparation of useful financial statements, but exactitude cannot be obtained.

The company has the primary responsibility for its financial statements. The CPA's function, in making an audit, is to express an opinion regarding their fairness. It is an informed, professional opinion, based on a careful examination of the accounting records and other evidence, but it is not a "certification" in the sense of being a guarantee.

In some cases, the CPA's report is brief. In others, it is quite detailed. Frequently, the CPA feels he must qualify his opinion. At times, he disclaims the expression of an opinion. It is important, therefore, to read the CPA's report carefully.

An audit is not a routine matter. Each must be designed to fit the conditions existing in the engagement. In many cases, the CPA performs part of his audit work during the year. Some audits are more extensive than others.

It should be noted that the CPA seldom reviews every transaction. On the contrary, most audits are based primarily on sampling. Experience shows that carefully planned tests of the accounting records and other data provide a high degree of assurance as to the reliability of the financial statements in most cases, but it does not insure that minor defalcations or errors will be uncovered.

In all his work, the CPA is guided by auditing standards which have been developed by the profession to assure the highest degree of professional performance. These standards relate to the personal qualifications which the CPA must possess, to his field work, and to his report. It is because of adherence to these standards that the work of CPAs has received widespread recognition.

The limitations of space inherent in a pamphlet of this kind permit

27 *Accounting Problems Arising from Devaluation of Foreign Currencies* — Statement by research department (American Institute of Accountants, 1949).

only a brief discussion of the principal considerations involved in making an audit. It should not be assumed that all aspects of an audit have been covered or that all procedures which might be employed in a particular case have been described. It is hoped, however, that the pamphlet has established a better understanding of the nature of financial statements and that it has provided a clearer view of how the CPA makes an audit and the responsibilities he assumes in expressing an opinion on financial statements.

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