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40 questions and answers about audit reports

American Institute of Certified Public Accountants (AICPA)

40 questions & answers about AUDIT REPORTS

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INDEPENDENCE

Excerpts from *Code of Professional Ethics,*
American Institute of Certified Public Accountants

1.01 Neither a member or associate, nor a firm of which he is a partner, shall express an opinion on financial statements of any enterprise unless he and his firm are in fact independent with respect to such enterprise.

Independence is not susceptible of precise definition, but is an expression of the professional integrity of the individual. A member or associate, before expressing his opinion on financial statements, has the responsibility of assessing his relationships with an enterprise to determine whether, in the circumstances, he might expect his opinion to be considered independent, objective and unbiased by one who had knowledge of all the facts.

A member or associate will be considered not independent, for example, with respect to any enterprise if he, or one of his partners, (a) during the period of his professional engagement or at the time of expressing his opinion, had, or was committed to acquire, any direct financial interest or material indirect financial interest in the enterprise, or (b) during the period of his professional engagement, at the time of expressing his opinion or during the period covered by the financial statements, was connected with the enterprise as a promoter, underwriter, voting trustee, director, officer or key employee. In cases where a member or associate ceases to be the independent accountant for an enterprise and is subsequently called upon to re-express a previously expressed opinion on financial statements, the phrase "at the time of expressing his opinion" refers only to the time at which the member or associate first expressed his opinion on the financial statements in question. The word "director" is not intended to apply to a connection in such a capacity with a charitable, religious, civic or other similar type of non-profit organization when the duties performed in such a capacity are such as to make it clear that the member or associate can express an independent opinion on the financial statements. The example cited in this paragraph, of circumstances under which a member or associate will be considered not independent, is not intended to be all-inclusive. (Effective January 1, 1964.)

2.02 In expressing an opinion on representations in financial statements which he has examined, a member or associate may be held guilty of an act discreditable to the profession if

(a) he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or

(b) he fails to report any material misstatement known to him to appear in the financial statement; or

(c) he is materially negligent in the conduct of his examination or in making his report thereon; or

(d) he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

(e) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.

2.03 A member shall not permit his name to be associated with statements purporting to show financial position or results of operations in such a manner as to imply that he is acting as an independent public accountant unless he shall: (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole and indicate clearly his reasons therefor, or (4) when unaudited financial statements are presented on his stationery without his comments, disclose prominently on each page of the financial statements that they were not audited.

This bulletin is published for the information and assistance of members of the Institute and others interested in the subject. It presents the views of the 1955-1956 members of the committee on co-operation with bankers and other credit grantors. Since it has not been considered and acted upon by the Council of the Institute, it does not represent an official position of the Institute.

A Brief Note to Lawyers

This publication was originally prepared by the American Institute of Certified Public Accountants' Committee on Cooperation with Bankers and Other Credit Grantors with the assistance of the Robert Morris Associates and the American Bankers Association. It is presented in question and answer form for ready reference and has the following objectives:

1. To help explain the auditing standards observed, and some of the auditing procedures that may be employed by certified public accountants in forming an opinion on the presentation of financial position and results of operations in a company's financial statements.

2. To emphasize the responsibilities assumed by the members of the accounting profession when they express an independent opinion on financial statements.

While the pamphlet was intended for the use of bankers in reaching a decision as to whether to extend credit (particularly related to the financial position of the borrower and the results of its operations as shown by its financial statements), it has considerable importance for lawyers who may have to consider questions that may reasonably be expected to arise in the use of audit reports issued by certified public accountants. For that reason, we are very grateful to the California Society of Certified Public Accountants for making this pamphlet available for distribution to the attorneys who register in the spring 1958 lecture series of the State Bar of California on "Legal Problems of Business Enterprises." The opinions and facts expressed in this pamphlet do not of course necessarily reflect the official views of the State Bar of California nor of the University of California Extension.

It is hoped that this pamphlet will contribute to and promote a fuller understanding of the CPA's representations as to the examination performed and his conclusions as to the financial statements and to build better ties between the legal and public accounting professions.

FELIX F. STUMPF, *Administrator*
Continuing Education of the Bar

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Opinions

1) *What kinds of opinions do CPAs express regarding financial statements?*

Depending upon his findings, the CPA may express:

a) an *unqualified* opinion as to the over-all fairness of the presentation of the financial data in conformity with generally accepted accounting principles consistently applied; or

b) an opinion *qualified* as to certain items on the financial statements or as to the consistent application of accounting principles.

However, he expresses only one kind of opinion on any particular set of financial statements. In some cases he may feel that he cannot give an opinion under the circumstances, in which case he should *disclaim* an opinion.

2) *When does a CPA express an unqualified opinion?*

If he is satisfied that the financial statements present fairly the financial position and results of operations in conformity with generally accepted accounting principles consistently applied, the CPA usually expresses an unqualified opinion to that effect.

He should not express an unqualified opinion unless he is satisfied in all material respects and has adequate grounds for his opinion. Bankers can help to assure unqualified opinions on the basis of adequate examinations by stressing to customers the necessity of receiving audit reports on which they can rely. The standard short-form report, reprinted on page 17 of this booklet, is an example of an unqualified opinion. Any deviation from the standard form should be read very carefully.

On occasion the section of the CPA's report dealing with the scope of his examination states that he has not, for example, confirmed accounts receivable, or has not observed the taking of inventories. If the receivables or inventories are material, he should disclaim an opinion except in rare circumstances where he may have been able to satisfy himself as to the items by other procedures, in which case he should say so and express an unqualified opinion. In other words, a qualification as to the *scope* of the examination does not always mean that the *opinion* is qualified.

An example of qualified scope of examination language is shown on page 18.

3) *When does a CPA express a qualified opinion?*

When a CPA believes the statements are a generally fair presentation, but he has not been completely satisfied on some point, or he feels that some part of the financial position or results of operations is not fairly presented, he may express a qualified opinion and indicate the nature of the reservation or exception. In general, the necessity for expressing a qualified opinion occurs when the CPA has not been permitted or was otherwise unable to make an examination sufficiently complete to warrant the expression of an unqualified opinion, or when he has found departures from accepted accounting principles which the company is unwilling to correct. Where a significant change has been made in the application of accounting principles the CPA qualifies his opinion as to the consistent application of generally accepted accounting principles. If he approves the change, he usually so states. Where possible, the CPA indicates the materiality of certain types of qualifications.

An example of qualified opinion language is shown on page 19.

When the CPA's exceptions as to accounting practices followed by the client are of such significance that he has reached a definite conclusion that the financial statements do not present fairly the financial position and results of operations, his report should clearly indicate his disagreement with the statements presented and give his reasons.

The CPA should not express an over-all opinion on the financial statements when, because of limitations on the scope of his examination or departures in the statements from generally accepted accounting principles, his exceptions or reservations would be such as to destroy the usefulness of an opinion on the statements taken as a whole. In such cases, he is not in a position to have formed an opinion as to whether statements make a fair presentation. (See question 4.)

4) *When does a CPA disclaim an opinion?*

The CPA should not express an opinion that financial statements present fairly financial position and results of operations in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, whenever the CPA permits his name to be associated with financial statements, he should state that he is not in a position to express an opinion on the statements taken as a whole and should indicate clearly his reasons therefor.

His disclaimer of opinion should be stated in writing either in a letter of transmittal bound with the financial statements or in the more conventional short-form or long-form report. However, when financial statements prepared without audit are presented in a CPA's report cover or on his stationery without comment by the CPA, a warning, such as *Prepared from the Books Without Audit,* appearing prominently on each page of the financial statements is considered sufficient.

It is not contemplated that the disclaimer of opinion should assume a standardized form. Any expression which clearly states that an opinion has been withheld and gives the reasons why is suitable for this purpose. However, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the CPA's opinion regarding the statements taken as a whole. It is incumbent upon the CPA, not upon the reader of his report, to evaluate these matters as they affect the significance of his examination and the fairness of the financial statements.

An example of a disclaimer of opinion is reprinted on page 20 of this booklet.

When the CPA has had to disclaim an opinion on the financial statements, his report is of dubious value to the banker.

5) *Is it an approved practice to recite in audit reports the procedures followed without stating clearly whether or not an opinion is expressed?*

No. The membership of the American Institute of Certified Public Accountants in 1949 approved a statement (incorporated in the summary of generally accepted auditing standards as the fourth standard of reporting and in

Rule 19 of the Rules of Professional Conduct, and often referred to as Statement No. 23) which calls upon the accountant either to express an over-all opinion regarding the statements taken as a whole, or to assert that such an opinion cannot be expressed whenever financial statements appear on his stationery or in his report. If no opinion is given, he should state why. (See question 4.)

6) *Does a CPA's name on financial statements, or on the report cover, mean that he approves them?*

No. CPAs often perform services for clients that require little or no audit work. Accordingly, he may not have a basis for approving the financial statements, depending upon the services he has been engaged to perform in the particular engagement. The CPA is obliged to disclose in his report the responsibility he assumes for the fairness of financial statements. The banker has an obligation to read the CPA's report carefully to be sure that the information developed by the engagement is suited to credit purposes.

Auditing Standards

7) *What are the "auditing standards" referred to in audit reports?*

Auditing standards are the underlying principles of auditing which control the nature and extent of 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 examinations. (A summary of generally accepted auditing standards adopted by the membership of the American Institute of Certified Public Accountants is presented inside the back cover of this booklet.)

The circumstances that exist in each audit engagement 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. These differences make it impossible to lay down a uniform program of procedures which would be generally satisfactory. The program of procedures for any particular engagement is developed through the exercise of the experienced judgment of the CPA. This philosophy is summed up in the standard audit report in the words: "Our examination . . . included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

8) *What is the significance of "independence" in relation to audit work?*

The term "independent accountant" means what the words imply. Independence is the keystone of the accounting profession. It is one of the CPA's most important attributes. If a CPA abides by the Rules of Professional Conduct of the American Institute of Certified Public Accountants, and similar rules adopted by numerous state societies of certified public accountants, he obviously must be independent in his relationship to clients.

While none of the Rules of Professional Conduct of the American Institute of Certified Public Accountants deal solely with independence, those which should be of particular interest to bankers in this respect are reprinted inside the front cover of this booklet.

Accounting Principles

9) *What is the significance of the expression "present fairly" in the CPA's report?*

The values of many items in financial statements cannot be measured exactly. The items which, in part at least, are subject to approximation are among the most important in the financial statements, such as inventories and provisions for current costs expected to be paid in the future.

Because of this, no one can be in a position to state that a company's financial statements "exactly present" financial position or results of operations. Accordingly, the CPA usually states that the financial statements "present fairly" in the sense that he believes they are substantially correct. For the same reason, his findings are expressed in the form of an opinion. However, it should be borne in mind that the judgment involved is an informed one, and is guided by generally accepted accounting principles.

10) *What are "generally accepted accounting principles"?*

They are a body of conventions for dealing with accounting problems. They have been developed over the years as a result of study and experience in presenting useful financial information, and have come to be widely recognized as sound guides in making accounting decisions. When financial statements have been prepared in conformity with generally accepted accounting principles, they should reflect financial facts fairly, even though approximations and estimates have been necessary. The series of Accounting Research Bulletins issued by the committee on accounting procedure of the American Institute of Certified Public Accountants are expressions of generally accepted accounting principles with respect to the matters covered by the bulletins.

11) *What does the CPA do to determine consistency in the application of accounting principles?*

The audit work for the period under examination provides the basis for his opinion as to that period. If an examination was made in the prior period that, of course, also provides the basis for the CPA's opinion as to the prior period. If no examination was made in the prior period, the CPA makes whatever review of prior periods he feels is necessary to satisfy himself as to the consistency of application of accounting principles.

Content of Report

12) *Are CPA audit reports prepared specifically for credit purposes?*

No. Most audit reports are prepared for "general" purposes; that is, they are intended to be useful to management, and stockholders and others, as well as to creditors. However, if it is known that the report will be used for credit purposes, and if the credit grantor makes known to his customer the information he wants, the customer can usually arrange to have the CPA present the desired information. (A booklet prepared by the Robert Morris Associates, the national association of bank loan officers and credit men, entitled *Financial Statements for Bank Credit Purposes,* describes financial information generally required by bankers. Copies may be obtained from Robert Morris Associates, Philadelphia National Bank Building, Broad and Chestnut Streets, Philadelphia, Pennsylvania, at 10 cents each.)

Some matters observed during the course of the examination are considered to be important primarily for internal consideration and are generally excluded from reports prepared for general purposes. For example, CPAs often prepare separate memoranda for management which contain suggestions for improving internal control, accounting procedures, method of operations, etc.

13) *Are the auditing standards for a short-form report any different than those for a long-form report?*

No. The auditing standards to be observed by a CPA, and the examination, are the same regardless of whether he prepares a short-form or a long-form report. The only important difference between the two kinds of reports is that the long-form report includes more details and comments regarding the financial position and results of operations. Language similar to that used in the standard short-form report (reprinted on page 17 of this booklet) should be incorporated in the long-form report.

Frequently, the client does not need a report presenting details and comments regarding financial position and results of operations, and is unwilling to pay the cost involved in preparing one for his own purposes. However, bankers find information as to such details useful. If they consider it important to have it included in the report, they should take the initiative by requesting the customer to authorize the CPA to prepare it. They should recognize, however, that there are data regarding which the CPA is willing to supply the best information available but as to which it is not practicable or reasonable for him to express an opinion. Examples are unit sales, production figures, or monthly balances of payables (which the ordinary audit would not cover in sufficient detail to support a regular type of opinion), and budget forecasts and adequacy of insurance coverage (which by their nature are not susceptible to audit check).

The CPA's opinion runs generally to the basic financial statements, with a lesser degree of responsibility being assumed with respect to the other financial data included in the long-form report. Information included in the CPA's comments and financial data other than the basic financial statements in the long-form report should not be construed as being necessary to the fair presentation and understanding of the basic financial statements in the report.

14) *Why don't more reports present details as to the scope of the examination?*

Although some long-form reports comment in considerable detail on auditing procedures employed, most CPA's believe that such comments are of no real use to bankers, and therefore omit them. One reason for this is that it is not practicable to describe fully in a report the program followed and the considerations involved. However, of even greater importance is the fact that no one can judge solely from a description of audit procedures whether an examination was adequate in the circumstances unless he is familiar with all of the facts in the particular case and with developments during the examination as it progressed. Conclusions as to the adequacy of an examination are not likely to be well founded if based merely on the information that could be presented in a report.

When a CPA states that his examination was made in accordance with generally accepted auditing standards, he takes responsibility for having made an adequate examination. Accordingly, bankers are justified in placing the same reliance upon a short-form report which contains that statement as they do upon a long-form report.

The CPA's Examination

Scope of Examination

15) *Does the CPA have a free hand in deciding upon the scope of his examination?*

The CPA determines the scope of the examination necessary to express an unqualified opinion. The client, however, determines whether an examination of such a scope will be permitted. It is the CPA's opinion that must be expressed. He assumes the responsibility and he must be permitted to perform all of the procedures he considers necessary if the objective is an unqualified opinion.

There may be reasons why a client decides not to permit an unrestricted examination. While the CPA abides by his client's decision, he patterns his report accordingly. The significance of this to bankers is that they should read the report to be sure that the opinion expressed is adequate for their purposes. To be sure that an acceptable opinion is obtained, they should, before the work is begun, see that the CPA is authorized by his client to perform an examination of sufficient scope to provide a suitable opinion.

16) *Is an examination an exact and complete verification of the figures on the statements?*

No. In most examinations, 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 investigation of selected transactions. He makes an examination which in his opinion is sufficient to satisfy him that the financial information is fairly presented in all material respects.

17) *What does the CPA mean by "tests"?*

"Sampling" may also be descriptive of the word "tests" frequently used by CPAs. When the CPA states that his examination has "included such tests of the accounting records" as he considered necessary in the circumstances, he means that he has examined a portion of the transactions and records to the extent he believes necessary for the expression of an opinion in a particular situation.

The extent of testing in any examination is decided by the CPA on the basis of his best judgment as to the amount required to constitute a fair sampling of the record being tested in the particular case. 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 effectiveness of the company's system of internal control. Other factors which enter into the decision include the materiality of the item to be tested, and the relative risk of the existence of irregularities.

A statement, fact, or item is material, if in the surrounding circumstances as they exist at the time, it is of such a nature that its disclosure or the method of treating it would be likely to influence or to "make a difference" in the judgment and conduct of a reasonable person. In applying his auditing procedures, the CPA focuses principal attention upon items which are, or may be, material.

Internal Control

18) *What does the term "internal control" mean?*

Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy

Unqualified Opinion
(Standard Short-Form of Accountant's Report)

We have examined the balance sheet of X Company as of December 31, 195x and the related statements of income and retained earnings 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 statements of income and retained earnings present fairly the financial position of X Company at December 31, 195x, 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.

Qualification as to Scope--Unqualified Opinion

. . . 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; however, it was not practicable to confirm accounts receivable from government agencies, as to which we have satisfied ourselves by other auditing procedures.

In our opinion, the accompanying balance sheet and statements of income and retained earnings present fairly . . .

Qualified Opinion

. . . 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, except as to such adjustments as may result from final determination of litigation as explained in Note 1, the accompanying balance sheet and statements of income and retained earnings present fairly . . .

Disclaimer of Opinion

In accordance with the terms of our engagement, we did not follow the generally accepted auditing procedures of communicating with debtors to confirm accounts receivable balances and of observing the methods used by your employees in determining inventory quantities. Because of these limitations, the scope of our examination was not sufficient to permit us to express an opinion on the accompanying financial statements taken as a whole.

and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. From the viewpoint of the CPA's examination, it means primarily the measures adopted by the business to check the reliability and accuracy of its accounting data.

The degree of internal control varies greatly among companies. For example, most large companies have well developed and effective systems of internal control and internal auditing procedures; while many small companies, because of few employees or failure to recognize the value of internal control, have less effective systems.

The primary responsibility for the establishment and enforcement of internal control rests with the company. The ordinary examination incident to the issuance of an opinion respecting financial statements is not designed and cannot be relied upon to disclose defalcations and similar irregularities, although their discovery frequently results. If a CPA were to attempt to discover defalcations and similar irregularities, he would have to extend his work to a point where its cost would be prohibitive. It is generally recognized that good internal control and surety bonds provide effective measures of protection.

19) *To what extent does the scope of an examination depend upon the effectiveness of the system of internal control?*

While the primary responsibility for adequate internal control rests with the client, its effectiveness is of vital importance in the selection and application of appropriate audit procedures. 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 ineffective, the CPA is compelled to extend his procedures considerably before expressing an informed opinion on the financial statements.

Receivables

20) *What does the CPA do to substantiate the amounts of accounts and notes receivable reported?*

The principal purposes of the CPA's examination of receivables are to establish their genuineness, the proper recording of receipts and the correctness of the balances, and to test the internal control. In addition, the CPA takes steps, such as analyzing the accounts according to age, to satisfy himself that reasonable allowances have been made for probable losses on doubtful accounts.

Accepted practice requires the CPA to seek confirmation of a representative portion of the balances of receivables wherever practicable and reasonable, and where the aggregate amount of the receivables represents a significant portion of the current assets or the total assets of the company. 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.

Although experience has demonstrated that confirmation is generally the most important procedure in substantiating receivables, it does not provide conclusive evidence. The CPA employs numerous additional procedures to satisfy himself as to the receivables, such as the inspection of subsequent collections, and 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.

The CPA also looks for the pledge, assignment or other hypothecation of receivables and customarily inspects the instruments in support of notes receivable.

21) *What is meant by "confirmation of receivables"?*

Confirmation consists of direct communication with the debtor to determine whether or not the balance shown on the company's books is in agreement with the debtor's records. Confirmation of the receivables is frequently performed on a test basis. If receivables have not been confirmed, and they are material, the CPA should state that fact in his report and indicate whether or not he has satisfied himself by other auditing procedures.

Inventories

22) *What responsibility does the CPA assume for the correctness of inventories?*

The CPA's procedures are designed to satisfy him that the amounts set forth by the company as inventories represent actual inventories either on or off the client's premises, that they are presented with reasonable accuracy and in accordance with generally accepted accounting principles consistently applied, and that the bases of stating the inventories as well as any pledge or assignment of inventories, are properly disclosed. These objectives require the CPA to investigate the care and accuracy with which the company has taken the inventories, the methods and bases adopted by the company in pricing them, and the substantial correctness of the company's mathematical computations. The CPA does not hold himself out as an appraiser, valuer, or expert in materials. He does not "take," "determine," or "supervise" the inventory.

23) *What is "observation of inventories"?*

To satisfy himself that the taking of the inventories was done carefully and accurately, and also to gain general familiarity with them, the CPA is required by generally accepted auditing practice to be present at the inventory taking to observe the effectiveness of the procedures when it is practicable and reasonable to do so and the amount of the inventories is significant. Although the CPA may review and approve the instructions for taking the inventories and may test some items, it is the company's responsibility to take the inventory satisfactorily. The CPA's purpose in observing the inventory taking is to satisfy himself that the company is discharging its responsibility.

24) *What does the CPA do to satisfy himself as to the fairness of the value at which inventories are stated?*

It is the CPA's duty to make sufficient tests to satisfy himself that the method, or combination of methods, used to determine "cost" and "market" 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 as shown by the inventory taking with quantities shown on the records, inspection of purchase invoices, investigation of current market quotations, 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.

25) *What does the CPA do about determining the extent of obsolescence of inventories?*

Throughout the inventory examination the CPA is on the alert to detect obsolete and slow-moving stock and to ascertain that adequate provision has been made to cover any probable substantial losses thereon.

26) *What does the CPA do as to inventory purchase commitments?*

The CPA's primary objective with respect to purchase commitments is to satisfy himself that adequate provision has been made for indicated probable losses. Evidence of such commitments may be disclosed during almost any phase of the examination, and the CPA investigates any leads obtained. He also makes general inquiry among those who would be in a position to have knowledge of such commitments, and often obtains a letter of representation from the management to the effect that adequate provision has been made for all expected losses.

27) *Why are officers of the client asked to sign representation letters regarding inventories and other matters?*

This is a customary procedure based on management's primary accountability for the company's financial statements. These certificates merely supplement the CPA's work on the examination but do not relieve him from responsibility for his opinion with respect to the financial statements.

Fixed Assets

28\ *What does the CPA do to substantiate the amount reported for property, plant and equipment?*

In examining these accounts the CPA's work consists largely of a review of the accounting principles applied by the company, analysis of the property accounts, and tests of the suporting 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 and have been consistently applied.

In his analysis of the accounts, the CPA customarily pays particular attention to the changes during the period under review, relying to a large extent upon inspection of supporting documents, such as authorization by the board of directors, work orders, invoices, and journal entries, in assuring himself that these changes had been properly recorded.

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 leasehold improvements are being properly written off, and that significant information regarding any long-term lease arrangements is adequately disclosed.

The CPA's review of the company's depreciation policies is generally made in conjunction with his examination of the property accounts. It is the CPA's responsibility to satisfy himself that the method adopted by the company is an accepted method and that it has been properly applied. This conforms to the general concept that the financial statements are statements of the client, and that the CPA's function is to examine the statements.

29) *What is the CPA's responsibility with respect to commitments for the acquisition or construction of major capital additions?*

The CPA has the responsibility to make inquiry as to the existence of significant commitments for the acquisition or construction of major capital items. These should be appropriately reflected by footnote to the financial statements. The CPA should ascertain that such disclosures are in accordance with the agreements and other evidences of the contemplated transactions.

30) *Why are fixed assets stated at cost?*

The primary reason for using cost is that financial statements are usually prepared on the basis of reporting on stewardship; i.e., the concept that the management is reporting on how it has utilized the resources made available to it. The net amount at which fixed assets are shown on a financial statement does not necessarily have any direct relationship to their market value or their replacement cost.

Other Items

31) *What does the CPA do to determine that accounts payable are properly reported?*

The examination of accounts payable is designed to establish, so far as possible, that all are included in the financial statements. In addition to checking open items in the accounting records, CPAs during the course of their examination customarily inspect vouchers and payments entered in the records subsequent to the balance-sheet date, unpaid invoices not yet entered, and regular monthly statements from creditors.

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 the examination, are generally investigated. Confirmation of such accounts is occasionally requested from the creditors by correspondence, especially when the internal control is weak.

32) *What does the CPA do to determine the adequacy of accruals for expenses?*

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

33) *What does the CPA do to ascertain that the provisions of loan agreements have been carried out?*

The CPA should review loan and similar agreements to satisfy himself that the financial requirements of the agreements, such as working capital, surplus, and dividend restrictions, are being observed. The significant terms of the agreements, together with any defaults in the principal, interest, or sinking fund provisions, or other financial requirements, should be disclosed and the amounts involved stated.

34) *What does a CPA do to determine the amount and nature of contingent liabilities, if any?*

To satisfy himself that all significant contingent liabilities have been given appropriate recognition in the financial statements, 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. He usually obtains from the management of the company a representation letter enumerating all significant items of this nature, and stating that adequate provision has been made in the statements or the pertinent information disclosed.

Although the dollar amount of litigation is often disclosed in footnotes to the financial statements, there frequently is no way of estimating, even within reasonable limits, the amount at which pending litigation will eventually be settled. Accordingly, it may not be possible to assign a reasonable dollar amount to the litigation in the accounts, although the existence of any significant litigation should always be disclosed. The CPA usually relies upon the opinion of the company's legal counsel in deciding what recognition, if any, should be given to pending litigation in the financial statements.

35) *What does the CPA do to determine material omission or inflation of sales?*

Since sales are so closely related to other items in the accounts, particularly inventories, accounts receivable and cash, he relies very largely on his examination of these accounts in satisfying himself as to reliability of the sales figures. Procedures directed specifically to satisfying himself that material amounts of sales have not been omitted, or that they have not been inflated, include checks on the cut-off procedures as to purchases and sales at the end of the accounting period and gross profits tests. The latter indicates whether or not gross profits for the period compare with experience in prior periods; the reasons for any material variations should be determined.

36) *Does the CPA review the operating accounts of a business?*

Yes, if he is to express an opinion on the financial statements. Much of his review of the operating accounts is performed in connection with his work on related assets and liabilities in the balance sheet. As to the operating accounts as such, the CPA depends primarily 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.

37) *What responsibility does the CPA assume with regard to the income tax provision?*

So far as the financial statements are concerned, the CPA's principal function with respect to income taxes is to satisfy himself that the provision is reasonable. Often, he assists in preparing the tax return and this provides an excellent basis for his decision. If he does not prepare the return himself, he usually reviews it. He also ascertains the last date to which the tax returns have been examined by government representatives and determines whether or not there are any items in dispute the tax effects of which should be reflected in the financial statements.

Miscellaneous

38) *What is the CPA's responsibility as to events occurring between the date of the financial statements and the date of his report?*

Events or transactions sometimes occur subsequent to the balance-sheet date and before the date of the CPA's report, which may be either extraordinary in character or of unusual importance. They may, therefore, have a material effect on the financial statements or be important in considering the statements.

The CPA has no duty to extend his audit procedures to events or transactions of a subsequent period as such. However, it is well recognized that an effective audit program relating to the period under examination should include certain procedures which are designed to acquaint the CPA with those post-balance-sheet events or transactions as to which he can be chargeable with a duty to have knowledge. If any such matters come to his attention, the CPA may request adjustment or annotation of the statements, or make disclosure in his report.

39) *Why are prepaid expenses included in current assets and cash surrender value of life insurance policies excluded?*

For accounting purposes the term *current assets* is used to designate cash and other assets or resources which are reasonably expected to be realized in cash, or sold or consumed during the normal operating cycle of the business. Prepaid expenses such as insurance, interest, rents, taxes, unused royalties, and current paid advertising service not yet received, are considered current assets under this definition. They are not current in the sense that they will be converted into cash, but in the sense that, if not paid in advance, they would require the use of current assets during the operating cycle.

The accounting concept of the nature of current assets excludes cash surrender value of life insurance policies from the current classification because, as a practical matter, life insurance policies are more in the nature of long-term investments which in the ordinary course of business do not provide working funds.

40) *Is the CPA free to discuss his client's affairs with bankers?*

The CPA's relationship with his client is a confidential one similar to that which a banker has with his customer. However, the CPA will be glad to discuss his client's affairs with bankers if authorized to do so by the client. It is often desirable for the client, the banker, and the CPA to meet together.

Explanation of Certain Terms

There are a number of terms used in this booklet which deserve special mention, either because they have technical meanings that differ somewhat from their meanings in everyday usage or because the concept they express requires a more complete explanation than seems appropriate in a series of brief questions and answers. The more important of these are explained here.

Analysis and Review: The principal means by which the CPA carries out his audit procedures is through careful analysis and critical review of the data presented, with a view to appraising whether they appear to be reasonable and reliable, rather than through a detailed checking of transactions.

Auditing Standards: The underlying principles of auditing which govern the nature and extent of the evidence to be obtained by means of auditing procedures, and which relate to the CPA's personal qualifications and the quality of his work, are referred to as generally accepted auditing standards. A summary of these standards appears inside the back cover of this booklet.

Confirmation: In numerous phases of the examination, the CPA seeks information as to items shown on the records by direct communication with the individual or company in a position to verify such items. This is commonly referred to as "confirmation," and is particularly valuable because the CPA communicates directly with persons or organizations that are independent of the company under examination.

Disclaimer of Opinion: A statement to the effect that the CPA is not in a position to express an opinion on the fairness of the financial presentation.

Examination (Audit): The process through which the CPA reaches an opinion as to the fairness of financial statements, including:

a) A review and evaluation of the existing internal control;
b) A general review of the accounts and records, and comparison of the figures shown on the statements with the sources from which they were drawn;
c) A study of the accounting procedures regularly followed by the company, and consideration of any departures from these practices;
d) Independent sampling tests (through inspection, correspondence, or other means) of the existence of assets;
e) Tests to determine so far as reasonably possible, that all liabilities are reflected in the balance sheet;
f) Analyses, tests, and over-all review of the income and expense accounts;
g) Test procedures designed to determine the credibility and general correctness of the accounts on which the statements are based; and
h) Inquiries of officers, employees and others to supplement the information otherwised developed by the examination.

Inspection: The CPA's work involves the inspection of some 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 and securities, examining notes, leases, etc., testing the inventory taking, 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.

Internal Control, System of: Internal control is a big subject about which it is difficult to generalize. However, a satisfactory system of internal control would certainly include:

a) Appropriate segregation of functional responsibilities;
b) Adequate authorizing and recording procedures to provide reasonable accounting control of assets, liabilities, revenues and expenses;
c) Sound practices in the performance of duties and functions of each of the organizational departments; and
d) A degree of quality of personnel commensurate with responsibilities.

Observation: The term "observation," as used in examinations, 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 taking of the inventory. In the course of his examination, the CPA should also observe the company's procedures in the handling of cash, and in the operation of other phases of its system of internal control.

Opinion: The CPA's statement as to his conclusions regarding the fairness of the financial presentation.

SUMMARY OF GENERALLY ACCEPTED AUDITING STANDARDS

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.