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ABC’s of Auditing

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The ABC's of Auditing

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"I have examined the balance sheet of the ABC Company as of December 31, 1962 and the related statements of income and retained earnings for the year then ended. My examination was made in accordance with the generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as I considered necessary in the circumstances." This is the first paragraph of the independent Certified Public Accountant's short form report which is rendered in connection with his examination of the financial statements of a company. In this paragraph, which is generally known as the scope paragraph, the independent CPA tells what was examined—the balance sheet and the statements of income and retained earnings of the ABC Company—and how his examination was made—in accordance with generally accepted auditing standards. Let us review the steps taken by the independent CPA in making his examination of the financial statements in accordance with generally accepted auditing standards.

The purpose of an audit will determine the nature of the audit to be made. The audit is made in order to report on the financial statements of a company to various interested parties—stockholders or owners, creditors, management, or governmental agencies. Generally there are two types of audits. One is a general audit in which an examination is made of the balance sheet of the company as of a given date and for the period then ended. The other type is known as an examination of financial position which covers an examination of the balance sheet only. An examination of financial position differs from a general audit in that the auditing procedures consist of an examination of the asset and liability accounts as of a certain date, and no comprehensive examination of the income and expense accounts or of the transactions during the period ended is made. In addition to these two types of audits, the independent CPA may be called upon to perform an audit of a specific account such as a cash audit or for a specific purpose such as in a case of suspected fraud. For the purpose of our discussion we shall discuss the general audit only. A general audit is usually made on a test basis as opposed to an examination of every transaction or entry.

In the scope paragraph of his report the independent CPA states that his examination was made in accordance with generally accepted auditing standards. These standards are the underlying principles which control the nature and the extent of his examination. As published by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants, these standards are:

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.

Sufficient 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 by the Independent Certified Public Accountant

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.

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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 shall be stated. In all cases where a CPA's name is associated with financial statements the report should contain a clear-cut indication of the character of his examination, or a statement that the financial statements have been prepared from the books without audit.

These standards determine the extent of the tests of the accounting records and what auditing procedures are to be used.

Before a general audit is started the independent CPA will make a thorough study of the system of internal control. Internal control is defined in the report "Internal Control" by the Auditing Procedure Committee of the American Institute of Certified Public Accountants as follows:

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

This study is made to evaluate the effectiveness of the internal control and determine the extent of reliance that can be placed on the system. The independent CPA frequently uses a questionnaire to facilitate his evaluation of the internal control. The internal control questionnaire consists of questions dealing with the various phases of the organization and is designed so that the questions may be answered yes or no. An affirmative answer would indicate a satisfactory situation as to internal control, and a negative answer would indicate a situation where the internal control is weak. Taking cash disbursements as an example, the internal control questionnaire would include the following questions:

Preparing Checks

Checks prepared by__________________

1. Is the supply of blank checks controlled?
2. Is the situation good in that the person who prepares checks does not:
   a. Sign the checks singly?
   b. Reconcile the bank account?
3. Are checks prepared from approved disbursement vouchers or check requisitions?

Recording Checks

Cash disbursements records kept by_____
____

1. Is the arrangement of duties and procedures such as to safeguard against falsification of the cash disbursements record?

Signing Checks

Checks signed by__________________

1. Is the situation good in that the person who signs checks does not:
   a. Prepare the checks?
   b. Reconcile the bank account?
2. If checks are signed mechanically, is the use of the machine and signature plate controlled?
3. Are checks accompanied by approved disbursement vouchers or check requisitions when presented for signature?
4. Are checks safeguarded against interception prior to being mailed?

Reconciling Bank Accounts

Reconcilements made by_______________

1. Is the situation good in that bank accounts are reconciled by a person who does not:
   a. Prepare the checks?
   b. Have access to cash?
2. Is the reconcilement procedure thorough?

After the CPA performs his study of the various phases of the internal control system by means of careful inquiry of responsible officials and by observations of the procedures being used, he will come to conclusions as to the situations which are good, bad, or mixed. For example, the internal control may be considered to be good in respect to cash receipts and mixed in respect to purchases and trade payables. The conclusions reached by the CPA in his evaluation of the system of internal control will determine the extent of the tests of the accounting records and may be used as a basis for recommendations to the client for improvements that can be made. After completing the evaluation of the internal control of the client, the independent CPA is ready to proceed with the audit.

Before any detail work is performed, the CPA will prepare a complete plan or program of the work to be performed based on his knowledge of the type of business, the company's accounting policies and procedures, and his review of the system of internal control. The audit program usually takes the form of the auditing procedures to be applied to each account or type of account such as cash, accounts and notes receivable, prepaid assets, etc. The audit program also provides a place for the accountant performing the particular auditing procedures to initial upon completion of the specified work. In summary the general audit program serves as a guide in arranging the work to be performed, as a check against possible omissions, and as a record of what work was done and who performed the work.

The independent CPA's working papers are the instrument through which he conducts his audit and records all pertinent information about the accounts under examination. They act as a basis for the conclusions to which the auditor comes and reports to the client. The "backbone" of the working papers is the general ledger trial balance which consists of a listing of the general ledger accounts, the asset accounts, the liability accounts, the capital accounts, the income and expense accounts, etc. Although the trial balance may take several forms, it usually includes the following information: account number, account name, adjusted balance of the account at the end of the preceding period, the book balance as of the period under review, any adjustments made by the CPA, the final or adjusted balance, and a reference to separate analyses or schedules of specific accounts. Ordinarily separate pages are used for each classification of account—assets, liability and capital accounts, profit and loss credits, and profit and loss debits. The net difference between the profit and loss credits and the profit and loss debits is carried forward to the capital section in order to balance the asset page to the liability and capital page. Using the trial balance as a guide, the CPA will prepare, if deemed necessary, analyses of the various asset and liability and capital accounts and will examine, or test examine, the transactions that result in the balance of these accounts.

There are two basic methods used in applying auditing procedures—examination of the balance sheet accounts by examining entries to the original records and testing transactions from the original records to the general ledger accounts. Let us first describe the audit procedures involved in the examination of the balance sheet accounts. The CPA follows the procedure of tracing from the general ledger account to the records of original entry the transactions that go to make up the balance of a particular account as of the date of examination. In this connection he will examine the source documents from which entries are made in the records of original entry—the cash receipts book, the cash disbursements book, the voucher register, the sales register, and the general journal. Let us take the general ledger cash account as an example and show the auditing procedures that may be used in the examination made by the independent CPA.

Because of its negotiable nature, cash is usually verified promptly at the end of the period to be audited if practicable. Cash on hand and on deposit is examined concurrently with negotiable instruments and securities in order to prevent any attempt to conceal a shortage. The verification of cash on hand generally consists of counting and listing the bills and coins as well as receipts for disbursements made from the petty cash fund. Any checks cashed out of the fund should be currently dated. Also any reimbursement checks included in the petty cash balance should have been entered as disbursements in the company's cash disbursements book. The verification of cash on deposit is made by reference to supporting documents such as bank statements, deposit slips, cancelled checks, and reconcilements prepared by the client. In addition, audit procedures usually include outside verification of the cash balance as well as any liabilities to the bank by means of an independent certificate, or bank confirmation, received directly from the bank. In order to obtain further verification that all outstanding checks and deposits in transit have been correctly recorded by the client, a cut-off bank statement or a bank statement for the subsequent month is obtained unopened by the CPA. Any checks listed as outstanding which do not clear the bank on the statement obtained by the auditor are investigated as to validity and entry in the cash disbursements book. Particular attention is also given to cash-in-transit as of the balance sheet date from an affiliated company, branch, or separate bank account. We have illustrated three types of supporting evidence used by the auditor in substantiating the records of the client: (1) externally prepared documents such as bank statements, (2) internally prepared documents such as checks, and (3) outside certifications or correspondence received directly by the CPA.

The other method used in applying auditing procedures is test checking of the original records and tracing the entry of the source documents into the original records and the posting of the original records to the general ledger. As previously stated, the independent CPA generally does not examine every transaction unless requested to do so by the client. Usually the extent of the CPA's examination of the transactions and records is determined by the effectiveness of the client's internal control system. Taking the voucher register as an example, we will illustrate the procedures used in testing the transactions and records. Generally vouchers or invoices which are prepared for disbursements by check are examined and checked to the voucher record. In connection with the voucher examination, the distribution of charges to the various accounts is tested. Attention is also given to approvals as to receipt of the goods or service, pricing, or terms. The extent to which the vouchers

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are examined is determined by the effectiveness of internal control over the recording of purchases and trade accounts payable. In addition to the examination of vouchers, the voucher record should be footed on a test basis depending upon the internal control—for example, the total column for one month, the distribution columns for another month, and crossfootings for still a different month. Finally, postings from the voucher record to the general ledger accounts are checked, for instance, for three non-consecutive months. We have illustrated three types of procedures used in testing the transactions and original records: (1) checking postings, (2) footing, and (3) examination of source documents.

In connection with the examination of the asset and liability accounts and the testing of transactions and the original records work has been performed on the operating accounts. For instance, depreciation expense is examined in connection with the examination of the fixed assets and related reserves as is interest, insurance, or rent expense in connection with the examination of prepaid assets and/or accrued liabilities. Furthermore in the testing of transactions and the original records, tests of the footings and postings of all accounts, including income and expense accounts, are made. In addition to the foregoing tests and examinations, the independent CPA will also perform an analytical review of the operating accounts on a month-to-month basis as well as a comparison of the balance this period to that of the previous period. Any significant ratios and averages should be computed as well as the use of graphs for the purpose of making comparisons. Any material fluctuations noted in making these comparisons should be investigated to determine whether the item was proper.

In addition to the verification and the testing of the accounting records, the independent CPA should request a representation by the client's officials as to the correctness of inventories and as to liabilities, direct or contingent, not disclosed by the accounts, which would materially affect the financial statements. These certifications do not relieve the CPA of his responsibility to carry out the audit procedures which are necessary in the circumstances. The purpose of such representations is to assure the CPA that nothing of material importance has occurred which has not been given effect to in the financial statements. In addition to these certifications, the CPA will read the minutes of meetings of the directors and stockholders of the corporation between the balance sheet date and the date of his report and will review any subsequent happenings which might have a material effect upon the financial statements.

With the completion of the audit work, we turn to the preparation of the accountant's report to the client in which he gives his opinion regarding the client's financial statements. The report should be prepared in accordance with the "Standards of Reporting" which were reviewed previously. In the first paragraph of his report the independent CPA defines the scope of his examination, and in the second paragraph he will give his opinion which may take the following form:

"In my opinion, the accompanying balance sheet and statements of income and retained earnings present fairly the financial position of the ABC Company at December 31, 1962 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."

In summary, the independent Certified Public Accountant has examined the financial statements of the ABC Company through the application of the generally accepted auditing standards in order to give his opinion regarding the statements.

Tax Forum
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Thus, a taxpayer who owned Hawaiian property which was damaged by the excessive rainfall and flooding on or about April 14, 1963, and who suffered a casualty loss of $2,000 as a result of such damage could file an amended return for 1962 and claim the $2,000 deduction if he had not claimed the loss in originally filing his return. If he does not claim the loss on his 1962 return, he may claim it on his 1963 return.