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"Memorandum of examples of inadequate auditing" (1946)
"Horrible examples"

American Institute of Accountants

INCORPORATED UNDER THE LAWS OF THE DISTRICT OF COLUMBIA

THE NATIONAL ORGANIZATION OF CERTIFIED PUBLIC ACCOUNTANTS

13 EAST 41ST STREET, NEW YORK 17, N. Y.

TO THE MEMBERS OF THE
AMERICAN INSTITUTE OF ACCOUNTANTS:

December 20, 1946

Gentlemen:

Re: Review of Auditing Standards and Procedures

From time to time the American Institute of Accountants receives from various sources criticisms of audit work by certified public accountants in specific cases. A collection of such criticisms has been made by the Institute's research department, from which a summary of typical "horrible examples" has been made and is attached hereto.

Every one of the cases cited shows ignorance or disregard of fundamental auditing standards or procedures amply described in the professional literature, and long since recognized by the profession itself as essential.

These cases may be rare exceptions of inferior work but they are disquieting because we have no way of knowing how exceptional they are.

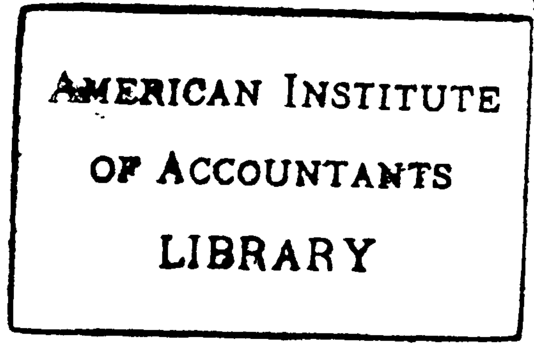
During the war years the accounting profession has been preoccupied with problems other than auditing procedure. Since 1939 several thousand new certified public accountants have been created in the United States. Many new members have been admitted to the Institute and to the state societies. Some of these new arrivals may not be fully conscious of the existence of such documents as "Examination of Financial Statements by Independent Public Accountants", "Extensions of Auditing Procedure", and the other 21 statements on auditing procedure issued by the committee on auditing procedure of the American Institute of Accountants, as well as other authoritative literature in this field. They may be unaware of the fact that the rules of professional conduct of the Institute, and of most of the state societies, subject members to reprimand, suspension, or expulsion for failure to observe generally accepted auditing standards; and that ignorance of such standards might result in loss of their CPA certificates and disbarment from practice before certain government regulatory agencies, and possibly in heavy civil liabilities.

it is suggested, therefore, that members of the Institute engaged in public accounting practice review their own auditing procedures, in order to make certain that they are in conformity with the standards which the profession has accepted as a measure of its responsibility. Every independent auditor should be thoroughly familiar with the indispensable steps which must be taken if he is to give an unqualified opinion.

Future opportunities of the accounting profession are contingent largely on continued public confidence in the ability and independence of the certified public accountant. Cases such as those described in the enclosed memorandum reflect discredit on the profession as a whole, and thus indirectly impair the opportunities of every practitioner.

Yours sincerely,

EDWARD B. WILCOX, *President*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Memorandum of Examples of Inadequate Auditing

From various sources we have accumulated a number of what we call "horrible examples" of violations of what are generally considered to be necessary procedures in the conduct of an audit. A number of such cases are outlined briefly below.

(1) An accountant commenced an examination on November 5th with the intention of working back to October 31st, the fiscal closing date, but finding the records incomplete took the client's status "as at September 30th" as representative of the position "as of October 31st." No satisfactory reconciliation was ever made between the conditions at November 5th and the accounts as at September 30th. In addition to the improper presentation growing out of the differences in dates, the auditor disregarded a number of standard audit procedures including a failure to count, examine, or otherwise account for important amounts of securities and cash purporting to be on hand, improper confirmation of bank balances and bank loans, and failure to confirm customers' and officers' accounts. As a result it was subsequently ascertained that 7 of the 14 items contained in the balance sheet were materially incorrect.

(2) An auditor failed to examine or count the securities of a client in the safe deposit box notwithstanding the fact that they represented more than half of the client's assets. The accountant justified his failure to do so by asserting that he "had known [the client] for some time and knew him to be unquestionably honest."

(3) Three-fifths of a client's cash at the date of the balance sheet consisted of four checks, either deposited at the date of the audit or on hand at that time, in substantial amounts:

(a) Two issued by an affiliate ostensibly in reduction of an open account at the date of the balance sheet, which were deposited in the following month after the affiliate received offsetting checks from the client.

(b) From a partner of the client, and deposited in the month following the balance sheet date after an offsetting check had been issued to the partner.

(c) From the wife of the partner mentioned in (b) in settlement of a purported stock transaction, the stock in question being sold back to the client four days after the balance sheet date.

After discovery of these facts, the auditor stated under oath that the tracing of checks, which were undeposited at the date of the audit, into the bank was all that was necessary to verify the checks were bona fide, and he indicated that it was not necessary to determine whether the checks might be involved in "kiting" transactions; that the auditor's responsibility ceases, in his opinion, with the deposit of the checks. Had these "kiting" transactions been eliminated, the client's net capital would have been reduced to a deficit.

(4) In a case in which two officers of the client had been misappropriating funds ultimately ascertained to have aggregated approximately 50% of the client's capital, the principal reason for the failure of the auditor to discover the shortage was due to his failure to ask the client's bank whether the client was indebted to the bank, and to his failure to check any entries in the client's account with a brokerage house. He simply confirmed the balance at the audit date, thereby failing to disclose numerous fictitious transactions which even a cursory check of the entries would have revealed.

(5) In a particular case it was ascertained that the auditors of a brokerage house failed to observe the following three standard audit procedures:

> (a) The accounts of customers were not confirmed by direct correspondence between the accountant and the customers; instead, confirmations were sent by the client and returned directly to the client's office where they were examined by the auditors; furthermore these confirmations showed only the securities position and omitted to show any money balances.
>
> (b) All securities were not examined or otherwise accounted for, and customers' securities were merely "test-checked."
>
> (c) Bank balances were not reconciled by the auditors at a date subsequent to the audit date.

(6) The certifying accountant did no more than obtain a confirmation of the bank balances. All other assets and liabilities were accepted on the statement of the client. The certificate read as follows:

> "We have prepared the above balance sheet as at March 12, 1946 on information submitted to us by [the proprietor].
>
> "The cash in the [bank] was confirmed by the bank. Other assets and liabilities were accepted on the statement of [the proprietor].
>
> "On the basis of the above, we hereby certify that, in our opinion, the above balance sheet sets forth the true financial condition of [name of the client] at March 12, 1946."

(7) The auditor of a brokerage house, whose certified financial statements are required to be filed with the Securities and Exchange Commission on forms and following procedures specified by that Commission, failed to follow specified minimum audit requirements, as follows:

> (a) Securities on hand at certain branch offices were not examined by the auditors but statements by the managers of those offices were accepted as conclusive evidence that they were on hand.
>
> (b) Requests for confirmation were mailed once to customers and dealers whose accounts disclosed security or money balances, but the Commission's requirement that second requests for confirmation must be sent out was not observed.

(8) The auditors of a brokerage house made no independent verification of the market value of bonds owned by the client but accepted the values submitted by a member of the brokerage firm, although such bonds represented more than 90% of the total assets of the firm; the auditors also failed to confirm the accounts of customers and the accounts due from salesmen, as required by the Commission's minimum audit requirements.

(9) In spite of all of the public discussion, both orally and in writing, with respect to the necessity of public accountants satisfying themselves with respect to the financial statements to which they attach their names, the following certificate was issued by an accountant who did not make even a cursory audit:

> "I hereby certify that the figures shown in the foregoing balance sheet are taken from the books of [name of company]. The figures may be accepted as presenting the financial position of the company as at December 31, 1945."

(10) Notwithstanding the reiteration of the reasons for the statements contained in the standard audit certificate or the rules of the Securities and Exchange Commission with respect to the representations that must be made by the auditor in connection with his certification of statements filed with that Commission on Form X-17A-5 which call for substantial

representation with respect to the work done and the findings of the auditor, the following two certificates were filed with the Commission by certified public accountants in connection with such form:

> (a) "We hereby certify that, in our opinion, the above statement sets forth the financial condition of [name of company] at December 31, 1945."
>
> (b) "We hereby certify that in our opinion the above balance sheet presents the financial condition of [name of company] as at April 30, 1946, in conformity with generally accepted accounting principles."

(11) A mercantile company had its inventories distributed among 16 locations in approximately equal proportions, and it had no well-designed internal control for such inventories. Nevertheless the auditor, year after year, observed the taking of inventories in only the 4 locations in the area immediately adjoining the principal office and made no physical tests of inventories in the other 12 locations; and professed to believe that he had made an adequate physical test of the inventories for the long period during which he made annual audits.

(12) In a prospectus prepared for the purpose of selling securities in amounts not subject to jurisdiction by the Securities and Exchange Commission, a balance sheet without profit and loss statement or statement of surplus was included. The report of the certified public accountant which covered the balance sheet stated that he had made a detailed audit, though other language in the opening paragraph, i.e., "have reviewed the system of internal control and the accounting procedures of the company . . . and have examined the accounting records of the company, and other supporting evidence, by methods and to the extent I deemed appropriate", indicated procedures appropriate to the usual type of test examination. The assets reflected in the balance sheet were cash, accounts receivable, inventory and fixed assets. In his certificate the auditor states that he did not employ "the usual auditing procedure of confirming accounts receivable", that the company did not take physical inventories at the balance sheet date "because of the nature of the material and in order not to interrupt production", and that "the board of directors was in a position to appraise the fixed assets" which were carried in the balance sheet at appraised value. Thus approximately 90% of the dollar value of the assets of the corporation as reflected in the balance sheet were not audited. The certificate further states that "verification of liabilities was not undertaken, but as a result of payments of these accounts subsequently verified, I believe they have been correctly stated."

Thus the auditor affixed his certificate to a balance sheet to which he had not applied any of the usual audit techniques to approximately 90% of the assets and 100% of the liabilities, yet without qualification stated: "In my opinion the accompanying balance sheet presents fairly the position of [name of company] as of July 31, 1946."

(13) The auditor of a loan company which had a number of offices did not visit any of the branch offices but restricted his examination of notes, collateral, etc., to those on hand at the main office, which constituted during the years under review less than 20% of the total included in the balance sheet. Even in the home office, where the loan application, notes, and supporting collateral were examined, no effort was made to confirm the receivables by communication with the debtors. The loans constituted more than 95% of the assets of the corporation.

(14) A firm of auditors finding itself short-handed as the result of the induction of one of its seniors into the armed services, had the working papers prepared by two employees of the client, namely, the treasurer and the chief bookkeeper.

CARMAN G. BLOUGH,

Director of Research