MONTGOMERY'S AUDITING

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NINTH EDITION

RONALD

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To

Robert H. Montgomery, C.P.A.
(1872–1953)

Author of the first six editions and
co-author of the Seventh Edition
of this book

Alvin R. Jennings, C.P.A.

Co-author of the Seventh Edition

Norman J. Lenhart, C.P.A.
(1894–1974)

Co-author of the Seventh and Eighth Editions

and

All the other partners and staff
of

Coopers & Lybrand

Who have contributed to the
furtherance of this work

Historical Perspective

Robert H. Montgomery (1872–1953) together with William M. Lybrand (1867–1960), Adam Ross (1869–1929), and T. Edward Ross (1867–1963) founded the firm of Lybrand, Ross Bros. & Montgomery in 1898, two years after the first CPA law was passed. The four had for some time previously practiced public accounting in Philadelphia.

Montgomery was a prolific writer and leader of his profession. He wrote many books, including a series on federal income taxes, and he was instrumental in the formation, and was president, of what is now the American Institute of Certified Public Accountants. Earlier, he also taught at Columbia University and the University of Pennsylvania.* He saw the need for a practical book on auditing and in 1905 and 1909 published American editions of *Dicksee's Auditing,* a British work. Noting the radical departure of American practice from Dicksee, he wrote the first American work on the subject, *Auditing: Theory and Practice,* in 1912. Seven subsequent editions followed from 1916 through 1957. For the Seventh Edition, co-authors Alvin R. Jennings and Norman J. Lenhart joined him and the book was renamed *Montgomery's Auditing.* The Eighth Edition, published after his death, was co-authored by Norman J. Lenhart and Philip L. Defliese. Comparisons of various editions reveal the development of public accounting in the United States.

During this period the firm flourished along with other major firms, paralleling the growth of business in the United States. In 1956, Cooper Bros. & Co. in the United Kingdom and abroad (founded in 1854) and MacDonald Currie & Co. in Canada (founded in 1910) joined Lybrand, Ross Bros. & Montgomery in forming the multinational firm of Coopers & Lybrand in recognition of the growing needs of international practice. Others have since joined and firms in 91 countries now serve clients of Coopers & Lybrand. Until 1973, the constituents retained their local names and used the Coopers & Lybrand name only internationally. In 1973, to eliminate the confusion of names, and in recognition of the integration of the firm's multinational practice, the constituents adopted the international name of Coopers & Lybrand and generally discontinued the use of local names.

Dropping the Montgomery name from a firm that had so long celebrated his contributions was not easy. However, his successors feel that the continued association of the Montgomery name with his major contribution to the literature of the profession is proper tribute to his memory.

*For a full account of Montgomery's contributions, see his autobiography *Fifty Years of Accountancy* (New York: The Ronald Press Co., 1939).

Preface

To those of us living and practicing in the profession in 1975, it often seems there can hardly be a worse time to publish a book on auditing with some expectation of durability. Problems beset the profession on all sides: the pace of change and the rising expectations of the public and government of the role the auditor plays; the threat of liability to both civil and criminal actions; the criticisms of the inadequacy of accounting and auditing—the state of flux posed by the Financial Accounting Standards Board, the committees of the American Institute of Certified Public Accountants, and the Securities and Exchange Commission—all point to a rather unstable period. The report expected in 1976 of the AICPA-sponsored Commission on Auditors' Responsibilities will, no doubt, contain far-reaching recommendations.

The present always seems a time of stress, and the future clouded, when so many things are happening all at once. Later they somehow always seem to fall into place. Thus has it ever been in our growing, but still very young, profession. In the prefaces of his various editions, Montgomery reported these convolutions over the years; he used his prefaces to expound his philosophies, hopes, and expectations. In the light of the present, a few excerpts are worthy of note.

On the pace of change and the problems, opportunities, and threats it poses:

From the Third Edition in 1921

> Since the publication of the second edition of this book in 1916, the fluctuations in financial and business conditions have been more violent than any previous five years in the history of the world. We have had unparalleled inflation and partial deflation. . . .

From the Fourth Edition in 1927

> . . . auditing principles under what we call normal conditions, even though when dealing with industry and finance as a whole, there does not seem to be any such thing as "normal conditions". . . .

From the Fifth Edition in 1934

. . . The economic adversities that befell the country laid bare or emphasized much in American business practice that is unsound and even reprehensible and there has been a general demand by investors, credit grantors, stock exchanges, and regulatory bodies for increased scrutiny of the accounts of businesses by competent independent auditors for the purpose of preventing a recurrence of such unsound practices.

And from the Seventh Edition in 1949

Recently, financial writers have written much about and freely criticized our presentation of financial reports. It's old stuff and not as important as it sounds. If it were really important, there would have been more changes than have taken place in the thirty-seven years since the first edition of this book. . . .

The litigious times in which we find ourselves cause every professional to fear that any statement which he puts in print may be turned against him. Montgomery had a few things to say, over the years, about rising expectations, increasing professional responsibilities, and what should be done about them:

From the First Edition in 1912

. . . More is now expected of the auditor, and, happily, many of the profession have met this broader demand and have shown that the services of the practitioner must extend over the whole field of business activity. . . .

From the Third Edition in 1921

. . . The future is bright because we have profited by our mistakes. . . .

From the Fourth Edition in 1927

I have noticed a disposition on the part of some auditors to accept the advantages and evade the disadvantages which come with greater opportunities. Some auditors regard it as justifiable professional practice to examine accounts and avoid making any positive or affirmative statement that the accounts are correct or incorrect; they avoid the use of the word "audit" feeling it may involve them in a lawsuit; they cheerfully admit their inability to verify inventory quantities and values, as if it were a virtue to disregard the most important item in most balance sheets; they indulge in time-consuming corrections of trifling errors and other non-essential work and avoid the verification of details of importance.

In my opinion professional auditors should assume responsibilities comparable with their opportunities.

And from the Fifth Edition in 1934

With the growth of general public appreciation of the value and usefulness of the services of the professional auditor have come increased duties and respon-

> sibilities. More is expected of auditors than ever before. This responsibility the profession is ready to assume only to the extent that it represents reasonable demands. Auditors should not avoid reasonable responsibilities and liabilities, but, on the other hand, the profession must resist strenuously all efforts by national, state, or private action to broaden its responsibilities to a point where they become improper and unjustifiably burdensome.

And on another current issue—the adequacy of generally accepted accounting principles and whether they can be relied on to "present fairly"—we find:

> *From the Fifth Edition in 1934*
>
> I believe that good accounting practice must conform to good business practice. At the same time, I believe that most professional auditors have tried to follow good business practice in their professional work and that many business men, and particularly some regulatory bodies, have not as quickly recognized certain good and bad business practices. . . .
>
> *And from the Sixth Edition in 1940*
>
> Most of the complaints of recent writers relate to financial statements which would be considered either incorrect or inadequate in the light of the best practice. Accordingly, the correction of such statements calls for no new standards or restatements of principles. What has been forced upon us is a bewildering mess of state corporation laws, lawyers' opinions supporting the so-called incorrect statements, and various governmental regulations. In most cases, the only remedy needed has been a simple application of old and tried standards to statements reflecting violent departures therefrom.

One might very well say that there seems to be nothing new under the sun. It is a temptation to browse on through those old prefaces, and take heart from the thought that if Montgomery and his associates lived through their times, we may live through ours. But enough is enough: two enduring expressions are nearly the last of our quotes:

> *From the Third Edition in 1921*
>
> Good accounting practice is merely the practice of good accountants.
>
> *And from the Seventh Edition in 1949*
>
> . . . Good accounting practice and good business practice cannot remain long apart. . . .

In the eighteen years since the publication of the Eighth Edition much has happened that has advanced the art and technology of accounting and auditing, and we leave the differences between the two editions to speak for themselves. But most important is the change in public visibility of the auditor and his role in the functioning of our capital market, traumatic as that change has been. In 1957 auditors were most concerned about their responsibility to clients for failure to detect defalcations and other similar irregularities. Today clients readily understand and accept the limitations of the auditing process. Instead, the public—over 30 million stockholders—is more aware of the auditor and more concerned about his role in uncovering management's misrepresentations (a scarce occurrence in the 1950's) and other illegal or immoral acts. That issue needs sorting out, because only in an atmosphere of mutual trust can auditors relate to their clients in a meaningful and productive way. The question is whether the profession has oversold the implication of an auditor's opinion on financial statements; an insurance policy it is not! An activist SEC is pursuing matters of disclosure in many areas within and beyond financial representation, and is now even encouraging forecasting. And the FASB is searching for the light that will underlie basic concepts of accounting and the framework upon which all subsequent authoritative pronouncements should rest. Of the future we can be sure of only one thing—change!

Tempting as it is, we have deliberately restrained ourselves from opining on the many and sundry issues that face the profession today, such as price-level and current value accounting and new ways of auditing or reviewing interim financial statements. That is not the purpose of this book. Our job is to catalog the status quo for reference and study; future editions will note the changes as they come. We succumb to one more temptation to quote from the preface of Montgomery's Third Edition in 1921:

> It is a cause for congratulation that accounting is living up to the best traditions of a learned profession and is discarding obsolete theories and substituting new ones as rapidly as conditions warrant. . . . It is imperative that financial statements should reflect full and true financial conditions.

We can only concur.

PHILIP L. DEFLIESE
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Acknowledgments

The long interval between the Eighth and Ninth Editions of this book requires explanation. At first the delay was occasioned by the many major accounting changes the AICPA's Accounting Principles Board was making and contemplating. More important, however, was the Firm's restudy of its auditing techniques occasioned by the emergence of recommendations in the late 1950's that statistical sampling techniques be considered as applicable to audit tests just when (in the Eighth Edition, page 49) we were convinced that our development of functional tests had matured. This led to a close re-examination of the nature and extent of audit tests and procedures, and the relevance of statistical sampling to the many facets of the auditing process, spearheaded by Thomas J. Cogan, C.P.A., an outstanding practitioner who served as my assistant until his death in 1968. The refinement, testing, field testing, and finally the articulation of the resultant integrated approach, described in Chapter 5, took time. It places statistical sampling in a minor role, because we are convinced that our experience has proved the merit of the systemized approach outlined, as opposed to a mathematical one.

We delayed publishing until we felt our approach was ready for exposure and until both our domestic and international practices were convinced of its efficacy. Much credit must go to our overseas partners in this connection, particularly the members of the Coopers & Lybrand International Committee on Accounting and Auditing and their associates.

It should be obvious therefore that this work has had the devoted attention, directly and indirectly, of many of my partners and staff, often at considerable personal sacrifice. It is impossible to honor each of them individually, much as I would like to, so I must do so with a collective expression of thanks and appreciation, particularly to my co-authors.

The book could never have met a reasonable standard of style, content, and consistency without the invaluable and arduous labors of Reed Storey, C.P.A., Ph.D., in content editing, Myra Cleary in style, grammar, and consistency editing, and Rosemary Trowsdale in endless typing. James Alfano, C.P.A., of our staff also provided valuable support.

P.L.D.

Introduction

This book is intended primarily for practicing certified public accountants. It should also be helpful to accounting and financial executives, bankers, underwriters, financial analysts, and lawyers. We trust it will merit the same attention from teachers and students of accounting and auditing as have earlier editions.

We have assumed a level of knowledge about business, finance, and accounting to be expected of a financial professional or of a student at an advanced stage of a course of study in business, economics, or accounting. As a result, we touch on fundamental subjects such as the organization of accounts and the double-entry system only to the extent necessary to discuss current professional problems.

Since the greater part of the work of professional independent auditors consists of examinations leading to opinions on financial statements intended for stockholders, creditors, and other nonmanagement users, substantially all of the book is devoted to that kind of examination. In the interest of size, we have not endeavored to bring together in this book a description of all of the matters that are, or might be, involved in the increasingly complex and sophisticated process of auditing as it is practiced by independent professional firms. Special investigations, acquisition audits, and the rest of the infinite variety of services an auditor is qualified and often called on to perform are not discussed, nor are the tax, consulting, actuarial, and other specialized services most firms provide. The valuable work of internal auditors and of auditors employed by agencies of government is beyond the scope of the book.

The book is intended to be an explanatory guide and a general reference work rather than a manual of specific procedures; therefore, we have concentrated on underlying logic and practical illustrations rather than specific rules of procedure of the kind that might be found in audit programs, internal practice manuals of CPA firms, or similar actual working directions. But we must add the caveat of previous editions: never will all the procedures outlined in this book be found necessary in any one audit.

As in previous editions, considerable emphasis is placed on the auditing aspect of the application of accounting principles. An auditor is more than a verifier of facts—his job is to scrutinize the translation of facts into accounting concepts and presentations, the highest form of the art. Thus, the accounting described in this book differs in its approach from that contained in many accounting and auditing texts.

Part I, consisting of the first eight chapters, sets forth our view of the theoretical and practical structure of an audit. Chapter 1 states the underlying theory, Chapter 2 describes the standards promulgated by the profession, Chapter 3 describes the central concept of internal control in terms that we believe facilitate its use in practice. Chapters 4 and 5 describe the auditing process and how and why auditors do what they do. Chapter 6 is a brief summary of the computer's impact on auditing: auditing computerized systems and using computers in auditing. Chapters 7 and 8 discuss organizing people to audit and to work harmoniously with clients' personnel.

In Part II, each of Chapters 9 through 16 is organized around one of the eight major activities or segments of the life cycle of a business through which economic activity is conducted and from which accounting aggregates are drawn for conventional financial statements. The rationale for that organization, which is different from that of earlier editions, requires explanation.

For many years auditing was organized almost precisely in parallel with the organization of financial statements. The audit program began with cash, proceeded through the accounts of the balance sheet and income statement, and ended with matters required for the statements and notes. The audit was planned and executed account by account, with some cross-referencing among related accounts.

As systems theory and related audit practice became more sophisticated, the interrelationship of accounts and the flow of data through them became more relevant. Auditors began to think of internal control as a system, and the concept of testing "from cradle to grave" came into being. From the resulting experience with viewing transaction processing systems from beginning to end grew an understanding of the significance to the accounts of the non-accounting aspect of many transaction flows. The next step was to organize the internal control testing phase of an audit in terms of transaction systems rather than accounts.

From that point it is only a short step to conceive of the entire accounting process—and, as a result, the entire audit—as falling into a number of related systems that produce the conventional financial statement accounts. Revenue and expense accounts measure the volume of transaction flow over a period of time, while the balance sheet accounts represent a cross section of the contents of the system at a given point in time. Thus, sales transactions flow through the revenue system, and the measurement of that flow is reported in the sales account; the accounts receivable balance at the end of a period is a measure of the total sales transactions still "in transit" at that time.

As elsewhere, the use of words having many meanings, such as "system" and "cycle," can be unnecessarily confusing. For purposes of differentiation and precision, we have in Part II introduced the term "segment" to describe the major transaction flows. The entire economic process in every organization consists of a cycle that begins and ends with cash. Cash is received, spent for the purposes of the enterprise, the product is delivered, and (if it is a successful product) more cash is received. Obviously, the major transaction flows are income and outgo of cash, but that simple division is too broad a generalization to be useful in describing auditing. It is convenient and useful to think of business operations, accounting, and auditing in terms of eight main types of transactions that make up segments of the cash-to-cash cycle.

Despite this difference in approach, the chapters in Part II retain the logical sequence of presentation of previous editions: a knowledge of the relevant accounting principles applied to a knowledge of typical transactions and related controls of the client provides a basis for the planning of the nature, timing, and extent of auditing procedures, culminating in fair presentation of the resultant financial statements.

Part III deals with reporting. The complex and still controversial subject of business combinations and consolidated financial statements is covered in Chapter 17; the presentation of financial statements, earnings per share, and notes in Chapter 18; and the auditor's report in Chapter 19. Chapter 20 describes the handling of, and reporting on, some commonly encountered assignments related to the ordinary examination which require special reports.

The aim in earlier editions of the book was to provide comprehensive coverage of generally accepted accounting principles. That is no longer necessary to the same extent because the authoritative literature is now much more comprehensive and is readily available in *AICPA Professional Standards,* which contains pronouncements of the FASB, APB, and their predecessors. Wherever pertinent, reference is made to sections or paragraphs in that publication. In most cases the original pronouncements (obtainable separately from the AICPA or FASB) are referenced as well. Reference is also frequently made to pronouncements of the SEC and other authorities. We believe the extracting and cross-referencing are most complete, but practitioners are cautioned to always consult the full texts. Nevertheless, the discussions of accounting principles and statement presentation in Chapters 9 through 16 and elsewhere will summarize the authoritative literature and elaborate on it as we think it will aid in understanding the underlying logic and its application in auditing practice.

References

References in this book to official pronouncements on accounting and auditing standards are as of September 1, 1975, and consist of the following:

Statements and Interpretations of the Financial Accounting Standards Board (FASB), since 1974.
Opinions, Statements, and Interpretations of the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA), predecessor to the FASB, 1959–1973.
Accounting Research Bulletins (ARB) of the Committee on Accounting Procedure of the AICPA, predecessor to the APB, 1938–1959.

Complete texts of all the foregoing may be obtained in original document form or found under topical headings in Volume 3 of the loose-leaf publication *AICPA Professional Standards* published for the AICPA by Commerce Clearing House, Inc., and cited herein as *AICPA Prof. Stds.*, vol. 3 (bound paperback versions are available periodically). Readers should note that the section and paragraph references are as of September 1, 1975, and that additional pronouncements will be inserted under appropriate topics as they are issued.

Statements on Auditing Standards (SAS) of the Auditing Standards Executive Committee (AudSEC) of the AICPA, since 1974.
Statements on Auditing Procedure (SAP) of the Committee on Auditing Procedure of the AICPA, predecessor to AudSEC, 1938–1973.

Complete texts of the foregoing may be obtained in original document form or found in Volume 1 of *AICPA Professional Standards* published for the AICPA by Commerce Clearing House, Inc.

Accounting and Auditing Guides for special industries, published by committees of the AICPA (available as separate AICPA publications).
Accounting Series Releases (ASR) of the U. S. Securities and Exchange Commission (SEC) since 1934 (Nos. 1—176; available in SEC services).

Although this book has been prepared primarily for use in the United States of America and outlines the standards and practices relevant to companies headquartered in the U. S. A. (regardless of location), its application is believed to be more universal. No references have been made to Standards published thus far by the new International Accounting Standards Committee (IASC) because such Standards are presently in harmony with U. S. A. pronouncements.

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