counting Practice will hold a public meeting on October 25, 1965 (6:30 p.m. at the Barbizon-Plaza) to discuss the new recommendation of the AICPA Council. The speakers will be two members of the Accounting Principles Board. The background leading to the adoption of the recommendation of Council and the effect of the action will be covered by Philip L. Defliese. The APB Opinion on the Status of the ARBS will be discussed by Donald J. Bevis. A panel of members of the Committee on Accounting Practice and the speakers will answer questions.

So that the meeting can be conducted efficiently and effectively, Society members are requested to submit their questions in advance to the Committee on Accounting Practice in care of the Society office.

—JULIUS W. PHOENIX, JR., CPA

INDEPENDENT REVIEW OF INCOME STATEMENT REASONABLENESS

Generally, the approach to auditing income and expense items is that of checking or test-checking the details that build up the accounts, the purchase bills and sales invoices, the cash receipts and disbursements, the individual journal entries, and the postings to the general ledger. If the parts are correct then the total must be correct. Sometimes the opposite approach can be a valuable auxilliary tool. If we can satisfy ourselves independently that the totals are approximately right by analyzing, comparing and reconciling income, cost and expenses then we may feel more confident that substantial error or fraud has not taken place. The extra time spent by the auditor (often with the aid of details and explanations supplied by the internal staff) may be time well spent.

There are a number of channels for a "rough" determination of reasonableness of the income and expense figures and, consequently, of the period's net income.

The major channels, commonly, are (1) comparison with statements of prior corresponding periods, (2) discussion with client's key personnel of major income and expense items and their views on the reasonableness of the net income, (3) interim financial statements prepared by company personnel for submission to banks and other credit grantors or for their own knowledge and guidance, (4) departmental statistical data, e.g., sales, units produced, etc., (5) cash flow analysis (6) comparisons with standards of gross profit margin and other key figures, and (7) industry statistics.

Revelations from this independent probing may sometimes be most revealing, not only as to errors of omission and commission but as to incidents of operating laxity and inefficiency that should be reported to management.

A material variation of an item from one period to another does not necessarily mean that something is wrong —only that something should be questioned and perhaps investigated. Obviously in a dynamic business entity we cannot expect all of the component figures of the income statement to remain approximately the same, but we can expect to find reasonable explanations for the striking differences.

To illustrate, the reasonableness of sales may be established, in some instances, by reference to sales department statistics, unit production records, and other collateral records existent in each instance.

Perhaps the most meaningful figure that can be analyzed in a manufacturing or jobbing concern is the gross profit margin, because it touches the heart of the business. We may be able to isolate the different elements and determine approximately how much each has varied compared to previous periods and how much it has varied in relation to existing standards, if any, in order to help explain a material fluctuation in the gross profit margin. This could lead to the discovery of unrecorded purchases and sales, inventory valuation errors and other related errors, or frauds or embezzlements. In manufacturing companies the cost of materials and labor, per unit produced, may be compared with estimated or standard costs. These analyses are relatively simple when the products produced are similar. More sophisticated techniques may be called for when there is a considerable product mix.

Some significant expense items also lend themselves to independent review. For example, advertising expense may be compared with statistical data maintained by the company's advertising manager or agency.

There is no limit to what an accountant's experience and sophistication will suggest as to ways and means of appraising the reasonableness of a period's results.

—LOCKE GRAYSON, CPA

ABSTRACTS FROM REPORT OF SPECIAL COMMITTEE ON APB OPINIONS

A special committee of the American Institute of Certified Public Accountants, created to study the operation and status of the opinions of the Accounting Principles Board, recently concluded its study and submitted an historic report.

Because of the great import of certain of the recommendations of the Committee, they are here reproduced for the benefit of those who may not have had access to, or read the report. The provisions omitted deal essentially with administrative aspects.

Recommendation No. 1. At the earliest possible time, the Board should:

(a) Set forth its views as to the purposes and limitations of published financial statements and of the independent auditor's attest function.

(b) Enumerate and describe the basic concepts to which accounting principles should be oriented.

(c) State the accounting principles to which practices and procedures should conform.

(d) Define such phrases in the auditor's report as "present fairly" and "generally accepted accounting principles."

(e) Consider, with the committee on auditing procedure, the possibility of improving the terminology of the auditor's report, and in particular the words "generally accepted" in the expression "generally accepted accounting principles."

(f) Define the words of art employed by the profession, such as "substantial authoritative support," "concepts," "principles," "practices," "procedures," "assets," "liabilities," "income," and "materiality."

Recommendation No. 2. The Board should move toward the reduction of alternative practices in accounting by adopting policies under which it will:

(a) Recognize the objective that variations in treatment of accounting items generally should be confined to those justified by substantial differences in factual circumstances.

(b) Set forth in its Opinions the criteria for application of such acceptable variations.

(c) In an Opinion dealing with a situation which the Board believes justifies alternatives even though there is no significant difference in factual circumstances, set forth the treatment to be preferred, and require disclosure of the treatment followed.

Recommendation No. 4. In its operation, the Board should:

(a) Establish a long-range program to deal with the whole accounting and