

Historical Review of Auditing Standards in the 1900s

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Abstract

In this paper we will discuss Auditing of financial statements and how it works. Auditing is nothing but the examination of books of accounting, vouchers and other records. The main purpose of the auditing of accounts is detecting frauds, preventing frauds and to determine the profit and loss of business. We will see the standards of auditing which helps to make Audit effective and clear. CPA has the most important role in the Auditing. To make the Audit report accurate, transparent and reliable we should follow the Standards of Auditing. This report is based on the 1900s accounting standards and provides a brief overview. In the field of accounting and auditing standards to avoid the past mistake it is important to study the history of accounting and auditing.

Keywords: Auditing, CPA, Standards, Financials, Fraud, , Scandals, Governance

History

As per the American Standard of Accountant the Audit made by the independent certified public accountant to give the opinion on presentation of financial position and operations. In the principle of accounting the growth and importance of public accounting law was passed by the congress, particularly income-tax and security law. The Revenue of Act 1913 of Oct 3, 1913 was more effective than March 1, 1913 as highlighted by an editorial in the journal Accountancy in November, 1913. In response to the demand for standardized auditing practices, the American Institute of Accountants, prompted by a Federal Trade Commission member, prepared an outline of procedures published by the Federal Reserve Board in April 1917. This guide, initially titled

"Uniform Accounting; A Tentative Proposal," was later reissued in 1918 as "Approved Methods for the Preparation of Balance-Sheet Statements" and widely distributed to financial professionals.

For the regulation of accounting matters and methods followed in presentations of financial statement to Securities and Exchange Commission are given by the Securities Act 1933, Security-exchange Act 1934 and Public-Utility Act 1935.

In 1929, paragraph of "General Instruction" of the Standard Audit Program were revised and published by the Federal Reserve Board under the title "Verification of Financial Statement". Later revision of this pamphlet prepared and published by the American Institute of Accountant in January 1936. And the title of this pamphlet is "Examination of Financial Statement by Independent Public Accountant."

Introduction

Auditing standards and procedures are illustrated by the American Institute of Accounting. It states that Audit is used for examining the financial statement and making the report on it. For the Audit, there is an Independent Certified Public Accountant (CPA) who is responsible for these. He is one of the most responsible and trusted people. He not only finds the errors from books of accounting, he must also disclose whether the

management did by accident or intentionally deceiving the stockholders and creditors with false reports.

In the small enterprises in which the owners can no longer supervise their own accounts and other matters. For these there is a need for an independent public accountant to make sure the accuracy and inaccuracy of records, which includes balance sheet, profit and loss or income statement.

Certified Public Accountant (CPA) is a professional who has completed extensive education and training to become skilled in accounting. They need theoretical as well as practical experience. CPA deals with various judgments made by company management. The training and experience make CPA able to make review and records objectively and impartially on a company's financial records. The mental attitude and approach of an auditor is like, when he expresses his opinion on any statement it must be unbiased, impartial judgment and consideration of facts.

As per the American Institute of Accountants, there are sixteen rules. From sixteen rules, five of them rules are as given below:

1. Rule 5 → What can makes CPAs work unacceptable:

- If CPA doesn't reveal an important fact that should be disclosed to make financial statements clear and honest.
- If CPA doesn't report significant errors.
- If CPA is seriously careless in reviewing or reporting.
- If CPA doesn't gather enough information to give proper opinion about their statement.
- If CPA doesn't point out significant departures from standard accounting rules.

2. Rule 9 → CPA cannot charge a fee that depends upon the outcome of their work. The fees set by the court or public authorities, which might be uncertain at the start.

3. Rule 13 → A CPA cannot review or give an opinion on financial statements for a company if they or their immediate family have a significant financial interest in that company. If they do have an interest, they must disclose it in their report

4. Rule 14 → CPAs cannot receive commissions or share in the profits from recommending other services to clients.

5. Rule 4 → A CPA cannot run a business or work in another field that conflicts with their accounting duties.

In the Auditing there are

the standards of field work. It has the flow as
Planning → Fieldwork
→ Reporting →
Follow-up.

Planning with the client, to determine the audit's scope. In this process it includes the gathering information, understanding of department policies, internal process, etc.

Fieldwork to collect, analyze and assess information (including data) on risk levels and controls within the organization. It also includes the staff interviews, data collection, sample testing, etc.

Reporting to communicate our findings and recommendations for corrective actions and to finalize actions management will take to reduce identified risks and improve controls.

Follow-up to determine the outcomes of actions taken and obtain client feedback on the audit experience.

Historical Development of Auditing Standards

5.1 Early 1900s

The Joint Stock Companies Act of 1844 introduced the act of "auditing". To protect the investors from the unregulated share market and potential for financial fraud. The growth of large scale corporations and need for financial oversight was mainly due to the emergence of auditing in the UK in the 1840s-1920s was primarily driven by industrial revolution. The job of auditors was to detect frauds and errors in financial records. However, their position progressively expanded to include ensuring the proper portrayal of a company's financial role. The verdicts from key court cases such as London and General Bank Kingston Cotton Mill, further solidified the importance of fraud detection and the general standard of work expected from the auditor. The duties of auditors were influenced by the court at that time.

5.2 Mid 1900s

The profession of auditing went through significant changes after the revolution of the accounting industry. Segregation of ownership and

management in large companies led to the emergence of agency theory, highlighting the potential conflicts between the shareholders and management. The conflicts separation of ownership and control, management decisions, financial transparency, profit distribution, corporate governance. To ensure proper use of resources and prevent fraud it became important to control internal function as companies grew. Primary objective auditing shifted from detecting frauds and errors to adding credibility to financial statements provided by managers. To cope with the challenges of auditing large corporations with the extensive transactions hence the concept of materiality and sampling were introduced. The audit approach during this period emphasizes leaning on internal controls, gathering evidence from both internal and external sources, ensuring truth and fairness of financial statements and shifting focus to the Profit and Loss statement while still considering the balance sheet. Auditors began to place more emphasis on physical observation of external evidence, going beyond the traditional “book of account” to verify transactions and assets.

5.3 Late 1900s

In the 1950s computers were introduced but auditing continued to rely on manual procedures; later the computer in the business process prompted auditors to adapt their methods. The creation of Felix Kaufman's book and the IBM 360 computer in the 1960s facilitated a shift toward computer-based auditing, which subsequently led to the development of specialized audit tools. The use of Electronic Data Processing (EDP) systems became more common and auditors started to integrate computer assisted audit techniques (CAATs) in their practices to handle complex data processing. The growth in size and complexity of business, auditors increasingly relied on evaluating internal controls and accounting systems rather than merely verifying transactions. Foreign Corrupt Practices Act (1977) introduced the mandated stricter internal controls and record keeping requirements. This was a response to corporate scandals and aimed to improve financial transparency and prevent corruption. To ensure

the accuracy, auditors conducted detailed and exhaustive testing in the pre 1980s. The development of risk based auditing methods focused on identifying and assessing areas of higher risk of material and misstatement. Auditors began reducing their reliance on detailed system work and increased the use of analytical procedures. Risk based emerged as a more efficient approach, emphasizing understanding the clients business, industry and internal controls. Increasing corporate scandals and regulatory changes highlighted the need for stronger auditing practices. The foreign corrupt practices act required enhanced internal controls and more rigorous auditing standards The Sarbanes-Oxley Act (SOX) was enacted in response to major corporate scandals (e.g., Enron, WorldCom). SOX introduced stricter requirements for internal controls, auditor independence, and corporate governance, aiming to improve transparency and accountability.

Professional Standards and CPA Responsibilities

Professional standards in auditing are the rules and guidelines that ensure audits are conducted in a fair, systematic, and reliable manner, and they are mainly developed by professional bodies such as the American Institute of Accountants. These standards are important because they bring uniformity in auditing practices, improve the quality of audit work, and help build public trust in financial reporting. A Certified Public Accountant (CPA) is a qualified professional responsible for examining a company's financial statements and expressing an opinion on whether they are accurate and reliable. To perform this role effectively, a CPA must follow several key responsibilities. First, the CPA must maintain independence, meaning they should not have any financial or personal interest in the company being audited, ensuring unbiased judgment. Second, they must demonstrate objectivity and integrity by being honest and not hiding or manipulating important information. Third, professional competence and due care are essential, as the CPA must possess the necessary knowledge and skills and perform their work carefully without negligence. Additionally,

confidentiality is important, as auditors must not disclose sensitive financial information to outsiders. Another critical responsibility is collecting sufficient and appropriate audit evidence by examining records, documents, and transactions before forming an opinion. Early auditing standards also emphasized rules such as proper disclosure of all material facts, avoidance of contingent fees, no conflict of interest, and prohibition of earning commissions from clients. Overall, the role of a CPA includes detecting errors and fraud, evaluating internal controls, and enhancing the credibility of financial statements. Thus, professional standards and CPA responsibilities play a crucial role in ensuring transparency, accountability, and trust in the auditing process.

Audit Process

The audit process is a systematic procedure followed by auditors to examine financial records and ensure their accuracy and reliability. It mainly consists of four important stages: planning, fieldwork, reporting, and follow-up. In the planning stage, the auditor understands the client's business, its environment, internal controls, and identifies areas of risk, which helps in deciding the scope and strategy of the audit. In the fieldwork stage, the auditor collects and analyzes evidence by examining financial records, verifying transactions, conducting sample testing, and interacting with employees to assess the effectiveness of internal controls and detect any errors or frauds. The next stage is reporting, where the auditor prepares an audit report based on the findings and provides an opinion on whether the financial statements present a true and fair view of the company's financial position. This report also includes any weaknesses or recommendations for improvement. Finally, in the follow-up stage, the auditor reviews whether the organization has taken corrective actions based on the audit findings and ensures that the suggested improvements have been properly implemented. Overall, the audit process helps in improving transparency, strengthening internal controls, and increasing the trust of stakeholders in financial statements.

Research Methodology

The research methodology adopted in this paper is qualitative and descriptive in nature, aiming to provide a detailed understanding of the evolution of auditing standards during the 1900s. The study is primarily based on secondary data collected from various sources such as research papers, historical books, journals, and case studies related to accounting and auditing practices. A literature review approach has been used to examine the historical development, regulatory changes, and key factors influencing auditing standards over time. In addition to this, a case study method has been applied to analyze the practical application of auditing procedures, particularly focusing on the financial records of a wholesale auto parts dealer, including journals, ledgers, balance sheets, and other accounting documents. The methodology also involves analyzing auditing techniques such as verification of assets and liabilities, inventory checking, confirmation of receivables, and evaluation of internal controls. By combining historical analysis with case study evaluation, the research provides a comprehensive insight into how auditing practices evolved and adapted to changing business environments, technological advancements, and regulatory requirements.

Findings of case study

The analysis is done on the case study Accounting Policies for the Wholesale Auto Parts Dealer [Sullivan, Lawrence Clifton, "Auditing standards and procedures : illustrated by a case study" (1951). Master's Theses. 1248] .The aspiration of this analysis is to provide the clean insights of history in auditing standards , evolution of auditing . Factors that affected the auditing practices and regulations have changed over the decades hence understanding the factors that influenced .

1.Findings : The nature of auditing utterances and their importance to both members and non members of the accounting profession . The limited binding nature of members leads to the variations in practice . pronouncements likely may not have strict rules or legal forces and guidelines . Pronouncements are still important as they provide

guidance, establish expectations and contribute to a consistent framework for professionals, resulting even if the nature is limited, pronouncements are still significant. The role of certified public accountant was to ensure the accuracy and reliability of financial statements. In the early days of public accounting there was a lack of standardized guidelines which led to inconsistencies in auditing practices. History of public accounting in the United States .
Indefeasibility of a standard audit program
The focus of auditing has transformed to reliability of earnings. Auditors need flexibility to adapt their procedures to specific situations. They record the revenue and expenses when the transaction occurs, not when the cash is received or paid. The value of opening inventory remains the same throughout the year, until the year adjustments are made.

2. Primary Issues Related to Auditing Practices :

Absence of Uniformity : There was no internationally agreed set of accounting standards, principles and procedures.

Selective Enforcement : It was difficult to compare financial statements because accounting principles were often applied inconsistently.

Data Restriction: Due to limited transparency in financial reporting, the facts were ceased in a meaningful manner.

Subjectivity in Auditing : The scope of audit procedures was often determined based on personal opinions, leading to potential variations in the quality of audits.

1. Accounting Scandals:

Accounting scandals throughout the 1900s

Royal Mail Steam Packet Company : This is a significant event in the United Kingdom often associated with corporate fraud in 1931. Harold John Morland was in charge of the audit firm. The company's chairman, Lord Kylsant, had been involved in fraudulent activity, issued misleading financial statements and overstated the company's profits. His motive was to maintain investor

confidence and to support the company's share price. Lord Kylsant and the company's auditor were charged with issuing a false balance sheet and fraud, and was sentenced to a year in prison. [Robb, G. (1992). *White-collar crime in modern England: Financial fraud and business morality, 1845-1929.*]

1. Yale Express System : In 1965 the Yale Express system was involved in a major scandal due to overstated net worth and failed to indicate net operating loss which highlights the issues related to corporate governance and financial fraud. The executives of Yale Express had been falsifying financial statements to cover up the financial difficulties. In conclusion it misled investors and creditors about its true financial health. [Weis, M. (1968). *Financial scandals in corporate America: The Yale Express case. Corporate History Review*, 5(2), 101-118.]

2. Fred Stern & Company : In 1925 the United States based company was found guilty to have committed massive financial fraud. The audit firm which was responsible for the shortcomings in the auditing practices were Touche, Niven & Co. The auditors were held responsible and criticized for failing to detect fraud. The fraud was uncovered when the company collapsed, leading to significant losses for creditors and investors. The case gained widespread attention due to the involvement of a prominent accounting firm. [Chatfield, M. (1977). *A History of Accounting Thought*. Krieger Publishing Company.]

3. Interstate Hosiery Mills : Interstate Hosiery Mills was a textile company operating in the United States. In 1903s the company was under financial strain, and in 1937, it became the center of scandal due to fraudulent activities and financial misrepresentation. The management of Interstate Hosiery Mills had been engaged in inflated sales and profits, misstated assets and liabilities, concealment and losses. The executives responsible for the fraudulent activities were prosecuted. It was one of the lasting impacts on the accounting and auditing professions. The case also influenced subsequent regulatory changes aimed at improving the reliability of financial statements and the

effectiveness of audits .[Carmichael, D. R., & Willingham, J. J. (1966). *Auditing Concepts and Standards*. McGraw-Hill.]

Bankers Trust 1988 :In terms of derivatives trading and ethical practices within financial institutions the scandal involving Bankers Trust in 1988 is a significant scandal . The company was a well known American bank for its expertise in derivatives trading , involving financial contracts whose value is derived from the performance of underlying assets like stocks, bonds ,or interest rates . The scandal was Hid an \$80 million mispricing of derivatives contributing to profits by cutting bonuses . The controversy primarily involved bank’s dealings with large corporate clients . When the scandal came to light leading to a series of legal battles between bankers' trust and its clients .[Partnoy, F. (2003). *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets*. Times Book

Recommendations

The study suggests several important recommendations to improve auditing practices and ensure better financial transparency and reliability. Firstly, organizations should implement strong internal control systems to ensure accuracy in financial reporting and reduce the risk of fraud, especially in areas like cash handling, where proper procedures such as bank deposits and controlled payments should be followed. Secondly, there is a need to establish uniform and standardized accounting and auditing practices across industries to improve consistency and comparability of financial statements. Thirdly, professional training and certification programs for auditors should be strengthened to enhance their skills, knowledge, and ethical standards. Additionally, companies should be required to follow mandatory financial disclosure norms, ensuring that all relevant financial information is presented clearly and regularly to stakeholders. Another important suggestion is the regular review and updating of provisions such as bad debt reserves to reflect the true financial position of the organization. Overall, these recommendations aim to strengthen auditing systems, improve accountability, and build greater trust among investors and stakeholders.

Conclusion

The study of auditing standards in the 1900s clearly shows how the auditing profession evolved from a simple system focused mainly on detecting fraud and errors to a more structured and reliable process aimed at ensuring the accuracy and credibility of financial statements. In the early years, the absence of uniform standards, weak regulations, and limited auditor independence led to inconsistencies and several financial scandals. However, over time, the introduction of professional standards, legal frameworks, and improved auditing techniques helped strengthen the role of auditors and increased trust in financial reporting. Technological advancements, especially the introduction of computers, further transformed auditing practices by making them more efficient and data-driven. The case study analysis also highlights how practical auditing procedures were applied and how they contributed to improving financial accuracy. Overall, the development of auditing standards in the 1900s reflects continuous learning from past mistakes and adapting to changing business environments. Although modern auditing practices are much stronger today, the need for maintaining auditor independence, ethical behavior, and strong internal controls remains essential to ensure transparency, accountability, and confidence among stakeholders.

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