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Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
270 Madison Avenue, New York 16, N.Y.

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No. 25
October 1954

Events Subsequent to the Date of Financial Statements

1. In recent years there has developed an increasing interest in exploring and clarifying the extent of the auditor's responsibility in connection with the disclosure of events occurring or becoming known subsequent to the date of statements concerning which he is expressing an opinion. This interest may be traced to specific happenings in part, but probably rests to a large extent on the general recognition that some such events may have a material effect on the related financial statements and may require disclosure or adjustment to prevent such statements from being misleading.

2. An auditor's report is ordinarily rendered in connection with financial statements which purport to show, on an accounting basis, financial position as at a stated date and results of operations for a period ended on that date. Although such financial statements may be used for subsequent guidance, they are essentially historical in character. Financial statements as of a given date and for a period ended on that date represent one instalment in the financial history of a business enterprise. They are so considered by the auditor in making his examination and in expressing his opinion with regard to the statements.

3. However, events or transactions, either extraordinary in character or of unusual importance, sometimes occur subsequent to the balance-sheet date which may have a material effect on the financial statements or which may be important in connection with consideration of the statements. Such events or transactions may require adjustment or annotation of the statements. Any such adjustment or annotation becomes a part of the financial statements.

4. This statement is intended to relate principally to auditors' responsibilities and to their examinations and opinions regarding financial statements for use in annual or other periodic reports. No discussion is included of the so-called "special purpose" type of reports because the variety of them is so great that general comments would be inapplicable in many cases, and the requirements can more appropriately be determined from the purpose of each report.

THE PROBLEM

5. There is general agreement (a) that some events occurring subsequent to the balance-sheet date may require adjustment or annotation of the financial statements, and (b) that a considerable portion of the auditor's examination must necessarily take place after the balance-sheet date. The problem with which this discussion is concerned is the extent to which the auditor has a responsibility to determine whether such an event has occurred.

CONCLUSION

6. The committee concludes that the auditor has no duty to extend the usual audit procedures to cover transactions of the subsequent period, as such, but recognizes that a well conceived audit program relating to the period under examination will include

(a) certain steps which ordinarily are carried out after the balance-sheet date (such as cash cut-offs, review of subsequent collections, confirmation follow-ups, etc.), and

(b) certain general procedures which are designed to support an informed opinion on the financial statements (such as reading available minutes and interim reports, discussions with management, etc.) which normally are continued throughout the auditor's examination.

7. These procedures vary with circumstances, including the degree of internal control exercised by the client, but are partly outlined below, and include recognized steps, application of which should acquaint the auditor with the events as to which he can be chargeable with a duty to have knowledge. The auditor's responsibility for reporting is outlined beginning on page 6.

TYPES OF "SUBSEQUENT" EVENTS OR TRANSACTIONS

8. In general, there are three types of subsequent events or transactions which are encountered in the period into which certain of the audit procedures extend.

9. Subsequent events of the first type affect directly the financial statements and should be recognized therein. Thus, if subsequent information is acquired in time to permit its use, if the information provides a basis for more accurate estimates or provisions, and if the information would have been utilized had it been available at the balance-sheet date, appropriate adjustments should be made in the financial statements. Examples are collection of receivables or settle-

ment or determination of liabilities on a substantially different basis than previously anticipated.

10. Subsequent events of the second type have no direct effect on and therefore do not require adjustment of the financial statements of the prior period but their effects may be such that disclosure is advisable. Examples of this type of transaction or event are the sale of a large bond or capital stock issue with restrictive covenants, mergers or acquistions, or serious damage from fire, flood or other casualty.

11. Subsequent events of the third type, sometimes more troublesome from the accounting viewpoint than the others, and usually not likely to require disclosure in financial statements, include non-accounting matters such as war, management changes, product changes, strikes, unionization, marketing agreements, loss of important customers, etc. Disclosure of such events frequently creates doubt as to the reason therefor, and inferences drawn could be misleading as often as they are informative. Obviously, also, it is not necessary to include in financial statements information as to general conditions, the impact of which on a business may be conjectural or subject to individual interpretation. In practice, accounting and non-accounting events are often not entirely separate and apart from each other; and in rare and special cases general conditions may have weighty effects on particular companies. Accordingly, effort should be made to distinguish between post-balance-sheet events of the third type as to which information might appropriately be presented in financial statements, and those which do not bear such relation to earlier-dated financial statements as to require adjustment or annotation therein.

12. It has been suggested that there may be a tendency to disclose in the financial statements subsequent events which are material in themselves, and of interest, but which are not directly related to the period covered by the financial statements under examination, or pertinent to any consideration of the financial position at the close of such period. The committee believes that the auditor should consider such events critically and confine disclosure to those matters essential to proper interpretation of the financial statements being presented.

CLIENT'S PRIMARY RESPONSIBILITY FOR FINANCIAL STATEMENTS

13. The following is set forth on page 12 of the *Codification of Statements on Auditing Procedure:*

> "Management has the direct responsibility for maintenance of an adequate and effective system of accounts, for proper recording of transactions in the books of account, and for safeguarding the assets. It is also charged with the primary responsibility to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations. The transactions with which the accounting records have to do and the recording of those transactions in the books and accounts are matters within the direct or primary knowledge of the company; the independent auditor's knowledge of them is a secondary one, based on his examination. Accordingly even though the *form* of the statements may show the influence of the accountant—it can only do so if the company accepts, and adopts, the form of disclosure advised by the accountant—the *substance* of the financial statements of necessity constitutes the representations of the company. The independent auditor's representations, therefore, are confined to and expressed in his report, or opinion, upon the statements. The pronouncements of the Institute to this effect have been given the added weight of general affirmation by the Securities and Exchange Commission."

14. The primary responsibility for the financial statements, and accordingly for any adjustment or annotation because of post-bal-

ance-sheet events, is that of the entity or person whose financial statements are under consideration, ordinarily the auditor's client. Information of such post-balance-sheet events and transactions as are here under consideration would in nearly all cases be received by members of the client's organization before it would be received by the auditor.

THE AUDITOR'S RESPONSIBILITY FOR REPORTING

15. The auditor's responsibility for reporting with regard to post-balance-sheet events or transactions, while not the subject of specific reference, is indicated by the following quotation from the special report on auditing standards, issued by this committee in 1947, and approved by the American Institute of Accountants in 1948:

> "Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

It is generally agreed that, to the extent the auditor has knowledge of post-balance-sheet events or transactions which may be significant in relation to specific financial statements, it is his duty either:

(a) To see that they are properly considered and, when deemed appropriate, given effect by adjustment or annotation of the statements; or

(b) If, in his opinion, there is, in the financial statements, significant lack of compliance with any of the points covered in (a) above, to qualify his report or present therein appropriate information, depending upon the circumstances.

AUDITING PROCEDURES WHICH EXTEND INTO THE SUBSEQUENT PERIOD

16. The committee believes that the auditor does not ordinarily have responsibility for extending the usual auditing procedures to transactions of any specified period of time subsequent to the balance-sheet date. It is recognized, however, that generally accepted auditing procedure usually calls for reading available minutes of meetings and interim company statements, also some examination or tests of such items as bank statements, returned checks, accounts receivable collections, subsequent sales of inventory, returns and allowances, etc., of a limited subsequent period, and that the auditor should follow such practices where appropriate as a part of his examination of statements and accounts as of the balance-sheet date. Accepted practice also includes appropriate inquiry of management as to whether any event or transaction has occurred after the balance-sheet date which is material in relation to the financial statements. It may also include any other follow up where the status of items included in or excluded from financial statements gave effect to tentative data, final corroboration of which could be sought in the period available to the auditor. These audit steps are illustrative, and although usually appropriate are not always mandatory, or all-inclusive.

17. The committee wishes to emphasize that there is no predetermined period, after the balance-sheet date, with which the auditor must be concerned in completing various phases of his examination. Obviously, the duration of this period will depend upon the practical requirements of each examination and may vary from a relatively short period to one of several months. It should also be recognized that all audit procedures are not carried out at the same time and that some phases of an examination of necessity will extend in varying degrees to transactions of the subsequent period whereas

others will be substantially completed on or before the balance-sheet date. Similarly, the auditor's contact and familiarity with transactions of the subsequent period ordinarily will be progressively less as he approaches completion of the various audit procedures which do extend into the subsequent period.

DETERMINATION OF THE "SUBSEQUENT PERIOD"

18. In general, the period of occurrence of post-balance-sheet events under consideration herein extends from the balance-sheet date to approximately the date of completion of all important audit procedures. The committee recommends that this date normally be used as the date of the auditor's report. In most cases this date will coincide with the completion of the work in the client's office.

19. There are many reasons why the report may not be issued as soon as all important audit procedures are completed. Some delays originate with the client and some with the auditor. Also, it appears that there is presently considerable variation in the practice of dating reports under such circumstances. The committee's recommendation as to dating would increase the significance of the date of the auditor's report, but the committee believes no uniform practice can be assumed by readers at the present time.

20. In those cases in which the auditor's report is dated substantially later than the date of completion of all important audit procedures, the auditor may think it wise to state that his report is based on an examination which was completed at an earlier date. On the other hand, he may find it practicable and consider it preferable to continue inquiry (but not examination) up to the date of his report and avoid the necessity of a special comment as to the date.

SPECIAL SITUATIONS

21. In keeping with the tenor of the comments herein, and in order to reconcile the views expressed with recurring problems or questions which arise in the everyday practice of the independent certified public accountant, the following opinions of the committee relate to the subject of post-balance-sheet events in the specific situations described:

I. Opinion Accompanying Financial Statements Forming Part of Form 10-K Filed with the Securities and Exchange Commission

22. Frequently, a company's annual report on Form 10-K is prepared for filing after an interval has elapsed since issuance of a printed annual report to stockholders. Sometimes the independent auditor finds it necessary to return to a client's office for additional work in connection with checking financial statements and schedules in the Form 10-K and sometimes such financial statements are prepared entirely or checked from information initially obtained during the regular audit. Inquiry indicates that most firms of independent accountants date their opinion as of the same date as that on the opinion included in the printed annual report to stockholders. The committee approves this dating practice and recommends general observance. This is for the purpose of removing any implication that events of a later period may have been reviewed.

23. It is the opinion of the committee that no duty rests upon the independent accountant to make a further investigation or inquiry as to events which may have occurred between the times of issuance of his opinion in the printed report to stockholders and the annual report on Form 10-K.

II. Long-form Report Submitted Subsequent to Issuance of Short-form Report

24. Frequently, the independent accountant will submit a standard short-form report for use as a part of an annual report to stockholders or for credit purposes or for any appropriate reason, but by agreement or understanding with his client a detailed auditor's report or "long-form" report follows. In the long-form report the financial statements may contain more detail than those accompanying the previously issued short-form report, and schedules may support the basic financial statements. The comments may contain tabulations and detail equivalent to that contained in some sub-statements or schedules. This report is sometimes prepared at the client's office a considerable period subsequent to the issuance of the short-form report and is sometimes prepared in the independent accountant's office from data obtained during the examination which was the basis for the issuance of the short-form report or opinion. It is the practice of many accountants to give the long-form report a date the same as the date of the short-form report for the purpose of removing any intimation that further audit work has been done. In some cases the report is dated at the time of issuance and bears such date with the added words "as of (date)," which latter date is the date of the first delivered report or opinion.

25. It is the opinion of the committee that observance of these dating practices is wise, or that the comments in the report should contain reference to the issuance of the earlier dated short-form report with proper notation that the subsequent report is based on the work then performed. It is the opinion of the committee, however, that the independent accountant has no duty to make further investigation or inquiry as to events which may have occurred during

the period between the times of issuance of his two reports provided the second report does not contain any indication of such subsequent examination.

III. Issuance of Additional Copies of Reports or Opinions Previously Furnished

26. For various reasons, it is not unusual that an independent accountant is requested by his client to furnish additional copies of a previously issued report. Generally, an effort will be made by the accountant to have these reports identical in appearance and identical as to date and therefore in the same condition as if the additional copies had been initially requested and furnished at the same time as the first copies were delivered.

27. It is the opinion of the committee that additional report copies may be delivered under such circumstances without further investigation or inquiry as to events which may have occurred between the date of issuance of the initial report and the request for additional copies.

28. In some unusual cases, it may be undesirable to deliver fresh copies of a report, such as where a radical change has occurred in the circumstances of a company's existence which has come to the attention of the auditor subsequent to the issuance of the original report. However, in such cases it may be appropriate to issue a revised report stating that it is currently submitted under the circumstances or conditions existing at the time of first issuance but with an accompanying disclosure relating to the change.

SPECIAL REQUIREMENTS UNDER SECURITIES ACT OF 1933

29. The committee believes that attention should be directed to special problems resulting from timing and availability of recorded financial information, which arise in connection with reports included in registration statements filed under the Securities Act of 1933.

30. Section 11 of the Act provides that, other than the issuer, no person shall be liable as provided therein if such person shall sustain the burden of proof that as to the part of the registration statement purporting to be made on his authority as an expert,

> "he had, *after reasonable investigation,* reasonable ground to believe and did believe, *at the time such part of the registration statement became effective,* that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading". (emphasis supplied)

Section 11 further provides that in determining what constitutes reasonable investigation and reasonable ground for belief,

> "the standard of reasonableness shall be that required of a prudent man in the management of his own property."

31. In discussing such key phrases as "after reasonable investigation" and "at the time such part of the registration statement became effective" it is not the intention of this committee to offer a legal interpretation of these statutory terms. Until the courts have interpreted such terms it can proceed only in accordance with its understanding of their meaning in accordance with accounting and auditing standards and procedures. Accordingly, the opinion of the members of this committee is here submitted on these matters subject to any judicial interpretation which may issue in the course of time.

32. After a registration statement has been filed the processing may be delayed by administrative procedures. There may be other causes brought about by issuers or underwriters necessitating continued deferral of the effective date. It is obvious that the accountant may encounter serious problems in keeping currently informed as to the happening of any extraordinary transactions or events bearing on the financial statements, and the procedures which may be involved would be unreasonably costly and impractical.

33. There are additional difficulties involved in keeping currently informed up to the time of the effective date by reason of the lack of recorded financial information during the period immediately preceding the effective date. Depending on the size of the company and the complexity of its operations this period of time may be substantial.

34. The committee therefore is of the opinion that a "reasonable investigation" (a) as to point of time, should be construed as referring to a period ending sufficiently prior to the actual effective date as is consistent with the practical availability of financial information, etc., and (b) as to procedures, should comprise the following:

1) The reading of available minutes of meetings of stockholders, directors, and finance or executive committees, as applicable.

2) Reading of such available interim financial statements as are regularly prepared by the client.

3) The reading of the full text of the prospectus and review of pertinent portions of the rest of the registration statement.

4) Inquiry of one or more officers or key employees and of legal

counsel, where appropriate, as to happenings which may be considered material in relation to the financial statements reported upon by the auditor and included in the registration statement. Such happenings, or the absence thereof, should be the subject of written representations.

5) Any other steps which the auditor deems necessary for a "reasonable investigation" under the particular circumstances.

35. It is obvious that the responsibility for the disclosure of post-balance-sheet events must, as a practical and reasonable matter, decrease following the close of the field work and that subsequent to that time the accountant must rely, for the most part, on inquiries of officers and key employees. In the case of an issuer with multiple offices and wide-spread operations, the officers and employees would be those at the home office level.

Two or More Independent Accountants Whose Opinions Are Related to Different Periods

36. It is not unusual for the "summary of earnings" or for some of the financial statements and schedules to cover periods which have been examined by more than one firm of independent accountants. Where a company has changed its independent accountants the report or opinion of the last one engaged will relate to the "summary of earnings" and to the financial statements and schedules for such years as have been covered by his examination. The previous independent accountant will submit an opinion covering the "summary of earnings" or the financial statements and schedules for any period for which he was the independent accountant.

37. Material charges and credits sometimes appear in statements of income and surplus for the period subsequent to the date of termination of services by the independent accountant whose report or opinion applies to the period to which such subsequent charges or credits relate. Examples might be in connection with recognition of additional Federal taxes for a prior period or income or expense in connection with litigation not settled until the subsequent period.

38. The committee is of the opinion that when the independent accountant whose opinion is to be submitted in respect to statements for previous years furnishes such opinion he should have available the full text of the registration statement and prospectus in which his opinion will appear so that he can read or review (as suggested in paragraph 34(b)(3) above) anything included therein which apparently relates to his period. The committee is of the opinion that no duty rests upon the independent accountant for such earlier period to make any subsequent examination or review other than the suggested reference to the documents it is proposed to file or from such assurances as he may request from the registrant or its current accountants.

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Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
270 Madison Avenue, New York 16, N.Y.
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No. 26
April 1956

Reporting on Use of "Other Procedures"

1. In 1939 the membership of the Institute approved the extension of auditing procedures to require observation of inventories and confirmation of receivables where either of these assets represents a significant proportion of the current assets or of the total assets of a concern.

2. These procedures were thus established as an integral part of generally accepted auditing procedures. Failure to apply them, where they are practicable and reasonable, in general precludes expression of an opinion on the fairness of the financial statements taken as a whole.

3. *Codification of Statements on Auditing Procedure* states (third and fourth paragraphs on page 21):

> "In all cases in which the extended procedures are not carried out with respect to inventories or receivables at the end of the period or year, and they are a material factor, the independent certified public accountant should disclose, in the general scope section of his report, whether short or long form, the omission of the procedures, regardless of whether or not they are practicable and reasonable and even though he may have satisfied himself by other methods.
>
> "In the rare situation in which they are applicable and are not used and other procedures can be employed which will enable him to express an opinion, he should, if the inventories or receivables are material in amount, disclose the omission of the procedures in the general scope paragraph without any qualification in the opinion paragraph with respect to such omission. In deciding upon the 'other procedures' to be employed he must bear in mind that he has the burden of justifying the opinion expressed."

4. It has become increasingly evident in those instances where the accountant's report has disclosed omission of the extended procedures that, in the minds of a number of interested parties, including

important groups of credit grantors, uncertainty often exists as to whether or not the accountant did actually undertake other auditing procedures.

5. Accordingly, it is the view of the committee that, *in all cases* in which the extended procedures are not carried out with respect to inventories or receivables as at the end of the period or year[1] and they are a material factor, the independent certified public accountant should not only disclose, in the general scope section of his report, whether short or long form, the omission of the procedures, regardless of whether or not they are practicable and reasonable, but also should state that he has satisfied himself by means of other auditing procedures if he intends to express an unqualified opinion. The second sentence of the scope paragraph of the independent auditor's report will then read somewhat as follows:

> "Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances; however, it was not practicable to confirm receivables (to observe the physical inventory taking), as to which we have satisfied ourselves by means of other auditing procedures."

In these circumstances, no exception would be required in the opinion section of the report.

6. *Codification of Statements on Auditing Procedure* points out that 'other procedures" can be satisfactorily employed only in *rare* situations in which the "extended procedures" are applicable and are not used. It is not the intention of the committee to withdraw in any way from its previous conclusion in this respect.

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1 Under appropriate circumstances, the procedures may be carried out at times other than at the end of the period or year.

COMMITTEE ON AUDITING PROCEDURE (1955-1956)

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Statements on Auditing Procedure

No. 27

July 1957

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Issued by the
Committee on Auditing Procedure,
American Institute of
Certified Public Accountants,
270 Madison Avenue New York 16, N. Y.

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Long-Form Reports

INTRODUCTION

1. In 1949, the membership of the Institute approved Statements on Auditing Procedure No. 23, entitled *Clarification of Accountant's Report When Opinion Is Omitted.* This action added a new auditing standard to those approved by the Institute membership in 1948. Accordingly, the substance of this statement was incorporated in the 1954 revised edition of *Generally Accepted Auditing Standards,* being stated therein as the fourth standard of reporting in the following manner:

> "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 should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking."

2. Much of the material comprising the *Codification of Statements on Auditing Procedure* and *Generally Accepted Auditing Standards* has been written in terms of reference to the so-called short-form of auditor's report, which has become generally considered to constitute the basic content for auditors' reports on financial statements. In many instances, however, this same material refers to the application of these standards and procedures to the more detailed forms of reports.

3. While the accounting profession has generally adopted the short-form report in connection with financial statements intended for publication, it is recognized that independent certified public accountants issue a substantial volume of so-called long-form reports on financial statements. These reports include greater details of the customary basic financial statements, statistical data, explanatory comments, and sometimes description of the scope of the auditor's examination beyond that which normally appears in the short-form reports. In some cases, both a long-form report and a short-form report are issued on the same engagement, but in many cases the long-form report constitutes the only report issued by the auditor. The committee believes that long-form reports often serve a valuable purpose in meeting the requirements of management and others, and accordingly it encourages the continued issuance of such reports, where appropriate.

4. For purposes of discussion, the financial and statistical material normally included in long-form reports is classified in the following categories:

(a) Basic financial statements (balance sheet and statements of income, retained earnings and capital).

(b) Financial data representing details of the basic financial statements.

(c) Statistical data and informative material, some of which may be of a non-accounting nature.

APPLICATION OF STANDARDS OF REPORTING

Current Year's Data

5. The committee believes that the basic concept "the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking," is applicable to both short-form and long-form reports. A study of current long-form report practices discloses that in many cases the usual short-form type of auditor's opinion is used, specifically covering the current year's basic financial statements, but without specific reference to the other data in the report. As a result of this practice, no distinction is made between data covered by the auditor's examination and data which may not have been examined by him, which may lead to an inference that he is assuming more responsibility than is his intention. This practice has also been questioned as to whether it is consistent with the concept of setting forth "a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking" with respect to the data described under items (b) and (c) of paragraph 4 above.

6. It is the opinion of the committee that, in the absence of a statement by the auditor to the contrary, it may be presumed that he assumes responsibility for such other data in the long-form report, to the same degree that he does for individual items in the basic financial statements; that is, that they are fairly stated in all material respects in relation to the basic financial statements, taken as a whole.

7. The committee believes that in some instances the auditor may wish to clarify his position in the foregoing respects by a brief statement in his comments, or as a preface to a separate section of the report which includes the other data, explaining:

(a) That the auditor's examination has been made primarily for the purpose of formulating his opinion on the current year's basic financial statements, taken as a whole,

(b) That the other data included in the report, although not considered necessary for a fair presentation of the financial position and results of operations, are presented primarily for supplementary analysis purposes, and either (1) that they have been subjected to the audit procedures applied in the examination of the basic financial statements and are, in his opinion, fairly stated in all material respects in relation to the basic financial statements, taken as a whole, or (2) that they have not been subjected to the audit procedures applied in the examination of the basic financial statements, stating the source of information and the extent of his examination and responsibility assumed, if any.

Some auditors follow the practice of indicating the extent of their examination and the responsibility they are assuming, if any, with respect to the detailed financial schedules and other data in long-form reports by footnotes on the various schedules or exhibits. Regardless of the method of presentation, the committee emphasizes the necessity of maintaining a clear-cut distinction between the management's representations and the auditor's representations.

Prior Year's Data

8. In the usual case where basic financial statements and details thereof for the prior year are presented primarily for comparative purposes (in either long-form or short-form reports), the committee believes that the auditor need not extend his opinion to cover the prior year's figures. Where the auditor has made an examination for the prior year, he may prefer to so state (for example, by an addition to the standard scope paragraph disclosing that he has previously examined and reported on the prior year's financial statements). Where the auditor has not made an examination of the prior year's figures, or where he presently has significant exceptions or reservations as to the prior year's figures, he should ordinarily make appropriate disclosure to that effect.

OTHER LONG-FORM REPORTING PROBLEMS

9. The committee believes it advisable to focus the profession's critical attention on two additional questions relating to long-form report practices:

(1) Where a long-form report is co-existing with a conventional short-form report,

(a) Does the long-form report contain data which, if omitted from the short-form report, might support a contention that the short-form report was misleading because of inadequate disclosure of material facts known to the auditor?, and

(b) Do any of the comments or other data contained in the long-form report lend themselves to a contention that they constitute exceptions or reservations, as distinguished from mere explanations?

(2) Does the long-form report, taken by itself, contain other financial data in such form as to support a contention that the auditor has made *factual* representations with respect to the financial statements or books of account rather than expressed an *opinion* on financial data consisting of management representations?

10. In connection with the first of the above questions, the auditor should recognize that, with both the long-form and short-form reports in hand, the reader may reasonably assume that the other financial data and textual comment in the long-form report are sufficiently relevant and significant to warrant their inclusion therein but that their omission from the short-form report does not result in inadequate disclosures in that report. It should be noted further that the report reader in this case may have the benefit of hindsight in appraising the auditor's exercise of judgment in the disclosures deemed material to a fair presentation and understanding of the financial statements included in the short-form report. The committee believes

that the profession should be continually alert to the possible problems inherent in the issuance of co-existing short-form and long-form reports. Care should be exercised to differentiate between the basic financial statements and the explanatory details and other informative data included in long-form reports, and to avoid any implications that the latter materials are necessary to a fair presentation of the financial position and results of operations.

11. Regarding the second question, the concept of management's basic responsibility for financial statements and of the auditor's representations being confined to his opinion on such statements has become firmly established since the general adoption of the conventional short-form report. Under this concept, the independent certified public accountant is expressing his professional opinion and is not "certifying" to facts true to his own knowledge. The committee believes that this same basic concept underlies the long-form report and directs the attention of each practitioner to the need for careful preparation of long-form reports in a manner that makes it clear that he is expressing therein the same type of professional opinion as in short-form reports.

COMMITTEE ON AUDITING PROCEDURE (1956-1957)

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Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of
Certified Public Accountants
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No. 28

October 1957

Special Reports

(Applicability of Reporting Standards in Special Circumstances)

INTRODUCTION

1. The independent certified public accountant has long had authoritative literature and accepted practice to guide him in that part of his work which has to do with reporting on the more usual types of financial statements of corporate business enterprises organized for profit. When he has undertaken to report on matters outside that category, he has had little besides his own experience and judgment to guide him, since the profession has not clarified the applicability of generally accepted auditing standards in such circumstances.

2. The purposes of this statement are:
   a. To provide a basis for differentiating between reports for which the wording of the usual short-form opinion or certificate (whether used in a short-form or long-form report) is appropriate and reports for which special wording in the opinion or certificate seems to be necessary. These latter reports are generally referred to hereinafter as "special reports."
   b. To clarify the applicability of generally accepted auditing standards to such special reports.

TYPES OF SPECIAL REPORTING CIRCUMSTANCES

3. Special reports (see paragraph 2a.) may include:
   a. Reports on financial statements of organizations which maintain their accounts and prepare their statements on a cash or other incomplete basis of accounting which is materially at variance with accounting practices customarily followed in preparing accrual basis statements. These organizations may include some organized for profit, particularly those carried on by individuals and partnerships, as well as some nonprofit organizations.
   b. Reports on financial statements of some nonprofit organizations which follow accounting practices differing in some respects from those followed by business enterprises organized for profit. These organizations may include municipalities, hospitals, cooperatives, and educational institutions.
   c. Reports prepared for limited purposes, such as:
      (1) Reports that relate only to certain aspects of financial statements. These reports may include reports, sometimes in letter form, relating to special studies, to compliance with certain provisions of bond indentures, or to the determination of the amounts of rentals, royalties, profit-sharing bonuses and the like.
      (2) Reports that are filed with various agencies on prescribed forms which provide a uniform statement presentation, in some cases with a preworded opinion or authentication. These reports may include reports prepared for filing with various governmental authorities or with credit and similar agencies.

4. Compliance by financial institutions, insurance companies, railroads, and the like, with accounting practices prescribed by a regulatory authority may create reporting problems; however, the committee, for the present, is not dealing with the usual reports on financial statements of regulated companies and this statement is not intended to apply to them or to alter any previous pronouncements applicable to them. Nor is this statement intended to apply to reporting problems relating to tax returns or to management service reports.

APPLICABILITY OF GENERALLY ACCEPTED AUDITING STANDARDS

5. The wording of the usual short-form opinion or certificate on examination of financial statements (whether included in a short-form or long-form report) is designed for an expression of opinion on the fairness with which such statements present financial position and results of operations. While no precise definition of the term financial statements has been made by the committee, it is quite clear that the term as used in the pamphlet *Generally Accepted Auditing Standards,* as well as in Statement on Auditing Procedure No. 27, *Long-Form Reports,* refers to financial statements which purport to show financial position and results of operations; such financial statements usually consist of a balance sheet and statements of income, retained earnings, and capital.

6. *Generally Accepted Auditing Standards* characterizes the term generally accepted auditing standards as used in auditors' reports on financial statements in such a way as to include (a) general standards, (b) standards of field work, and (c) standards of reporting. It is the opinion of the committee that, to the extent appropriate in view of the character of the engagement, the substance of the general standards and of the standards of field work applies to engagements involving special reports.

7. The four standards of reporting require (1) an opinion as to conformity of financial statements with generally accepted principles of accounting, (2) an opinion as to the consistency with which these principles have been observed, (3) adequate informative disclosures, and (4) an expression of opinion regarding the financial statements taken as a whole, or a statement to the effect that an opinion cannot be expressed, together with the reasons therefor, and, in all cases, a clear-cut indication of the character of the auditor's examination, if any, and of the degree of responsibility he is taking.

8. Although there may be occasions when it is appropriate for the auditor to report upon conformity with generally accepted accounting principles of incomplete financial presentations, such as in reports upon

compliance with certain provisions of bond indentures, the committee is of the opinion that the requirement of the first standard of reporting does not apply to statements which do not purport to set forth financial position and results of operations. Statements prepared on the basis of cash receipts and disbursements, for example, usually do not purport to present financial position or results of operations. In reporting on statements which do not so purport the auditor should make sure that it is clearly stated what they do purport to present and the basis on which they have been prepared. He should express his opinion as to whether or not the statements fairly present the data on the basis indicated. The committee believes it to be generally preferable in these circumstances to avoid the use of the terms "balance sheet," "income statement," or similar titles with respect to such statements; notwithstanding this preference, the committee recognizes the long-established acceptance of these terms and accordingly feels that it should not, at this time, do more than express its preference.

9. In reporting on statements prepared on a cash basis (or substantially so) which nevertheless may appear to present financial position and results of operations, disclosure should ordinarily be made in the statements or their footnotes or, less preferably, in the auditor's report, (a) of the fact that the statements have been prepared on the basis of cash receipts and disbursements and (b) of the general nature of any material items omitted (such as accounts receivable and accounts payable) and, where practicable, of the net effect of such omissions on the statements. The auditor's opinion might then be worded somewhat as follows:

> "In our opinion, the accompanying statements present fairly the assets and liabilities of the XYZ Company, at December 31, 19___, arising from cash transactions, and the revenues collected and expenses disbursed by it (and changes in proprietary interest, fund balances, etc., where reflected in cash basis statements) during the year then ended, on a basis consistent with that of the preceding year."

Notwithstanding the foregoing, where the auditor thinks that misleading inferences may still be drawn from the statements, he should include an explanation in his report that the statements do not present financial position and results of operations.

10. In reporting on statements prepared on a modified accrual basis of accounting, which nevertheless usually purport to present financial position and results of operations, the auditor may consider the resulting statements to be materially incomplete or to have been prepared in accordance with accounting practices materially at variance with those customarily followed in preparing accrual basis statements. In such cases it is desirable to disclose the nature and amounts of the major items involved and, in his report, to state an exception or explain clearly why he is unable to express the usual opinion on the fairness of presentation of financial position and results of operations.

11. If the statements are those of a nonprofit organization they may reflect accounting practices differing in some respects from those followed by business enterprises organized for profit. It is recognized that in many cases generally accepted accounting principles applicable to nonprofit organizations have not been as clearly defined as have those applicable to business enterprises organized for profit. In those areas where the auditor believes generally accepted accounting principles have been clearly defined (as indicated by authoritative literature and accepted practice, etc.) he may state his opinion as to the conformity of the financial statements either with generally accepted accounting principles, or (alternatively, but less desirably) with accounting practices for nonprofit organizations in the particular field (e.g., hospitals, educational institutions, etc.), and in such circumstances he may refer to financial position and results of operations; in either event, it is assumed that the auditor is satisfied that the application of such accounting principles and practices results in a fair presentation of financial position and results of operations or that he will state his exceptions thereto. In those areas where the auditor believes generally accepted accounting principles have not been clearly defined, the other provisions of this statement apply.

12. When the report relates to statements which purport to present financial position or results of operations, the second standard of reporting as to consistency in the application of generally accepted accounting

principles is, of course, applicable. When the report relates to other matters, reference to consistency is frequently appropriate, depending upon the nature of the matter reported upon.

13. As to the third standard of reporting, adequate informative disclosures are, of course, required at all times. Where the auditor considers the basis on which the financial statements have been prepared to be inappropriate or unsuitable in the circumstances, appropriate disclosures should be made.

14. The fourth standard of reporting requires that the report shall contain either an expression of opinion, or an assertion to the effect that an opinion cannot be expressed and the reasons therefor. This standard also requires that the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking. At the time this standard was adopted the major concern was with statements purporting to show financial position or results of operations. The requirements of this auditing standard, however, are, in the committee's opinion, applicable to special reports.

OTHER ASPECTS

15. Special reports in which incomplete financial presentations or no financial presentations are made (e.g., calculations of royalties, profit-sharing bonuses, rentals, etc.) should be drafted with a view to their special purpose and, accordingly, should state what information is presented, the basis on which it was prepared, and whether, in the auditor's opinion, it is presented fairly on that basis. As indicated in paragraph 8 there may be occasions when it is appropriate for the auditor to report upon conformity with generally accepted accounting principles of incomplete financial presentations; such occasions usually arise when there is interest in establishing that a part only of the financial statements is in conformity with generally accepted accounting principles, such as the determination of "working capital" under a bond indenture. There may be occasions, in reports containing an expression of an opinion on the fairness with which financial statements present financial position and results of operations, where the auditor also expresses an opinion as to

the adequacy or reasonableness of specific accounts, such as those for the allowance for doubtful accounts receivable or the liability for income taxes. The usual examination of financial statements is designed for the purpose of formulating an opinion with respect to financial statements taken as a whole and not necessarily with respect to specific accounts. Accordingly, it is generally undesirable for an auditor to render a separate opinion on a specific account, but where the situation is such that he considers it appropriate to do so, he should be cognizant of the added responsibility he may thereby be assuming and the possible necessity of extending the scope of his examination.

16. Statements prepared on printed forms designed by the authorities with which they are to be filed may require inappropriate classifications or other similar procedures that, in the auditor's opinion, do not fairly present the financial position or results of operations of the particular company filing the statements, even though they purport to do so. Also, such forms may involve the additional problem of conforming the preworded auditor's opinion or certificate to professional standards. Many of these forms are not acceptable to the independent certified public accountant because the desire for uniform financial presentation conflicts with fair presentation in the particular case, or the printed language of the auditor's opinion or certificate calls for assertions by him that are not part of his functions and responsibilities as an independent certified public accountant. Some forms can be made acceptable by typing in additional captions or wording; others can be made acceptable only by complete revision. Whenever the printed forms call upon the auditor to make an assertion which he believes he is not justified in making, he generally has no alternative but to reword them or to submit his separately typed report.

The statement entitled "Special Reports (Applicability of Reporting Standards in Special Circumstances)" was adopted unanimously by the twenty-one members of the committee, of whom one, Mr. Sprague, assented with qualification.

Mr. Sprague qualifies his assent because he believes the reporting problems referred to in paragraph 4 should have been outlined for clarification and that the statement should have included a discussion of the manner in which the auditor's opinion can meet the requirements of existing standards of reporting and also deal with the requirements of regulatory bodies.

COMMITTEE ON AUDITING PROCEDURE (1956-1957)

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No. 29
October 1958

Scope of the Independent Auditor's Review of Internal Control

1. The purpose of this statement is to clarify previous pronouncements relating to the scope of the independent auditor's review of internal control as it pertains to his examination leading to an expression of opinion on the fairness of financial statements. No attempt is made in this statement to consider the scope of reviews of internal control by the independent auditor for other purposes, such as special engagements involving systems surveys, revisions, etc.

BACKGROUND AND DISCUSSION

2. The standard short-form report[1] includes the following sentence:

> "Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

3. The generally accepted auditing standard relating to internal control is summarized in the standards of field work[2] as follows:

> "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."

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[1] Codification of Statements on Auditing Procedure, page 16.
[2] Generally Accepted Auditing Standards, page 13.

It is generally recognized that as a by-product of this study and evaluation, the independent auditor is frequently able to offer constructive suggestions to his client on ways in which internal control may be improved.

4. In practice, certain questions arise concerning the scope of the independent auditor's review of internal control because of the broad definition set forth in the Special Report on Internal Control issued by the committee on auditing procedure in 1949. The definition reads 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 definition possibly is broader than the meaning sometimes attributed to the term. It recognizes that a 'system' of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments. Such a system might include budgetary control, standard costs, periodic operating reports, statistical analyses and the dissemination thereof, a training program designed to aid personnel in meeting their responsibilities, and an internal audit staff to provide additional assurance to management as to the adequacy of its outlined procedures and the extent to which they are being effectively carried out. It properly comprehends activities in other fields as, for example, time and motion studies which are of an engineering nature, and use of quality controls through a system of inspection which fundamentally is a production function."

5. Internal control, in the broad sense, includes, therefore, controls which may be characterized as either accounting or administrative[3], as follows:

(a) Accounting controls comprise the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, the safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports

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[3] In one sense all controls may be characterized as "administrative," even the accounting controls. The division being made here is for the purpose of distinguishing the accounting controls, with which the independent auditor is primarily concerned, from all other controls.

from those concerned with operations or asset custody, physical controls over assets, and internal auditing.

(b) Administrative controls comprise the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls.

The extent to which organizational plans and control methods and procedures may be classified as accounting controls or administrative controls will, of course, vary in individual circumstances.

CONCLUSIONS

6. In the ordinary examination, the selection of auditing procedures, their timing, and the determination of the extent to which they should be followed will depend largely upon the auditor's judgment of the adequacy and effectiveness of the internal controls. This judgment is arrived at as the result of his study and evaluation (which may involve testing, observation, investigation and inquiry) of those internal controls which, in his opinion, influence the reliability of the financial records. In the course of his examination the auditor obtains appropriate knowledge of his client's organization and operations, on which he bases his selection of the internal control areas he proposes to evaluate. Accounting controls, as described in paragraph 5(a), generally bear directly and importantly on the reliability of financial records and would, therefore, require evaluation. Administrative controls, as described in paragraph 5(b), ordinarily relate only indirectly to the financial records and thus would not require evaluation. However, if the auditor believes that certain administrative controls, in a particular case, may have an important bearing on the reliability of the financial records, he should consider the need for evaluating such controls. For example, statistical records maintained by production, sales or other operating departments may be considered by the auditor as requiring evaluation in a particular instance.

7. The committee has considered whether the part of the definition of internal control concerning the safeguarding of assets and the auditing standard concerning study and evaluation of internal control, taken together, are inconsistent with the statement in the Codification[4] to the effect that, in the ordinary examination, the auditor does not assume responsibility for the detection of defalcations and other similar irregularities. The committee sees no conflict in this regard since the objective of the audit program (which is designed, in part, as a result of the evaluation of internal control) is to provide a basis for the expression of an opinion on the financial statements, taken as a whole, and not to detect defalcations or similar irregularities. In developing such a program, the auditor has a responsibility for evaluating internal controls designed to safeguard assets, and when such controls are weak or lacking his program should take this condition into consideration. This consideration might lead either to the extension of audit tests, or to the shifting of emphases or timing of the audit procedures; for example, counts, reconciliations, confirmations, or observations of certain assets (such as cash, receivables or inventories) might be made at the balance-sheet date rather than at an interim date.

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[4] Codification of Statements on Auditing Procedure, "Responsibilities and Functions of the Independent Auditor," pages 11-13.

COMMITTEE ON AUDITING PROCEDURE (1957-58)

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No. 30

September 1960

Responsibilities and Functions of the Independent Auditor in the Examination of Financial Statements

The purpose of this statement is to clarify that section of the Codification of Statements on Auditing Procedure *relating to the responsibilities and functions of the independent auditor in connection with his examination of financial statements. Since the issuance of the Codification in 1951, questions have been raised concerning the position taken therein regarding the responsibility of the independent auditor for the discovery of fraud (including defalcations and other similar irregularities), and concerning the proper course of conduct of the independent auditor when his examination discloses specific circumstances which arouse his suspicion as to the existence of fraud.*

The committee on auditing procedure believes that clarification is best accomplished by a restatement of the pertinent section of the Codification. Accordingly, the section of the Codification beginning on page 11 and ending at the top of page 13 is hereby revised as set forth in the following paragraphs:

Responsibilities and Functions of the Independent Auditor in the Examination of Financial Statements

1. The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness of their presentation. The report is the medium through which he expresses such opinion. This examination is made in accordance with generally

accepted auditing standards. Such standards require him to state in his report whether, in his opinion, the financial statements are presented in accordance with generally accepted principles of accounting and whether such principles have been consistently observed in the preparation of the financial statements of the current period in relation to those for the preceding period.

2. Management has the responsibility for the proper recording of transactions in books of account, for the safeguarding of assets, and for the substantial accuracy and adequacy of financial statements. The transactions which should be reflected in the accounts and in the financial statements are matters within the direct knowledge and control of management; the independent auditor's knowledge is limited to that acquired through his examination. Accordingly, even though the financial statements may show the influence of the independent auditor (for example, as a result of management's acceptance of his advice), the statements are the representations of management. The independent auditor's responsibility is confined to the expression of a professional opinion on the financial statements he has examined.

3. In the observance of generally accepted auditing standards, the independent auditor must exercise his judgment in determining the auditing procedures which are necessary in the circumstances to afford a reasonable basis for his opinion. His judgment is required to be the informed judgment of a qualified professional person.

4. The professional qualifications required of the independent auditor are those of a person trained and qualified to practice as such, but do not include those of a person trained for or engaged in another profession or occupation. For example, the independent auditor, in observing the taking of the physical inventory, does not purport to act as an appraiser, valuer, or expert in materials. Similarly, although the independent auditor is informed in a general manner about matters of commercial law, he does not purport to act in the capacity of a lawyer and is entitled to rely upon the advice of attorneys in all matters of law.

5. In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist; financial statements may be misstated as the result of defalcations and other similar irregu-

larities, deliberate misrepresentation by management, or both. He recognizes that any fraud, if sufficiently material, may affect his opinion on the fairness of the presentation of the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the ordinary examination incident to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from noncompliance with generally accepted auditing standards.

6. Reliance for the prevention and detection of fraud should be placed principally upon the maintenance of an adequate accounting system with appropriate internal control. The well-established practice of the independent auditor of evaluating the adequacy and effectiveness of the system of internal control by means of tests of the accounting records and related data and of relying on such evaluation and tests for the selection and timing of his other auditing procedures has generally proved sufficient for the purpose of expressing his opinion. If an objective of an independent auditor's examination were the discovery of all fraud, he would have to extend his work to a point where its cost would be prohibitive. Even then he could not give assurance that all types of fraud had been detected or that none existed because items such as unrecorded transactions, forgeries, and collusive fraud would not necessarily be uncovered. It is generally recognized that good internal control and fidelity bonds provide protection more economically and effectively.[1]

7. When an independent auditor's examination leading to an opinion on financial statements discloses specific circumstances which arouse his suspicion as to the existence of fraud, he should decide whether the

[1] In the case of fidelity bonds, protection is afforded not only by the indemnification for discovered defalcations, but also by the posssible deterrent effect upon employees; the presence of fidelity bonds, however, does not affect the scope of the ordinary examination.

fraud, if in fact it should exist, might be of such magnitude as to affect his opinion on the financial statements. If the independent auditor believes that fraud may have occurred which could be so material as to affect his opinion, he should reach an understanding with the proper representatives of the client as to whether the independent auditor or the client, subject to the independent auditor's review, is to make the investigation necessary to determine whether fraud has in fact occurred and, if so, the amount thereof. If, on the other hand, the independent auditor concludes that any such fraud could not be so material as to affect his opinion, he should refer the matter to the proper representatives of the client with the recommendation that it be pursued to a conclusion. For example, frauds involving "lapping" accounts receivable collections, or frauds involving overstatements of inventory, could be material, while those involving peculations from a small imprest fund would normally be of little significance because the operation of the fund tends to establish a limitation.

8. The subsequent discovery that fraud existed during the period covered by the independent auditor's examination does not of itself indicate negligence on his part. He is not an insurer or guarantor and, if his examination was made with due professional skill and care, in accordance with generally accepted auditing standards, he has fulfilled all of the obligations implicit in his undertaking.

The statement entitled "Responsibilities and Functions of the Independent Auditor in the Examination of Financial Statements" was unanimously adopted by the twenty-one members of the committee.

COMMITTEE ON AUDITING PROCEDURE (1959-60)

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Issued by the
Committee on Auditing Procedure,
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270 Madison Avenue, New York 16, N. Y.

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No. 31

October 1961

Consistency

Generally accepted auditing standards were defined by this committee in 1947, approved by the membership in 1948, and accorded further recognition in 1954 with the publication of the booklet Generally Accepted Auditing Standards, Their Significance and Scope. *The second standard of reporting set forth therein requires that the independent auditor's report shall state whether in his opinion the principles of accounting employed in the financial statements have been consistently observed in the current period in relation to the preceding period; this reporting standard is sometimes referred to as the "consistency standard."*

The committee believes that the experience of the ensuing years in the interpretation and application of the consistency standard of reporting makes it advisable to review the objective of that standard and to provide further guides to the independent auditor in the exercise of his judgment in applying it.

Accordingly, the section of Generally Accepted Auditing Standards *beginning on page 51 and ending at the top of page 52 is hereby revised as set forth on the following pages.*

OBSERVANCE OF CONSISTENCY IN THE APPLICATION OF ACCOUNTING PRINCIPLES

Consistency Standard

1. The second standard of reporting requires that the independent auditor's report shall state whether in his opinion the principles of accounting employed in the financial statements have been consistently observed in the current period[1] in relation to the preceding period. It is implicit in the standard that such principles have been consistently observed within each period.

Objective of the Consistency Standard

2. The objective of the consistency standard is:

(1) To give assurance that the comparability of financial statements as between periods has not been materially affected by changes in the accounting principles employed or in the method of their application; or

(2) If comparability has been materially affected by such changes, to require a statement of the nature of the changes and their effects on the financial statements.

Accounting Principles and Their Application

3. The committee believes that the term "accounting principles" as used in reporting standards should be construed to include not only accounting principles and practices but also the methods of applying them. For brevity, accounting principles and practices and the methods of applying them are at times referred to herein as "accounting principles."

[1] The terms "current period" or "current year" used throughout this statement mean the most recent period or year upon which the independent auditor is reporting. These terms also contemplate periods of less than one year.

Comparability of Financial Statements

4. Proper application of the consistency standard requires a clear understanding of the relationship of consistency to comparability. The consistency standard involves the consistent application of accounting principles; lack of consistency produces lack of comparability. However, lack of comparability may be caused by other factors unrelated to consistency and even unrelated to accounting.

5. In general, comparability of financial statements as between years is affected by changes arising from:

(a) A change in accounting principles employed.

(b) Changed conditions which necessitate accounting changes but which do not involve changes in the accounting principles employed.

(c) Changed conditions unrelated to accounting.

6. Only the first of these three classes involves the consistency standard and therefore only changes of this class having a material effect on the financial statements require recognition in the independent auditor's opinion as to consistency. Changes of the second and third classes having a material effect on the financial statements will not ordinarily be commented upon in the independent auditor's report. However, fair presentation may require their disclosure in the notes to the financial statements. Distinguishing characteristics of the types of changes included in each of these three classes are more fully described and commented upon in the following paragraphs.

A. Comparability of Financial Statements Affected by a Change in Accounting Principles Employed

7. A characteristic of this type of change is that it involves a choice by management from among two or more accounting principles. The reason for the change need not be stated. Examples are a change from the straight-line method to the declining-balance method of depreciation,

and a change from the pay-as-you-go basis to the accrual basis of accounting (whether or not funded) for an existing pension commitment or plan.

8. This type of change is intended to be covered by the consistency standard and should be recognized in the independent auditor's opinion (see "Reporting on Inconsistency," p. 48).

B. Comparability of Financial Statements Affected by Changed Conditions Which Necessitate Accounting Changes But Which Do Not Involve Changes in the Accounting Principles Employed

9. A characteristic of this type of change is that it is an accounting change required by altered conditions (rather than by the consummation of a business transaction). It involves no choice by management since the accounting principles employed have not changed; hence, although comparability may be affected, consistency is not involved. Examples are a change in the estimated remaining useful life of plant property arising from operating experience or obsolescence, and a changed provision for pension plan accruals arising from revisions in actuarial assumptions based upon experience of the plan.

10. A change of this type having a material effect on the financial statements should be disclosed in a note to the financial statements. It would not ordinarily be commented upon in the independent auditor's report[2] since it would not affect his opinion as to consistency. If commented upon in his report, it would be as a disclosure matter under the third standard of reporting.

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[2] With respect to financial statements filed with the Securities and Exchange Commission, Regulation S-X requires the independent auditor to disclose in his report, and express his opinion of any material changes in accounting principles or practices or methods of applying them which affect comparability, or any material retroactive adjustments of the accounts, as described in the applicable rules. With respect to a type B change described above, these requirements may be met by the use of a middle paragraph which describes the change and expresses the independent auditor's view thereon; when this is done the change need not be referred to in the opinion paragraph since the consistency standard is not involved.

C. Comparability of Financial Statements Affected by Changed Conditions Unrelated to Accounting

11. A characteristic of this type of change is that it results from some specific happening or transaction which has an accounting effect, as do most business transactions, but which does not involve a change in any accounting principle employed. As a result, an accounting principle may be employed for the first time; this is not a "change" in accounting principles and therefore does not require comment as to consistency in the independent auditor's opinion. Examples are the acquisition or disposition of a subsidiary or plant, and the original adoption of a pension plan.

12. Only in unusual circumstances would this type of change be commented upon in the independent auditor's report, although fair presentation may require disclosure in the notes to the financial statements; if commented upon in the independent auditor's report it would be as a disclosure matter and not as a consistency matter.

Reclassifications

13. Although reclassifications of items in the financial statements may result in lack of comparability, they are usually not of sufficient importance to necessitate any disclosure. However, material changes in classification should be indicated and explained in the financial statements or notes; if appropriately disclosed, such changes ordinarily need not be referred to in the independent auditor's report.

Period to Which the Consistency Standard Relates

14. The consistency standard is aimed at comparability of the financial statements of the current year with those of the preceding year (whether presented or not) and at comparability of all financial statements presented in comparative form. When the independent auditor's opinion covers the statements of two or more years, there is generally no need to disclose an inconsistency with a year prior to the years for which

statements are being presented. Accordingly, the phrase "on a basis consistent with that of the preceding year" is ordinarily inapplicable whenever the opinion covers two or more years. Instead, language similar to "consistently applied during the period" or "applied on a consistent basis" should be used.

Reporting on Inconsistency

15. When a change has been made in the accounting principles employed during the year or years the independent auditor is reporting upon (type A referred to under section "Comparability of Financial Statements," p. 45) and the change has a material effect upon financial position or results of operations, he should refer in his opinion paragraph to a note to the financial statements which adequately describes the change and its effect, or describe adequately in his report the nature of the change and its effect. Where the change affects net income, the disclosure should include the amount by which net income is affected after consideration of related income taxes.

16. Ordinarily, the disclosure would give the amount by which the current year's net income was affected as a result of the change; however, there may be instances where the effect the change would have had on the prior year's net income would be considered an appropriate disclosure.

17. Although the independent auditor's advice is frequently sought and followed, management has the responsibility for the selection of the appropriate accounting principles to be employed in its financial statements. The expression of the independent auditor's opinion of changes affecting consistency will vary with the circumstances, as follows:

Change to an Alternative Generally Accepted Accounting Principle

18. When the client makes a change from the use of one generally accepted accounting principle, practice or method of application to another which is generally accepted, the independent auditor need not indi-

cate whether he approves or accepts the change. Although reference to the change is required in the opinion, the absence of qualification regarding fair presentation in conformity with generally accepted accounting principles is sufficient to indicate that the independent auditor considers the newly adopted accounting principle to be generally accepted. However, if he wishes, the independent auditor may express his approval of the change in his report.[3] An illustration of expression of approval follows:

> . . . in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year, except for the change, (insert expression of approval), in pricing of inventories . . . as described in Note — to the financial statements.
>
> (*Note*: Some expressions of approval are "which we approve," "in which we concur," "to an accepted alternative method," and "to which we do not object." The use of these expressions is optional.)

Change from a Principle or Practice Which Lacks General Acceptance to a Generally Accepted Accounting Principle

19. Ordinarily, the independent auditor will want to express his approval of a change from a principle or practice which lacks general acceptance to a generally accepted accounting principle. In these instances the illustrations in paragraphs 18, 25, 26, and 34 are considered appropriate.

Change to a Principle or Practice Which Lacks General Acceptance

20. Where the effect of a change to a principle or practice which is not generally accepted is material, the independent auditor should so state in his report. Such statement requires either a qualification of the independent auditor's opinion as to fair presentation in conformity with generally accepted accounting principles or, if the change is *sufficiently*

[3] See footnote 2, p. 46.

material, an adverse opinion on the financial statements taken as a whole. Illustrations follow:

Qualified opinion

(Opinion paragraph)

In our opinion, except for (brief description of the change and its effect) as explained in Note —, a practice which we believe is at variance with generally accepted accounting principles, the accompanying statements present fairly the financial position of X Company at October 31, 19—, 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.

Adverse opinion

(Middle paragraph)

The company has heretofore followed the practice of (brief description of prior practice) and has now adopted the practice of (brief description of new practice). As a result of this change, reported net income for the year ended October 31, 19—, and retained earnings as of that date, are each $—— greater than they otherwise would have been.

(Opinion paragraph)

In view of the materiality of the effect of the above noted change to a practice which we believe is at variance with generally accepted accounting principles, we are of the opinion that the financial statements do not present fairly the financial position of X Company at October 31, 19—, or the results of operations for the year then ended, in conformity with generally accepted accounting principles.

(*Note*: Since the independent auditor completed his examination in accordance with generally accepted auditing standards, and *has* an opinion (adverse) on the statements, he should not *disclaim* an opinion.)

Changes Expected to Have a Material Future Effect

21. If a change is made in the accounting principles employed which has no material effect on the financial statements in the current year, but which is reasonably certain to have substantial effects in later years, it should be appropriately disclosed in a note to the financial statements for the year in which the change is adopted by the client. An example of such a note follows:

> It has been the consistent practice of the company to provide for the depreciation of properties on a straight-line basis over their estimated useful lives. Commencing with the current year, the company is providing for depreciation on new additions to property on the declining-balance method. This change has no material effect on the current financial statements.

22. If such a change is appropriately disclosed in a note to the financial statements as indicated above, it need not be mentioned in the independent auditor's report. However, if such a change is not set forth in a note to the financial statements, it should be disclosed by the independent auditor in his report.

Restated Amounts in Financial Statements of Prior Years

23. When a change has been made in the accounting principles employed and the accounts have been adjusted retroactively, it is desirable to restate financial information which is presented for any prior year, or years, affected. Such a restatement places all the periods being compared on the same basis with respect to the use and application of accounting principles.

24. In such cases, the independent auditor may report only on the current year, or he may report on all the years which have been restated, as well as on the current year. In either case, disclosure of the change should be made in the financial statements or the notes with an indication of its effect on the year or years restated in the comparative financial statements.

25. When he reports only on the current year, a change in that year should be referred to in his opinion as described under section "Reporting on Inconsistency," p. 48, or somewhat as follows:

> . . . in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year after giving retroactive effect to the inclusion, which we approve, of the accounts of foreign subsidiaries as explained in Note — to the financial statements.
>
> (*Note*: The use of "which we approve" is optional.[4])

26. When the independent auditor reports on all the years which have been restated as well as on the current year, he may be giving a new opinion with respect to the earlier years. Even though all years covered by his report are on a consistent basis, and the changes made are adequately disclosed in the financial statements and notes, the committee believes that his report should make reference to the restatement in the year of change. If such reference is made in the opinion paragraph, it may read somewhat as follows:

> . . . applied on a consistent basis after giving retroactive effect to the inclusion, which we approve, of the accounts of foreign subsidiaries as explained in Note — to the financial statements.
>
> (*Note*: The use of "which we approve" is optional.[5])

27. If the change took place in other than the current year and prior years have been restated, no reference to the change is necessary in the independent auditor's report. However, disclosure of the change should be made in the financial statements or notes relating to any prior year restated in comparative financial statements.

Financial Statements of Prior Years Not Restated

28. When financial statements are presented in comparative form and prior years are not restated to give effect to a change in the

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[4] See footnote 2, p. 46.
[5] Ibid.

accounting principles employed, adequate disclosure requires a description of the nature and effect of the change.

29. When the change took place in the current year, it should be disclosed in the independent auditor's report as explained under section "Reporting on Inconsistency," p. 48.

30. When the change took place in other than the current year and the independent auditor:

(a) Is reporting on all the years, he should refer in the opinion paragraph of his report to a note to the financial statements which adequately describes the change and its effect, or make such disclosure in his report;

(b) Is reporting only on the current year, no reference is necessary in his report but disclosure of the change should be made in an appropriate note to the financial statements.

The Independent Auditor's First Report

31. When the independent auditor reports on the first accounting period of a newly organized company, he need make no reference to consistency, since there exists no previous period with which to make a comparison.

32. When the independent auditor makes his first examination of an established company, he should adopt procedures that are practicable and reasonable in the circumstances to assure himself that the accounting principles employed are consistent as between the current and the preceding year. The committee believes that where adequate records have been maintained by the client, it is practicable and reasonable to extend auditing procedures sufficiently to give an opinion on consistency. Limitations imposed by the client with respect to these procedures would require appropriate qualification.

33. The committee recognizes that there may be situations where the inadequacy of the financial records for the earlier years precludes the

independent auditor from forming an opinion as to the consistent application of accounting principles and the reasonable accuracy of the account balances at the beginning of the current year. Where such amounts could materially affect current operating results, the independent auditor would be unable to express an opinion on the current year's statement of income. When this is the case the independent auditor should state in his report that the inadequate condition of the records prevents him from expressing an opinion not only on consistency but also on the statement(s) of income and retained earnings for the current year. For example, the independent auditor's report might contain the following:

> . . . and such other auditing procedures as we considered necessary in the circumstances, except as indicated in the following paragraph.
>
> Because of major inadequacies in the company's accounting records for the previous year, it was not practicable to extend our auditing procedures sufficiently to enable us to express an opinion on the statement(s) of income and retained earnings for the year ended (current year) or on the consistency of application of accounting principles with the preceding year.
>
> In our opinion, the accompanying balance sheet presents fairly the financial position of the X Company as of (current year end) in conformity with generally accepted accounting principles.

34. If accounting records for prior years were kept on a basis which did not result in a fair presentation of financial position and results of operations for those years, comparison of the statements upon which the independent auditor is reporting with those of prior years would be of little significance. Accordingly, the customary reference to consistency in the independent auditor's report may be omitted and his report could be presented as follows:

> (Middle paragraph)
>
> The company has kept its records and has prepared its financial statements for previous years on the cash basis with no recognition

having been accorded accounts receivable, accounts payable, or accrued expenses. At the beginning of the current year the company, with our approval, adopted the accrual basis of accounting, and appropriate adjustments, where material, have been made to retained earnings as of the beginning of the year.

(Opinion paragraph)

In our opinion, the accompanying balance sheet and statement(s) of income and retained earnings present fairly the financial position of the X Company as of October 31, 19—, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles.

Pooling of Interests

35. When companies have been merged or combined in accordance with the accounting concept known as a "pooling of interests," appropriate effect of the pooling should be given in the presentation of results of operations and earnings per share of years prior to the year of pooling as described in Accounting Research Bulletins Nos. 48 and 49. Comparative financial statements which do not give appropriate recognition to the pooling are not presented on a consistent basis. The inconsistency arises, in this case, not from a change in the application of an accounting principle in the current year but from the lack of such application to prior years.

36. Accordingly, in order to avoid a misleading inference which might otherwise arise, the independent auditor should refrain from the use of the expression "on a basis consistent with that of the preceding year" whenever comparative statements are presented in which prior years' operating statements of the constituents have not been appropriately combined or shown separately. In such instances he should disclose in his report the lack of consistency and describe, or refer to a note to the financial statements which describes (1) the nature of the pooling

and (2) the effect of the pooling upon results of operations of all prior years presented.

37. When single-year statements only are presented, a note to the financial statements should adequately disclose the pooling transaction and state the net incomes of the constituent companies for the preceding year separately or on a combined basis. Omission of such a disclosure would require appropriate comment in the independent auditor's report. With either type of disclosure, the independent auditor may express the usual opinion on consistency.

The statement entitled "Consistency" was adopted unanimously by the twenty-one members of the committee, of whom one, Mr. Devore, assented with qualification.

Mr. Devore qualifies his assent because the statement takes the position that changes in accounting principles which have no material effect on the financial statements in the year of the change, but which are reasonably certain to have substantial effects in later years, should be disclosed in notes to financial statements but need not be mentioned in the independent auditor's report. He believes changes of such importance should also be mentioned in the independent auditor's report in the year of the change as an exception to the consistency of application of accounting principles.

NOTES

Unless otherwise indicated, Statements on Auditing Procedure present the considered opinion of the twenty-one members of the committee on auditing procedure, reached on a formal vote after examination of the subject matter by the committee and the technical services division. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the statements rests upon the general acceptability of the opinions so reached.

The committee on auditing procedure is the senior technical committee of the Institute designated to express opinions on auditing matters. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the committee's recommendations must be assumed by those who adopt other practices.

COMMITTEE ON AUDITING PROCEDURE (1960-61)

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Statements on Auditing Procedure

No. 32

September 1962

Issued by the
Committee on Auditing Procedure,
American Institute of
Certified Public Accountants
666 Fifth Avenue, New York 19, N. Y.
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Qualifications and Disclaimers

(Clarification of Reporting Standards)

When an independent auditor's name is associated with financial statements which purport to present financial position and results of operations, generally accepted auditing standards (the fourth standard of reporting) require him to express an opinion on the financial statements taken as a whole or, if an opinion is not being expressed, to state that he is unable to express an opinion and to give his reasons.

Rule 2.03 of the Institute's Code of Professional Ethics requires compliance with the fourth standard of reporting when it states:

> A member or associate shall not permit his name to be associated with statements purporting to show financial position or results of operations in such a manner as to imply that he is acting as an independent public accountant unless he shall: (a) express an unqualified opinion, or (b) express a qualified opinion, or (c) disclaim an opinion on the statements taken as a whole and indicate clearly his reasons therefor, or (d) when unaudited financial statements are presented on his stationery without his comments, disclose prominently on each page of the financial statements that they were not audited.

The committee considers it desirable to clarify the application of this standard and rule and to provide suggestions whereby the independent auditor, in the exercise of his judgment, may assure himself that his opinions on financial statements will be clearly and unequivocally expressed or, in the absence of an opinion, that the degree of responsibility being taken will be clearly indicated.[1]

[1] This statement is not intended to supersede Statements on Auditing Procedure No. 28, "Special Reports."

Objective of the Fourth Reporting Standard

1. The objective of the fourth reporting standard is to prevent misinterpretation of the degree of responsibility the independent auditor is assuming whenever his name is associated with financial statements. The standard requires the independent auditor to include in his report, in all cases, a clear indication of the character of his examination, if any, and the degree of responsibility that he is assuming in the light of the scope of examination described. This requires him:

(1) to express an opinion regarding the financial statements taken as a whole; or

(2) to state that an opinion is not being expressed, and to give the reasons why an opinion cannot be expressed; or

(3) when unaudited financial statements are presented on his stationery, without his comments, to disclose prominently on each page of the financial statements that they are unaudited.

2. In considering the degree of responsibility he is assuming, the independent auditor must bear in mind that justification for the expression of his opinion, whether qualified or unqualified, rests on the degree to which the scope of his examination conforms with generally accepted auditing standards.

3. Although the fourth reporting standard states that "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," the committee believes that this standard does not preclude the expression of separate opinions on financial position and results of operations. The independent auditor may also express an unqualified opinion on one of the financial statements and disclaim an opinion or express a qualified or an adverse opinion on the others (see paragraph 28).

Unqualified Opinion

4. An unqualified opinion that financial statements present fairly financial position and results of operations may be expressed only when the independent auditor has formed the opinion, on the basis of an examination made in accordance with generally accepted auditing standards, that the presentation conforms with generally accepted accounting principles applied on a consistent basis and includes all informative disclosures necessary to make the statements not misleading.

Qualified Opinion

5. Qualified opinions were given recognition in the publication *Generally Accepted Auditing Standards,* 1954, on page 47, as follows:

> . . . Thus, when an unqualified opinion cannot be expressed, the accountant must weigh the qualifications or exceptions to determine their significance. If they are not such as to negative the opinion, a properly qualified opinion would be satisfactory.

6. When a qualified opinion is intended, the opinion paragraph of the standard short-form report should be modified in a way that makes clear the nature of the qualification. It should refer specifically to the subject of the qualification and should give a clear explanation of the reasons for the qualification and of the effect on financial position and results of operations, if reasonably determinable. Reference in the opinion paragraph to a note to the financial statements or to a preceding paragraph in the report that describes the circumstances is an acceptable method of clarifying the nature of a qualification. However, a qualification based upon the scope of the examination ordinarily should be covered entirely in the independent auditor's report. When a qualification is so material as to negative an expression of opinion as to the fairness of the financial statements as a whole, either a disclaimer of opinion or an adverse opinion is required.

7. The committee recommends the use of phrases that include either "except" or "exception" in qualified opinions on financial statements. However, in certain cases where the outcome of a matter is uncertain the phrase "subject to" may be appropriate (see paragraphs 29, 44 and 45). The committee believes that phrases such as "with the foregoing explanation" are generally not clear or forceful enough for a qualification and should not be used to qualify an opinion.

8. Any modifying phrases in the standard short-form opinion paragraph (or sentence) should be considered as qualifying the opinion in some manner; however, reference to the report of other independent auditors as the basis, in part, of the opinion, whether made in the scope paragraph or the opinion paragraph, is not to be construed as a qualification of the opinion on the fairness of presentation of the consolidated financial statements or consistency, but rather as an indication of the divided responsibility for the performance of the work (see paragraphs 31-35).

Adverse Opinion

9. An adverse opinion is an opinion that the financial statements do not present fairly the financial position or results of operations in conformity with generally accepted accounting principles.

10. *Generally Accepted Auditing Standards*, 1954, on page 48, gives recognition to adverse opinions as follows:

> . . . It is possible that cases may occur where the accountant's exceptions as to practices followed by the client are of such significance that he may have reached a definite conclusion that the financial statements do not fairly present the financial position or results of operations. In such cases, he should be satisfied that his report clearly indicates his disagreement with the statements presented.

In addition, the Code of Professional Ethics, Rule 2.02 (a) and (b) states:

> In expressing an opinion on representations in financial statements which he has examined, a member or associate may be held guilty of an act discreditable to the profession if . . . he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading, or . . . he fails to report any material misstatement known to him to appear in the financial statements. . . .

11. An adverse opinion is required in any report where the exceptions as to fairness of presentation are so material that in the independent auditor's judgment a qualified opinion is not justified. In such circumstances a disclaimer of opinion *is not* considered appropriate since the independent auditor has sufficient information to form an opinion that the financial statements are not fairly presented.

12. Whenever the independent auditor issues an adverse opinion, he should disclose *all* the substantive reasons therefor, usually by referring to a middle paragraph of his report describing the circumstances (see paragraph 37).

Disclaimer of Opinion

13. When he has not examined sufficient competent evidential matter to form an opinion on the fairness of presentation of the financial statements as a whole, the independent auditor should state in his report that

he is unable to express an opinion on such statements. The necessity of disclaiming an opinion may arise either from a serious limitation on the scope of examination or from the existence of unusual uncertainties concerning the amount of an item or the outcome of a matter materially affecting financial position or results of operations, causing the independent auditor not to be able to form an opinion on the financial statements as a whole.

14. With respect to significant scope limitations, he may recite the procedures followed (in which case the standard short-form scope paragraph should not be used) or the procedures omitted. In either case, he should state clearly that the scope of examination was not adequate to warrant the expression of an opinion on the financial statements taken as a whole.

15. Whenever the independent auditor disclaims an opinion, he should give *all* substantive reasons for doing so. For example, when he disclaims an opinion because the scope of examination was inadequate, he should also disclose any reservations or exceptions he may have regarding fairness of presentation.

Unaudited Statements

16. When no audit has been performed, or the auditing procedures performed are insignificant in the circumstances, any financial statements with which the independent auditor is in any way associated should be clearly and conspicuously marked on each page as unaudited, whether accompanied by his comments or not. The committee believes it preferable that a disclaimer of opinion accompany all such statements; when they are accompanied by comments, the independent auditor *must* issue a disclaimer of opinion. Such a disclaimer of opinion may read as follows:

> The accompanying balance sheet as of November 30, 19.... and the related statements of income and retained earnings for the year then ended were not audited by us and we express no opinion on them.

Phrases which may cause the reader to believe an examination or review of any type was made should be avoided in any such disclaimer.

17. The independent auditor should refuse to be associated in any way with unaudited financial statements which he believes are false or misleading.[2]

[2] See Opinion No. 8 of the committee on professional ethics.

Negative Assurance

18. Where the scope of the examination is limited by the omission of necessary auditing procedures, reports should not be issued which temper the qualification or disclaimer of opinion by the inclusion of expressions similar to ". . . However, nothing came to our attention which would indicate that these amounts (statements) are not fairly presented (stated)."

19. However, negative assurances are permissible in letters required by security underwriters in which the independent auditor reports on limited procedures followed with respect to unaudited financial statements or other financial data pertinent to a registration statement filed with the Securities and Exchange Commission. These letters usually state specifically that no audit has been made of such statements and data, and distribution of the letters is restricted to parties to the underwriting agreement.

20. In situations involving special reports covering data which do not purport to present financial position or results of operations, negative assurances may be given provided the auditing procedures followed are appropriate and reasonable in the circumstances and the scope of the examination is described in the report.[3]

Piecemeal Opinions

21. *Generally Accepted Auditing Standards,* 1954, pages 47 and 48, refers to limited or piecemeal opinions as follows:

> . . . To the extent the scope of his examination and the findings thereof justify, he may also comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an opinion on the over-all fairness of the financial statements. . . .
>
> In some cases of extensive exceptions, where an over-all opinion has been disclaimed, it may be possible to express an opinion limited to the items in the financial statements with which the accountant is satisfied. When that is done, however, the report must make clear that no over-all opinion as to position or operating results is intended and the accountant should be careful to indicate clearly the limitation of such comments to the individual items in the financial statements.

22. Thus, it seems clear that the independent auditor may issue a piecemeal opinion only when, in his judgment, the scope of his examination and his findings justify it, and then only if it is accompanied by a

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[3] *See paragraphs 6 and 15 of Statements on Auditing Procedure No. 28, "Special Reports."*

disclaimer of opinion or adverse opinion with respect to the financial statement(s) taken as a whole. Moreover, the piecemeal opinion should not overshadow or appear to contradict the disclaimer of opinion or adverse opinion; otherwise it may result in a misleading inference regarding the financial statements taken as a whole.

23. A piecemeal opinion may name the accounts covered by the opinion, or may name those accounts which are excluded and designate the accounts which are covered with an expression such as "all the other accounts." The interrelationship of the accounts affected should be carefully considered by the independent auditor if the latter approach is used. For example, when an opinion is disclaimed because the taking of the closing inventory has not been observed, it would ordinarily be improper for the independent auditor to use the expression "all the other accounts," thereby covering in his piecemeal opinion cost of sales, gross profit, profit before taxes, taxes, net profit, accrued income taxes, retained earnings, and, perhaps, accounts payable. In such cases, a listing of the accounts that are covered by the piecemeal opinion would be preferable.

24. The independent auditor should realize that the expression of a piecemeal opinion with respect to individual items included in a financial statement may require a more extensive examination of such items than would be required if he were expressing an opinion on the financial statements as a whole.

Circumstances Which Require a Departure From the Standard Short-Form Report

25. The usual circumstances which may require the independent auditor to deviate from the standard short-form report on financial statements are as follows:

A. The scope of his examination is limited or affected:
   (1) By conditions which preclude the application of auditing procedures considered necessary in the circumstances.
   (2) By restrictions imposed by clients.
   (3) Because part of the examination has been made by other independent auditors.

B. The financial statements do not present fairly financial position or results of operations because of:
   (1) Lack of conformity with generally accepted accounting principles.
   (2) Inadequate disclosure.

C. Accounting principles are not consistently applied.

D. Unusual uncertainties exist concerning future developments, the effects of which cannot be reasonably estimated or otherwise resolved satisfactorily.

These circumstances are discussed below.

SCOPE OF EXAMINATION

Conditions Which Preclude the Application of Necessary Auditing Procedures

26. Circumstances may at times make it impracticable or impossible for the independent auditor to follow certain customary auditing procedures. When this occurs, the independent auditor may be able to satisfy himself by the application of other auditing procedures. If he is able to do so there is, in effect, no limitation on the scope of the examination and reference to alternative procedures is not required, except in those cases where confirmation of receivables or observation of the taking of inventories has been omitted with respect to the latest balance sheet.[4] In these two cases the independent auditor should refer in the scope paragraph to the omission of customary procedures even when he is able to satisfy himself by the application of other auditing procedures. In any event, where he has been able to satisfy himself by other procedures he should not refer to them in the opinion paragraph of his report.

27. Where he is unable to satisfy himself by the application of other auditing procedures, the independent auditor should indicate clearly in the scope (or middle) paragraph the limitations on his work and, depending on the materiality of the amounts involved, he should either qualify his opinion or disclaim an opinion on the financial statements taken as a whole.

28. An illustration follows:

(Scope paragraph)
We have examined the balance sheet of XYZ Company as of September 30, 1962, and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and ac-

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[4] It should be noted that the omission of observation of the taking of opening inventories is not required to be disclosed in situations where the independent auditor has satisfied himself with respect to such inventories by other auditing procedures. (See Codification of Statements on Auditing Procedures, page 21). However, he may wish to disclose the circumstances of the engagement and briefly describe the other procedures.

cordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except as stated in the following paragraph.

(Middle paragraph)
Because we were not engaged as auditors until after September 30, 1961, we were not present to observe the physical inventory taken at that date and we have not been able to satisfy ourselves concerning inventory quantities by other procedures. The beginning inventory has a significant effect on the results of operations for the year. Therefore, we do not express an opinion on the accompanying statements of income and retained earnings for the year ended September 30, 1962.

(Opinion paragraph)
In our opinion, the accompanying balance sheet presents fairly the financial position of the Company at September 30, 1962, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(*Note*: It is assumed that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles.)

Restrictions Imposed by Clients

29. When a qualified opinion is expressed because the scope of the examination was restricted, the qualification should relate to the items in the statements on which an opinion cannot be expressed, rather than to the restriction, as such. For example, the report may read:

(Scope paragraph)
. . .and such other auditing procedures as we considered necessary in the circumstances, except as noted in the following paragraph.

(Middle paragraph)
In accordance with your instructions, we did not request any owners to confirm their balances of accumulated storage charges. Accordingly, we do not express an opinion as to accumulated storage charges, stated as $......, which amount enters into the determination of financial position and results of operations.

(Opinion paragraph)
In our opinion, with the exception stated in the preceding paragraph, the accompanying . . .

Such wording would appear to be preferable to "Except for the abovementioned limitation on the scope of our examination, in our opinion . . ." which bases the exception not on a possible material effect but on the restriction. The committee recognizes that uncertainties are present when limitations on the scope of the examination have been imposed, but it believes such uncertainties are not of the nature and type which permit the use of "subject to" in qualifying the opinion (see paragraph 7).

30. Restrictions imposed by clients on the scope of the examination most commonly concern the omission of the observation of inventory taking or the confirmation of receivables by direct communication. Generally, in such cases when inventories or receivables are material the independent auditor should disclaim an opinion on the financial statements taken as a whole (see paragraphs 14 and 15). An illustration follows:

> (Scope paragraph)
> . . . and such other auditing procedures as we considered necessary in the circumstances, except as noted in the following paragraph.
>
> (Middle paragraph)
> In accordance with your instructions we were not in attendance at the taking of the physical inventory as of November 30, 19. . . . Accordingly, we do not express any opinion concerning such inventory stated at $. . . . .
>
> (Opinion paragraph)
> Because the inventory at November 30, 19. . . . enters materially into the determination of financial position and results of operations, we do not express an opinion on the accompanying financial statements taken as a whole.

Part of the Examination Made by Other Independent Auditors

31. In reporting on financial statements, the independent auditor may not have examined the financial statements of one or more subsidiaries, divisions, or branches included therein, but he may have received the reports of other independent auditors with respect to such statements. Similar situations are often present in the case of business combinations. In these situations, questions arise as to the extent of the responsibility of the independent auditor reporting on the consolidated or combined statements with regard to such reports of other auditors and the financial statements covered thereby. In such cases, the principal auditor is usually willing (after following certain procedures described later) to utilize the report of the other independent auditor for the purpose of expressing his opinion on the consolidated or combined statements, but

he is unwilling (unless he otherwise states[5]) to assume responsibility for the performance of the work (to the same extent as though he had performed that work himself) which served as a basis for the opinion of the other auditor. The committee considers such utilization reasonable in these circumstances (and in accordance with generally accepted auditing standards) and believes that the principal auditor may appropriately express an unqualified opinion on the fairness of the consolidated or combined statements without assuming responsibility for the report or work of the other independent auditor, provided the basis for his opinion is adequately described. This description should include a statement in the scope paragraph or in the opinion paragraph to the effect that in the formation of his opinion, amounts applicable to the entities examined by the other independent auditor were included solely upon the basis of the report of such other auditor (see paragraph 8).

32. Before he utilizes the report of another independent auditor for this purpose, the principal auditor should make such inquiries or adopt such measures as, in his judgment, are appropriate to satisfy himself as to the independence and professional reputation of the other auditor. If the other independent auditor's primary place of practice is outside of the United States, the principal auditor should also satisfy himself that the other auditor is familiar with, and will report in accordance with, auditing standards and accounting principles generally accepted in the United States. He should also take whatever action he deems essential to assure the necessary coordination of his activities with those of the other independent auditor to achieve a proper review of the matters affecting consolidation of the financial statements, such as arrangements for evaluating the company's elimination of intercompany transactions, uniformity of accounting practices, etc. In some cases he may need to issue instructions to, or make periodic visits with, the other independent auditor. Despite the foregoing, the other independent auditor remains responsible for the performance of his own work and for his opinion, and the principal auditor assumes no responsibility in this connection except for the matters heretofore discussed in this paragraph.

33. The following language is considered appropriate where the principal auditor is utilizing the reports of other independent auditors:

We have examined the consolidated balance sheet of X Com-

[5] However, as to filings with the Securities and Exchange Commission, Rule 2-05 of Regulations S-X states: "If, with respect to the certification of the financial statements of any person, the principal accountant relies on an examination made by another independent public accountant of certain of the accounts of such person or its subsidiaries, the certificates of such other accountant shall be filed . . . ; however, the certificate of such other accountant need not be filed (a) if no reference is made directly or indirectly to such other accountant's examination in the principal accountant's certificate, or (b) if, having referred to such other accountant's examination, the principal accountant states in his certificate that he assumes responsibility for such other accountant's examination in the same manner as if it had been made by him."

> pany and subsidiaries as of November 30, 19. . . . and the consolidated statements of income and retained earnings for the year then ended.[6] Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of B Company, a consolidated subsidiary, which statements were examined by other certified public accountants whose report thereon has been furnished to us. Our opinion expressed herein, insofar as it relates to the amounts included for B Company, is based solely upon such report.
>
> In our opinion, the accompanying consolidated financial statements present fairly . . .

As an alternative, reference to the report of the other independent auditor as the basis, in part, for the opinion expressed may be placed in the opinion paragraph rather than in the last sentence of the scope paragraph. An illustration follows:

> (Opinion paragraph)
>
> In our opinion, based upon our examination and the aforementioned report of other certified public accountants, the accompanying consolidated financial statements present fairly . . .

34. If the principal auditor is unwilling to utilize the report of the other independent auditor in these cases, he should appropriately qualify or disclaim his opinion on the fair presentation of the consolidated financial statements (disclosing the percentages of consolidated assets and revenues which are qualified[7]) and give his reasons. The use of "except for" is recommended when the intention is to qualify the opinion.

35. In some instances the principal auditor may be willing to assume responsibility for the work of another auditor to the same extent as though he had performed the work himself. This would usually be the case when:

(a) The principal auditor has engaged the other auditor as his agent; or
(b) The other independent auditor is an affiliated or correspondent firm whose work is usually accepted by the principal auditor; or
(c) The principal auditor has made sufficient review of the other auditor's work to justify accepting full responsibility; or
(d) The amounts are immaterial.

When the principal auditor assumes responsibility for such work, he need make no reference to the other independent auditor in either the scope or opinion paragraph of his report. If reference is made, he should state that he is assuming responsibility for such work.

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[6] The auditor may prefer to modify the introductory sentence to the effect that he has not examined the financial statements of B Company.

[7] The committee sees no need to make this disclosure if a qualification is not intended. Some independent auditors may, however, prefer to make this disclosure in all cases.

FAIRNESS OF PRESENTATION

Lack of Conformity with Generally Accepted Accounting Principles

36. Whenever financial statements deviate materially from generally accepted accounting principles, the issuance of a qualified opinion or an adverse opinion is required by the first reporting standard.

37. When the independent auditor believes the presentation of a material item to be at variance with generally accepted accounting principles, he should qualify his opinion or, if he regards the effect of such variance as sufficiently material, express an adverse opinion. The basis for the qualified or adverse opinion should be clearly stated. Illustrations follow:

> Although the proceeds of sales are collectible on the installment basis over a five-year period, revenue from such sales is recorded in full by the Company at time of sale. However, for income tax purposes, income is reported only as collections are received and no provision has been made for income taxes on installments to be collected in the future, as required by generally accepted accounting principles. If such provisions had been made, net income for 1961 and retained earnings as of December 31, 1961 would have been reduced by approximately \$........ and \$........, respectively, and the balance sheet would have included a liability for deferred income taxes of approximately \$........
>
> *Qualified Opinion*
>
> In our opinion, except that provision has not been made for additional income taxes as described in the foregoing paragraph, the accompanying financial statements present fairly . . .
>
> *Adverse Opinion*
>
> Because of the materiality of the amounts of omitted income taxes as described in the preceding paragraph, we are of the opinion that the financial statements do not present fairly the financial position of X Company at December 31, 1961 or the results of its operations for the year then ended in conformity with generally accepted accounting principles.

Regulated Companies

38. In the past, in the absence of a clear statement on the subject by this committee, there has been a question concerning the applicability of the first reporting standard to an independent auditor's opinion on published financial statements of companies whose accounting practices are prescribed by governmental regulatory authorities or commissions.[8] Such companies include public utilities, common carriers,

[8] See paragraph 4, Statements on Auditing Procedure No. 28, "Special Reports."

insurance companies, financial institutions, and the like. The basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to such regulated companies.[9] Accordingly, the first reporting standard is equally applicable to opinions on financial statements of such regulated companies presented for purposes other than filings with their respective supervisory agencies, and material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this will require either a qualified or adverse opinion on such statements. However, an adverse opinion may be accompanied by a piecemeal opinion on the unaffected items in the statements or on any supplementary data furnished which are fairly presented in conformity with generally accepted accounting principles.

39. In instances where the financial statements of regulated companies purport to be primarily presentations in accordance with prescribed accounting regulations the independent auditor may also be asked to report upon their fair presentation in conformity with such prescribed accounting. The committee sees no objection to the independent auditor's report containing such an opinion provided that the first standard of reporting is also observed by the issuance of a qualified or adverse opinion, as required by the circumstances.

Inadequate Disclosure

40. Information essential for a fair presentation should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. When the client declines to disclose data considered essential to a fair presentation or to incorporate it by reference in the notes, the independent auditor should provide the necessary supplemental information in his report, usually in a middle paragraph, and appropriately qualify his opinion.

[9] It should be recognized, however, that appropriate differences exist with respect to the application of generally accepted accounting principles as between regulated and non-regulated businesses because of the effect in regulated businesses of the rate-making process, a phenomenon not present in non-regulated businesses. Such differences usually concern mainly the time at which various items enter into the determination of net income in accordance with the principle of matching costs and revenues. It should also be recognized that accounting requirements not directly related to the rate-making process commonly are imposed on regulated businesses and that the imposition of such accounting requirements does not necessarily mean that they conform with generally accepted accounting principles.

41. An illustration of appropriate wording in such instances follows:

(Middle paragraph)
On January 15, 1962, the company issued debentures in the amount of \$........ for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 1961.

(Opinion paragraph)
In our opinion, the accompanying financial statements, except for the omission of the information in the preceding paragraph, present fairly . . .

42. There may be instances where the independent auditor may wish to include in his report additional explanatory matter (which is not required for adequate disclosure) to highlight certain circumstances or to aid in the interpretation of the financial statements. Since such additional disclosure is not intended to qualify the scope of examination or the opinion on the statements, no reference thereto should be made in the opinion paragraph of the independent auditor's report.

Lack of Consistency

43. Statements on Auditing Procedure No. 31, *Consistency,* should be referred to in considering the question of qualifications based on lack of consistency in the application of generally accepted accounting principles.

Unusual Uncertainties as to the Effect of Future Developments on Certain Items

44. The management of a company ordinarily is expected to evaluate matters affecting financial position and results of operations. In cases where the probable effects of a matter are not reasonably determinable at the time of the opinion, such as in the case of certain lawsuits, tax matters, and other contingencies which may have a material effect upon the financial statements, and the final outcome is dependent upon the decision of parties other than management, the independent auditor should appropriately qualify his opinion. In such instances use of the phrase "subject to" is appropriate. An example follows:

(Opinion paragraph)
In our opinion, subject to any adjustments to the balance sheet and statement of retained earnings which may result from the final determination of the company's income tax liability for prior years as indicated in Note A to the financial statements, the accompanying financial statements present fairly . . .

NOTE A: The Company is presently contesting deficiencies in consolidated federal income taxes proposed by the Internal Revenue Service for the years 1958 to 1960, inclusive, in the aggregate amount of $........, exclusive of interest. The point in question is one on which there are conflicting federal court decisions and on which further litigation may be required; consequently it is impossible to determine the extent of the Company's liability, if any, at this time. No provision has been made for this contingent liability.

45. Occasionally, uncertainties arising from questions of valuation or realizability of assets dependent upon management's judgment may require a qualification of opinion. In such cases, use of the phrase "subject to" is also considered appropriate. For example:

(Opinion paragraph)
In our opinion, subject to the successful conclusion of X project and the ultimate recovery thereby of the related deferred research and development costs in the amount of $........ described in Note .., the accompanying financial statements . . .

46. In some instances where the outcome of a matter is uncertain, the amount concerned may be so material that a qualified opinion is inappropriate. An example of such a situation would be a case in which the company is a defendant in a suit claiming damages of a very large amount in relation to the company's net assets and there is considerable uncertainty as to the outcome of the suit. In such cases, the facts may be disclosed in a middle paragraph of the independent auditor's report and the disclaimer of opinion may read as follows:

(Opinion paragraph)
Because of the possible material effect on the financial statements of the above-mentioned lawsuit, the outcome of which is uncertain, we do not express any opinion on the company's financial statements taken as a whole.

The statement entitled "Qualifications and Disclaimers (Clarification of Reporting Standards)" was adopted unanimously by the twenty-one members of the committee, of whom seven, Messrs. Armstrong, Comer, Gellein, Halvorson, Luther, Malone and Steres, assented with qualification.

Messrs. Armstrong, Comer, Luther, Malone and Steres qualify their assent to the Statement with respect to paragraph 8 and related portions of paragraphs 31 and 33. Paragraph 8 clearly indicates that reference to the report of other independent auditors as the basis, in part, of the principal auditor's opinion, whether made in the scope paragraph or the opinion paragraph, is not to be construed as a qualification of the opinion on fairness of presentation or consistency of the consolidated financial statements, but rather as an indication of the divided responsibility for the performance of the work. They believe reference to other independent auditors in such situations should be shown only in the scope paragraph or a middle paragraph of the principal auditor's report in order to clearly and unequivocally express an unqualified opinion on the fairness of presentation of the consolidated or combined financial statements. Otherwise, the use of the alternative placement of such reference in the opinion paragraph, permitted by paragraphs 8, 31 and 33, would confuse readers of the auditor's report, who would be inclined to believe that any modifying phrase in the opinion paragraph constituted a qualification of fairness of presentation or consistency.

Mr. Halvorson disagrees with the implied preference in paragraphs 31 and 33 for disclosing reliance on the reports of other auditors in the scope paragraph of the principal auditor's report without mention of such reliance in the opinion paragraph. He believes that such disclosure should always be made in the opinion paragraph, since he believes it to be a qualification, and that to permit its omission will defeat one of the principal objectives of the Statement, which is to "assure . . . that . . . opinions on financial statements will be clearly and unequivocally expressed. . . ."

Messrs. Gellein and Halvorson do not agree with those parts of paragraphs 7, 8 and 42 which proscribe (with one stated exception) the inclusion of explanatory phrases in the opinion paragraph of the standard short-form report. They believe this deprives the independent auditor of an effective means of giving emphasis to important matters not calling for qualification of an opinion. They object further to that part of paragraph 18 which proscribes the use of negative assurance in reports on financial statements. They believe this deprives the independent auditor of an effective means of making it clear that he does not have knowledge of additional pertinent information—that he is not holding anything back. In their view these practices should be circumscribed by definition, explanation, and illustration, but should not be prohibited.

NOTES

Unless otherwise indicated, Statements on Auditing Procedure present the considered opinion of the twenty-one members of the committee on auditing procedure, reached on a formal vote after examination of the subject matter by the committee and the technical services division. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the statements rests upon the general acceptability of the opinions so reached.

The committee on auditing procedure is the senior technical committee of the Institute designated to express opinions on auditing matters. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the committee's recommendations must be assumed by those who adopt other practices.

COMMITTEE ON AUDITING PROCEDURE (1961-62)

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