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Statements on auditing procedure, no. 1-24

American Institute of Accountants. Committee on Auditing Procedure

Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York, N. Y.

No. 1

October 1939

Extensions of Auditing Procedure

TO THE MEMBERS OF THE
AMERICAN INSTITUTE OF ACCOUNTANTS:

GENTLEMEN:

Under date of May 9, 1939, the council of the American Institute of Accountants adopted a report submitted by the special committee on auditing procedure entitled "Extensions of Auditing Procedure," and at the same time it was anticipated that the committee would make a supplemental report at the September meeting. The report of May 9th emphasized that it was the ultimate responsibility of the independent certified public accountant to adopt such procedures as in his professional judgment he deemed appropriate, but recommended that certain additional procedures regarding inventories and accounts receivable should be considered as generally accepted practice. It further recommended that, where these additional procedures regarding inventories and accounts receivable had not been undertaken, that fact should be disclosed in the auditors' report or opinion.

The action of the council received widespread support of state organizations of certified public accountants, and the recommendations evoked the hearty approval of investors, credit grantors, the press, and the public.

During the four months which elapsed between the issuance of the report and the September meeting, the committee had considerable discussion and correspondence with informed people, both within and without the profession, and held a number of meetings. While the recommended additional procedures had the united support of independent accountants, it was evident that there was some misconception as to the meaning intended to be conveyed by the term "physical tests" as applied to inventory quantities, that considerable misunderstanding had arisen as to the responsibility which the auditor might be assuming, and that the recommended reference in the auditors' report of opinion to the omission of such procedures had been misconstrued.

In its supplemental report presented to council under date of September 18th, the committee explained the term "physical tests" and indicated that in his capacity as auditor the independent certified public accountant could properly attend at the inventory-taking and observe the methods of taking the inventory, making in conjunction therewith such suitable inquiries or requiring such test checks under his observation as he deemed advisable, and that such a program was within the meaning of the term "physical tests."

The auditor's duty was increased in that the additional procedures were adopted as generally accepted practice wherever they are practicable and reasonable, but beyond this the auditor's responsibility remained unchanged. The responsibility of the management for taking proper inventories was again emphasized.

The committee reiterated its recommendation of May 9th that, where exceptions were required, such exceptions should be expressed clearly and unequivocally. However, where exception was not called for under the terms of the report, it was felt that no good purpose would be served by requiring negative explanations, because discussion and experience in the meantime had demonstrated that negative references in the auditors' report gave rise to misconception in that they tended to convey implications of reservations or exceptions where none existed or was intended. In other words, they had the effect of casting an unwarranted cloud on the statements.

The council at its meeting on September 18, 1939, adopted the supplemental report of the committee which, after discussion at the meeting of the Institute on September 19th, was approved. The executive committee was authorized and instructed by council to coördinate the two reports into one document and to distribute it to the membership. This document is submitted herewith; it supersedes the report of May 9, 1939.

Respectfully submitted,

EXECUTIVE COMMITTEE

By: JOHN L. CAREY, *Secretary.*

October 18, 1939.

EXTENSIONS OF AUDITING PROCEDURE

REPORT OF MAY 9, 1939, AS MODIFIED AND APPROVED AT THE ANNUAL MEETING, SEPTEMBER 19, 1939

Following the adoption by council on May 9, 1939, of the report of the special committee on auditing procedure entitled "Extensions of Auditing Procedure" and the approval at the annual meeting of the supplementing and interpreting report of the same committee dated September 18, 1939, the executive committee was instructed by council to coördinate the two reports into one document and to distribute it. There is presented herewith the modified report which deals with the following matters:

Examination of inventories
Examination of receivables
Appointment of independent certified public accountants
Form of independent certified public accountants' report

Auditing procedures and related matters dealt with herein relate to those cases in which financial statements are accompanied by a report and opinion of an independent certified public accountant. Accordingly, that which follows should be read in the light of this limitation.

At the outset it is pertinent to state that, since the late disclosure of conditions existing in exceptional cases, certified public accountants have been considering possible implications which may arise therefrom in relation to their practice. The committee desires to state its opinion that auditing procedure has kept, and continues to keep, pace with the growth and development of industry and that the well established custom of making test checks of accounting records and related data and, beyond that, reliance upon the system of internal check and control after investigation of its adequacy and effectiveness has with very few exceptions proved sufficient for its purpose. Because of public interest and discussion in the press, there is a question now before the profession as to whether its procedures shall be extended. In order to consider the question intelligently there must first be some general understanding of certain fundamentals.

In the performance of his duties as auditor, the independent certified public accountant holds himself out as one who is proficient in accounting practice and auditing procedure. The function of the independent certified public accountant is to examine a concern's accounting records and supporting data, in certain matters to obtain outside confirmations, and to require and consider supplementary explanations and information from the management and employees, to the extent necessary to enable him to form an opinion as to whether or not the financial statements as submitted present fairly the position and the results of periodic operations. Generally speaking, his function is limited to reporting upon situations arising out of business transactions that have taken place in the past. In no sense is he an insurer or guarantor. In offering his opinion, the independent certified public accountant assumes heavy responsibilities. He must be skilled in his professional work and must have made a reasonable examination of the accounts in order to warrant his expression of an opinion. He must state his opinion clearly and unequivocally.

Management itself has the direct responsibility for the maintenance of an adequate and effective system of accounts, for the proper recording of transactions in the books of account, and for the safeguarding of the assets of a concern. 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.

In order to qualify himself to carry out his function, the independent certified public accountant has completed a rigorous course of professional study and training as a background to the essential practical experience he must obtain, for it is only by study, training, and practical experience that the independent auditor acquires skill in accounting and related matters. In the ordinary course of his day-to-day practice, he encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to examine and report upon the affairs of a concern because, through his training and experience, he has become not only skilled in accounting and auditing but has acquired the ability and habit of considering dispassionately and independently the facts recorded in books of account or otherwise disclosed by his examination and because, as a result, his opinion provides reasonable assurance that a fair and adequate presentation of pertinent information has been made in the financial statements.

The independent auditor must also exercise his best judgment in determining the scope of his examination and in deciding whether the interests of stockholders and creditors justify the time and expense involved in the extension of any particular line of inquiry. Experience shows that, with few exceptions, the personnel of business organizations is honest. The ordinary examination incident to the issuance of financial statements accompanied by a report and opinion of an independent certified public accountant is not designed to discover all defalcations, because that is not its primary objective, although discovery of defalcation frequently results. In a well organized concern the principal reliance for the detection of such irregularities is placed upon the maintenance of an adequate system of accounting records with appropriate internal check and control. It is the duty of the independent auditor to review the system of internal check and accounting control so as to determine the extent to which he considers that he is entitled to rely upon it. To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises—a cost which would pass all bounds of reasonable expectation of benefit or safeguard therefrom, and place an undue burden on industry.

In carrying out his work the independent certified public accountant must always be on his guard against collusive fraud and be alert in detecting any sign of such collusion. However, on the basis of his examination by tests and checks, he relies upon the integrity of the client's organization unless circumstances are such as to arouse suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified.

The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion.

Turning now to consideration of the specific matters referred to at the beginning of this report, it may be noted in passing that in some cases independent certified public accountants have attended at the inventory-taking or observed physical test checks of inventories and have confirmed receivables by direct communication with debtors. Such steps, however, have usually been undertaken as additional procedures under arrangement with the client, or where the accountant thought them essential or desirable in a particular case.

It is believed that recognition should be given to the widespread demand for an extension of auditing procedures with regard to inventories and receivables. However, it should be noted that additional expense to business will be involved in the added procedures.

Inventories

Added steps may well be taken to give greater assurance with regard to inventories. The extent of such additional procedures will necessarily vary with the circumstances, because the independent auditor is justified in giving consideration to the effectiveness of the internal check and control as applied not only to book records, but also to the procedure of taking physical inventories. But, however extensive these may be, the training and experience of an independent certified public accountant do not qualify him as a general appraiser, valuer, or expert in materials. The public should understand that, while he can in his capacity as an auditor undertake additional procedures as to inventories, such procedures do not invest his opinion with a degree of authority which he does not claim for it or impose upon him a measure of responsibility which the nature of his work does not justify. Such procedures are only for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition.

Taken in consideration with the foregoing discussion of auditing procedures, the following recommendations are made concerning inventories:

(A) That hereafter, where the independent certified public accountant intends to report over his signature on the financial statements of a concern in which inventories are a material factor, it should be generally accepted auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified public accountant may require physical tests of inventories to be made under his observation.

In cases where the inventory is determined solely by means of a physical inventory at the end of the accounting period (or at a date prior or subsequent thereto but within a reasonable time thereof, with adequate records supporting the interim changes), it will ordinarily be necessary for the foregoing procedures to be followed at that time.

In cases where the concern maintains well kept and controlled perpetual inventory records supported by (1) a complete physical inventory at a date not coincident with the balance-sheet date, or (2) physical inventories of individual items taken from time to time so that the quantity of each item on hand is compared with the inventory record for that item at least once in each year, it will be satisfactory to undertake the procedure outlined at any interim date or dates selected by the auditor, his purpose being to satisfy himself as to the credibility of the perpetual-inventory records and whether they may be relied upon to support the inventory totals as shown on the balance-sheet.

(B) That hereafter, in the case of inventories which in the ordinary course of business are in the hands of public warehouses or other outside custodians, direct confirmation in writing from such custodians is acceptable procedure; except that, where the amount involved represents a significant proportion of the current assets or of the total assets of a concern, the independent certified public accountant shall make supplementary inquiries.

It should be clearly understood that in undertaking these auditing procedures regarding inventories, the independent certified public accountant does so for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition and does not hold himself out as a general appraiser, valuer, or expert in materials.

The general adoption of such added procedures regarding inventories may necessitate procedural changes on the part of clients. So many corporations close their books upon a calendar-year basis that it is doubtful whether the profession as at present organized can undertake the additional work adequately and satisfactorily on the last day of each year. Many corporations do not have adequate perpetual-inventory records and greater use of them should be encouraged.

The extension of procedures regarding inventories would be greatly facilitated if each concern adopted its natural business year instead of the calendar year as its fiscal year, and introduced continuous well kept perpetual inventory records.

The proposed changes will take time to bring about, and in the meantime the profession may well be faced with the necessity of submitting qualified reports in those cases in which it has been impracticable to carry out the added procedures.

Receivables

In regard to the question of confirming receivables by direct communication with the debtor, the following recommendation is made:

That hereafter, wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of confirming receivables in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment.

Appointment of Independent Certified Public Accountants

Apart from the specific phases of auditing procedure which have been the subject of consideration, the method of appointment of the independent auditor and his status in relation to the client are believed to be subjects of great importance to stockholders and creditors.

To emphasize the auditor's independence of the management, some corporations affected by public interest have adopted the practice of having the independent auditor engaged or nominated by the board of directors or elected annually by the stockholders. Other corporations have provided that the stockholders be given an opportunity to ratify the selection made by the directors.

It is suggested that the auditor should be appointed early in each fiscal year so that he may carry out part of his work during the year.

Form of Independent Certified Public Accountant's Report or Opinion

The services which independent auditors render usually culminate in a report, which may take varying forms. In some cases a detailed report is rendered, accompanied by statements and supporting schedules; in other cases the report is limited to a concise statement of the scope of the examination and the related opinion of the independent auditor concerning the accompanying financial statements of the client. For present purposes the discussion is confined to the short form of auditor's report, which is sometimes described as a certificate. The terms "report," "opinion," "report and opinion," and "certificate" have been used interchangeably. As uniformity is desirable, either of the words "report" or "opinion" is recommended for general use. The word "report" has been adopted in the following comments.

In January, 1934, the Institute issued a pamphlet entitled *Audits of Corporate Accounts*, dealing with a standard form of auditor's report. The short form of report then recommended, and since widely adopted by the profession, met a long-felt need.

Developments during the five years in which the standard form of report has been used indicate the need of revision in the interest of clarity. The revised short form of report consists of two paragraphs. The first contains a brief statement of the scope of the examination, and the second deals with the auditor's opinion on the financial statements of the client as a result of his examination.

The major changes recommended pertain to the description of the scope of the examination, specifically to include reference to the system of internal control. The phrase "obtained information and explanations from officers and employees of the company" has been omitted because it is inherent in all auditing procedure to obtain information and explanations from officers and employees concerning the accounts, either as supplementing information obtained from other sources or as constituting the only available information on the subject. In the latter case, the auditor must decide, in view of all the circumstances, whether he should rely upon such information without disclosure of the source. The phrase in question has led to serious misconception as to the degree of reliance on such information and explanations. The sense of the statement "but we did not make a detailed audit of the transactions" has been retained in a revised form. It will be recalled that this clause was included in the standard form of 1934 in order to make clear that the auditor's usual procedure consisted of testing and sampling rather than a detailed audit. It is believed that the business and financial public now fully understand that, in a well organized concern, the detection of irregularities is primarily a matter of internal procedure, and that testing and sampling to determine whether such procedure is adequate in scope and effective in operation is the usual practice of the independent auditor. Nevertheless, it is considered advisable for the purpose of emphasis to include the phrase, "without making a detailed audit of the transactions." There has been excluded the phrase "based upon such examination," as it is obvious that the independent certified public accountant can express an opinion only after he has completed the work set forth in the first paragraph of the report.

The independent certified public accountant should recognize that in some cases the revised short form recommended may not be altogether appropriate. For instance, there may be cases where the auditor may prefer to alter the first sentence of the standard short form, substituting some words to the effect that the accounting records (instead of the financial statements) have been examined. Obviously, also, it would be erroneous to mention internal control if none existed. Accordingly, while the proposed form is submitted as a standard, it is not prescribed or recommended for invariable use, but should be adapted to the needs of the particular case. For example, the report may be used in connection with an examination covering a period of years, in which case a modification of language would be necessary. Also, in new engagements appropriate investigations relating to prior years will have to be made to justify the use of the short-form report. However, in the interest of reasonable uniformity it is recommended that the substance of phrases in the standard form be used unless inappropriate.

In considering the independent certified public accountant's opinion, the reader should bear in mind one of the most important underlying concepts of financial statements, viz., that normally many of the assets of a concern are not realizable in cash, but are commonly stated at their historical cost or going-concern basis at amounts which are usually greater than the realizable value in forced liquidation. Again, the true profit or loss of a concern can be determined with accuracy only over its entire existence. Therefore, in any attempt to allocate to specific periods profit or loss applicable thereto, it must be recognized among other considerations that, as many transactions are not fully completed within such periods, the result as shown must contain many estimates and approximations in the endeavor to present fairly the operating results of a period in conformity with generally accepted accounting principles.

Assuming that normal procedures have been carried out, it is not considered necessary to describe the details of the examination in this form of report. Any such details as are given should be included in separate paragraphs of the report. For example, reference may be made to procedures which the accountant has adopted regarding the examination of inventories and receivables; also, it may be pertinent to mention the fact that certain portions of the auditor's work have been carried out at different times during the course of the year. This may be indicated by inserting the words "at times" in the first paragraph of the short form of report immediately after the words "by methods."

It should be borne in mind that the financial statements, with all supplemental descriptive and explanatory data, including footnotes, are regarded as representations of the client. It is upon all these representations that the independent certified public accountant renders his opinion. If he considers explanations essential or desirable, and they have not been made in the financial statements, it will be necessary for him to make such explanations in a separate paragraph of his report.

In explanation of the general principles governing the auditor's opinion, with particular regard to explanations and exceptions, it is pertinent to state that the auditor satisfies himself as to the fairness of the statements "by methods and to the extent he deems appropriate," in general conformity with the auditing procedures recommended in the Institute's bulletin *Examination of Financial Statements.* Ordinarily, if he has so satisfied himself, he is in a position to express an unqualified opinion. However, if he considers it in the interest of clear disclosure of material fact to include explanations of procedures followed, he is free to do so. If, on the other hand, such disclosures are made by reason of any reservation or desire to qualify the opinion, they become exceptions and should be expressly stated as such in the opinion paragraph of the auditor's report. As previously stated, if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole.

It is desirable as a general rule that exceptions by the independent certified public accountant be included in a paragraph separate from all others in the report and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, any particular item of the financial statements, the soundness of the company's procedures (as regards either the books or the financial statements), or the consistency of accounting practices where lack of consistency calls for exception.

It is the responsibility of the accountant—and one which he cannot escape—to determine the scope of the examination which he should make before giving his opinion on the statements under review. If in his judgment it is not practicable and reasonable in the circumstances of a given engagement to undertake the auditing procedures regarding inventories and/or receivables set forth in this report as generally accepted procedure and he has satisfied himself by other methods regarding such inventories and/or receivables, no useful purpose will be served by requiring an explanation in his report. If physical tests of inventories and/or confirmation of receivables are practicable and reasonable and the auditor has omitted such generally accepted auditing procedure, he should make a clear-cut exception in his report.

It is worthy of repetition that the extent of sampling and testing should be based upon the independent auditor's judgment as to the effectiveness of internal control, arrived at as the result of investigations, tests, and inquiries. Depending upon his conclusions in this respect, the independent certified public accountant should extend or may restrict the degree of detailed examination. Consequently, in some cases it may be necessary to modify or omit reference to reliance upon the system of internal control. Clearly also where a detailed examination is made, the phrase "without making a detailed audit of the transactions" would be inappropriate.

It is contemplated that, before signing a report of the short-form type suggested, the independent certified public accountant will be satisfied that his examination is in conformity with the procedures and practices outlined in *Examination of Financial Statements*, a bulletin published by the American Institute of Accountants in January, 1936, or in any subsequent revision thereof.

The report should be addressed to the board of directors or the stockholders if the appointment is made by them.

The description of the financial statements in both paragraphs should, of course, conform to the titles of the accompanying statements.

In consideration of the foregoing remarks the following short form of report is recommended:

Short Form of Independent Certified Public Accountant's Report or Opinion

To the Board of Directors (or Stockholders) of the XYZ Company:

We have examined the balance-sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate.

In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at April 30, 1939, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

It is worthy of repetition and emphasis that, while the proposed form is submitted as a standard, it is not prescribed or recommended for invariable use but should be adapted to the needs of the particular case.

Special Committee on Auditing Procedure

P. W. R. Glover, *Chairman*
George Cochrane
George P. Ellis
Stanley G. H. Fitch
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Norman L. McLaren
Maurice E. Peloubet
Walter A. Staub
Victor H. Stempf
C. Oliver Wellington

John L. Carey, *Secretary*

Statements on Auditing Procedure

No. 2

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Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York, N. Y.

The Auditor's Opinion on the Basis of a Restricted Examination

THERE has been submitted to the special committee on auditing procedure a question involving the propriety or otherwise of the independent certified public accountant's expressing an opinion regarding the financial statements on the basis of a restricted examination. The committee believes that the question is of sufficient interest that the substance of its views should be made available to the membership.

The circumstances surrounding the particular engagement, as furnished to the committee, are as follows: Approximately 50 per cent of a client's assets are represented by current assets. Inventories account for 55 per cent of the current assets, and receivables an additional 13 per cent. Over 90 per cent of the receivables are maintained at branch offices and approximately 60 per cent of the inventories are located at branches. Approximately 90 per cent of sales (and thus presumably 90 per cent of the income) originate at the branches. The cash and fixed-asset accounts, investments and other asset accounts can be satisfactorily examined at the head office. Most of the liabilities originate at the branches. The branch accounts are examined by the client's internal auditing staff.

The committee is also informed that the company is well managed, its accounts are conservatively stated and there is no reason, from the work done at head office, to question the completeness and accuracy of the reports of the traveling auditors.

It is proposed that the examination by the independent certified public accountants be limited to the head-office records and that, as to the several important branches located throughout the country, they should rely entirely on reports of the client's internal auditing staff. The independent certified public accountants are not afforded an opportunity to confirm receivables by communication with debtors or to make physical tests of inventory quantities.

The situation with regard to receivables and inventories, in the opinion of the committee, comes clearly within the scope of the recommendations contained in the report, "Extensions of Auditing Procedure," dated October 18, 1939, in that (1) "inventories are a material factor" and (2) "the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets." Also there is no opportunity for the independent certified public accountants to satisfy themselves by examination in the field that the system of internal check and control, including the internal audit procedures, is being carried out as formulated. The committee believes that, depending on conditions, the effectiveness of the procedures regarding internal check and control at the branches (including the internal audit) might be determined by reasonable tests, i.e., without necessarily attending at all the branches.

In comparison with generally accepted auditing procedure, the proposed examination appears to be deficient in the following respects:

1. Restriction of the examination to the head-office records, and to that extent failure to make an examination in conformity with the procedures and practices outlined in the bulletin, *Examination of Financial Statements;*
2. Omission of confirmation of receivables;
3. Omission of generally accepted auditing procedures with regard to physical quantities of inventories.

The question is whether, on the basis of an examination thus limited, the auditors are justified in giving a qualified opinion in which they state the limitations.

The pertinent statement in the report, "Extensions of Auditing Procedure," dated October 18, 1939, reads as follows:

"As previously stated, if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole."

In view of the materiality of the assets and transactions involved, the committee is of the opinion that in this case the exceptions with regard to the scope of the examination are sufficiently material to negative the expression of an opinion, and that, accordingly, the auditors should refrain from expressing one.

Having dealt with the immediate question before it, the committee believes that it should take advantage of this opportunity to make certain observations. To quote the report of October 18, 1939: "It is the responsibility of the accountant—and one which he cannot escape —to determine the scope of the examination which he should make before giving his opinion on the statements under review." This is a responsibility which cannot be shared by the client. The independent certified public accountant should determine the scope of his examination and the client must rely upon the professional integrity and standing of the accountant for his assurance that no work unnecessary in the circumstances will be undertaken.

Internal auditing departments are an important part of the system of internal check and control, particularly where a concern has numerous plants or offices. The work of the internal auditor reduces the volume of testing and checking required of the independent auditor. However, the objectives, purposes, and points of emphasis of the two are by no means parallel. An internal audit stresses particularly the accuracy of the bookkeeping records, the fact that they conform with standard accounting procedures of the concern, and the discovery of irregularities and possible shortages. The independent auditor also has these matters in mind but they are not his primary objective. He concerns himself more particularly with the soundness of the judgments of the management as reflected in the financial statements and their conformity with generally accepted accounting principles and conventions. Furthermore, one of the safeguards of an independent audit is the fact that it is made by those independent of the concern under examination. For the reasons stated, an internal audit, however efficient, cannot be considered as a substitute for the work of the independent auditor.

Statements on Auditing Procedure

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13 East 41st Street, New York, N. Y.

Inventories and Receivables of Department Stores, Instalment Houses, Chain Stores, and Other Retailers

Query: Is it practicable and reasonable to observe the taking of inventories and to communicate directly with debtors, as added auditing procedures in the examination of the financial statements of department stores, instalment houses, chain stores, and other retailers?

THE REPORT of the American Institute of Accountants dealing with extensions of auditing procedure indicates that, where "practicable and reasonable," observation of the taking of inventories and direct communication with debtors are to be considered "generally accepted auditing procedures," meaning that they are normal, usual, or customary. The conjunction "and" is used; the procedures must be both practicable and reasonable. If they are both, their application cannot be avoided. Their omission under such circumstances necessitates a clear-cut exception.

On the other hand, if these procedures are not practicable and reasonable in the circumstances of a given engagement, and if the auditor has otherwise satisfied himself, he need make no exception or explanation in his report. Under such circumstances, however, if he prefers to do so, he may make any explanation he sees fit.

The primary meaning of "practicable" is:

"capable of being put into practice, done, or effected, especially with the available means or with reason or prudence."

The primary meaning of "reasonable" is:

"endowed with reason, or rational, having or exercising sound judgment, or sensible."

Rarely is a procedure impossible or incapable of being put into practice, but it seems that the auditor may view "practicable" in the light of "with the available means," or "with reason or prudence." The operations may be practicable, but they may *not* be reasonable, i.e., not "sensible" in the light of surrounding circumstances. Notwithstanding these refinements in meaning, it is believed that there will be very few cases in commerce and industry as a whole in which the procedures cannot be applied, to the extent that will afford such tests as the auditor, in the exercise of his judgment, determines to be reasonable.

In the case of the receivables of department stores, instalment houses, chain stores, and other retailers, there might be justifiable question as to the reasonableness of applying the positive form of confirmation, but it is believed that there is no question as to the practicability and reasonableness of applying the negative form of confirmation which requires no reply unless the recipient challenges the balance shown. When dealing with housewives, as is the case in department stores particularly, the negative form is more practicable than the positive, as it places the recipient definitely on notice that the creditor's books show a stated balance, and that the auditor assumes the correctness of that balance unless the debtor objects within reasonable time.

It is believed, therefore, that department stores, instalment houses, and others dealing with ultimate consumers are among the cases in which the application of the negative form of direct communication with debtors, when carried out in the manner suggested in the bulletin, *Examination of Financial Statements*, is to be considered as compliance with "generally accepted auditing procedure."

There is a further distinction between the larger institutions with large masses of receivables which may run into tens of thousands of items and the smaller ones, because the very mass of the accounts requires more than ordinary division of duties affording opportunity for more effective internal control. Confirmation of receivables by a selective test, where the conditions justify it, is within the contemplation of the added procedures prescribed. As a rule, the larger the mass, the smaller the average amount, and the more effective the internal control, the smaller may be the percentage of confirmation; and in unusual cases quite a small percentage may well be proper.

As to the added procedures regarding inventories of department stores, instalment houses, chain stores, and other retailers, it is likewise believed to be practicable and reasonable for the auditor to participate by suitable observation at the time inventories are determined by physical count by the client, or to require physical tests of inventories to be made under his observation. The method, extent, and time of applying this extension of auditing procedure necessarily will vary with the circumstances, and the procedures will be undertaken in addition to the usual auditing tests and checks of the inventory accounts and records, with due consideration to the effectiveness of the internal check and control as applied not only to book records, but also to the procedure of taking physical inventories.

Here again there is a distinction between large institutions with a great number of branches and/or departments and the more compact or simple organizations, because the volume of transactions requires more than ordinary division of duties, affording opportunity for more effective internal control. In such cases, the observation or tests of physical inventories may well be limited to a relatively small number of branches or departments, and the larger the number of branches or departments and the more effective the internal control, the smaller may be the percentage to be covered; and in unusual cases quite a small percentage may well be proper.

The auditor's purpose is to satisfy himself as to the credibility of the client's representations concerning inventories, but he does not hold himself out as an appraiser, valuer, or expert in materials. The auditor does not "take," "determine," or "supervise" the inventory. These operations are undertaken by management, antecedent to its primary representations concerning quantity, condition, and value of the inventories. The independent certified public accountant "observes" these procedures in his capacity as an auditor, for the purpose of satisfying himself as to the fairness of representations made by the client, but he does not, and should not in his ordinary capacity as auditor, make the original determination. Within these clear limitations, it is believed that observation of the taking of inventories of department stores, instalment houses, chain stores, and other retailers is "practicable and reasonable" and, therefore, to be considered "generally accepted auditing procedure."

There appears to be a question in the minds of some concerning the character of exceptions necessitated by the omission of the added procedures when their application is practicable and reasonable. When the auditor has been unable to satisfy himself concerning the *amount* of inventories or receivables (or any other asset) stated in the accounts, he will continue, as in the past, to make a definite exception as to the amount. Moreover, where the added procedures prescribed in "Extensions of Auditing Procedure" are practicable and reasonable, if the auditor has not adopted them an exception is still required even though he may have satisfied himself by other means as to the fairness of the amount. What is the character of the exception in these circumstances?

The report, "Extensions of Auditing Procedure," clearly refers to several types of exceptions in the following language:

"Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, any particular item in the financial statements, the soundness of the company's procedure (as regards either the books or the financial statements), or the consistency of accounting practices."

This leads to the obvious conclusion that when the added procedures are applicable and the auditor has not adopted them but has satisfied himself by other methods, his exception need cover only the omission of the procedures (affecting the scope of work), without calling into question the inherent fairness of the representations. On the other hand, were the auditor not satisfied, and were his exceptions so material or the scope of his examination so limited as to negate the expression of an opinion, he would limit his report to a statement of findings, and, if appropriate, say that the limitations, or exceptions, were such as to make it impossible to express an opinion concerning the fairness of the statements as a whole.

There follows a restatement of the standard short form of independent certified public accountant's report including a typical paragraph relating to the exception which should be made when (a) the added procedures are "practicable and reasonable," but (b) have not been applied, and (c) the auditor has otherwise satisfied himself:

"We have examined the balance-sheet of the XYZ Company as of blank date, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate, except as stated in the following paragraph.

"Auditing tests and checks of accounts and records concerning accounts receivable and inventories have been made, but upon instructions of the company we have not applied the generally accepted auditing procedures of direct communication with debtors or attendance at the physical count of inventories; nor have physical tests of inventories been made under our observation.

"In our opinion, subject to the exception stated in the foregoing paragraph relating to the limitations of the scope of our examination, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at blank date, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

It should be emphasized that the language in which the exceptions are stated above is to be regarded as typical and not as standard. Each accountant must feel free to state his exceptions in whatever form his judgment dictates.

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Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York, N. Y.

No. 4

March 1941

Clients' Written Representations Regarding Inventories, Liabilities, and Other Matters

INTRODUCTORY NOTE

An inquiry was directed to the committee on auditing procedure last fall relating to the form and content of written representations obtained by practising accountants from their clients with regard to inventories, liabilities, and other matters, and a subcommittee was appointed to look into the matter. The subcommittee has made extensive inquiries and research into the subject in recent months and has submitted a report thereon to the committee. This report contains considerable information which the committee believes will be useful as research material to practising accountants, and the committee has accordingly authorized that it be published for the information of members. The report is reproduced hereunder.

REPORT OF SUBCOMMITTEE ON CLIENTS' WRITTEN REPRESENTATIONS TO AUDITORS

Fifty-two representative accounting firms, large and small, partners of which are members of the Institute, have coöperated with the committee in its effort to make a survey of practice in respect to requiring written representations from clients covering inventories, liabilities in general, and contingent liabilities. Many of the moderate-sized and smaller firms which require written inventory and liability representations do not have special forms, and these representations are not required in every engagement. There is great variation in what these representations cover and there are several points which are included in the inventory representation by some firms and in the liability representation by others. Obviously, there is little similarity in language in the forms used, but the purpose and the desired effect seem to be fairly uniform.

The practice of requiring a comprehensive written representation covering practically all items on the balance-sheet is limited to some of the larger firms, but the firms which use this type of representation are of sufficient importance that it is the opinion of the subcommittee that a description of such representations should be given.

Whether or not a written representation is required from the client, the information would necessarily have to be obtained where pertinent, and oral representations be made by the client. Reducing these to writing has the advantage of confirming the statements made and of avoiding any misunderstanding regarding them. Moreover, they have the effect of reminding the client or the management of the client company that the primary responsibility for the correctness of the statements rests with the client rather than the auditor and of insuring that the client realizes this primary responsibility and gives some thought to the general position on inventories and liabilities beyond that covered by routine procedures and duties. There seems to be little or no feeling that the representations of the client regarding inventories or liabilities reduce the examination the auditor should make or relieve him of his responsibility. The purpose is rather to insure the active coöperation of the client.

The case with information regarding liabilities obtained from the client's legal counsel is somewhat different. If the client's legal counsel states that he knows of no contingent liabilities in respect to litigation, the auditor would seem to be entitled to rely on such a statement.

The letters received from the fifty-two firms which submitted statements of their procedure generally ask that the results of the inquiry be summarized and made available to the members of the Institute. The preparation of standard forms was recommended by some members, while by others the use of standard forms was considered undesirable. The preparation of anything in the nature of adequate standard forms for general use seemed to be a practical impossibility and, after considering it, the committee on auditing procedure concluded that even if practicable it would be undesirable because consideration is required to be given to the circumstances of the individual case. The committee felt, however, that a summary of practice would be useful and desirable.

The question of presentation was also discussed by the committee and it was agreed that the results of the inquiry made by the subcommittee could be most usefully presented in a skeleton form, which would cover the practice of the majority of those firms responding to the subcommittee's inquiry, accompanied by notes and explanations of the nature and purpose of the information requested. Such data is given herewith. From this it is believed that any member can either check his present practice with what appears, from the result of this inquiry, to be the combined or aggregate current practice or revise his present forms or devise new ones from the information given to include such matters as he deems necessary. The complete tabulation is undoubtedly more extensive than the majority of members will need.

Certain points were covered sometimes in the inventory form and sometimes in the liability form and these are indicated. Generally, there seems to be no reason to prefer the inclusion of a particular item in one form or another.

Presented herewith are:

Skeleton form of representation covering inventories and notes thereon
Description of representation covering liabilities
Description of comprehensive representation

WILLIAM EYRE
MAURICE E. PELOUBET
Subcommittee of Committee on Auditing Procedure

WRITTEN REPRESENTATION COVERING INVENTORIES

Blank Company,
Certified Public Accountants,
Blank Street, City

Dear Sirs:

In connection with your examination of the accounts of (blank company) and more particularly in connection with your examination of the (blank company or department) as at (blank date), we hereby make the following statements and representations concerning inventories of (blank company):

A. QUANTITIES AND AMOUNTS

B. TITLE AND OWNERSHIP

C. PRICES AND CALCULATIONS

D. COMMITMENTS

E. CONDITION

The foregoing constitutes a fair statement of quantities and valuations of the respective inventories as at (date as of which audit is made) to the best of the knowledge and belief of the undersigned.

(Signature)

(Date signed)

Notes on Written Inventory Representation

General

The representation may be prepared either for one or several classifications of material, as raw materials, goods in process, finished goods, supplies, and may be subdivided if convenient, and if the amount is sufficiently important, into separate representations for the inventories in particular departments or plants. It is preferable for the representation to specify the particular location of the inventory by plant or warehouse.

The officials and employees who sign the representation are usually asked to state that the inventory was taken under their direction. In the case of junior executives, this would mean under their direct supervision. In the case of executive officials it would mean under their general instructions.

The items listed for attention and consideration under the various headings shown in the skeleton form for inventory representation are all reported to have been used by some of the fifty-two firms who have coöperated with the subcommittee in making this inquiry. There are some items common to the representations of practically all firms reporting while others are included in the representations of a much smaller number of firms depending, presumably, in many cases on the nature of the practice or the particular trades or industries in which a majority of a firm's clients may operate. The list of items to be considered under each heading may, therefore, be regarded as a maximum rather than a minimum and it is quite likely that there will be few cases in which every item will be applicable.

A. Quantities and Amounts

The items falling under this heading are:

1. A classification of the inventory as between, say, raw materials, goods in process, finished goods, supplies, etc.;
2. A statement that the inventories covered by the representation were taken under the direction of those signing the representation;
3. A statement that the inventories were taken in accordance with

inventory instructions, copies of which had been delivered to the auditors;

4. A statement that the quantities were correct and were determined by actual count, weight or measurement under the supervision of an official of the company on a specific date;
5. A statement that the books have been adjusted to the physical inventory, that all adjustments between book values and physical inventories have been made, that any adjustments necessary because inventories were taken at a date different from the close of the fiscal year have been made and that the books have been closed on the bases of such physical inventories;
6. If a physical inventory was not taken, a statement that an adequate perpetual-inventory system is maintained and the foregoing quantities and amounts are in agreement therewith;
7. Where perpetual inventories are relied on, a statement as to the frequency and coverage of physical tests;
8. Where there are methods of inventory-taking in use which are generally considered to be physical but which are, to a certain extent, calculated or based on records (as, for instance, where the determination of the content of tanks of chemicals, fuel oil, or similar material has been made by physical or chemical tests or the calculation of a pile of coal, stone or similar material by an engineering calculation) a statement to that effect.

B. Title and Ownership

Under this heading there are included in the various forms of written representations submitted by the coöperating firms statements that the inventory as shown by the books adjusted as described above:

1. Is the unencumbered property of the company and includes no material held on consignment from others, except:
2. Has not been pledged as collateral, except:
3. Includes no items billed by the company prior to (date as of which audit is made);
4. Includes no items not paid for or for which the liability has not been taken into account;

   Is subject to no liens or other encumbrances for duties, taxes or similar items which have not been taken into account with the specified exceptions.

C. Prices and Calculations

This caption includes statements that:

1. The inventory is priced at the lower of cost or market with a general statement of the basis on which this cost is determined, as first-in, first-out, average, last-in, first-out, or the like (where any

method representing an unusual or not generally recognized practice is used, the form sometimes requests this to be described fully);

2. The basis of pricing and method of computation is the same as used for the previous period, and unless definite instructions have been given to use different methods or principles in pricing the inventory, a statement that the inventory basis is the same as that used for the previous period; the company's own internal check and the independent audit should disclose variations from the method prescribed which were made in error, which this item is presumably not intended to cover;
3. The method described does not place a value on the inventory in excess of cost;
4. The prices used for materials are not in excess of the replacement cost at the date as of which the audit is made;
5. The replacement cost of inventory has not materially declined between the date as of which the audit is made and the date on which the representation is signed;
6. If the inventory is valued at market, where market is below cost, the market price is determined by some recognized method which is to be described.

D. Commitments

Where this item is covered by inventory representations, it is generally provided that statements should be made that:

1. No sales commitments exist below inventory prices;
2. No purchase commitments exist at prices in excess of current market as of the date of the balance-sheet except:
3. No purchase or sales commitments exist in excess of normal requirements, with specified exceptions.

E. Condition

The forms submitted included statements to the effect that no slow-moving, obsolete, damaged, depreciated or deteriorated materials or merchandise are included in the inventory at prices in excess of net realizable value.

Signature

The number of signatures and the position and title of those signing the representations for the client company vary greatly in the different forms of inventory representations submitted. In many cases, a single signature or general approval of an executive official only is asked for, while in others, separate signatures of junior executives responsible respectively for quantities, values and prices, and condition are required in addition. In general, where officials or employees sign separately for quantities, values and prices, and condition, it is contemplated that they do so as a matter of direct personal knowledge.

The signature for general approval may or may not indicate direct personal knowledge. This signature may be that of a general executive who signs merely on the basis that he has given instructions to subordinates on whom he relies and who, he assumes, are carrying out his instructions and their duties correctly. In a smaller concern the signature for general approval will probably indicate greater specific knowledge on the part of the official signing than in a larger organization.

Written Representation Covering Liabilities

Representations obtained from the client cover all known liabilities, contingent or otherwise. Liabilities which have been reduced to definite claims against the company, or those which are evidenced by existing contracts or agreements or which will eventually become due in the future for materials or merchandise received or included in inventory, or for services rendered, or in relation to any other obligation actually existing as of date as of which the audit is made, will be included in the books of the company; and such liabilities are not considered here except as they are covered by the general statement in the representation that all known liabilities are provided for. The representation forms also cover liabilities of a prospective or contingent nature and these are covered in some detail.

A statement is frequently required that no assets other than those of which the auditor has been advised are pledged as security for any obligation of the company and if any such pledge is made, forms submitted include provision for a description of the asset and a statement of its book value.

Where commitments are included in this representation much the same language is used as in inventory representation.

The representations also include a statement that no contingent liabilities, except those reported, exist. Some forms include, as a kind of reminder but without necessarily limiting contingent liabilities as to those specified, a list of the more usual types of contingent liabilities encountered. Those listed include contingent liabilities in respect of:

Customers' or other notes discounted, sold, or otherwise transferred
Drafts negotiated
Federal and state income, profits, and other taxes
Accommodation endorsements
Guarantees
Leases (except as reflected on the books)
Bonds or other obligations of other companies

Contracts or purchase agreements above current market
Profit-sharing arrangements
Pending lawsuits
Repurchase agreements
Any other agreements
Fair-labor-standards act (federal wage-and-hour law)
Accounts, notes, or other evidences of debt assigned to others with a guaranty of collection or under a repurchase agreement
Open balances on letters of credit
Additional taxes for prior years of which there is present knowledge based upon formal or informal advice
Any other pending or prospective claims, whether or not in litigation, such as claims for injuries, damages, defective goods, other than minor items arising in the ordinary course of business, for patent infringements, and deficiency judgments on real-estate bonds covering mortgaged property sold.

A comparatively small number of firms include a representation that no obligations not recorded on the books of the company exist for extension of plant and equipment or in connection with any other prospective activity of the company which are significant in amount or, if such obligations exist, a description of them.

Occasionally legal counsel are requested to state whether they have any knowledge of any transfers of property made during the period under examination, although this practice is not general.

Certain features of the liability representation are clearly within the scope of the knowledge of company officials, while on others the opinion of legal counsel may be required.

There is considerable diversity in the manner in which the forms call for these representations to be signed but whether they are signed by a company official, legal counsel, or both, the evident purpose is to place the responsibility on some person who may be expected to have actual knowledge of the conditions or transactions which the representations cover.

Comprehensive Written Representations Covering the Balance-sheet in General

A comparatively small number of firms, which handle a substantial proportion of audit work done by the profession, require comprehensive written representations signed by the treasurer, controller or other executives.

The subcommittee sees no objection to this practice, but the evidence available indicates that it is in use only to a comparatively limited extent. However, the following summary is considered to be of sufficient interest to be presented for the information of members. In each case, representations concerning inventories and liabilities are included in these comprehensive representations, but as these matters have already been dealt with separately, nothing will be repeated under these headings. The following items are covered in the practice of one or more of the firms referred to:

Property, Plant and Equipment

1. All charges to fixed-asset accounts represent actual additions.
2. Sales, dismantlements and abandonments have been properly accounted for.
3. The company has title to property included in plant, machinery and equipment accounts.
4. The basis on which the property has been carried is properly described in the statements.
5. All property, plant and equipment is being utilized in current operations or exceptions are noted.
6. The property is maintained in an efficient working condition.
7. No obsolete machinery or equipment is included in the asset accounts.
8. All property, plant and equipment has been paid for or liability therefor taken up on the books.
9. There are no liens or encumbrances on properties except as recorded on the books.
10. If properties are appraised the results of the appraisal as compared to the book value is fully and fairly set forth.

Reserve for Depreciation

1. In the opinion of the signer of the representation the annual provision for depreciation and depletion is adequate except as noted.
2. The total reserve for depreciation as compared with the asset is adequate at the date of the balance-sheet.
3. The basis for providing depreciation is consistent with the previous year or exceptions are noted.

Accounts Receivable

1. The notes and accounts receivable of the corporations represent valid claims against customers and other debtors.
2. Indebtedness of officers, stockholders and persons directly or indirectly controlling or controlled by the corporation and persons under direct or common control with the corporation is correctly stated in the statements.
3. Accounts receivable in respect of material or merchandise shipped on approval or on consignment are so described in the accounts-receivable records of the corporation.

4. Accounts receivable hypothecated or assigned are so described in the records of the corporation.
5. The accounts receivable as summarized do not include any charges in respect of material or merchandise shipped subsequently to closing date.
6. The accounts receivable as summarized above are not subject to deductions for discounts other than cash discounts not in excess of 2 per cent, for allowances in respect of defective material or merchandise, transportation charges, price adjustments, or for any other deductions of similar nature except as provided for by the corporation in its reserve accounts.
7. All notes and accounts receivable as at the closing date that are known to be uncollectible have been charged off as at that date.
8. In the judgment of the signer of the representation, the amount of $........ provided as a reserve for doubtful notes and accounts is adequate to provide for any losses that may be sustained in collecting the notes and accounts due from customers and other debtors as at the closing date.

Minute Books

A letter from the secretary of the company stating that the minutes furnished to the auditors are true, full and correct.

Special Provisions in Representations

One firm requires a statement that reserves are adequate for the purposes for which they are set up; that no extraordinary or nonrecurring items of income or expense are included in the profit-and-loss account except as noted; that the accounting principles and policies followed during the period are consistent with those followed during the previous period except as noted; and that officials of the company know of no additional material facts not shown on the books of account or made known to the auditors in writing.

Another firm requires a statement in regard to income taxes; a statement that there are no matters of strictly personal or private nature adversely affecting the successful continuation of the operations of the company known to exist at the balance-sheet date or which have arisen since; and a statement that, to the best of the knowledge and belief of the company officers, no shortages or defalcations have occurred which would affect the audit.

A third firm requires a statement that no events have occurred or matters been discovered since the balance-sheet date which might render the balance-sheet as of that date, or the profit-and-loss or expense statements, untrue or misleading; that no special matters have occurred during the period covered by the financial statements except as noted; and that there have been no shortages or irregularities not disclosed to the auditors which would have a bearing on the statements. In addition there is a statement of the understanding of the company officers of the scope of the audit and a statement that there have been no intentional omissions by the company officers to state material facts to the auditors.

Statements on Auditing Procedure

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Issued by the Committee on Auditing Procedure, American Institute of Accountants, 13 East 41st Street, New York, N. Y.

No. 5

February 1941

The Revised S.E.C. Rule on "Accountants' Certificates"

THE REVISED rule of the Securities and Exchange Commission regarding accountants' certificates known as rule 2–02 was issued on February 5, 1941, and is effective March 1, 1941.

The rule in draft form was the subject of consideration and discussions with the Commission for several months, and during this period there have been a number of meetings, considerable correspondence, and two formal hearings before the Commission. Since the release of February 5, 1941, letters have been exchanged between the committee and the Commission as follows:

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C.

GENTLEMEN:

This committee has given consideration to the Commission's release of February 5, 1941, covering the revised rule regarding accountants' certificates contained in amendment No. 3 to Regulation S-X. In view of the fact that the amendment becomes effective on March 1, 1941, and in conformity with the purpose of the American Institute of Accountants to coöperate to the fullest possible extent with the Commission, this committee deems it desirable that a suggested new form of certificate for use in connection with financial statements filed with the Commission should be put forward promptly which will be acceptable to the Commission.

The committee believes that the new requirements in the normal case can be met by the insertion of an additional sentence immediately following the present statement regarding the extent of the audit, and that the language of this sentence should follow as closely as possible that of the release. In substance, the statement of the auditors which we ask the Commission to approve would be: "In our opinion our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and it included all procedures which we considered necessary."

The amendment apparently contemplates that any such statement should be made as a statement of fact. However, the release clearly recognizes what this committee has maintained in discussions with the Commission that there is no criterion or group of criteria by which conformity of audit procedures in given circumstances to a generally accepted standard or standards can be factually determined and any statement such as is contemplated cannot be more than an expression of belief for which the auditor has reasonable grounds. The committee submits that, in the interests of a frank and clear statement to the public and in justice to the profession and investors, this should be frankly recognized and that our position should be made known.

The release contemplates that in considering whether procedures are in accord with generally accepted auditing standards regard shall be had, inter alia, to procedures prescribed by authoritative bodies such as the various accounting societies and governmental bodies having jurisdiction—whose requirements may not be uniform—and also to procedures ordinarily applied by other accountants skilled in their profession—as to which the auditor can have an opinion or belief but no certain knowledge or means of knowledge. No auditor can be in a position to state as a fact that his audit has conformed to a standard which is undefined and indefinable as indicated by the Commission's own statement, though he may have a well founded belief that he has conformed to such a standard. For this reason, the committee submits that the statement to be made in the certificate in regard to conformity of the audit to generally accepted standards should be prefaced by the words "In our opinion" or the equivalent.

The committee conceives that the liability of the profession under the act would in no way be restricted by the use of the words "In our opinion" but that if auditors express an opinion in respect of financial statements of a registrant without having made a reasonably adequate audit, liability attaches to them. The committee submits, however, that members of the profession should not be put in the position of being required to make as a statement of fact what is known to them to be, and shown by the Commission's release to be, no more than an expression of well founded belief.

The committee respectfully requests (a) that it may be advised whether the substantive part of the proposed sentence is acceptable to the Commission; (b) that the Commission permit the inclusion in the sentence of the words "In our opinion" or the equivalent thereof.

The complete certificate, amplified as herein proposed, would be as follows (new sentence underlined):

> We have examined the balance-sheet of the XYZ Company as of February 28, 1941, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by

methods and to the extent we deemed appropriate. In our opinion, our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and it included all procedures which we considered necessary.

In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at February 28, 1941, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Respectfully submitted

FOR THE COMMITTEE ON AUDITING PROCEDURE

February 14, 1941. Samuel J. Broad, *Chairman*

MR. SAMUEL J. BROAD, CHAIRMAN
COMMITTEE ON AUDITING PROCEDURE
AMERICAN INSTITUTE OF ACCOUNTANTS
70 PINE STREET, NEW YORK

DEAR SIR:

The Commission has instructed me to reply to your letter of February 14th as follows:

Your letter discusses briefly the recently adopted rule 2–02 of Regulation S-X and asks whether in a normal case the language "In our opinion, our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and it included all procedures which we considered necessary," if added to the form of certificate presently recommended by the Institute, would meet the requirements of the new rule. You also inquire specifically whether under the new rule the use of the words "In our opinion" is permissible.

As was pointed out in the release adopting the new rule 2–02, careful consideration was given to the views of your committee, as set forth in several letters and by oral argument before the Commission, and to the comments and suggestions of other professional bodies and of a large number of accounting firms and individual accountants. Consideration was also given to the conditions disclosed by the Commission's study of accountants' certificates and audit procedure in its investigations in the matter of McKesson & Robbins, Inc. and other auditing cases, and to those disclosed by registration statements and annual reports on file with the Commission. As a result, it was deemed necessary and appropriate to make a clear distinction in the new rule between matters as to which the accountant was asked to express an opinion and matters as to which it was felt that the accountant should make a positive representation consistent with the implied representations he makes by holding himself out as a professional and expert accountant or auditor. For this reason, sections (b) (i) (ii) of the rule require representations as to the scope of the audit, and section (c) of the rule, in contrast, requests the accountant's opinion as to the financial statements filed and as to the accounting principles and procedures followed by the registrant.

The suggested modification of the form of accountant's certificate presently recommended by the American Institute of Accountants may be considered in the light of the foregoing discussion. So analyzed, the substance of the modification would in a normal case appear to be consistent with the recently adopted rule. However, the use of the words "In our opinion" appears to be inconsistent with section (b) (ii) of that rule.

Very truly yours

WILLIAM W. WERNTZ
Chief Accountant

February 21, 1941.

The gist of the communications is that no difference of opinion arose on the substantive language appropriate to be added in the normal case. The committee emphasized the fact that the new language must be based on opinion, and proposed that it should be preceded by the words "In our opinion." The Commission, without questioning the fact, emphasized by the committee, indicated that it regarded the new sentence as "a positive representation consistent with the implied representation he [the accountant] makes by holding himself out as a professional and expert accountant or auditor," and said that the proposed use of the words "In our opinion" appeared to be inconsistent with section (b) (ii) of the rule. The correspondence indicates that a certificate would be acceptable to the Commission in the normal case if it takes the following form:

> We have examined the balance-sheet of the XYZ Company as of February 28, 1941, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.

In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at February 28, 1941, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

It will be noted that the suggested form is identical with that included in the report, "Extensions of Auditing Procedure," except for the addition of the second sentence in the first paragraph. This second sentence adopts language substantially identical to that used in subsections (b) (ii) and (b) (iii) of the rule.

There are other changes in the rule which in special cases will have an effect upon the accountant's report. Under subsection (b) (i) "if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission" is required. It is indicated in the release that such a statement is part of the description of the scope of the examination and is not considered as an exception unless specifically so expressed.

Under subsection (c) (ii), by reference to rule 3–07, the opinion of the accountant is required regarding "any significant retroactive adjustments of the accounts of prior years" and under (c) (iii) regarding "the nature of, and the opinion of the accountant as to, any significant differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review." These requirements are also new.

COMMITTEE ON AUDITING PROCEDURE

SAMUEL J. BROAD, *Chairman*	P. W. R. GLOVER	NORMAN L. MCLAREN
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Statements on Auditing Procedure

No. 6

March 1941

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York, N. Y.

The Revised S.E.C. Rule on "Accountants' Certificates"

(Continued)

THE COMMITTEE on auditing procedure recently issued a statement (Bulletin No. 5) in which it incorporated a modified short form of accountant's report or opinion which it understood would be acceptable to the Securities and Exchange Commission in the normal case for use in connection with financial statements filed with the Commission.

The committee also called attention to other changes in the Commission's revised rule on "accountants' certificates" which in special cases would have an effect upon the accountant's report. These are now dealt with in greater detail and, for convenience, the revised rule and the accompanying release of the Commission are appended herewith.

Under subsection (b) (i) "if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission" is required. The bulletin, "Extensions of Auditing Procedure," issued by the American Institute of Accountants under date of October 18, 1939, stated that, if in the judgment of the auditor it was not practicable and reasonable in the circumstances of a given engagement to undertake the extended auditing procedures regarding inventory quantities and/or confirmation of receivables and he had satisfied himself by other methods regarding those assets, no useful purpose would be served by requiring an explanation in the auditor's report. However, under the Commission's rule a specific designation of the procedures omitted is required and also of the reasons for their omission. According to the Commission's release accompanying the rule "the designation of procedures omitted would be confined to primary auditing requirements which have been recognized as normal auditing procedures as, for example, the circularization of receivables, and would not extend to detailed or mechanical steps." This may be regarded as defining the word "procedures" as used in the rule.

Subsection (b) (ii) of the rule deals with conformity with "generally accepted auditing standards" and the release states that "in referring to generally accepted auditing standards the Commission has in mind, in addition to the employment of generally recognized normal auditing procedures, their application with professional competence by properly trained persons," and that "in referring to generally recognized normal auditing procedures the Commission has in mind those ordinarily employed by skilled accountants and those prescribed by authoritative bodies dealing with this subject, as for example the various accounting societies and governmental bodies having jurisdiction." These in turn may be regarded as definitions of the term "generally accepted" and the term "auditing standards" as used in the rule.

A distinction was drawn by the Commission in its discussions with the committee between auditing standards and auditing procedures. Auditing standards may be regarded as the underlying principles of auditing which control the nature and extent of the evidence to be obtained by means of auditing procedures. In regard to inventory pricing, for example, auditing standards would require the auditor to satisfy himself by reasonable evidence and approved methods that the prices had been determined on a basis that was recognized as generally accepted in the circumstances. Procedures would embrace the details of his work, whether he satisfied himself by reference to cost records, purchase invoices, published quotations, subsequent selling prices, gross-profit test, retail method or any or all of these and other methods. The committee believes this distinction between standards and procedures has not been drawn with sufficient clarity in accounting literature and should be emphasized more than it is.

Subsection (b) (ii) is thus evidently intended to require the auditor to assure the reader that the examination would stand up in comparison with what competent auditors would have felt necessary in the particular case. The term "generally accepted auditing standards applicable in the circumstances" does not imply a representation that in the particular case all procedures were followed which would be followed in the majority of all cases. It rather implies evidence which accountants generally would consider adequate in the particular circumstances.

Subsection (b) (iii) requires a statement "whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case." In the view of the Commission as expressed in the covering release the circumstances of a particular case "may call for the extension of normal procedures or the employment of additional procedures." Tests which might be adequate in normal circumstances might, under the circumstances of a particular case, be insufficent, due perhaps to lack of adequate internal control or for other causes. This has long been recognized by the profession and is inherent in the phrase commonly used in describing the scope of the examination, "by methods and to the extent we deemed appropriate."

The Commission makes it mandatory that appropriate consideration be given to the adequacy of the system of internal check and control, following the standard set forth in the report, "Extensions of Auditing Procedure," and in accounting discussion and literature during recent years. The succeeding sentence, "Due weight may be given to an internal system of audit regularly maintained by the use of auditors employed on the registrant's own staff," is permissive. No reference is made to the work of internal auditors who may be employed by a subsidiary of the registrant but, as the sentence is permissive and not restrictive, the committee does not consider the omission serious. Where circumstances surrounding an internal audit made by employees of a subsidiary are such as to justify a measure of reliance upon it, the committee believes the auditor should give due weight to it also as constituting part of the system of internal control.

In subsection (c) the matters on which the opinion of the accountant is required are made more specific and are also somewhat extended. Subsection (c) (ii) refers to rule 3–07. Rule 3–07, as amended, now deals not only with significant changes in accounting principle or practice, but covers also "any significant retroactive adjustment of the accounts of prior years"; and under (c) (ii) the opinion of the accountant as to any such significant changes or adjustments is required. The committee understands that the term "any significant retroactive adjustment" is not intended to cover the ordinary type of "surplus adjustments," but rather items which have significant bearing upon previous years' accounts (e.g., settlement of a substantial lawsuit charged to surplus or retroactive adjustment of depreciation provision), or adjustments which might affect the basis on which the accounts have previously been stated. Under the latter category would come such adjustments as a change in the basis of stating fixed assets from appraised value to cost or vice versa, the setting up by a utility for the first time of unbilled revenue at the end of a year, or the writing off of deferred charges, and similar adjustments which, if applied, would have had a significant effect on the accounts of a prior year. It is, of course, impossible for the committee to give an inclusive description of the types of adjustments which may be involved, but probably every important adjustment of surplus, and possibly other important adjustments, will require to be considered to determine whether they come within the scope of this rule requiring an expression of the accountant's opinion. The opinion doubtless will cover the propriety of the adjustment from an accounting standpoint and the manner in which it has been dealt with in the statements.

Subsection (c) (iii) contains a new requirement. It relates to differences between the books as finally closed and the financial statements, and will probably be applicable only in rare instances. It is not intended to embrace the normal adjustments and eliminations consequent upon the preparation of consolidated statements.

Additional opinions to be expressed by the accountant will occasionally be required under (c) (ii) and (c) (iii), but the form of these will be influenced so much by the circumstances involved that no standard form can be suggested. The committee suggests, however, that matters to be dealt with under these subsections be incorporated in separate paragraphs between the first and final paragraphs of the standard form and that the accountant specifically express his opinion on the various matters in those intermediate paragraphs. In the final or opinion paragraph it will then be unnecessary to repeat such comments or opinions, though reference to them may be required; for example, if there has been a change in accounting principle or practice, the last clause of the opinion paragraph might read: "in conformity with generally accepted accounting principles applied on a basis consistent, except as set forth in the next preceding paragraph, with that of the preceding year."

The revised rule is, of course, applicable only to reports filed with the Commission. As a practical matter, however, practising accountants may in course of time consider it advisable to apply the same standards of disclosure in reports for other purposes also, though the old form will doubtless continue to be used for an intermediate period.

APPENDIX

SECURITIES AND EXCHANGE COMMISSION
Securities Act of 1933
Release No. 2460
Securities-Exchange Act of 1934
Release No. 2776
Accounting Series
Release No. 21 February 5, 1941

The Securities and Exchange Commission today announced the adoption of amendments to rules 2–02 and 3–07 of Regulation S-X, which are designed to correct certain defects disclosed by the Commission's studies of accountants' certificates. Regulation S-X governs the form and content of financial statements required to be filed on form A-2 under the securities act of 1933 and most of the forms promulgated under the securities-exchange act of 1934. The amendments become effective March 1, 1941.

At the time of the adoption of Regulation S-X it was stated that "In view of the pending proceedings in the matter of McKesson and Robbins, Incorporated, and several other cases, the rules governing certification by accountants, although altered and clarified in some respects, have been retained in substantially the form now found in the General Rules and Regulations under the securities act of 1933 and the several major forms under the 1933 and 1934 acts. Upon completion of these proceedings, however, such rules are to be considered with a view to revisions deemed necessary as a result of these cases."

The form of the accountant's certificate was considered at some length in the *Report of Investigation, In the Matter of McKesson & Robbins, Inc.* The following conclusions reached on this subject are quoted from pages 434–435 of the report: *

". . . it appears to us that the following principles should be adopted respecting the form and content of accountants' certificates in order to avoid possibility of confusion in the future.

"The work done should be described as the auditor sees fit and any desired information concerning the accounts may be stated. While we do not think that each audit step should necessarily be set forth, it is to be hoped that really descriptive language will be used as distinguished from a standard form based upon procedures set forth in a bulletin neither of which is referred to in the certificate. While the road is left clear to the auditor to describe in his own language what he has done and what he has found, we suggest one positive requirement in this connection. The certificate should state as part of the description of the scope of examination every generally recognized normal auditing procedure which has been omitted and the reasons for the omission.

"We believe that, in addition to the present expression of opinion that the company's position and results of operations are fairly presented by the accounts, the accountant should certify that the examination conducted was not less than that necessary in order to form the foregoing opinion. This statement may well replace the one generally in use in certificates prior to the present hearings in which the only reference to the examination in the opinion paragraph was in the words 'based upon such examination' or 'subject to the foregoing' following 'In our opinion.' Besides not definitely stating whether the examination was sufficient in scope, these words would seem to incorporate all prior references to the examination in the preceding paragraphs of the

* Copies of the report may be obtained from the Superintendent of Documents, United States Government Printing Office, Washington, D. C., price 60 cents.

certificate and base the auditor's opinion thereupon without specifically stating whether those references were purely descriptive or in the nature of exceptions. Exceptions to the scope of the audit or to the accounts should be expressly so stated in the same sentence as the certification as to the scope of the audit and the opinion as to the accounts, respectively. Exceptions may be incorporated by reference in such sentences but must be specifically designated as 'exceptions.' If any required information has been withheld by the client or access to records denied these facts should, of course, be treated as exceptions.

"We said above that the auditor should certify that the examination was not less than the required minimum of accepted practice both as to procedures and the manner of their application. While accountants may not be able to certify as to the correctness of the figures appearing on the financial statements in the sense of guaranteeing or warranting their correctness but can merely express their opinion with respect to them, we do think they can and should certify that the examination, on which their opinion as to the financial statements was based, was at least equal to professional requirements."

Amendments of the rules as to accountants' certificates have for some time been the subject of correspondence and discussion between committees representing the American Institute of Accountants, the Controllers Institute of America, and the American Accounting Association, and numerous individual accountants and members of the Commission's staff. During this time the suggestions made by individuals as well as by the committees have been given careful consideration and a number of them embodied in drafts of the rules which have been made available to the coöperating committees and individuals for further criticism. Successive revisions and criticism have resulted in the revised rules now adopted by the Commission.

The revised rule 2–02 sets forth requirements as to the contents of the accountant's certificate and is divided into four sections.

Section (a) states certain technical requirements and involves no change from previously existing rules.

Section (b) contains the requirements for the accountant's representations as to the nature of the audit which he has made. Under subdivision (i) the accountant must give a reasonably comprehensive description of the scope of the audit which he has performed. In accordance with the opinion of the Commission in the McKesson report, the subdivision also requires that, if any generally recognized normal auditing procedures have been omitted with respect to significant items in the financial statements, such omissions shall be stated with a clear explanation of the reasons for such omission. It is contemplated that designation of procedures omitted would be confined to the primary auditing requirements which have been recognized as normal auditing procedure, as for example, the circularization of receivables, and would not extend to detailed or mechanical steps. Since in particular circumstances such omissions may be proper, the specification of such omissions and the reasons therefor in connection with the description of the audit would not be considered as exceptions or qualifications unless specifically so noted in connection with subsection (ii) which requires that the accountant shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances. In referring to generally recognized normal auditing procedures the Commission has in mind those ordinarily employed by skilled accountants and those prescribed by authoritative bodies dealing with this subject, as for example, the various accounting societies and governmental bodies having jurisdiction. In referring to generally accepted auditing standards the Commission has in mind, in addition to the employment of generally recognized normal auditing procedures, their application with professional competence by properly trained persons. The Commission further recognizes that the individual character of each auditing engagement and the facts disclosed through a vigilant, inquisitive, and analytical approach by the auditor may call for the extension of normal procedures or the employment of additional procedures. Therefore, subsection (iii) requires that the accountant also state whether he omitted any procedure deemed necessary by him under the circumstances of the particular case.

Paragraphs two and three of section (b) incorporate provisions of previous rules and add the requirement that "appropriate consideration shall be given to the adequacy of the system of internal check and control," thus emphasizing the importance of this basic element.

Section (c) concerning the opinion of the accountant as to the financial statements covered by the certificate and the accounting principles followed is for the most part a restatement and clarification of previous rules.

Section (d) includes an important change from previous rules, in that it requires in addition to a clear identification of all exceptions that, to the extent practicable, the effect of each exception on the related financial statements be given. A clear explanation of the effect on the financial statements of the use of accounting principles to which exception is taken is deemed necessary if the statements are not to be misleading to investors.

Rule 3–07 incorporates the new requirement that if "any significant retroactive adjustment of the accounts of prior years has been made at the beginning of or during any period covered by the profit-and-loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and if the . . . adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation."

The text of the Commission's action follows:

Amendment No. 3 to Regulation S-X

The Securities and Exchange Commission, acting pursuant to authority conferred upon it by the securities act of 1933, particularly sections 7 and 19 (a) thereof, and the securities-exchange act of 1934, particularly sections 12, 13, 15 (d) and 23 (a) thereof, and finding such action necessary and appropriate in the public interest and for the protection of investors, and necessary for the execution of the functions vested in it by the said acts, hereby amends rules 2–02 and 3–07 of Regulation S-X to read as follows:

"*Rule 2–02. Accountants' Certificates*

"(a) *Technical requirements*

"The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.

"(b) *Representations as to the audit*

"The accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made including, if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

"In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed.

"Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

"(c) *Opinions to be expressed*

"The accountant's certificate shall state clearly:

"(i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein;

"(ii) the opinion of the accountant as to any changes in accounting principles or practices, or adjustments of the accounts, required to be set forth by rule 3-07; and

"(iii) the nature of, and the opinion of the accountant as to, any significant differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

"(d) *Exceptions*

"Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

"*Rule 3-07. Changes in Accounting Principles and Practices*

"If any significant change in accounting principle or practice, or any significant retroactive adjustment of the accounts of prior years, has been made at the beginning of or during any period covered by the profit-and-loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and, if the change or adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation."

The foregoing action shall be effective March 1, 1941.

COMMITTEE ON AUDITING PROCEDURE

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Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York, N. Y.

No. 7

March 1941

Contingent Liability under Policies with Mutual Insurance Companies

A QUESTION has been directed to the committee on auditing procedure as to whether it is customary or necessary for a company which carries insurance with mutual insurance companies to indicate on its balance-sheet under the heading of contingent liabilities or otherwise that the company is subject to assessment under the insurance policies.

In an endeavor to ascertain the nature and extent of the contingency and the frequency with which losses have been sustained in the past, inquiries have been made of American Mutual Alliance, an association of mutual insurance groups whose members operate in the fire- and casualty-insurance field.

Information from this source indicates that, except for farm companies which usually operate in a strictly limited territory and on an assessment basis after losses are determined, companies with which the independent public accountant seldom comes into contact, there are very few mutual insurance companies in the general field which carry an unlimited-assessment provision in their policies. It is also stated that the vast majority of mutual fire and casualty companies which operate on a state-wide or national basis issue either policies under which there is no liability for assessment, commonly referred to as nonassessable policies, or limited-liability policies under which provision for an assessment of one additional premium is made. A few of these companies issue policies carrying unlimited liability. A greater number of others limit the assessment liability to from two to five times the annual premium or deposit. Occasionally the liability is limited to a small percentage of the face amount of insurance carried.

American Mutual Alliance has furnished a tabulation of special assessments levied by mutual insurance companies operating in the field referred to above which were still active at the close of 1940. This tabulation shows that only ten companies in the general class have levied assessments since 1900, and the highest of these assessments appears to have been equal to one year's premium.

The committee took into consideration the fact that deposits are required to be made by the insured which are usually several times greater than a normal year's premium, so that several years' normal losses are covered by the deposit and the likelihood of the insured being called on to pay out any amount of cash is therefore remote. As a rule, any material increase or decrease in losses is reflected by higher or lower premiums (or by lower or higher "dividends") in subsequent periods.

The committee accordingly reached the conclusion that the likelihood of any losses occurring which would wipe out the insurance deposit, or impair it by an amount which would be material in reference to the position of the insured, was so remote that there was no necessity for making a notation of such a contingency on the balance-sheet.

The committee was also of the opinion that it had not been general practice to make such notations, although the committee recognized that there had been occasional cases where, in what was probably a desire for the fullest disclosure possible, a notation had been inserted.

Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York, N. Y.

No. 8
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Interim Financial Statements and the Auditor's Report Thereon

SEVERAL inquiries have been received by the committee on auditing procedure as to what opinion, if any, could properly be expressed in the auditor's report covering interim monthly financial statements in those situations where audits of the usual scope are made on either a semi-annual or annual basis in accordance with generally accepted auditing standards, but where on other interim dates one or more procedures such as, for example, the confirmation of accounts receivable or the examination of securities are omitted. While these inquiries are partially covered in the first statement of the committee, "Extensions of Auditing Procedure," the inquiries are of sufficient frequency to make further amplification seem desirable.

The two major questions which the inquiries appear to present are:

1. What procedures, in addition to the examination of intervening transactions incident to the usual periodical interim examination and to the examination of the regular semi-annual or annual financial statements, are necessary in order that the auditor be in a position to furnish an unqualified opinion with respect to the interim statements; and
2. Whether a qualified opinion would be appropriate and, if so, what should be the nature of the qualification.

Turning to receivables as illustrative of the first question, the need for confirmation is clearly indicated in "Extensions of Auditing Procedure" as follows:

> "That hereafter, wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; . . ."

It is further recognized, however, in "Extensions of Auditing Procedure" that the confirmation may properly be made at a date other than that of the particular balance-sheet. The above statement goes on to say:

> ". . . and that the method, extent, and time of confirming receivables in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment."

The committee believes that frequently the conditions surrounding a particular engagement may be such as to warrant, or even make desirable, the "staggering" of the confirmation throughout the semi-annual or annual period. If this could be done in an acceptable manner and the results were satisfactory, such procedure would obviate the necessity for a qualification as to the scope of the interim examination in respect of confirmation of receivables.

Similarly, in the case of inventories, the recommendations of the bulletin "Extensions of Auditing Procedure" indicate that where there is a well kept and controlled perpetual inventory record, the procedures with regard to inventory quantities may also be undertaken at a date other than that of the balance-sheet. Here too, it is possible that this work could be "staggered" throughout the year if the necessary conditions mentioned in the bulletin are present. If so, a qualification would also be unnecessary as to the scope of the interim examination in respect of inventory quantities. However, where "well kept and controlled perpetual inventory records" are not tied in with the inventory-control accounts maintained in dollars, it is essential that such quantity records be tied in with the dollar controls as of the date of the balance-sheet or at some date within a reasonable time thereof.

Where the regular procedures in connection with receivables and inventories were complied with at a date prior or subsequent to the date of the interim financial statements, but within a reasonable time thereof, considering the rapidity of turnover and adequacy of the records supporting the interim changes, this will also eliminate the necessity of a qualification. The plan of carrying out the customary procedures at some date or dates other than the balance-sheet date in respect of these items, as well as in respect of some other items where appropriate, should be encouraged as a means of spreading the examination activities to reduce the year-end pressure and thereby make for more efficient audits.

To summarize, with regard to receivables and inventories it is the opinion of the committee that the standards of auditing procedure applicable to regular semi-annual and annual statements are likewise applicable to interim statements if an opinion is to be expressed. The same is true as to auditing standards applicable to other items in the financial statements, such as securities, bank balances, liabilities, etc., though with the closer contact and greater familiarity with the business which periodical interim examinations give the auditor it may be unnecessary to carry through in as complete detail at interim dates all the procedures customary at the year-end.

Turning to the subject of exceptions in the auditor's report the committee believes the following statement contained in "Extensions of Auditing Procedure" should be considered as applicable to interim as well as to year-end statements:

> "The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

Thus, if, because of the significance of the items affected, the exceptions as to the scope of the work are of sufficient importance to negative the opinion expressed, the report should be limited to a statement of findings without the expression of an opinion regarding the financial statements as a whole. The test in this connection should be whether the exceptions as to the scope of the examination concern items which could easily be incorrect and which if incorrect are of such importance that the position and results could be misstated to a significant extent. For example, an exception that minor bank balances had not been confirmed would not be of sufficient importance to negative the opinion; an exception that intervening property additions had not been vouched might similarly be unimportant if these were of minor amounts. But an exception to the effect that the auditor had gone to head office only and had not visited numerous branches at which he would normally make an examination probably would negative the opinion, as also would an exception that the auditor had made no examination of the inventories, either as to the book records or the physical inventories themselves; and the committee believes that in such circumstances no opinion should be expressed.

Assuming, on the other hand, that the items with respect to which generally accepted auditing procedures have been omitted are not of sufficient importance to negative the opinion, it is nevertheless the view of the committee that, unless the items are inconsequential, any auditing standard which has not been complied with should be stated and any opinion submitted be correspondingly qualified whether it accompany interim or year-end statements. It is not sufficient that the auditor believe the statements present fairly the position and results of operations; his belief must be based on an examination which conforms to generally accepted auditing standards and in the absence of such an examination the opinion he expresses, if any, should be qualified.

COMMITTEE ON AUDITING PROCEDURE

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Statements on Auditing Procedure

No. 9

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13 East 41st Street, New York, N. Y.

Accountants' Reports on Examinations of Securities and Similar Investments under the Investment Company Act

THE SECURITIES and Exchange Commission has issued Release No. 27 in its Accounting Series containing an opinion by the chief accountant as to the nature of the examination and the report by the independent public accountants required by paragraph (4) of rule N-17F-1 and by paragraph (7) of rule N-17F-2 promulgated under the Investment Company Act of 1940. A copy of this release is appended hereto for convenient reference.

Attention is directed to the chief accountant's interpretation of the requirements of rule N-17F-2 for a "complete examination" of the securities and similar investments. It will be noted that attention is called to the necessity, in addition to making physical examination or confirmation of the securities and reconciling them with the books, of making "an appropriate examination of the investment accounts and supporting records, including an adequate check or analysis of the security transactions since the last examination and the entries pertaining thereto."

What constitutes an "appropriate examination" and "an adequate check or analysis" will, as in almost all cases involving the extent of auditing procedures, vary with the circumstances of the particular situation. The examination required by the rule is a partial one, relating solely to the securities and similar investments. While it cannot be expected to be as conclusive as a more extended examination, there may be cases where the accountant will consider that an adequate examination of the investments necessitates an examination of the intervening cash transactions and confirmation of the bank balances at the date as of which the securities and investments are inspected. Circumstances which would be controlling might be the period which had elapsed since the last examination, the activity of the portfolio, the frequency with which regular examinations of the accounts are made and the degree of effectiveness of the bookkeeping methods of the company as observed by the accountant during previous examinations.

The release sets forth the requirements for the accountant's report, and for the assistance of practicing accountants the committee has prepared the following form which it believes covers the requrements and might be used to the extent to which it is applicable:

To the Board of Directors,
X Y Z Company (see note):

We have examined the securities and similar investments shown by the records of X Y Z Company to be on hand at the close of business on (date) by physical count and inspection in the vault of (name of depositary) on (date), and have obtained confirmation direct from the pledgee(s) and transfer agent(s) in respect of securities and investments pledged and out for transfer. In connection therewith we examined the investment accounts and supporting records and analyzed the security transactions and checked the entries pertaining thereto for the period from (date), the date of our previous examination, to (date). Our examination was made without prior notice to the company.

All the securities and similar investments shown by the records of the company as of (date) were properly accounted for.

Note.—If the report is to be sent directly to the Commission by the accountant the report might appropriately be addressed "To the Securities and Exchange Commission."

It should be emphasized that this form is suggestive only and should be modified to the extent necessary to meet the circumstances of the particular case. For example, the statement that the examination was made without prior notice to the company could, of course, be used only where that condition applied. The committee understands that if one of the required examinations is made as of the end of the company's fiscal year a separate report on such examination is required. This report will doubtless include a statement that the examination was *not* made without prior notice to the company but no such statement is necessary in the accountant's report on the company's annual financial statements.

Release No. 27 also interprets paragraph (4) of rule N-17F-1 which requires an "actual examination" of the securities and similar investments in the circumstances to which it pertains, and states that substantially the same considerations are involved as those relating to paragraph (7) of rule N-17F-2. Rule N-17F-1 sets forth conditions under which securities and similar investments may be kept in the custody of a member of a national securities exchange and the reference in the suggested form of accountant's report to the vault of the depositary may become inapplicable and require modification.

Where a company is subject to the provisions of both rule N-17F-1 and rule N-17F-2, the committee is informed that a single report will be satisfactory providing it conforms to the requirements applicable to each of the two rules.

APPENDIX

SECURITIES AND EXCHANGE COMMISSION
Investment Company Act of 1940
Release No. 279
Accounting Series
Release No. 27 December 11, 1941

The Securities and Exchange Commission today made public an opinion of its chief accountant in its Accounting Series discussing the nature of the examination and certificate required by paragraph (4) of rule N-17F-1 and by paragraph (7) of rule N-17F-2 under the Investment Company Act of 1940. These rules require that where registered management investment companies retain custody of their portfolio investments, or place them in the custody of a member of a national securities exchange, such investments shall be verified at least three times each year by an independent public accountant.

The opinion, prepared by William W. Werntz, chief accountant, follows:

"Inquiry has been made as to the nature of the examination and certificate required by paragraph (4) of rule N-17F-1 and paragraph (7) of rule N-17F-2 promulgated under the Investment Company Act of 1940.

"Rule N-17F-2 sets up certain standards to be followed by management investment companies registered under the Investment Company Act of 1940 which maintain in their own custody their portfolio securities and similar investments. Paragraph (7) of that rule is as follows:

> "'Such securities and investments shall be verified by complete examination by an independent public accountant retained by such registered company at least three times during the fiscal year, at least two of which shall be chosen by such accountant without prior notice to such company. A certificate of such accountant, stating that he has made an examination of such securities and investments and describing the nature and extent of the examination, shall be transmitted to the Commission promptly after each such examination.'

"The securities and investments referred to in the quoted paragraph are identified by paragraphs (1) and (2) of the rule as (a) securities on deposit in a vault or other depository maintained by a bank or other company whose function and physical facilities are supervised by federal or state authority; (b) securities which are collateralized to the extent of their full market value; (c) securities hypothecated, pledged, or placed in escrow for the account of such registered company; and (d) securities in transit. The examination and certificate required by the quoted paragraph should therefore cover all of the securities listed in paragraphs (1) and (2).

"In order to make a complete examination of the securities, it is, in my opinion, necessary for the accountant not only to make a physical examination of the securities themselves, or in certain cases to obtain confirmation, but also to reconcile the physical count or confirmation with the book records. Furthermore, in my opinion it is a necessary prerequisite to such a reconciliation that there have been made an appropriate examination of the investment accounts and supporting records, including an adequate check or analysis of the security transactions since the last examination and the entries pertaining thereto. While the certificate filed must describe the nature and extent of the examination made, it is not necessary that each step taken be set out;

instead, there should be included in the certificate in general terms an appropriate description of the scope of the examination of the accounts and the physical examination or confirmation of the securities.

"Finally, in order to meet the requirements of paragraph (7) of rule N-17F-2 the certificate should comply with the usual technical requirements as to dating, salutation and manual signature and, in addition to the description of the examination made, should set forth:

"(a) the date of the physical count and verification, and the period for which the investment accounts and transactions were examined;

"(b) a clear designation of the depository;

"(c) whether the examination was made without prior notice to the company; and

"(d) the results of the examination.

"Rule N-17F-1 specifies the conditions under which a registered management investment company may place or maintain its securities and investments in the custody of a company which is a member of a national securities exchange. Paragraph (4) of that rule calls for periodic examinations of the securities and investments so placed or maintained and for certificates as to the verification thereof. In my opinion the requirements of such paragraph (4) involve substantially the same considerations as those of paragraph (7) of rule N-17F-2 and the above discussion is therefore likewise applicable to the examination and certificate required by such paragraph (4)."

Statements on Auditing Procedure

No. 10
June 1942

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York, N. Y.

Auditing Under Wartime Conditions

JOINT REPORT OF THE COMMITTEE ON AUDITING PROCEDURE OF THE AMERICAN INSTITUTE OF ACCOUNTANTS AND THE COMMITTEE ON PRACTICE PROCEDURE OF THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

In March, 1942, the special committee on wartime problems of The New York State Society of Certified Public Accountants requested the Society's committee on practice procedure to study and report upon the maximum work of an annual examination that can properly be performed during interim periods and to make this information available to the membership and to the public; to foster the recommended procedure in order to alleviate peak periods; and to suggest steps to induce the adoption by clients of natural business years where this would serve a useful purpose.

These and other related problems had been the subject of serious consideration by the committee on auditing procedure of the American Institute of Accountants. In order to avoid duplication of work and effort, it was arranged that a subcommittee comprised of members of the two committees should make a careful study of the various questions involved. A subcommittee was appointed and has presented its report, which is reproduced hereunder:

Mr. S. J. Broad, Chairman,
Committee on Auditing Procedure,
American Institute of Accountants

Mr. Myron A. Finke, Chairman,
Committee on Practice Procedure,
New York State Society of Certified Public Accountants

Dear Sirs:

Your subcommittee on auditing procedure during wartime has held two meetings, one of which was attended by Messrs. Werntz and King of the Securities and Exchange Commission and Mr. West of the New York Stock Exchange, and submits the following report for consideration by the full committees.

It is generally recognized that the present war emergency has created a difficult situation for public accountants as for most other professions and business generally. It is the opinion of your committee, however, that during this emergency the standards of professional work should not be lowered and the auditing procedures now in force should be maintained. It is felt that further progress can be made in spreading the auditing work more evenly over the twelve-months period by extending the adoption of the natural business year by clients, by extensions of the time limits for submitting annual reports and statements, and by making more extensive examinations at interim dates.

In the spread of auditing work throughout the year first consideration must be given to the adequacy of the system of internal control since the degree of such control has an important bearing on the extent to which it is sound to spread the examination over the year. It must be recognized that due to the emergency many companies have been forced to modify the extent of their internal checks which had been previously in force and therefore the review of the system of internal check and control should ordinarily be made during the early months of the period under audit, in order that the audit program can be prepared, giving due weight to the internal procedures and separation of duties within the client's organization.

There are many companies with reasonable internal control over inventories where physical inventories are taken during the year either at selected dates or at times when stocks are low. Naturally the accountant in these cases can make the physical examination of inventories at the same date or dates as his client.

In the same way it may be possible to deal with other phases of audit work throughout the year. Where proper conditions exist, consideration may be given to work, at an earlier date than the close of the year, on confirmation of accounts receivable, aging of accounts receivable, changes in property accounts, cash, tests of operating accounts, and other audit steps so that in suitable cases and under proper circumstances much of the accountant's work can be done at dates earlier than the end of the client's fiscal year. One of the most satisfactory ways of saving time at the end of the year is to keep in close touch with the accounting problems of the client throughout the year so as to reach agreements upon them as they arise.

Similarly, the internal controls may justify dispensing with annual audits of branches or subsidiaries, especially the smaller ones, and rotating them from year to year.

Your committee has made a request, both orally and in writing, of the Securities and Exchange Commission that the dates for filing

Form 10-K and other registration statements under the 1934 Act be extended by two months, from 120 days to 180 days. Financial statements of the registrant must be submitted as of the close of its fiscal year. There is no absolute requirement that all of the companies included in the consolidated statements should be as of the same date. Your committee has also requested the Commission's approval for using in consolidation financial statements ending on some other date for certain subsidiaries so long as they are not more than 93 days prior to the fiscal year closing of the registrant and so long as certain other conditions are met.

A request has also been made of the Securities and Exchange Commission for consideration of the possibility of requiring financial statements to be prepared for the period of the natural business year of each industry where there is a clear-cut natural business year, even when that is not used for tax purposes.

Your committee strongly supports certain of the recommendations of the committee on federal taxation for greater liberality in granting extensions of tax returns and also for modifications of the rules for computation of tax in the case of companies changing to a different fiscal year. The present basis of putting the shorter period on an annual basis is and has been a very serious deterrent on companies changing to their natural business year.

A request has been made of the New York Stock Exchange to extend the limitation of three months at present in effect for annual meetings of listed companies. It is also suggested that adjournments of annual meetings at present scheduled for the first three months of the calendar year be encouraged in the spring of 1943 with the understanding that the fifteen-day requirement for mailing annual reports to stockholders and also for proxy statements be applied to the date of the adjourned meeting rather than the original date. In this connection it is important to acquaint business executives generally, investment counsel, statisticians and other interested parties, with the war problems facing all accountants both private and public, and the necessity for submitting reports at a later date than they have heretofore been accustomed to.

Mr. West raised the question that the Exchange may consider it necessary to allow or recommend preliminary releases of earnings without audit. In such cases he said he would like to be assured that the independent public accountant had at least reviewed them and satisfied himself that there were no important differences arising from accounting principles being applied inconsistently with the previous year. It was agreed that in cases where a considerable amount of interim work has been done the accountant should ordinarily be acquainted with the major problems which would arise at the year end and could generally satisfy himself regarding these points, although he would not be in a position to express an opinion until he had completed his auditing work and any indication to the public that he had reviewed the statements would only lead to misunderstanding.

Yours very truly,

PERCIVAL F. BRUNDAGE } *Joint Chairmen*
NORMAN J. LENHART }
GEORGE P. ELLIS
EDWARD A. KRACKE

May 7, 1942.

The report of the subcommittee has been approved by both the committee on auditing procedure of the American Institute of Accountants and the committee on practice procedure of The New York State Society of Certified Public Accountants.

The suggestions and requests which the subcommittee reported had been made of the Securities and Exchange Commission and the New York Stock Exchange were formalized in letters written to these two bodies. These letters and also the replies received are reproduced as an appendix to this bulletin. The committees wish to record their appreciation of the sympathetic understanding of the problems of the accounting profession which these replies evidence and of the serious consideration given to the requests made. It is worthy of mention that both Mr. Werntz and Mr. West were among the speakers at a luncheon meeting held in New York City on May 26th for the purpose of furthering the adoption of natural business years.

The report of the subcommittee endorses recommendations of the committee on federal taxation of the American Institute of Accountants looking to modification of the rules for computation of income taxes in the case of companies changing to a different fiscal year. As the exposition of the subject accompanying the recommendations and the examples given may be helpful to practicing accountants and their clients a copy of these recommendations with respect to corporate taxpayers is given as an appendix. Similar recommendations were made with regard to individual taxpayers. According to an announcement on June 5th, the Ways and Means Committee of the United States House of Representatives has approved amending the law in the manner proposed by the committee on federal taxation. If this amendment is finally incorporated in the law, an important deterrent to the adoption of the natural business year will be removed.

June 18, 1942.

APPENDIX

LETTER TO THE SECURITIES AND EXCHANGE COMMISSION

Mr. William W. Werntz, Chief Accountant,
Securities and Exchange Commission,
18th & Locust Streets,
Philadelphia, Pa.

Dear Mr. Werntz:

As we have previously advised you, a joint subcommittee of the committee on auditing procedure of the American Institute of Accountants and the committee on practice procedure of The New York State Society of Certified Public Accountants has been studying certain problems of the profession which arise from, or have been accentuated by, war conditions, with a view to making suggestions for their relief.

On the one hand, the need for accounting and auditing services by industry, particularly industry engaged in war work, has increased substantially, not only as a direct result of increased volume of business but also because the pressure under which the increased volume is carried out, and a shortage of trained accounting personnel result in a lowering of the quality of corporate accounting and further increase the audit work necessary. On the other hand, substantial numbers of practicing accountants and their staff are now in government employ; in addition, their numbers have been depleted as a result of selective service, as well as the active demand for trained personnel by industry at the present time. These conditions have already created a shortage and while it is not yet possible to say how serious the shortage may become, it will evidently be severe.

It seemed to the subcommittee that there were two possible ways of alleviating the situation: (a) by decreasing the amount of work actually done in individual engagements through a relaxation of auditing standards, particularly as to the examination of inventories, the confirmation of receivables and the review of internal check and control; and (b) by spreading auditing work more evenly over the year, thereby making more efficient use of available personnel.

The committee quickly came to the conclusion that any relaxation of auditing standards was most undesirable not only in the public interest but also from the standpoint of practicing accountants. It is believed that, while situations may arise in which qualified opinions may properly be expressed, any general adoption of such a practice at the present juncture would result in an indefiniteness which is unsatisfactory to stockholders, to creditors, to the Commission and to public accountants.

Accordingly, the subcommittee turned to the second possibility, namely spreading the work throughout the year, thereby minimizing work at the peak period and covering more territory with the personnel available. It is the intention to issue a report encouraging the undertaking of as much work as possible before the year end. Particular stress will be laid on the review of internal check and control, the examination of inventories and the confirmation of receivables, all at some date prior to the close of the year in cases and to the extent to which conditions justify it.

The Institute early this month issued a pamphlet in its public information series urging the more extended adoption of the natural business year. This is a continuation of a campaign which has been carried on for some years with no more than moderate success. It would be most helpful if the Commission would exercise its powers to require companies, in industries in which there is clearly a natural business year ending other than December 31, to adopt a corresponding fiscal period. You spoke of making further inquiry into such a possibility and we bespeak the serious consideration of the Commission on this point.

The steps mentioned above look towards the moving of more work backward into the part of the year prior to December 31. The subcommittee also considered possibilities of extending the peak period further in the other direction, i.e. beyond December 31. During the current year it has been quite difficult, partly due to conditions within clients' accounting organizations and partly those in the public accountants' offices, to have all annual reports (Form 10-K) ready for filing by April 30. While the Commission has given sympathetic consideration to requests for extension when these were necessary, there has been a natural disinclination on the part of registrants to apply for extensions after April 30 if it is humanly possible to comply with the regulations. This has resulted in continued and increasing pressure to get the statements out before April 30, a condition which will undoubtedly be aggravated in 1943. We believe that the situation would be considerably alleviated if the Commission would grant for 1943 a blanket extension of a time within which annual reports can be filed with the Commission, from one hundred twenty days after the close of the fiscal year to one hundred eighty days thereafter.

In connection with our review, we also considered the possibilities of a more extended application of the terms of Rule 4-02 with respect to consolidated statements of the registrant and its subsidiaries, and the corresponding rule under the regulations for Form 10-K (which is stated in somewhat different terms). It is our understanding that the statements of the registrant must be submitted as of the close of its fiscal year, which in most cases is December 31st. Would it meet with the approval of the Commission if the consolidated statements included subsidiaries as of a date different from that of the registrant but not more than ninety-three days prior thereto and with the understanding that the other requirements in subsection (b) of Rule 4-02 are met? We have in mind particularly cases such as the following:

(a) Where the parent company's year ends on December 31st and the fiscal year of two subsidiaries end on September 30th and October 31st respectively. Would it be possible to consolidate the statements of the subsidiaries on the basis of including full twelve-months operations but with balance-sheets as of a date different than that of the parent; provided, of course, that the public accountant satisfies himself that there are no intervening inter-company transactions which would materially affect the consolidated figures? It is our understanding that this has been permitted for some time in the case of foreign and domestic subsidiaries whose accounts could not easily be obtained as of the same balance-sheet date as that of the parent.

(b) Where the fiscal years of both parent company and subsidiaries end on December 31st but because of the shortage of personnel or for other reasons it is impractical to file certified statements as of the same date. Would it be permissible (possibly as an extension of Rule 4-02) to submit consolidated statements including the accounts of certain subsidiaries as of September 30th, October 31st or November 30th; provided (1) a full twelve-months operating figures (or alternatively in the first instance the part of the calendar year down to the date selected) are included and (2) the public accountant is satisfied that there are no inter-company transactions which would materially affect the financial statements between the dates of the subsidiaries' balance-sheets and that of the parent company?

The objective of the accounting profession, in this time of emergency, is to do as effective work, and to cover as much of the field, as is possible with restricted personnel. The Commission, we know, wishes this too and it thus remains to be determined what modifications will best serve this purpose. The foregoing suggestions are directed to that end.

Yours very truly,
Samuel J. Broad,
Chairman, Committee on Auditing Procedure

April 20, 1942.

REPLY RECEIVED FROM THE SECURITIES AND EXCHANGE COMMISSION

Mr. Samuel J. Broad, Chairman
Committee on Auditing Procedure
American Institute of Accountants
New York, N. Y.

Dear Mr. Broad:

This is in further reply to your letter of April 20, 1942, discussing certain problems of the accounting profession which arise from, or have been accentuated by, war conditions, and making certain suggestions looking to their solution.

I am in complete agreement with you that it would be most unwise and highly undesirable to seek to alleviate the situation by in any way relaxing auditing standards. Any tendency in that direction would, to my mind, seriously undermine the confidence which could be placed in the results of the accountants' examination. The use of a qualified certificate indicating the work not undertaken also opens the way to many dangers. It seems to me that it would be extremely difficult to appraise the extent to which the value of the accountants' review had been decreased by the omission of certain fundamental steps. Such qualified certificates may be inevitable in certain cases, but it would seem highly desirable to avoid them wherever possible.

I have elsewhere expressed my views with respect to the desirability of businesses shifting for accounting purposes to the natural business year. As I have there stated, the advantages are obvious and such disadvantages as may exist have never been proved to outweigh the benefits. I have discussed with the Commission the possibility of rules requiring a changeover to the natural business year. After careful consideration it appears that the practical difficulties of establishing such rules are so great as to render inadvisable any such action. This decision, however, should not be interpreted as in any way weakening the Commission's belief in the desirability of more general employment of the natural business year.

Careful consideration has also been given to your proposal that the Commission grant, for 1943, a blanket extension of the time within which annual reports may be filed under the Securities Exchange Act, from 120 days after the close of the fiscal year to 180 days thereafter. As you know, Rule X-13A-1 provides a method by which extension of the time of filing may be granted upon a showing of undue hardship or impossibility. Such provisions appear satisfactorily to take care of those cases in which loss of personnel by the company or its accountants makes it extremely difficult or impossible to file the annual report within the prescribed 120 days. It is our practice to consider such factors as a proper basis for a request for extension of the time of filing.

Your final suggestion relates to the interpretation of Rule 4-02 which deals with the presentation of consolidated statements of the registrant and its subsidiaries. You point out that the relevant rule in the instruction book for Form 10-K differs somewhat from the language found in Rule 4-02 of Regulation S-X. It may be well to point out that the adoption of Regulation S-X and its application to Form 10-K had the effect of superseding the language in the instruction book to that form with respect to the matters dealt with in Rule 4-02. The latter rule reads, so far as here pertinent, as follows:

"(b) If the statements of a subsidiary are as of a date or for periods different from those of the registrant, such subsidiary may be consolidated only if all the following conditions exist: (1) Such difference is not more than 93 days; (2) . . . ."

Pursuant to such rule, it is my opinion that it is permissible for a consolidation to be made of a parent whose fiscal year ends on December 31 with subsidiaries whose fiscal dates end within 93 days of the parent's. In preparing such a consolidation it would be appropriate to consolidate balance-sheets as of the several fiscal dates and operating statements for the fiscal years ended on such dates. In such a case the certifying accountant should of course satisfy himself that there are no intervening transactions which would have a material effect upon the consolidated statements. It would also be necessary of course that the conditions provided by Rule 4-02(b) in paragraphs 2, 3, and 4 be met.

You will have noted from the comparison of Rule 4-02(b) with the corresponding language of Form 10-K that the words "If the statements of a subsidiary are as of a date or for periods different . . ." have been substituted for the language "If the fiscal year of any subsidiary ends on a date different . . ." One effect of this change is to place emphasis on the periods covered by the statements of the respective subsidiaries rather than upon the fiscal dates of such subsidiaries. Accordingly, it would be permissible to consolidate such subsidiaries with the parent if the statements of the subsidiaries are as of dates or for periods ending within 93 days of the date of the parent's statement. For example, if a subsidiary and its parent both had a December 31 fiscal date, the statements of the parent required to be included in consolidation would be as of December 31. The statements included for the subsidiary, however, might be as of any date within 93 days, for example, November 30. In my opinion, it would ordinarily be necessary in such a case for the income statement of the subsidiary to cover the year ending on the closing date selected, here November 30. Here, again, it would of course be necessary, as in the previous illustration, for the accountant to satisfy himself that there were no interim transactions which would materially affect the statements, and it would also be necessary to meet the conditions of paragraphs 2, 3, and 4 of Rule 4-02(b).

The revised Rule 4-02 would also permit, in my opinion, the consolidation of subsidiaries whose fiscal years closed on a date *more than* 93 days from the date of the parent's fiscal year, if the statements of such subsidiaries included in the consolidation ended as of a date within 93 days of the parent's statements.

The problems which you have raised in your letter are, of course, of great interest and significance to the work of this Commission. I should be very glad at any time to explore these problems with you further and to discuss possible ways of meeting them.

Very truly yours,

William W. Werntz
Chief Accountant

May 15, 1942.

LETTER TO THE NEW YORK STOCK EXCHANGE

MR. PHILIP L. WEST, ACTING DIRECTOR
OF THE DEPARTMENT OF STOCK LIST,
NEW YORK STOCK EXCHANGE,
NEW YORK, N. Y.

DEAR MR. WEST:

As we have previously advised you, a joint subcommittee of the committee on auditing procedure of the American Institute of Accountants and the committee on practice procedure of The New York State Society of Certified Public Accountants has been studying certain problems of the profession which arise from, or have been accentuated by, war conditions, with a view to making suggestions for their relief.

On the one hand, the need for accounting and auditing services by industry, particularly industry engaged in war work, has increased substantially, not only as a direct result of increased volume of business but also because the pressure under which the increased volume is carried out, and a shortage of trained accounting personnel result in a lowering of the quality of corporate accounting and further increase the audit work necessary. On the other hand, substantial numbers of practicing accountants and their staff are now in government employ; in addition, their numbers have been depleted as a result of selective service, as well as the active demand for trained personnel by industry at the present time. These conditions have already created a shortage and while it is not yet possible to say how serious the shortage may become, it will evidently be severe.

It seemed to the subcommittee that there were two possible ways of alleviating the situation: (a) by decreasing the amount of work actually done in individual engagements through a relaxation of auditing standards, particularly as to the examination of inventories, the confirmation of receivables and the review of internal check and control; and (b) by spreading auditing work more evenly over the year, thereby making more efficient use of available personnel.

The committee quickly came to the conclusion that any relaxation of auditing standards was most undesirable not only in the public interest but also from the standpoint of practicing accountants. It is believed that, while situations may arise in which qualified opinions may properly be expressed, any general adoption of such a practice at the present juncture would result in an indefiniteness which is unsatisfactory to stockholders, to creditors, to the Stock Exchange, to the Securities and Exchange Commission and to public accountants.

Accordingly, the subcommittee turned to the second possibility, namely spreading the work throughout the year, thereby minimizing work at the peak period and covering more territory with the personnel available. It is the intention to issue a report encouraging the undertaking of as much work as possible before the year end. Particular stress will be laid on the review of internal check and control, the examination of inventories and the confirmation of receivables, all at some date prior to the close of the year, in cases and to the extent to which conditions justify it.

The Institute early this month issued a pamphlet in its public information series urging the more extended adoption of the natural business year. This is a continuation of a campaign which has been carried on for some years with no more than moderate success. We are requesting the Securities and Exchange Commission to use its influence or its powers to get companies, in industries in which there is clearly a natural business year ending other than December 31, to adopt a corresponding fiscal period. Any influence which the Exchange may feel disposed to use in this same direction would, we feel sure, be a valuable contribution.

We are also asking the Commission to issue a blanket extension of the period within which annual reports (Form 10-K) are due to be filed, from one hundred twenty days to one hundred eighty days; and, in addition, are requesting an interpretation or an extension of the terms of Rule 4–02, which deals with the dates as of which financial statements of subsidiaries can be included in consolidated financial statements.

The greatest pressure and the greatest peak of work within a public accountant's office is during the first three months of each calendar year and we foresee that it may be impossible in 1943, with depleted staffs and more work, to meet certain deadlines which result from agreements between listed companies and the Exchange regarding the issuance of financial statements. While we recognize the importance from the standpoint of investors of their receiving information as promptly as possible after the close of a fiscal period, it seems likely that this will not be possible to the same extent as heretofore. Would it be possible for the Exchange, in respect to the companies whose fiscal years end on December 31, to: (a) suspend temporarily the agreement which requires financial statements to be issued to stockholders within three months, (b) encourage the postponement of annual meetings of stockholders when these fall within the ninety-day period, (c) adopt a modification of the rule requiring that statements be mailed to stockholders fifteen days prior to the date of the annual meeting so that this requirement will apply to the date of an adjourned annual meeting, when the meeting is to be adjourned, rather than to the original date of the meeting.

As you stated at your meeting with the joint subcommittee, many listed companies will probably wish to issue a preliminary release of their figures, before their annual reports are issued. In many cases sufficient interim work could have been performed to enable the independent public accountant to cover the major accounting points but he would not be in a position to express an opinion pending the completion of his examination and any indication of the public that he had reviewed the statements would only lead to misunderstanding.

The objective of the accounting profession, in this time of emergency, is to do as effective work, and to cover as much of the field, as is possible with restricted personnel. The Exchange, we know, wishes this too and it thus remains to be determined what modifications will best serve this purpose. The foregoing suggestions are directed to that end.

Yours very truly,

SAMUEL J. BROAD

April 21, 1942. CHAIRMAN, COMMITTEE ON AUDITING PROCEDURE

REPLY RECEIVED FROM THE DEPARTMENT OF STOCK LIST OF THE NEW YORK STOCK EXCHANGE

MR. S. J. BROAD, CHAIRMAN
COMMITTEE ON AUDITING PROCEDURE
AMERICAN INSTITUTE OF ACCOUNTANTS
13 EAST 41ST STREET
NEW YORK CITY

DEAR MR. BROAD:

The problems outlined in your letter of April 21, 1942, have received our careful consideration in view of their far-reaching effect upon the agreements listed corporations have with this Exchange providing for the release of timely financial information.

We understand from your letter that the increased volume of business and pressure upon industry, on the one hand, and the depletion of the staffs of both practicing accountants and industry on the other hand have already created a shortage of trained accounting personnel which threatens to become severe.

We further understand that a subcommittee of practicing accountants which studied the problem concluded that there were two possible ways of alleviating the situation — (a), by decreasing the amount of work done in individual engagements through a relaxation of auditing standards, and (b) by spreading auditing work more evenly over the year in order to make more efficient use of available personnel.

We agree fully with the subcommittee's decision that any relaxation of auditing standards would be most undesirable.

This leaves open only the other course suggested by the subcommittee, that is, spreading the work more evenly through the year and, in this connection we are pleased to note that independent auditors will be urged by your group to undertake as much of the work as possible before the end of the year. We hope that this point will be strongly emphasized as it will aid materially in the earlier issuance of reports.

Adoption of the natural business year as the fiscal period in lieu of the calendar year would also be a great aid to spreading the work of auditing more evenly through the year. In addition, reports which are based upon the natural business year present a better picture of the company's operations and give more timely information to security holders. The Exchange for some time past has recommended this step to listed corporations and we shall continue to urge it at every opportunity. Such a change in procedure, however, may involve serious problems in many cases and, therefore, we feel it should be a voluntary step by the individual corporations and not made mandatory.

As your letter points out, circumstances may make it impossible for some of the listed corporations to issue their annual reports at least fifteen days in advance of the scheduled meeting date for stockholders or within three months after the close of the fiscal year, as required by agreements with the Exchange. Our statement at this time as to that aspect of the problem should be regarded as tentative, as our decision as to the best method of meeting that situation must be governed by the actual conditions which obtain at the end of this year and the early part of next year. Should the problem become as serious as developments now indicate, we would be willing to extend the time limit for the issuance of printed annual reports to stockholders for an appropriate period in excess of the three months after the close of the fiscal year and to a date fifteen days in advance of a postponed meeting or the reconvening of an adjourned meeting. Such an extension would be conditioned upon the publication by the company of a preliminary report of operations appropriately qualified as being subject to audit and to any adjustments arising therefrom.

The minimum data required for such preliminary reports would include earnings, both before and after taxes, and possibly the dollar volume of sales, depending upon circumstances. No objection would be made to any further detail the company might care to give. We would ask that the company consult with its accountants prior to the release of such a preliminary report with the object of holding major adjustments to a minimum as far as it would be practicable to do so. We would also ask that the preliminary statement be released as soon as possible after the close of the fiscal year and not later than the time limit set for it in the company's agreement with the Exchange.

As you know, the Exchange has consistently stood for the early issuance of the full annual reports to stockholders, but the current emergency has placed all of us under necessity of making adjustments and compromises to meet changing conditions. It is hoped that the necessity for extensions of time will be held to a minimum through the spreading of work more evenly through the year. We shall be glad to have any comments on the procedure proposed above and shall be pleased to confer with you toward the close of the year concerning conditions existing at that time and the steps which may then be considered advisable.

Yours very truly,

P. L. West
Acting Director

June 8, 1942.

RECOMMENDATION REGARDING COMPUTATION OF INCOME TAXES OF COMPANIES CHANGING TO A DIFFERENT FISCAL YEAR

Item No. 25 of Recommendations for Revision of the Internal Revenue Code Submitted by the Committee on Federal Taxation of the American Institute of Accountants to the Ways and Means Committee of the United States House of Representatives

The provisions for the computation of excess-profits taxes for periods of less than twelve months should be revised to eliminate unjust hardship and the possibility of tax avoidance:

The provisions of the excess-profits-tax law with respect to the determination of excess-profits taxes for periods of less than twelve months will result in either an unjust hardship or tax avoidance. This matter is covered by subsection 711(a) (3) which applies in cases where the taxable year is changed, so that for the period of the change a return for less than twelve months is required, in the case of newly organized corporations adopting a fiscal year ending less than twelve months after organization and last returns of liquidating corporations. The requirement that the income be placed on an annual basis will produce an equitable and fair tax only if it be a fact that the income for the short period is a ratable portion of normal earnings for a full year. Should such short-period earnings be in excess of the average rate per month, the tax will be excessive and unduly burdensome. Should the earnings be less, a way for avoidance of tax is open.

During recent years there has been a definite tendency and trend on the part of business in general to adopt fiscal years that coincide with the natural business year, instead of the calendar year. Altogether, 21,861 taxpayers made such a change between July 1, 1935 and January 1, 1942 but the rate has declined materially in the last two years, possibly because of the causes herein set forth. This change has been fostered, not only by the accounting profession, but by business organizations generally, and particularly the Securities and Exchange Commission, which supports the use of a natural business year in the interest of providing security holders and prospective investors with the more informative statements and earnings reports that the use of the natural business year for accounting purposes makes possible.

Many businesses are seasonal, and when changes in fiscal years are made the income for the short period is usually considerably in excess of a ratable portion of the year's earnings because the proper fiscal year end should coincide with the end of the active business season; this including, as a general rule, the profitable period of operations. A typical illustration is that of a corporation operating a winter resort business, the season for which ends in mid-spring, say May 31st. Practically all the income of such a corporation will be derived from operations during the first five months of the year. During the remainder of the calendar year, the corporation may be lucky to "break even," particularly as during the last few months of the calendar year it is likely to be incurring substantial expenses in the nature of getting ready for the next year's seasonal operations. To illustrate the effect of section 711(a) (3) as at present and as herein proposed, assume the case of a corporation engaged in such a business and earning during the five months ended May 31st, a net income for excess-profits-tax purposes of $66,000. Assume further that it has an invested capital of $500,000 upon which it is entitled to an exemption rate of 8 per cent. Such a corporation may earn little or nothing during the remaining seven months of the year, and for this illustration we assume that the remaining seven months produce neither net gain nor loss. If it continued for the full calendar year, its tax, on the figures given, would amount to $10,550.00, but under the provisions of section 711(a) (3), if it should change to a natural business year, ending May 31st, it would be required to pay a tax of $27,170.83. (Tax rates proposed by the Secretary of the Treasury are used in these computations.) A law that produces such a result is most inequitable. Conversely, if the income for the short period should be less than the annual average, too low a tax will be payable.

To remedy this, we suggest that the law be modified to provide that in the case of a period of less than twelve months there be added to the income for the short period the income for the remainder of the full twelve-months' period, taking the months immediately following the end of the short period; that the tax be computed on the basis of that twelve-months' income, and that the amount payable for the short period be such proportion of the tax on the twelve-months' income as the amount of the income for the short period is of the income for the twelve-months' period.

If the income for the short period be the same as for the year, the full tax thus determined would be payable and, if the income for the short period be greater (because a net loss was sustained during the balance of the year), there would be payable an excess-profits tax, computed at the same average rate on the larger short-period income as results from the full year computation.

The following is a summary of the excess-profits tax that would be payable under this proposal compared with what would be payable under the existing method, in the case of a corporation changing to a fiscal year ended May 31st, earning during that period $66,000 on an average invested capital of $500,000, and assuming operating results for the remaining seven months as shown below:

	Operating results for the remaining seven months	Excess-profits tax under existing method	Excess-profits tax under proposed amendment
(A)	No gain or loss (Year's net $66,000)	$27,171	$10,550
(B)	Profit of $11,000 (Year's net $77,000)	27,171	14,228
(C)	Loss of $6,000 (Year's net $60,000)	27,171	8,250

Such a change would present no complications and would not reduce revenues, but, if anything is likely to increase revenues. Obviously, a corporation that would be required to pay an excessive tax, under the present law, will not change its fiscal year; while one that might pay a lesser tax, under existing law, will not be reluctant to request permission to make such a change. Under the change proposed the latter will pay more tax. On the other hand, the continuance of the present provision will probably stop completely the very desirable trend of business corporations towards the use of a natural business year for accounting and other purposes.

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Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York 17, N. Y.

No. 11
September 1942

The Auditor's Opinion on the Basis of a Restricted Examination (No. 2)

THE COMMITTEE previously expressed itself regarding the circumstances in which it would not be proper for the independent auditor to express an opinion.[1] In "Extensions of Auditing Procedure"[2] it was stated:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

Questions arise however, in particular cases as to whether or not the exceptions are of such materiality as to negative the opinion. Bulletin No. 2 issued by this committee dealt with one case where the facts led to the conclusion that the items and transactions involved in the exceptions were so material that there seemed to be insufficient basis for even a restricted opinion and it was concluded that the auditor should refrain in the particular situation from expressing any opinion at all.

Another case was recently presented to the committee, and since the committee took the position that a restricted opinion might be proper in this situation, it is the belief of the committee that the case might be of sufficient interest to the membership to merit presentation in a formal statement by the committee. In this particular case, several questions were involved, but the present statement deals only with the major question of the propriety of a qualified opinion.

The company involved is a federal savings and loan association operating under the rules and regulations promulgated for such associations

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[1] Statements on Auditing Procedure No. 2, "The Auditor's Opinion on the Basis of a Restricted Examination."

[2] Statements on Auditing Procedure No. 1.

by the Federal Home Loan Bank Board. In accordance with the request of his client, the independent accountant who had been called in by the association to make an audit did not independently confirm mortgage loans, share loans, and shareholders' accounts, although such confirmation was practicable and reasonable and was called for under the rules and regulations for the Federal Savings and Loan Associations which require that the examination shall be based upon the audit program outlined in the "Audit of Savings and Loan Associations by Independent Certified Public Accountants" published by The American Institute of Accountants in July, 1940. Subsequently, the independent accountant rendered his report and stated that, with the exception of the confirmation of the above stated accounts, in his opinion the examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which he considered necessary; but the auditor did not render an opinion as to whether or not the balance-sheet fairly presented the position of the association as of the audit date.

The agent in charge of the Federal Savings and Loan Insurance Corporation took the position that the rules and regulations called for an opinion on the part of the independent accountant, even though it were qualified. The auditor was uncertain, however, whether he could properly render an opinion qualified to so great an extent and sought the advice of the committee. The response on behalf of the committee was as follows:

"The committee on auditing procedure has so far not attempted to state with any particularity the circumstances in which, under the rule mentioned, the exceptions should be considered as sufficiently significant to prevent the proper rendering of an opinion. The nearest that the committee has approached such a statement is in the paragraph contained on page 57 of Bulletin No. 8 where rather extreme cases of minor and major exceptions are given. The difficulty lies in drawing a dividing line at the proper point between these two extremes and in stating conclusions which depend on circumstances existing in the individual situation.

"In the instant case you have not furnished particulars as to the amount involved in the mortgage loans, loans on pass books and certificates, contracts for the sale of real estate, and accounts being dealt with by the association's attorneys, but presumably, in view of the nature of the organization, these would represent a very substantial portion of the total assets.

"Inasmuch as the examination is stated to have been made in conformity with generally accepted auditing standards in other respects it is clear that the customary examination of documents and the book records has been undertaken. As you have not stated otherwise it may be assumed that as far as you have pursued your examination it has proved satisfactory. There is not a complete absence of auditing procedures in respect to the items involved but solely of the confirmatory procedure of communication with debtors. From the fact that you have not stated otherwise, it can be assumed that you consider it practicable and reasonable to make such confirmation. This is evidently the case as you state that the Federal examiners have heretofore done it.

"One of the criticisms, and perhaps the major one, directed at auditing procedure which led to the adoption of 'Extensions of Auditing Procedure' was that the auditor did not have sufficient direct contact with the assets of the organization. Thereafter he was called upon to have physical contact with the inventories and to communicate with debtors where these items were important. The omission of confirmation in the instant case would probably leave the auditing procedures subject to this major criticism because there are, presumably, substantially no other assets in respect of which the auditor can go beyond the company's records.

"The situation thus narrows itself down to the question whether the omission of a particular and important auditing procedure in respect of a major portion of the assets is sufficient to preclude the expression of an opinion.

"In dealing with this question it is necessary to consider what are the possibilities of material misstatement which could occur as a result of the failure to make confirmation. The existence of bonds and mortgages, contracts, and loan agreements together with related documents such as insurance policies, tax bills, appraisals, etc., and the payment of cash or other consideration for their receipt is strong evidence of the existence of receivables at the date of their creation. The continued holding of such documents uncanceled, supplemented by appropriate test checks of related transactions during the period under review, may constitute persuasive evidence that the records continue to reflect the situation with reasonable accuracy. Any overstatement or understatement of the face amount of the asset could arise only from incorrect entry of subsequent receipts or charges relating to the receivables. The probability of errors or irregularities of this nature in an aggregate amount sufficient to affect substantially the validity of the statements as a whole may be rather remote. In view of these various considerations and in the absence of information from you which might lead to a contrary conclusion it seems that this may be a situation where the risk of misstatement inherent in the failure to carry out the confirmation procedure, may not be of sufficient moment to preclude expression of a qualified opinion. However, the independent public accountant is the one who must form the opinion and he should be the sole judge of whether he can give one, and he must, moreover, be prepared to assume the responsibility for any restricted opinion he does express.

"As a practical matter, there would seem to be a question whether any opinion which you might express (assuming you should express one) would meet the audit requirements of the Federal Home Loan Bank. The section of the rules and regulations which you quote states 'If a federal association is not audited at least once each year in a manner and by auditors satisfactory to the Board, the examination of such federal association shall include an audit.' It is stated on page 5 of the Institute bulletin 'Audit of Savings and Loan Associations,' that the Federal Home Loan Bank Board requires a minimum circularization of at least 10 per cent of the number and amount of each class of accounts. Thus an opinion so qualified presumably would not be 'satisfactory to the Board.' Perhaps your client's interest would be best served if, even at this late date, he instructed you to complete the examination to a point where it could meet the generally recognized auditing standard."

The general conclusion in the above letter seems clear. Although a particular and important auditing procedure in respect of a major portion of the assets may be omitted, under certain circumstances the other evidence existing and available to the auditor may be of sufficient weight to justify the auditor in expressing a properly qualified opinion. It is worthy of emphasis, however, that the sole responsibility for that opinion must rest with the independent public accountant; he must be the sole judge of whether he can give one and be prepared to assume responsibility for it.

The committee's conclusion in this case may be contrasted with that expressed in Bulletin No. 2, which dealt with the same question but under different circumstances. In the instant case the committee felt that, while all the evidence required by normal auditing procedures was not available to the auditor, nevertheless considerable evidence of a weighty character was available and this might justify the auditor in forming an opinion as to the existence and probable value of the related assets and as to the financial statements as a whole. The decision on this question was one for the auditor himself to make and the committee did not consider that he should be precluded from expressing an opinion if in the particular circumstances he had formed one.

On the other hand, in the case dealt with in Bulletin No. 2, the situation with relation to the greater portion of the current assets and a substantial portion of the operating transactions of the client was that the primary evidence which is normally required was to a major extent unavailable to the auditor, and his principal reliance in respect of these items would have to be upon the fact that the company was well and conservatively managed and that the particular items had been examined by the company's internal auditing staff. The absence of normal auditing procedures was almost complete in respect of the relative items because the auditor could not observe the inventory taking, confirm the receivables or have access to the detailed records in respect of either. The committee felt that there could not, in the circumstances, be sufficient evidence to warrant the expression of even a qualified professional opinion.

It may also be noted that in the letter quoted on pages 80 to 82 attention was called to the practical aspects of the situation. While the committee felt that it could properly deal with the general aspects of the problem, it pointed out that it was doubtful whether any restricted opinion could satisfactorily serve the client's needs under the rules and regulations existing in this special field. The committee emphasizes the necessity of meeting the requirements of the governmental agency involved and suggests that the auditor shall urge his client to meet those requirements. The committee also calls attention to the importance of following the pertinent procedures set forth in the related bulletin on audit of savings and loan associations issued by the American Institute of Accountants.

While the committee deems it desirable to avoid restricted or qualified reports so far as possible, situations may arise, perhaps increasingly in the current emergency, in which it will not be practicable to carry out particular normal procedures. Under such circumstances the propriety of a restricted opinion becomes of greater current importance and the considerations involved in the above case may have more general applicability.

Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York 17, N. Y.

No. 12
October 1942

Amendment to Extensions of Auditing Procedure

FOREWORD

IN MAY, 1942, the committee on auditing procedure of the American Institute of Accountants issued a supplementary report to the council in which the committee recommended an amendment to the report, "Extensions of Auditing Procedure," approved at the annual meeting of the Institute on September 19, 1939.[1] The council approved this supplementary report with the understanding that it would subsequently come before the annual meeting of the Institute. It was presented at the annual meeting in Chicago on October 1, 1942, and was formally approved. The report follows.

SUPPLEMENTARY REPORT OF THE COMMITTEE ON AUDITING PROCEDURE

On September 19, 1939, at the annual meeting of the American Institute of Accountants, the membership approved suggestions of the special committee on auditing procedure as to extensions of auditing procedure, particularly with regard to examination of inventory quantities and confirmation of receivables, contained in a report entitled "Extensions of Auditing Procedure."

The report also discussed certain phases of the independent public accountant's report or opinion. It stated, in part, as follows:

> "It is the responsibility of the accountant—and one which he cannot escape—to determine the scope of the examination which he should make before giving his opinion on the statements under review. If in his judgment it is not practicable and reasonable in the circumstances of a given engagement to undertake the auditing procedures regarding inventories and/or receivables set forth in this report as generally accepted procedure and he has satisfied

[1] Statements on Auditing Procedure No. 1.

himself by other methods regarding such inventories and/or receivables, no useful purpose will be served by requiring an explanation in his report. If physical tests of inventories and/or confirmation of receivables are practicable and reasonable and the auditor has omitted such generally accepted auditing procedure, he should make a clear-cut exception in his report."

The second sentence of this paragraph made unnecessary the disclosure of the omission of certain normal procedures when in the accountant's judgment they are not practicable and reasonable and when he had satisfied himself by other methods.

The committee on auditing procedure believes that there was considerable merit in the philosophy underlying this statement; it placed full responsibility on the independent public accountant and emphasized the necessity of users of financial statements relying on the professional judgment, skill, and reputation of the practitioner making the particular examination. In those cases in which application of the extended procedures was not practicable and reasonable, it also avoided the casting of what might appear to be an unwarranted cloud upon the financial statements.

The fact that disclosure was not required, however, has given rise to widespread misunderstanding, and especially so since the Securities and Exchange Commission in its amended rule[2] regarding accountant's "certificates" made such disclosure mandatory in all reports filed with the Commission. The difference in the two requirements has given the appearance of different standards as between listed and unlisted companies.

This impression is unfortunate in view of the fact that many, if not the majority, of practitioners follow the Commission's rule in all cases regardless of whether listed or unlisted companies are involved. In Bulletin No. 6, issued in March, 1941, which dealt with the new Commission rule, the committee stated:

"The revised rule is, of course, applicable only to reports filed with the Commission. As a practical matter, however, practicing accountants may in course of time consider it advisable to apply the same standards of disclosure in reports for other purposes also, though the old form will doubtless continue to be used for an intermediate period."

The committee feels that the profession, to a substantial extent, has already adopted the new standards of disclosure and that the present Institute rule no longer is in agreement with the more common practice.

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[2] Rule 2—02 (b) (i) of Regulation S—X, as amended.

Amendment to Extensions

It has also become increasingly evident since the issuance of "Extensions of Auditing Procedure" that relatively few cases exist in which the application of the normal procedures with respect to inventories and/or receivables is not practicable and reasonable, so that the considerations which gave rise to the original rule are in large measure inapplicable.

Accordingly, the committee on auditing procedure hereby recommends that hereafter disclosure be required in the short form of independent accountant's report or opinion in all cases in which the extended procedures regarding inventories and receivables set forth in "Extensions of Auditing Procedure" are not carried out, regardless of whether they are practicable and reasonable, and even though the independent accountant may have satisfied himself by other methods.

May 1, 1942

COMMITTEE ON AUDITING PROCEDURE

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Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York 17, N. Y.

No. 13
December 1942

The Auditor's Opinion on the Basis of a Restricted Examination (No. 3)

Face-Amount Certificate Companies

Foreword

THE COMMITTEE has already dealt with two cases involving the auditor's opinion on the basis of a restricted examination. In one case[1] the committee expressed the view that the examination proposed was not sufficiently extensive to warrant the expression of any opinion. In the second case[2] the committee's view was that the omission of a single though important audit procedure in respect of the major portion of the assets, was not, in the circumstances of the particular case and in view of other collateral evidence available, sufficient to prevent the expression of a qualified opinion if the auditor had formed one and was prepared to take the responsibility for expressing it.

A further case involving the auditor's opinion on the basis of a restricted examination has been referred to the committee. This case relates to the examination of the financial statements of a so-called "face-amount certificate company," and raises the question whether an independent certified public accountant would be justified in expressing a qualified opinion on the basis of an examination which excluded consideration of the reserves (variously described) for liabilities to certificate holders of such companies. In view of the specialized nature of this kind of company, it may be desirable first to outline briefly the general functions of face-amount certificate companies and the nature of their reserves.

Operations of Face-Amount Certificate Companies

A face-amount certificate company is a specialized type of investment company, which sells certificates, in the form of contracts, providing for specified payments to the company in periodic instalments.

[1] Statements on Auditing Procedure No. 2, issued in December, 1939.
[2] Statements on Auditing Procedure No. 11, issued in September, 1942.

The company agrees to pay the purchaser the face amount of the certificate at the end of a given period of years, or a cash-surrender value at any time prior thereto after a specified number of instalments have been paid. The cash-surrender value is relatively small during the early years because a large part of the "load" for selling and other certificate expenses is taken out of the instalments during those years; but due to the greater importance of interest credits the surrender value increases at an accelerated rate during the later years until it equals the face amount of the certificate at maturity.

The holder of a face-amount certificate may ordinarily delay his periodic instalments for a maximum length of time, during which the certificate does not advance toward maturity, but is "stretched out" over a longer period. During this period of delayed instalments the company benefits from the use, without cost, of funds already paid in by the certificate holder. The income of face-amount certificate companies is derived primarily from investments and special fees for servicing mortgages, etc. Expenses of selling certificates, as already indicated, are met primarily from the "load" taken out of instalments. Other operating expenses and the cost of financing certificates are charges against the income of the company.

The operations of face-amount certificate companies generally follow the aforementioned pattern, although each series of certificates has its own terms and conditions, and there are variations in special provisions as to advance payments, reinstatement of status following lapses, death and disability options, etc.

A face-amount certificate company must eventually provide for the ultimate liability to certificate holders at the maturity of each series of certificates. Since the face amount of the certificate exceeds the aggregate of instalments required to be paid, the difference must be provided out of income of the company during the life of the certificate.

At any given time prior to maturity, the company has a minimum liability for the cash-surrender value of outstanding certificates. As this amount is usually less than the accrued "liability to mature," an additional provision is needed to cover the difference. If a certificate lapses as a result of delinquent instalments or is otherwise surrendered for the cash-surrender value, the additional provision applicable to the particular certificate is no longer required.

Holders of face-amount certificates are creditors rather than stockholders of such companies; the reserves against certificates—including liability for cash-surrender values and the additional provision to mature certificates and for other purposes—ordinarily represent the major liability of these companies. While the setting up of such reserves is directly related to the determination of income, it is not the purpose of this statement nor the function of the committee to deal with questions of accounting procedure involved.

Regulation of Face-Amount Certificate Company

The importance of reserves in the accounting of companies issuing face-amount certificates is recognized in the Investment Company Act of 1940, which includes such companies as a class of investment companies subject to the Act, and establishes the basis for minimum reserves required against certificates issued by them on and after January 1, 1941.

Section 28 of the Act contains provisions which regulate certain of their activities. Companies continuing to sell face-amount certificates on and after January 1, 1941, are required to maintain at all times minimum certificate reserves on all their outstanding face-amount certificates, based on assumed periodic reserve payments, which shall be sufficient in amount, when accumulated at specified rates of interest, to provide the face amount of the certificate at maturity. "At no time shall the aggregate certificate reserves . . . be less than the aggregate surrender values and other amounts to which all certificate holders may be then entitled." The Act contains further provisions relating to reserve requirements, as well as requirements as to qualified assets, asset maintenance, cash-surrender values, the payment of dividends, loading, etc.

Auditor's Responsibility for Reserves

As previously indicated, the reserves of face-amount certificate companies (including reserves variously described as or cash-surrender value, advance payments, reserves to mature, etc.) represent the major liability of such companies; they also are of major importance in the determination of periodic income. It is, therefore, the opinion of this committee that, in the case of such companies, an examination which excludes consideration of the amount of the reserves and the propriety of the accounting principles underlying their determination, affords an inadequate basis for an opinion as to the fairness of the financial statements. The committee believes that an examination on this basis would require an exception as to its scope sufficiently material to negative the opinion; and that accordingly the auditor would not be justified in expressing even a qualified opinion.[8]

[8] See Statements on Auditing Procedure No. 1, issued in October, 1939, page 11

While it is not intended in this statement to deal with the detailed auditing procedures required in an examination of face-amount certificate companies, it, nevertheless, may be desirable to state the committee's view as to the auditor's responsibility in satisfying himself regarding the reserves of such companies. In addition to other auditing procedures normally required, the auditor would be expected to ascertain whether reserves: (a) are being provided in accordance with the terms of each series of certificates outstanding; (b) meet the minimum requirements of applicable legislation, such as the Investment Company Act of 1940; and (c) are set up in accordance with generally accepted accounting principles, whether required by regulation or not.

COMMITTEE ON AUDITING PROCEDURE

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Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York 17, N. Y.

No. 14
December 1942

Confirmation of Public Utility Accounts Receivable

Query: The XYZ Corporation is a utility with a satisfactory system of internal control and has approximately 50,000 residential, commercial, rural, industrial, and other customers. Is it practicable and reasonable to communicate directly with these customers as a matter of regular procedure in the examination of its financial statements, and if so, how extensive should the confirmation be?

On October 18, 1939, the special committee on auditing procedure of the American Institute of Accountants recommended that, wherever practicable and reasonable, confirmation of accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent and time of confirming receivables in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment.

The aggregate balance of all receivables of utilities usually averages 2 per cent of all assets and about 10 per cent of annual revenues. Accumulations of receivables materially beyond these percentages result from unusual conditions and would invoke inquiry, apart from the question of confirmation. The average account balance for all accounts receivable of utilities seldom averages more than $10 per customer.

In dealing with the specific question, it is desirable to discuss it in relation to the receivables under two general categories, namely:

I. The large accounts – Municipal, other utilities, industrial and miscellaneous accounts receivable

II. The "mass" accounts–Residential, commercial, rural and merchandise accounts receivable

Experience indicates that on the average a little less than one-half of the aggregate electric utility receivables is represented by the first group of accounts, consisting of industrial and other large accounts, and that for utilities other than electric the proportion is usually lower.

It is recognized that many utilities do not maintain general ledger control accounts classifying receivables into these two categories; however, most utilities ordinarily maintain sufficient subdivisions in the detail records to permit such a classification.

I. The Large Accounts—Municipal, Other Utilities, Industrial and Miscellaneous Accounts Receivable

These large accounts are with organizations which maintain complete accounts and, accordingly, are in a position to express an informed opinion on the correctness of charges made against them. The methods of computation for service rendered to these customers are often very technical, complicated, and difficult to test-check. While internal control is important and must be considered in connection with these accounts, it cannot be relied upon as greatly by the auditor to serve his purposes as in the case of "mass" accounts discussed later. Furthermore, because of the size of individual accounts it is possible for irregularities, if any should exist, to be confined to relatively few accounts. The committee accordingly believes that the extent of confirmation of these accounts receivable should be similar to that of the accounts of an industrial enterprise where comparable conditions prevail.

II. The "Mass" Accounts — Residential, Commercial, Rural and Merchandise Accounts

There are many factors which distinguish this class of accounts from those of the first group. The average number of "mass" accounts of a utility is very large in relation to the gross revenues. The number of these accounts varies from a few thousand for a small public utility to hundreds of thousands in the larger utilities. The individual balances average a few dollars each; even including merchandise instalment accounts an average of $5.00 per customer is ordinary. Utilities follow the policy of disconnecting service if the "mass" accounts are not promptly paid and in many cases also grant more than ordinary discounts for prompt payment, with the result that the aggregate amount of utility service receivable balances not derived from the current month's billings is generally not significant.

The characteristics of these accounts create a large volume of small and simple repetitive operations which require special skill and efficiency for economical performance. As a result these operations are ordinarily assigned to separate employees or departments which operate independently of each other. In the particular case under consideration it was found that the more important separation of duties among employees and departments was as follows:

(a) Installation and removal of meters or stations
(b) Meter reading
(c) Billing and maintenance of receivable ledgers
(d) Receiving payment on accounts
(e) Investigation and collection of delinquent accounts

In addition to the above segregation of major duties among independent departments or employees, further secondary checks were employed; for example, rotation of meter readers among routes, checking of new accounts against those previously written off, maintenance of control accounts by employees other than those assigned to detail accounts, requirements that vacations be taken by cashiers, and approval of discounts forfeited.

These segregations of duties among dissociated employees create an internal control which prevents any particular employees from controlling a sufficient number of the operations to conceal material irregularities. Consequently, only relatively petty irregularities are experienced in these accounts and these are ordinarily detected in the normal operation of the system of internal control. It is believed in this case that a sufficient separation of duties exists to assure substantial accuracy and to avoid significant irregularities in the maintenance of the "mass" accounts. In reviewing such systems, the presence or absence of a particular feature of the system should not be stressed unduly unless it is likely to be the source of a fundamental weakness. It is the effectiveness of the system as a whole which is important and which justifies reliance upon the resulting accounts.

In all essential respects, where applicable, controls comparable with the foregoing are also maintained over merchandise accounts receivable. The company collects merchandise instalments as part of its monthly bill for service and, in addition to disconnecting service if the monthly bill is not paid, it follows the practice of repossessing the merchandise after an instalment is thirty days overdue. As a result the amount of overdue accounts is negligible.

Experience gained from reviews and certain test checks, where applicable, of systems of internal control such as the one described indicates that the "mass" accounts receivable balances maintained by most utilities are reliable for financial statement purposes, and that, where the system in operation is good, test confirmation is not necessary for the purpose of checking the credibility of the company's representations as to their authenticity.

Where the conclusion is reached for a specific utility that the system in operation is good, experience has nevertheless indicated the desirability of making a small sample or test circularization as an additional check upon the functioning of the internal control. In the case of the XYZ Corporation, which has a satisfactory system of control and approximately 50,000 "mass" accounts receivable with customers and approximately one-half that number of accounts having unpaid balances, it is believed that a confirmation of a few hundred accounts would be fully adequate for this purpose; and that, in view of the purpose of the test, namely, to provide an additional check upon the functioning of the internal control, such a test confirmation is desirable even in cases in which test confirmations may be made by internal auditors employed by the utility.

The division of duties comprising internal control will vary among utilities according to type of utility and concentration of activities. and it should be borne in mind that where a satisfactory system of internal control does not exist, a larger portion of the accounts should be confirmed, the extent thereof being dependent upon the circumstances of the particular situation.

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… Statements on Auditing Procedure

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13 East 41st Street, New York 17, N. Y.

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Disclosure of the Effect of Wartime Uncertainties on Financial Statements

In accounting Research Bulletin No. 13 the committee on accounting procedure referred to the limited significance of financial statements prepared currently to cover comparatively short periods of time. The committee pointed out that "The tentative character of such statements is accentuated under war conditions because of the change in methods of doing business and because accounting measurements are largely dependent on the course and duration of the war. Current financial statements are, therefore, necessarily less indicative of such things as earning capacity, ability to pay taxes, and capital value than statements prepared under normal conditions."[1]

Renegotiation of War Contracts

In Accounting Research Bulletin No. 15, issued in September, 1942, the committee on accounting procedure considered the financial statements of contractors or subcontractors who are affected by the provisions of the War Profits Control Act. The committee indicated therein that the basic objective of accounting is to present the fairest possible financial statements and at the same time to direct attention to uncertainties which limit the significance of such statements.[2] It was concluded that the possibility of renegotiation of war contracts should be disclosed; that ordinarily a footnote to the financial statements would accomplish the required disclosure; that in some cases a reserve, shown as a deduction in the income account, might be necessary. In arriving at these conclusions, it was recognized that the law required clarification and the committee indicated its intention to reconsider the subject later in the year.

Since that time the statute has been amended[3] and provision has

[1]Accounting Research Bulletin No. 13, p. 113.
[2]Accounting Research Bulletin No. 15, p. 127.
[3]Sec. 801, Revenue Act of 1942.

been made in the Internal Revenue Code[4] for the correlation of renegotiation and taxation. These enactments have eliminated some of the uncertainties to which the committee directed attention.[5] In addition, the various Price Adjustment Boards have been conducting renegotiation proceedings as a result of which general policies are being formulated, but the possible effects of renegotiation on individual companies are still obscure. Serious uncertainties exist in most cases and their nature is such as to indicate the necessity of further consideration to the end that their significance be brought home to the readers of financial statements.

Other Wartime Uncertainties

With the advent of the war, other important uncertainties have developed as a result of the many difficulties of doing business. A large proportion of all business is now being done directly or indirectly on contracts for the Federal Government or subcontracts thereunder; the profits to be reflected in the income statement in any accounting period with respect to such contracts must of necessity be based on estimates subject to adjustment on final acceptance of the product and final payment therefor. Under all such contracts or subcontracts, whether based on cost-plus-a-fixed-fee or a fixed-price, the profit on both of which is subject to renegotiation, there is opportunity for difference of opinion on the elements of cost to be included and under many there are rejections and claims which are frequently not cleared up until long after the completion of the contract.

The operations of some companies, like steamship companies and oil companies on the eastern seaboard, are being carried on under special arrangements with Government agencies which involve complicated provisions for reimbursement of excess costs due to the war. The position at the close of any accounting period is difficult to determine and may be subject to material adjustments.

The Revenue Act of 1942 contains many provisions, including relief provisions, upon which varied interpretations can be placed and the ultimate effect of which will require considerable time to determine. The current computation of taxes must, therefore, of necessity be based on estimates which are subject to revision after the regulations are issued and final determinations are made as to invested capital, base-period earnings, and taxable income.

The decision of the War Production Board and other Government agencies to discourage or forbid physical inventories in war

[4]Sec. 3806, added by Sec. 508, Revenue Act of 1942.
[5]Accounting Research Bulletin No. 15, pp. 124-127.

plants where they would require a shutdown for even a short period has increased the possible margin of error in inventories even when prepared with the greatest possible care. The shortages of accounting personnel of corporations referred to in Bulletin No. 10 of Statements on Auditing Procedure, results not only in delays in the issuance of annual reports, but also in an increase in the necessity for making estimates, particularly with respect to Government contracts in process at the end of the fiscal period.

War damage has been inflicted on the property of many companies and insurance claims may have been filed, or may subsequently be filed, the ultimate outcome of which is uncertain.

Special amortization allowances for wartime facilities are computed for tax purposes over a five-year period commencing with the operation of the facilities in question, and are subject to adjustment if the war terminates before the end of that period. For various reasons some companies are spreading the amortization over shorter or longer periods of time. Accelerated depreciation of facilities not subject to special amortization is being provided, whether or not deductible for tax purposes, to meet the strain of the multiple-shift operation resulting from pressure to produce regardless of the effect on plant and equipment.

Disclosure in Financial Statements

In view of these and other major uncertainties engendered by the war, an important question arises as to the manner in which they may best be brought to the attention of those interested. Ordinarily, the financial statements are the appropriate place for disclosure. Depending upon the circumstances, the disclosure may take the form of a footnote setting forth such pertinent information as may be available regarding matters which are material. In other cases, where the effects of renegotiation and other matters are reasonably determinable, reserves may be established under the principles set forth in Accounting Research Bulletin No. 13.

In some cases the effect of the uncertainties may be such that the companies in question will desire also to direct attention thereto in the text of their reports to stockholders; in some instances the conditions may be such as to suggest the use of a general footnote to the financial statements, indicating that the statements are provisional in character and that the directors have exercised their best judgment as to such matters as renegotiation, taxation, cost accounting under government contracts, and the provision of reserves.

Despite all uncertainties, however, financial statements are essential. It is necessary to furnish reports to stockholders which are as informative as possible. Tax returns must be prepared and taxes paid. These conditions emphasize the value of an independent review of the judgment of the directors and of the fairness of disclosure by an independent public accountant as to matters coming within his purview.

Disclosure in Auditor's Report

The necessity of disclosure of, or emphasis on, the existing uncertainties, in the independent auditor's report presents a further problem. The auditor may feel in some instances that disclosure in the financial statements (of which the footnotes are an integral part) should be supplemented by mention thereof in his report. Exceptions in the report should be avoided so far as reasonably possible, particularly as to matters over which the client has no control or which the client cannot correct.

With respect to material uncertainties, three types of situations, among others, may be contemplated:

(1) The case in which the auditor believes that the financial statements, so far as possible, present fairly the position and the results of operations, but feels that the uncertainties are such that special attention should be drawn to them in his report, as well as in the statements themselves, but without taking an exception.

(2) The case in which one or more uncertainties are such as to require an exception.

(3) The case in which the cumulative effect of the uncertainties is so great that no opinion is possible, although the auditor may be able to make a statement as to the extent to which he approves the statements and the reasons for omitting the usual opinion on the statements as a whole.

Each independent public accountant will, of course, prepare his report to meet the circumstances peculiar to the particular case and, accordingly, your committee does not propose any specific form.

The foregoing statement was prepared by a joint subcommittee of the committee on auditing procedure and the committee on accounting procedure, and in addition to approval by the former committee, it has been approved by eighteen members of the latter committee and there were no dissenting votes.

COMMITTEE ON AUDITING PROCEDURE

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Case Studies on Inventories

FOREWORD

BULLETIN NO. 1 issued by the committee on auditing procedure, "Extensions of Auditing Procedure," contains the following statements:

"(A) That hereafter, where the independent certified public accountant intends to report over his signature on the financial statements of a concern in which inventories are a material factor, it should be generally accepted auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified public accountant may require physical tests of inventories to be made under his observation.

"In cases where the inventory is determined solely by means of a physical inventory at the end of the accounting period (or at a date prior or subsequent thereto but within a reasonable time thereof, with adequate records supporting the interim changes), it will ordinarily be necessary for the foregoing procedures to be followed at that time.

"In cases where the concern maintains well kept and controlled perpetual inventory records supported by (1) a complete physical inventory at a date not coincident with the balance-sheet date, or (2) physical inventories of individual items taken from time to time so that the quantity of each item on hand is compared with the inventory record for that item at least once in each year, it will be satisfactory to undertake the procedure outlined at any interim date or dates selected by the auditor, his purpose being to satisfy himself as to the credibility of the perpetual-inventory records and whether they may be relied upon

> to support the inventory totals as shown on the balance sheet....
>
> "It should be clearly understood that in undertaking these auditing procedures regarding inventories, the independent certified public accountant does so for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition and does not hold himself out as a general appraiser, valuer, or expert in materials."

Several questions bearing upon the interpretation of these statements contained in "Extensions of Auditing Procedure" and relating to procedures applicable in specific cases, have been directed to the committee. The committee believes that an expression of its views on these questions will be helpful to practicing accountants and other interested parties and accordingly has set them forth herein. In general it is the committee's view that the procedures outlined in the individual cases described meet the requirements of generally accepted auditing standards.

I. Materials Stored in Piles (Scrap Iron, Iron Ore, etc.)

Query: What can the independent auditor do to satisfy himself that quantities of materials stored in piles have been fairly determined where external measurement or survey of the piles may be inadequate for the following reasons: (1) *the ground on which the pile rests may not be level;* (2) *the material may comprise both heavy and light metal, making it impracticable to use a common measure of weight per unit of volume;* (3) *the extent to which the pile has sunk into the ground may not be determinable; or* (4) *the density of the pile may not be uniform due to a variety of shapes causing uneven packing?*

While physical confirmation of quantities by the independent auditor would not be practicable and reasonable in such circumstances, there may nevertheless be other factors which may guide him in either accepting or declining to accept the representations of his client.

One such factor may be the operating and accounting practices of the client in respect of the piles. A company, for instance, may operate more than one pile of material under an arrangement whereby no pile is increased by adding more material after withdrawals of materials have once started. In this way, one or more piles will continuously grow by receipts without any diminution by withdrawals, while a previously completed pile will be drawn upon. Every pile in turn will be completely liquidated, whereupon a check can be made upon the accuracy of the record of its content and usage.

Under such conditions, the auditor would have available for his examination information showing adjustments which have been necessary in the past in respect of completely used piles. This will be valuable evidence bearing on the accuracy of the records and on the credibility of the management's representations based thereon. His further examination would include auditing tests and checks of the stock pile records to the extent indicated by the internal control.

On the other hand, a company may operate one or more piles, each of which may undergo concurrently additions for material received and withdrawals for material used. In such a situation the company's procedure does not permit adequate periodic corroboration of stock pile records, and this fact should be suitably disclosed if the amount is material and there is not adequate supporting evidence of some other character by means of which the auditor can satisfy himself.

II. Inventories of Packaged Materials (Barrels, Boxes, or Bags) Stacked in Solid Formation

Query: What, if any, special procedures should an independent auditor adopt in the case of large quantities of packaged materials stacked in solid formation?

The independent auditor sometimes encounters a situation where packaged materials contained in barrels, boxes, or bags are stacked in a solid formation of considerable width and depth. In such cases, the possibility of fraud perpetration exists by means of a so-called "hollow square" within the allegedly solid formation.

It should be borne in mind that physical stock taking is not the sole evidence on which the auditor bases his opinion. The physical stock taking and the records are complementary and each corroborative of the other. Where the records are defective or not supported by adequate internal check and control, the physical inventory is the principal source of reliance. On the other hand, where the reverse situation exists and especially where "staggered" inventory checks are made, the physical inventory is primarily a check on the records. The possibility of fraud under these conditions is minimized.

For example, a sugar refinery which kept its raw sugar (in bags) in separate piles for each lot, had received into its bonded warehouse within two weeks of the inventory date a cargo of raw sugar. The auditor had the evidence of the stock records, the receiving records, the invoice and other documents as to the quantities involved. He was also satisfied from his inquiries in the warehouse that the sugar had only recently been received and put in its present location. By means of this evidence and his own inspection he was able to satisfy himself without further precautions against a "hollow square."

In other circumstances, where the amount of the inventory involved is material and where the corroborative evidence is not so strong, it may be an inescapable duty of the auditor to have someone inspect the merchandise from above or to require the client to move enough of the goods in solid formation to preclude the possibility of the existence of a "hollow square." This latter type of inventory situation emphasizes the need for the earliest possible planning by the auditor with the client, as far in advance of the inventory date as possible, in order that stacked goods may be so "deployed" as to obviate the existence of a "hollow square."

It is not possible, in the opinion of the committee, to set up uniform procedures which will apply in all cases. The procedures must be determined by the exercise of judgment in the light of all the circumstances of the particular situation.

III. Chain Stores

Query: What audit procedures are usually followed by the independent auditor in his observation of the taking of physical inventories of (a) grocery chain stores and (b) chain stores selling miscellaneous merchandise at prices from 5 cents to $1.00 and generally known as variety chain stores?

In the first place, one can hardly speak of procedures usually followed, when different circumstances in different cases may naturally call for variations in procedures; these case studies are illustrative for the particular conditions recited in each.

In considering the inventory problems which arise in connection with the examinations of the accounts of all types of chain stores, a distinction must be made between the chains with a relatively efficient system of internal check and control carried out through the head office organization and records or otherwise, and chains whose system of internal check and control is limited. The scope of the examination will depend to a considerable extent on the conditions existing in this respect.

In the case of chain store organizations having a large number of stores or units, it is not practicable and reasonable for the independent auditor to observe inventory taking at many locations. He must, therefore, devise or utilize a plan through which he can be satisfied as to the authenticity of the inventory records.

Practically all of the larger grocery chain store organizations maintain inventory controlling records at the head office and have a very close control by dollar amounts of inventories at individual locations. The procedures outlined below were those adopted in an examination of the accounts of a grocery chain which operated over 800 stores served by a single central warehouse, and had an adequate system of internal check and control. It maintained control of the store inventories by the retail method, charging each store's inventory account with the selling price of merchandise shipped to the store and crediting it with the sales proceeds, price reductions, etc. In this instance, the company employed inventory crews, who, from time to time throughout the year and at least three times annually, visited all of the retail stores without previous notification to the store manager and took the inventory at retail prices. The total amount of the inventory as reported by the inventory crews was compared by a member of the head office organization with the store's inventory account. If a large shortage or overage developed further investigation was made. In addition, at the end of the fiscal year each store manager under the general supervision of a district manager took a physical inventory, also at retail prices.

The independent auditors satisfied themselves as to the physical existence of the stores by seeing that bank deposits were made by each store representing store sales, or by reference to reports of the inventory crews on the inventories they had taken, by review of tax records, or by other available means.

Having in mind that the inventory in an average store was not more than $5,000 and in view of the reliability of the book inventory records and also the continuous check made by the inventory crews, the independent auditors did not consider it necessary to visit the retail stores to satisfy themselves further as to the authenticity of the records, but they did visit a very few of the stores during the physical stock taking for the sole purpose of substantiating the inventory methods followed. At the fiscal year end they also observed the taking of the inventory in the central warehouse, which comprised a large percentage of the total inventory.

As part of their examination at the head office they made a test check of the store inventory accounts, and particularly of the controlling account, to satisfy themselves that goods shipped had been charged to the stores and that goods reported as sold and credited to the stores had been properly accounted for in cash or otherwise.

On the basis of evidence provided by the foregoing tests and methods of operation, the auditors were satisfied as to the reliability of the inventory records.

Inventory procedures followed in the examination of the accounts of a grocery chain operating about 200 stores were somewhat similar to those outlined above. The average store of this chain had an inventory of about $2,000 while the super-markets had an inventory of from $10,000 to $15,000 with rapid turnover in both types of store. In this instance the head office records and control were good but the work of the inventory crews was not as well organized as in the case of the larger company. For this reason the independent auditors deemed it advisable to visit ten representative stores during the course of the periodical inventory check made by inventory crews or during the year-end stock listing, at which time they observed or reviewed the inventory procedures.

As to variety chain stores, inventory procedures generally differ from those used by grocery chains for the principal reason that the inventories usually consist of a much larger variety of items and are greater in amount. Frequently also variety chain stores do not follow the "retail method" of inventory control; they do not as a general rule utilize the services of inventory crews to make periodic checks throughout the year. Instead, they usually rely principally upon physical inventories at the end of the fiscal year as taken by the store manager, assisted by office, store and stockroom employees.

The procedures outlined below were those adopted in connection with an examination of the accounts of a company operating about 200 variety stores. All store managers were notified to expect, at the conclusion or during the progress of the physical stock listing, visits from representatives of the head office, and possibly also from representatives of the independent auditors. Representatives of the head office, or the managers of other stores acting as head office representatives, visited all of the stores and made test checks of the quantities listed, the prices, conditions of stock, etc., and then mailed or delivered the inventory sheet to the head office. Store managers who visited other stores for the test check were not notified of their assignments prior to the day of their departure for the location to be checked. These measures were adopted for the purpose of providing internal check and control in the inventory taking and for protection against the possibility of collusion.

Representatives of the independent auditors visited certain of the stores of the chain without previous notification to the store managers as to the location of the stores to be visited. In such instances, the representatives of the independent auditors, while cooperating with the company representatives who were assigned to the store to test check the quantities and mail the inventory sheets, were primarily interested in observing the methods adopted by the company and satisfying themselves whether the protective measures provided were carried out. In view of the careful organization necessitated by the larger number of stores, the protective methods afforded and the control exercised by the head office on the inventory taking, and taking into consideration the primary purpose of the independent auditors' attendance at the stores, it was considered that in this case a visit to eight or ten of the stores would be sufficient.

IV. Department Stores

Query: What is the usual audit procedure of the independent auditor in respect of observation of inventories of department stores?

As explained in the preceding answer dealing with "Chain Stores," these case study answers apply to the particular case discussed and therefore cannot be considered so broad in application as the word "usual" might imply.

The larger department store differs from the grocery chain store and the limited price variety chain store from a physical inventory point of view, principally in that it is not customary to take the entire inventory in a single day or even in several succeeding days. For a store which operates on a January 31st fiscal year it may be customary to inventory furniture, other heavy goods, and some other merchandise immediately after Christmas, to inventory a number of other departments during January and to inventory all of the remaining departments, representing the bulk of merchandise, during the last week of January, but usually not on January 31st. In addition to the merchandise on the sales floor which is inventoried at retail prices, there will be merchandise which is also inventoried at retail prices in the departmental reserve stock rooms in the store, as well as in one or more warehouses which may be at some distance from the store; and there may also be advance purchases for following seasons (usually in the warehouses) which have not been marked and which will be inventoried at cost. In some stores, the retail inventories of a number of departments handling expensive merchandise, such as furniture and furs, are supplemented by unit control records and, in such departments, the pricing may be done from the unit control records and not from the merchandise itself.

In one case of a large department store considered by the committee the foregoing procedures have been followed. Prior to the commencement of the audit, the auditor agreed with the controller upon the plan of inventory taking. It was provided that the physical count was to be supervised and controlled by the controller and not by the merchandise manager. Prior to inventory time, prenumbered sheets or tags were distributed to buyers in accordance with their requirements, based upon plans submitted, showing prenumbered shelves, tables, and other fixtures. The physical count was made by teams of two employees, the one most familiar with the stock calling and the other listing, the sheets being left in the fixtures until all of the stock had been listed. When the listing had been completed a representative of the controller's office made independent test counts of a portion of the inventory, selecting the items in a manner to insure the testing of a representative cross section of the entire stock on hand. The sheets were then gathered by the buyer or his assistant under the supervision of the representative of the controller's office and were turned over to the controller for extension and footing. In large departments where the inventory was not taken in a single day, the stock in the reserve stock rooms and in the warehouses was taken as closely as possible to the day on which the floor stock was taken and precautions were instituted to guard against inventory once counted in the reserve rooms and warehouses being transferred to the floor and counted a second time.

In departments for which the pricing was done from unit control records, the sheets were under the supervision of the controller's office while the prices were being inserted as a precaution against change in quantities. With respect to advance purchases, the pricing was done in the controller's office.

On the day or days of inventory taking the independent auditor had present a number of representatives (the number being determined by the size of the store) to observe that the method of taking inventory was in accordance with the plans previously agreed upon and that test counts were made by representatives of the controller's office. The independent auditors did not make test counts themselves of any portion of the inventory, their work being limited to observing that the methods and tests outlined were being followed.

In the case of another large department store considered by the committee, it was found that the merchandise was listed by employees of each department on inventory sheets which were then placed with the merchandise on the counter or in the bin, drawer, etc. Inspectors, appointed from members of the store's staff not connected with the handling or sale of merchandise, made test checks by comparing the quantities shown on the inventory sheets with the quantities on the counter, in the bin, etc., noting that the season letter, retail price, etc., were correctly entered.

Representatives of the independent auditors visited each department of the store subsequent to the actual listing of the merchandise but before the inspectors had completed their test check. Certain of the items tested were listed by the auditors for subsequent comparison with the inventory sheets and with the merchandise on the selling floor. After all tests were completed, the inventory sheets were "pulled" by the inspectors, care being taken to place them in the custody of designated persons not connected with the handling of merchandise until computations could be made of the total amounts of the inventory, by season letters, of each department. In the examination under consideration, the inventory sheets were sent to an outside independent calculating company for computation. The calculating company furnished the independent auditors with a certificate and a summary showing the total dollar value of the inventory by departments.

The dollar amounts of the items and dollar footing of each inventory sheet were not large. Furthermore, it was found that an adequate control could be exercised through a comparison of overage and shrinkage figures and other data. Under these circumstances the independent auditors deemed it necessary to make only minor test checks of the extensions and footings of the individual inventory sheets. The total inventory for each department, at retail value, as shown by the inventory summary, was compared with the corresponding inventory controlling account. If a substantial difference was revealed in any department which could not be accounted for, the inventory of that department was taken.

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Statements on Auditing Procedure

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Physical Inventories in Wartime

The Problem

Among the many problems arising out of the war which particularly affect accounting is the one created by the failure of a company to make a physical count of its inventory, either all at one time or on a staggered basis throughout the year. Many companies have omitted such physical inventories this year, either voluntarily or by direction of the government, in order not to interrupt necessary production of war materials.

The foregoing circumstances raise questions as to (1) what additional or alternative auditing procedures can and should be undertaken to remedy the omission and (2) the effect on the independent accountant's short form of report. If the company does not undertake to make the customary physical count of goods in the inventory, the independent accountant obviously cannot make the usual observation or physical tests thereof in accordance with generally accepted auditing procedure.[1] Under these circumstances, to what extent is he justified in relying on alternative procedures to satisfy himself as to the fairness of inventory amounts and what is the effect on the accountant's report? For example:

(a) Is it proper for the independent public accountant to render a report or opinion, with an exception as to the amount of the inventories?

(b) If the inventory is material, would such exception be sufficiently important to require a disclaimer as to the ability to express an opinion on the financial statements as a whole?

Discussion

Since proper answers to the foregoing questions will depend upon the circumstances in each case, the committee does not here undertake to reach categorical conclusions thereon. It believes that the

[1] Statements on Auditing Procedure No. 1, p. 6.

conclusions in a particular case should be left to the judgment of the individual accountant determined on the basis of certain general underlying considerations. However, in order to clarify the various issues, there are set forth herein suggesitons as to alternative auditing procedures and assumed circumstances which will influence the decision.

Significance of Physical Inventories

The committee desires to emphasize the fundamental difference between (a) the taking of physical inventories by a client and (b) the observation of the inventory taking or the testing of the inventories by the independent public accountant. The determination of inventory quantities, either by complete periodic physical inventory or by a consistently planned and executed system of staggered physical counts and adjustment of inventories throughout the year in connection with perpetual inventory records, is an important part of the accounting function of a corporation in reporting its financial position and the results of its operations. It is an essential responsibility of the client to determine the amount of inventory to be incorporated in his financial statements. The function of the independent accountant, on the other hand, is to satisfy himself concerning the credibility of the representations made by the client; such function, however, should in no sense be regarded as a substitution for the taking of a physical inventory by the client.

Where adequate book records of inventories are not kept, the taking of a physical inventory by the client is essential to the presentation of satisfactory financial statements; otherwise, relatively unreliable and rough estimates of inventories, obtained by the gross profit method or some similar calculation, must be used. These at best are merely calculations of the amount that *should be* on hand and not a determination of what *is* on hand. Where adequate book inventory records are maintained, the periodic physical inventory sometimes reveals substantial differences from book amounts, even in normal times. In wartime, the very circumstances which are offered as reason for refraining from the usual physical inventory-taking (i.e., high production, multiple-shift operation, constant pressure, overtime work, shortage of manpower, employment of less efficient personnel, etc.) are likely to render present book records less reliable than usual. No amount of supplementary work by the independent accountant can thus completely remedy the basic weakness resulting from the client's failure to provide some form of physical inventory.

In spite of the fundamental importance of physical inventories, recognition must, nevertheless, be given to the demands of the war program and to the fact that many companies are in fact compelled by circumstances to omit such procedure. However, it is urged that such omission be confined to those parts of the inventory where it is unavoidable and that the company undertake a physical count (either at one time or on a staggered basis) of all other parts of the inventory. In such cases particular care should be exercised to see that purchased materials, parts, sub-assemblies, etc., included in such physical counts, are not included also in the book balances of those parts of the inventory not physically counted.

It will no doubt be found that in most cases a physical inventory can be taken of the raw materials, supplies, and finished goods without interrupting production of war goods, and that it is the physical count of the work-in-process inventory which would be most likely to hamper such production. The following discussion of auditing procedures, therefore, refers primarily to work in process, on the assumption that the company will usually be able to make a physical check, either at one time or on a staggered basis, of the other parts of the inventory.

Alternative Procedures

Where no physical inventory of work in process is taken by a company, the inventory amounts must necessarily be based on book records, and the independent accountant's alternative procedures must be based on such records. To the extent that the work-in process inventory can be broken down and a section or sections of it can be checked by the independent public accountant by physical inspection without interrupting production, consideration may well be given to whether these procedures are an acceptable alternative. Where physical inspection cannot be made by the independent public accountant, the only remaining procedures available are confined to the accounting records and statistical data. Reliance upon them would require sufficient tests of such records and supporting data, based on a careful review of the system of accounting and internal control, to satisfy the accountant, as far as is possible in such a limited examination, as to the fairness of the inventories as a whole.

Probably the most satisfactory accounting record of work in process is a perpetual inventory record which ties in directly with a general ledger control account. In many cases, however, general ledger control accounts of work in process are not supported by formal perpetual inventory records, but by some form of underlying detailed cost records. Properly maintained, such detailed cost records may in some cases be equivalent to perpetual inventory records relating to work in process, and are, therefore, sometimes susceptible of staggered physical check. This is particularly true of those industrial operations which are basically of the "job cost" type, which is characteristic of some companies engaged on war contracts where the continuance of production is vital. However, it should be pointed out that the work-in-process inventory is constantly changing in form and amount and its complicated nature requires of the independent accountant a greater degree of skill than is ordinarily required in the case of raw material or finished stock.

There will no doubt be cases where the only accounting record of work in process is a general ledger account, there being no underlying detailed cost records which would serve as a basis for validating the total amount of work in process. Under such circumstances the total dollar amount could not be checked without listing the quantities of all the stock covered by the general ledger account and extending them at cumulative unit costs; test checking of quantities, therefore, would not be feasible. The accountant could make an exhaustive test of the entries by which the book amounts had been developed, but this could not be considered as a satisfactory substitute for a listing of the stock and physical inventory by the company.

Where a company maintains a current book record of the amount of work in process, whether supported by detailed records or not, actual or estimated costs must be used as a basis for relieving the account of goods sold or transferred to finished stock. The independent accountant should undertake a careful review of such costs in order to satisfy himself as to their propriety in the light of existing conditions. Particular consideration should be given to the advisability in many cases of revising, or weighting, standard costs to conform with new conditions, such as change-over from civilian to war production, greatly increased production, higher wages and material costs, deferred repairs and maintenance, etc. Obviously, standard costs based upon normal production are not suitable without review, and probably modification, for production on a greatly increased scale.

In addition to the usual accounting records, production and engineering data will often furnish further evidence as a basis for over-all and specific tests to support, within broad limits, the reasonableness of book inventories of work in process. Such data may include production schedules, records of units in process at the balance-sheet date and completed thereafter, reports of engineers as to percentage of completion of contracts, percentage of capacity of operation, etc. Information as to units and cost of goods completed shortly after the inventory date may be especially helpful to the accountant in substantiating the work-in-process inventory.

In the case of all companies using strategic materials subject to priority ratings, and particularly those engaged on war contracts calling for essential military equipment and supplies, there is an obligation to maintain some form of production scheduling and planning records in order to comply with W.P.B. reporting requirements and regulations.[2] These records governing the flow of materials can serve also as a helpful medium for corroborating the credibility of the related inventory amounts.

Experience has shown that in many cases the difficulties arising in the absence of ordinary physical inventories can be minimized by consultation between the accountant and his client in advance of the year-end. For example, arrangements can be made for partial physical inventories or for the preparation of data supporting the work in process. In some cases it may be feasible to take physical inventories on a staggered basis where it would be inexpedient to take them all at one time.

The aforementioned alternative procedures which might be undertaken by the independent accountant where a company fails to make a physical check of all or part of the inventory, are set forth on the assumption that the company has some form of book record of inventory. Otherwise, the amount of inventory would have to be determined by very rough over-all estimates which in most cases would be too unreliable to provide a basis for an informed opinion as to the financial statements as a whole.

Effect on the Independent Accountant's Report

Before reaching conclusions as to the effect of the omission of adequate physical inventory-taking on the independent accountant's short-form report, it may be desirable to review briefly certain of the previous pronouncements of this committee. Observation or tests of physical inventories by the independent accountant, where practicable and reasonable, were recognized as generally accepted auditing procedures in "Extensions of Auditing Procedure."[3] Under a subsequent amendment to this bulletin,[4] the failure to make such physical tests was held to require disclosure in the short form of report, "regardless of whether they are practicable and reasonable, and even though the independent accountant may have satisfied himself by other methods."

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[2] Under the Controlled Materials Plan, which is to become fully operative on July 1, 1943, bills of materials and production schedules based on contracts or orders are essential to the obtaining of allotments of scarce materials.

[3] Statements on Auditing Procedure No. 1.

[4] Statements on Auditing Procedure No. 12.

The question of omitting physical inventories was previously presented to the committee in 1941, at which time "it was mutually agreed that there could properly be no relaxation of generally accepted standards."[5] This view was reiterated in "Auditing Under Wartime Conditions" when it was said "that during this emergency the standards of professional work should not be lowered and the auditing procedures now in force should be maintained."[6] Hence when the failure of a client to make a physical check of its inventories (either at the year-end or on a staggered basis throughout the year) precludes observation or physical tests by the independent accountant, this represents a departure from generally accepted auditing procedures which should be disclosed in the section of the report dealing with the scope of the examination, regardless of alternative procedures undertaken and regardless of whether the accountant has otherwise satisfied himself as to the fairness of the inventory amounts.

There remains the question as to the effect of the omission of physical inventories by a client upon the opinion expressed by the independent accountant. This opinion will necessarily be affected by the extent to which the accountant has been able, as a result of the alternative or additional procedures he has adopted, to satisfy himself regarding the amount of the inventory. The extent to which this is possible may vary; for example:

(1) If the company has adequate records and effective inventory control, it may be possible for the accountant to adopt alternative procedures which are substantially the equivalent of observation of inventory taking or a test check of quantities and which result in his being able to form an unqualified opinion regarding the amount of the inventory;

(2) In other circumstances, even though unable to satisfy himself, except within broad limits, as to the amount of the inventory he may be able to satisfy himself, by evidence of the more general character indicated above, that any discrepancy in the amount shown could not be sufficiently large to distort seriously the position of the company or the results of its operations as reported;

(3) The situation again may be such that there are no effective means of reaching even the conclusion indicated under (2).

In general, where the independent accountant has satisfied himself in the manner and to the extent indicated in (1) above, there would appear to be no need for him to qualify the opinion he expresses

[5] Annual report to council, 1941 Yearbook, p. 107.
[6] Statements on Auditing Procedure No. 10.

regarding the financial statements. However, where the amount of inventory involved is material the committee believes it advisable that the section of the report dealing with the scope of the examination be expanded by the insertion of a paragraph setting forth the alternative procedures undertaken, on the strength of which the accountant expresses his opinion.

Where, as in (2) above, the accountant has been able to satisfy himself in the absence of a complete physical inventory that the discrepancy could not be sufficiently great to distort seriously the position of the company or the results of its operations, and particularly if a reserve has been set up to make reasonable provision for possible overstatement, the committee believes that it would be appropriate for the accountant to express an opinion upon the financial statements as a whole, but with an exception regarding the inventories. In this case, in addition to the exception in the opinion paragraph, it would probably be necessary also to insert in the report an explanatory statement dealing more fully with the situation.

In the circumstances indicated in (3) above, where the records and other supporting data are inadequate to satisfy the accountant as to the credibility of the inventory amounts, and where the amounts involved are material in relation to the financial position and results of operations, the committee believes that the accountant should disclaim sufficient basis for the expression of an informed opinion regarding the financial statements as a whole. The situation would come within the scope of the following statements contained in "Extensions of Auditing Procedure"[7]:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings, and, if appropriate, his reasons for omitting an expression of opinion."

Position of the Securities and Exchange Commission

The Securities and Exchange Commission in its Accounting Series Release No. 30, issued in January, 1942, permits the omission of the customary taking of inventory where such taking would curtail production of war materials, "so long as all reasonable and practical alternative measures are taken by the company and its independent

[7] Statements on Auditing Procedure No. 1, p. 5.

public accountants to assure the substantial fairness of inventory amounts stated in the financial statements and proper disclosure is made." Companies coming under this requirement should consult with the S.E.C. in advance in order to clarify any questions as to the acceptability of alternative procedures proposed.

The S.E.C. release requires, among other things, that the accountant's report shall contain statements as to the extent to which normal procedures were omitted, the reason therefor, the extent of the accounting records and controls as to inventories, an opinion as to their adequacy and a description of the supplementary procedures undertaken. The release continues: "In many cases, it is probable that by means of their alternative and extended procedures the independent public accountants will have satisfied themselves as to the substantial fairness of the amounts at which inventories are stated, and in such case a positive statement to that effect should be made. In some cases it may be that, while the scope of procedures followed will not be such as to have so satisfied the accountants, they will be able to take the position that on the basis of the work done they have no reason to believe that the inventories reflected in the statements are unfairly stated."

The release also refers to cases in which "the scope of the work done or the results obtained from the procedures followed or the data on which to base an opinion are so unsatisfactory to the accountants as to preclude any expression of opinion, or to require an adverse opinion" and states that in such cases the "situation must be disclosed not only by an exception referring to the scope of the audit, but also by means of an exception in the opinion paragraph as to the fairness of the presentation in the financial statements."

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Statements on Auditing Procedure

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Confirmation of Receivables from the Government

AS the war progresses an increasing percentage of the receivables of companies are represented by amounts recorded as due from departments or agencies of the United States Government. These departments and agencies, under existing war conditions, rarely confirm amounts stated in requests for confirmation and have frequently expressed their inability to do so. As a result such confirmation in most instances cannot be considered practicable at the present time.

In the opinion of the committee, the use of the "negative" type requests in confirming amounts due from government departments or agencies would not, under present conditions, constitute compliance with the spirit of "Extensions of Auditing Procedure." That report did not contemplate that the "negative" form would be used if the independent public accountant had reason to believe that the request would fail to receive consideration and that he would not be advised if the amount stated in the request differed from the amount shown on the debtor's records. Some public accountants may continue to send "positive" type requests for confirmation of receivables from government departments and agencies in the hope that, in some cases, replies may be received. Other public accountants have indicated that they believe the number of replies received to such request, stating either agreement or disagreement with the amount shown on the clients' records, will be so few as not to warrant continuation of the sending out of "positive" type requests for confirmation.

In any case in which receivables from government agencies or departments represent a significant proportion of the current assets or of the total assets of a concern and confirmation thereof by direct communication with the debtors has not been accomplished, disclosure should be made of such situation in the report of the independent public accountant. This is necessary in order to conform with the amendment to "Extensions of Auditing Procedure," contained in bulletin No. 12 of Statements on Auditing Procedure, which ended with the following paragraph:

> "Accordingly, the committee on auditing procedure hereby recommends that hereafter disclosure be required in the short form of independent accountant's report or opinion in all cases in which the extended procedures regarding inventories and receivables set forth in 'Extensions of Auditing Procedure' are not carried out, regardless of whether they are practicable and reasonable, and even though the independent accountant may have satisfied himself by other methods."

In many, and perhaps most, cases the independent public accountant may be able by reference to shipping records, contracts, correspondence, or other documentary evidence, or the subsequent payment of the accounts, to satisfy himself on a test basis as to the validity of such receivables. In such cases his disclosure of inability to secure confirmation of government receivables by communication with the debtor may well be accompanied by a statement that he has satisfied himself by other means. Both purposes may be accomplished by changing the sentence regarding conformity with generally accepted auditing standards contained in the short form of report so that it will read somewhat as follows: "Except that it was not practicable to confirm receivables from United States Government departments (and agencies, if applicable), as to which we have satisfied ourselves by means of other auditing procedures, our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary." It is obvious that in these circumstances no exception need by taken in the opinion section of the report.

There may be some cases in which, due to the particular circumstances, the independent public accountant may not be able to satisfy himself by other methods as to such receivables. In those cases he must decide in the light of the circumstances whether the situation properly can be covered by taking an exception in the opinion paragraph; there may occasionally be situations in which the exception is of such a nature and so material in relation to the financial position and results of operations that the independent public accountant would require to disclaim sufficient basis for the expression of an informed opinion regarding the financial statements as a whole.

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Confirmation of Receivables (Positive and Negative Methods)

"EXTENSIONS OF AUDITING PROCEDURE," approved by the membership of the American Institute of Accountants and issued in 1939, contains the following recommendation:

> "That hereafter, wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of confirming receivables in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment."

It will be noted that the *method* of confirming receivables in each engagement is left to the judgment of the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment.

Generally speaking there are two methods of confirming receivables by direct communication with the debtor, known as the "positive" and the "negative" methods. When the "positive" method is used a communication is addressed to the debtor asking him to confirm to the independent public accountant the accuracy or otherwise of the balance shown. When the "negative" method is used a communication is addressed to the debtor asking him to advise the independent public accountant only in cases in which the amount stated is incorrect.

In dealing with confirmation of receivables from the government, the committee stated that "Extensions of Auditing Procedure" "did not contemplate that the 'negative' form would be used if the independent public accountant had reason to believe that the request would fail to receive consideration and that he would not be advised if the amount stated in the request differed from the amount shown on the debtor's records."[1] In such circumstances the committee suggested the nature of alternative procedures to be adopted in lieu of direct confirmation with the debtor.

In Bulletin No. 3 the committee stated that, "It is believed, therefore, that department stores, instalment houses, and others dealing with ultimate consumers are among the cases in which the application of the negative form of direct communication with debtors, when carried out in the manner suggested in the bulletin, 'Examination of Financial Statements,' is to be considered as compliance with 'generally accepted auditing procedure.' "[2]

The foregoing statements by the committee were of limited applicability and it has been suggested that the committee deal with the subject in a more general way. Although the method of confirmation must, in the final analysis, be determined by the independent public accountant in the exercise of his judgment, the committee believes that certain general observations may be helpful.

In cases in which there is reason to believe that the possibility of disputes, inaccuracies or irregularities in the accounts is greater than usual, or where the balance involved is of outstanding materiality, it is probably desirable that the "positive" method of confirmation be adopted. For example, it is generally customary to use the "positive" method of confirmation in the case of receivables of stock brokerage houses. Also, where a company sells a substantial portion of its output to one, or only a few, customers, so that the balances involved are of relatively major importance, the "positive" method of confirmation would seem preferable.

On the other hand, it is the opinion of the committee that the "negative" type of confirmation is in accordance with generally accepted auditing standards and practice in the majority of circumstances, and that an independent public accountant using this method of confirmation, where there are no indications that it may be inadequate, is conforming with generally accepted auditing standards.

Not infrequently independent public accountants employ both the "positive" and the "negative" methods upon the same engagement—the "positive" as to accounts where a definite reply may be

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[1]"Statements on Auditing Procedure No. 18," page 127.
[2]"Statements on Auditing Procedure No. 3," page 18.

deemed desirable and the "negative" as to accounts where this consideration does not apply.

When "positive" confirmations are sought, it is usually impossible to secure responses to all requests; as a matter of fact, even in the case of stock brokerage houses, where the requests are usually followed up more actively than in the ordinary case, it is rare that replies are received to all requests.

Whether the response to "positive" confirmations requested is satisfactory is usually judged by comparing the number of replies received and the aggregate amount thereof with the number and amount of the confirmations requested, taking into account also the nature of the replies and the situation they disclose. The percentage of replies received, experience has shown, varies considerably with the type of customer with whom the organization deals. The independent public accountant must assume the responsibility for deciding whether the nature and the extent of the response, taken in conjunction with his other auditing procedures, constitute a satisfactory basis for his opinion as to the bona fides of the receivables. This is a matter for the exercise of his judgment in the circumstances of the individual case. If he does not consider the confirmation satisfactory he should pursue the matter further, either by communicating again with those who have not replied or by adopting alternative procedures of the nature referred to previously.

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Termination of Fixed-Price Supply Contracts

Examination of Contractors' Statements of Proposed Settlements

MANY government supply contracts have already been terminated. Acceleration of the trend of cancellation of contracts for the convenience of the government is to be expected as the war progresses. At the conclusion of hostilities it seems likely that a high percentage of remaining contracts will thereupon be terminated. Prompt and fair settlements will be of vital importance to industry and the nation.

The preparation of termination proposals and the necessary reviews and audits of them at the end of the war will place a heavy responsibility on the accounting profession. Unless the available accounting and auditing talent is used with maximum effectiveness, the available supply will not be adequate. The accounting profession faces an opportunity for service to the public and to business on a national scale that is of tremendous significance. It will require service of a highly proficient character performed on a strictly independent basis.

Under date of July 7, 1943, the War Department issued a manual entitled "War Department Termination Accounting Manual for Fixed-Price Supply Contracts" (herein referred to as the manual), which contains accounting and auditing instructions. Under date of August 20, 1943, the War Department also published Procurement Regulation No. 15 (herein referred to as PR-15) entitled "Termination of Contracts for the Convenience of the Government"; this contains statements of policies and procedures to be followed in connection with contract termination. A copy of each of these two documents has been furnished to each member of the Institute. Every member of the Institute who may be called upon to render any advice or service with respect to termination of War Department contracts should carefully study the manual and PR-15.

There are but three methods under which determination of the amount due to a contractor upon termination may be reached, namely, (1) by agreement, that is, the settlement of the amount by negotiation; (2) by formula, if the contract includes a definite formula for determining the amount due; and (3) by litigation.

The manual was issued for use by all agencies of the War Department in the accounting review or examination of settlements proposed by contractors under the first method stated above, that is, by negotiation. The manual applies exclusively to the termination of fixed-price supply contracts. Although it does not apply to cost-plus-a-fixed-fee contracts, it does apply to fixed-price subcontracts thereunder.

Negotiated settlements of terminated fixed-price contracts and subcontracts are based on the two broad elements of cost and profit (see PR-15, par. 15-531). The determination of costs is a matter of accounting with respect to which the independent public accountant should be qualified to give an opinion (see PR-15, par. 15-501.3 and the manual, par. 1108.1); the determination of a fair and reasonable allowance for profit is a matter for negotiation between the contracting parties.

Scope of Examinations

The manual (par. 1106.1) states that, whenever possible, reliance should be placed on intelligent reviews rather than detailed audits. If the independent public accountant's examinations are so extensive that they are unduly costly and cause delay, they will more than offset any benefits to be derived. The demands on the profession for such service may well reach a point beyond its available manpower, and under such circumstances it would seem that it best can serve the national interest in the important matter of contract terminations by making intelligent reviews and by applying test checks less extensive than those commonly performed in industrial practice, even though this entails assuming a lesser degree of responsibility.

The services which independent public accountants can render to their clients and to the government will be valuable only to the extent that the work they do meets the requirements of the government department and assists contractors and the contracting officer in reaching an agreement. In a number of cases, the independent public accountant may be called in by his client for advice regarding the preparation by the client's staff of a termination settlement proposal. In other cases, the independent public accountant may be requested to participate in its preparation. In still other cases, the independent public accountant may not be requested to render any service until a termination settlement proposal has been submitted to the contracting officer, who then may request a review or examination by an independent public accountant. The committee believes that services within any of these categories may properly be rendered by independent public accountants, but that the nature of the services should be made clear to the various parties interested.

In the event the independent public accountant is asked to render any service in connection with a termination settlement proposal, it is important that, before the work is started, he discuss with his client, and with the contracting officer, if appropriate, the scope of work and form of report which will be most helpful to both the contracting officer and the client, with the minimum expenditure of time and money. In the case of many small claims, and perhaps some large claims, the service the contracting officer may desire of an independent public accountant may be in the nature of a quick or high-spot review, without the assumption by the independent public accountant of responsibility for the integrity of any of the figures underlying the contractor's claim.

The examinations of statements which independent public accountants may be called upon to make in connection with settlement proposals may thus be broadly classified into two categories: (1) a general review of the accounting practices followed in the preparation of the settlement proposal, including the bases of allocations of costs, overhead, etc., but without an audit of the figures except to see that they are based upon the underlying records, and (2) an examination sufficiently extensive in scope to afford the contracting officer assurance as to the reliability of the costs, the adequacy of presentation thereof, and the acceptability of accounting practices followed, so that he may reasonably conclude that further audit by government personnel is not required to protect the interests of the government. The interests of both the government and of clients may be best served by reducing detailed auditing or examination of statements of proposed settlements to a minimum consistent with prompt and fair settlements.

It should be emphasized that the manual does not prescribe certain rules or regulations, the mere following of which will necessarily result in statements of proposed settlements acceptable to the War Department as the sole basis for the determination of the amount of a claim. The manual does set forth certain general principles and certain accounting and auditing instructions which should guide contractors in the preparation of statements of proposed settlements and guide government personnel in their accounting reviews or examinations of such proposals undertaken to provide the contracting officers with a factual basis on which to negotiate settlement. It therefore appears that no matter how extensive an examination made by the independent public accountant of a settlement proposal may be, the report and opinion of the independent public accountant will be considered by the War Department as acceptable evidence supporting the adequacy of the presentation and the reliability of the data presented, but not necessarily as conclusive.

In the event a contracting officer requires an audit, Part III of the manual is stated to embrace such audit procedures as would ordinarily be required to protect the interests of the government. Accordingly, it would appear that as a general proposition the War Department would also regard it as indicative of the scope of examination which should be undertaken by an independent public accountant in order to express an opinion, if he is asked to do so, regarding the cost data set forth in the settlement proposal. The audit procedures in the manual are designed to minimize detailed checking; they contemplate reliance upon the contractor's system of internal control to the extent that such reliance appears warranted; they emphasize the importance of giving special attention to the accounting practices followed by the contractors; and they prescribe the use of selective methods of audit. Thus, fundamentally, the auditing practices set forth in the manual conform to those established by the accounting profession. In some cases, more detailed checking will be necessary than in others in order to protect the interests of the government and those of the contractor.

The independent public accountant regularly employed by a contractor should normally be the one best qualified to make an examination of the proposed settlement or to assist in its preparation. To some extent, the procedures outlined in Part III of the manual are followed as a part of the examinations or audits regularly made by independent public accountants. If the contractor has been a client for a considerable time, the independent public accountant should have a rather extensive knowledge of the accounting procedures followed and the reliability of the contractor's records. Paragraph 3106 of the manual recognizes that, to a considerable extent, regular audits by independent public accountants tend to establish the general credibility of the contractor's records and accounts.

Responsibility of Independent Public Accountant

While paragraph 3111 of the manual relates to the responsibility of the government auditor, inferentially it would also seem applicable, within reasonable limits, to the responsibility of the independent public accountant who has been requested to make such examination as will enable him to express his opinion regarding the adequacy of presentation and reliability of the cost data included in a proposed settlement.

As previously stated, the determination of the amount to be allowed the contractor for profit is a matter for negotiation and it is the view of this committee that the independent public accountant should not undertake to pass upon the profit element of the contractor's claim.

It is possible that many questions will arise which can be settled only by negotiation between the contracting officer and the contractor. In all such cases, the independent public accountant's responsibility would seem to be discharged if his report, together with the contractor's statement, contains adequate disclosure of items which should be brought to the attention of the contracting officer, including any departures from recognized accounting practices. It is particularly important to note that the following of "recognized accounting practices" does not necessarily mean that one accounting practice must be followed to the exclusion of all others. In a number of instances there may be alternative recognized accounting practices, any one of which may be acceptable. In such a case, disclosure of the practice is important.

Claims of Subcontractors

It will be noted from paragraph 2401.1 of the manual that the War Department considers it the primary responsibility of the contractor to review or examine, in an appropriate manner, all claims of subcontractors arising out of the termination. The manual further says that the problem faced by the contractor's accounting personnel in making the accounting review or examination of claims of subcontractors is similar to the problem faced by the government auditor with respect to the proposed settlement of the prime contractor. Paragraph 2401.2 provides that the contractor in this respect should be held to the standard of scrutiny that a businessman would employ in the conduct of his own affairs. In considering the claims of each subcontractor, the prime contractor presumably must decide whether an audit of the scope contemplated by Part III is required to meet the standard laid down in paragraph 2401.2. Paragraph 1114 indicates that the manual is suitable for use by contractors in the accounting examination by them of claims of subcontractors.

If the contractor decides that an audit by independent public accountants should be made of the subcontractors' statements of proposed settlement, it seems that the independent public accountant regularly employed by the subcontractor should normally be the one best qualified to make such examination. Here again, it is desirable that before the work is started he discuss with his client, the prime contractor, and the contracting officer, if appropriate, the scope of work and the form of report which will be most helpful. There is little doubt that the independent public accountant employed by the prime contractor will frequently be called upon to review subcontractors' claims and accompanying audit reports. Such review, in some cases, may involve visits to the subcontractors' plants, as well as a review of the working papers of the independent public accountants who have reviewed the subcontractors' statements.

Report of Independent Public Accountant

The committee believes that in any letter or report which the independent public accountant may render, either to his client or to the contracting officer, he should *not* express his opinion as to the fairness of the total amount of any claim. The contracting officer is interested in the certified public accountant's report only to the extent that it assists him in arriving at a conclusion as to the reliability of the costs, the adequacy of presentation thereof, and the acceptability of accounting practices followed.

In any letter or report covering services rendered by an independent public accountant in connection with a proposed termination settlement, the scope of examination, including any limitations thereon, should be clearly brought out and the independent public accountant should be particularly careful so to word his report that the contracting officer should not place reliance upon the independent public accountant's examination and report beyond that warranted by the scope of his examination.

In many cases the independent public accountant may not wish to assume responsibility for the reasonableness of quantities of material and work in process in relation to the quantitative requirements of the uncompleted portion of the contract, or the allocation of materials of a common nature. Regulations on such questions will doubtless be issued by the government departments concerned and these should receive the attention of the accountant.

The committee believes that any letter or report, whether based upon a review or a more comprehensive examination, should include at least the following:

1. A description of the scope of the review or the examination, stated in reasonably comprehensive form, though without unnecessary detail.

2. A reference to any previous examination which the indepen-

dent public accountant may have made of the financial statements of the contractor or subcontractor, including a general description of the scope similar to that set forth in the periodic reports on such examinations. Such a reference should aid in establishing the general credibility of the contractor's accounts.

3. A statement regarding the treatment of any items which the independent public accountant considers to be unsupported by recognized accounting practices or otherwise sufficiently within the area of uncertainty to require disclosure.

In general, disclosure of all material facts including accounting practices used, basis of allocation, etc., should be set forth in the statements or schedules by notation or otherwise, as the statements would be incomplete without such information. If such disclosure is not made, corresponding information should be set forth in the report of the independent public accountant, but it does not seem appropriate that such factual information should be set forth only in the report.

In those cases in which the independent public accountant has been asked to render an opinion with regard to the cost data contained in the settlement proposal, the committee believes the opinion expressed in the report, where no qualification is required, should be somewhat along the following lines:

> Based upon our examination, it is our opinion that the attached statement by XYZ Company of proposed termination settlement of contract No. 100 fairly sets forth the cost data applicable thereto and that such cost data have been prepared in accordance with recognized accounting practices.

Working Papers

Chapter 1 of Part IV of the manual relates to working papers. Contractors and independent public accountants should endeavor to follow the suggestions in this chapter to the extent practicable in order that the working papers may be most useful for such examination as the contracting officer or other government personnel may wish to make of them.

Committee on Auditing Procedure

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Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st St., New York 17, N. Y.

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July, 1944

Wartime Government Regulations

DURING the past decade there has been a significant increase in governmental control over business. Such control, particularly by the federal government, has been greatly extended under wartime conditions, as is evidenced by the laws and regulations relative to priorities, allocations, prices, wages and salaries, etc. As a result, business is subject to many procedural and reporting requirements which are implemented by penalties of varying severity for failure to comply. In the light of these conditions, important questions have arisen as to: (a) whether the responsibility of the independent accountant under the circumstances is such as to require an extension in the scope of the usual examination of financial statements to ascertain whether the client has complied with such wartime regulations; and (b) what steps the independent accountant should take when he has reason to believe that violation has occurred. In this statement the committee on auditing procedure deals with these questions.

Regulations Under Consideration

The laws and regulations under consideration are those prescribed by the federal government to meet wartime conditions. The more important of these controls, the general nature of their requirements, and the penalties involved are set forth briefly as follows:

(1) The priorities and allocations system is designed to control the acquisition, fabrication, holding, and disposition of raw materials and products. Except at the retail level (where it is generally administered by the Office of Price Administration), this system is administered by the War Production Board, which has issued a great number of general and specific orders and regulations, applicable to various industries and products, prescribing procedures and requiring reports of many kinds. Failure to comply may involve civil or criminal penalties, including suspension of operations, denial of priorities assistance, fine and/or imprisonment.

(2) The Emergency Price Control Act of 1942, as amended, is designed to control prices and to prevent abnormal price increases. It is administered by the Office of Price Administration, which has also issued many general and specific orders limiting the prices of goods and services. Failure to comply may involve fine and/or imprisonment, multiple damages, and the revocation of the license to do business.

(3) The granting of consumer credit is restricted under the Federal Reserve Board's Regulation "W." Failure to comply may involve suspension of license, fine and/or imprisonment.

(4) The National War Labor Board and the Salary Stabilization Unit of the Treasury Department are charged with the responsibility of enforcing legislation designed to stabilize wages and salaries. They have issued regulations governing changes in the rates of wages and salaries paid to individuals. Failure to comply may involve fine and/or imprisonment, as well as the drastic and unusual penalty of disallowing the entire amount of salaries and wages containing unauthorized adjustments as: (a) deductions in computing taxable income, (b) costs under government contracts, and (c) costs under any law or regulation of the federal government.

Scope of Usual Examination

The independent accountant's responsibility with respect to wartime regulations is considered here in connection with the usual examination of financial statements. The primary purpose of such an examination is to enable the accountant to express an opinion as to whether the financial statements present fairly the position of the client at a given date and the results of its operations for the period under review, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding period.[1]

The expression of such an opinion is based on an examination made in accordance with generally accepted auditing standards applicable in the circumstances of the case. This type of examination is usally based on testing and sampling of a portion of the financial transactions during the period rather than on a detailed examination. Such an examination is not designed to reveal relatively minor errors or irregularities in the accounts, and, in view of its purpose, it is generally limited in scope to matters which may have a material effect

[1] See Statements on Auditing Procedure No. 5, issued in February, 1941, pp. 40 and 41

on the financial statements and which are, or should be, reflected in the financial records and books of account. It is also limited to those matters upon which the accountant, through his professional training and experience, is qualified to pass, and which are reasonably within the sphere of his activities as an independent public accountant. Obviously, it does not include matters of law which require the judgment of an attorney.

Extension of Usual Examination

These limitations of the usual examination, both in scope and as to purpose, are important considerations in determining whether and, if so, to what extent, an examination should be extended for the purpose of ascertaining whether there has been compliance with wartime regulations. The effect of noncompliance on the financial statements is the primary consideration, and here, as in the case of auditing procedures in general, the likelihood of the statements being affected materially should determine the course of action.

As indicated above, failure to comply with wartime regulations may involve liabilities in the form of fines, refunds, damages, or other financial penalties. Where such liabilities may have a material effect on the financial statements, the independent accountant must take cognizance of the possibilities. He is expected to have knowledge of the existence and general nature of regulations governing materials, prices, wages, etc., and of the fact that noncompliance may result in a financial liability. Under these circumstances, the usual procedures for determining the existence of liabilities would be applicable.

The usual examination includes inquiries as to the system of internal control and the accounting procedures of the company. In addition, the accountant will usually make general inquiries of the management as to the safeguards, procedures, and organizational steps which have been adopted to insure compliance with applicable regulations. It is also customary to obtain a statement, preferably in writing and signed by a responsible official of the client, indicating that all outstanding liabilities are reflected in the accounts and setting forth the status of any contingent liabilities.[2] Possible penalty for violation of wartime regulations is one of the matters to be considered in such a statement.

The committee points out, however, that auditing procedures of

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2 See Statements on Auditing Procedure No. 4, issued in March, 1941.

the usual examination cannot be expected to provide assurance that a client has complied with all detailed requirements of some of the regulations, such as the War Production Board's priorities requirements and OPA price ceilings, because the transactions involved do not normally come within the independent public accountant's scrutiny. Reasonable assurance of such compliance would necessitate an undue extension of the scope of the usual examination which, in the absence of special grounds for question, would not be warranted by the probable effect on the financial statements. The accountant, therefore, need not extend his examination to include a search for violations of this type unless he has reason to believe that violations have occurred, or unless he comes upon evidence of their existence.

Under the same criterion of materiality, however, the accountant should make more specific inquiries in respect of such matters as compliance with wage and salary stabilization regulations, in view of the severe penalties for their violation and the possible effect such penalties may have on the financial statements, particularly the reasonableness of the provision for federal income and excess-profits taxes.

While the accountant would not ordinarily be expected to seek for isolated changes in the compensation of minor employees, especially when their number is large, he should consider changes in the compensation of important executives and general horizontal changes in the compensation of large groups of employees. In such cases, he should satisfy himself that the changes have been authorized by the appropriate governmental body or are of a nature which, under the regulations, do not require such authorization. He is faced with uncertainty as to the legal status of many transactions under wage and salary stabilization; but, after considering the various aspects of the situation, he should arrive at a conclusion as to whether or not a reserve should be provided.

As to any of the wartime regulations, the accountant must make further inquiry if, in the course of his usual examination, he encounters evidence which leads him to believe that violations have occurred which might result in liabilities or penalties materially affecting the financial statements. The nature of such further inquiry will necessarily vary in the circumstances of each case. Reference to the applicable laws and regulations will be required, but it is pertinent to point out that many of the regulations are very detailed, complicated, technical, and difficult of interpretation. In some cases the accountant may find it necessary to obtain counsel's opinion as to the interpretation and effect of the regulations in question, and he is ordinarily entitled to rely on such opinions.

In view of the pervasive nature of wartime regulations, the independent accountant ordinarily will have no assurance, as a result of his usual examination, that the client has not, innocently or otherwise, violated some one or more of the many detailed regulations. While the accountant may be expected to take general cognizance of these regulations, it is the opinion of the committee that the scope of his usual examination should not ordinarily be greatly extended for the purpose of detecting instances of violations unless he has reason to believe that violations have occurred; he should, however, be alert to recognize indications of violations. The need for extending the usual procedures will vary with the circumstances, depending upon the relative importance of the consequences of violation on the financial statements, the safeguards provided by the client, the nature of the evidence coming to the attention of the accountant, and possibly other considerations.

The foregoing conclusions as to the usual examination do not preclude the independent accountant from undertaking a special examination for the purpose of determining whether a client has complied with specific regulations, or from extending the scope of his usual examination for this purpose, when requested to do so. Even in these cases, however, the limitations on the accountant's ability to interpret the applicable laws and regulations must not be overlooked.

Procedure Where Violation Has Occurred

Where the independent accountant, in the course of his usual examination, comes upon information which leads him to believe that the client may have violated one of the wartime regulations and, as a result of further inquiry, he is reasonably certain that a violation has occurred, the matter should be brought to the attention of the management with a recommendation that adequate provision be made in the financial statements for the resulting liability. Where inadequate provision is made and the amount is material, the accountant should take an exception in his opinion on the financial statements. If the exception may be of sufficient importance to nullify the opinion he should consider whether he is warranted in expressing any opinion.

A suggestion has been made that the accountant include in his report a statement to the effect that he was unable to determine whether wartime regulations had been complied with during the period under review. It is the belief of the committee that such a procedure should be discouraged because it might at times represent an unwarranted disclaimer of the accountant's responsibility; it might also cast an unwarranted doubt upon the practices and reputation of the company concerned.

Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York 17, N. Y.

No. 22
May 1945

References to the Independent Accountant in Securities Registrations

Statements on Auditing Procedure represent the considered opinion of the members of the committee on auditing procedure expressed by formal vote after examination of the subject matter by the committee and the research department. Statements of the committee are not intended to be retroactive nor applicable to immaterial items and, except in cases in which formal adoption by the Institute membership has been secured, the authority of the statements rests upon the general acceptability of opinions so reached.

1. Since the passage of the Securities Act of 1933, accountants and others have given much consideration to the nature and extent of the responsibility of the accountant in connection with security registrations under that Act and to the choice of language in such registrations designed to express or explain clearly the responsibilities of the accountant as an expert.

2. Section 11 of the Securities Act of 1933 provides possible liability for false or misleading registration statements on the part of: "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him:" (Section 11 (a) (4))

3. However, this possible liability of the accountant may not exist when:

"as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) 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, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert;" (Section 11 (b) (3) (B))

4. The financial data which may appear in a registration statement or a prospectus in reliance upon the examination or review of the accountant as an expert, are of two general types: (1) the financial statements, usually consisting of balance-sheets, statements of profit and loss and surplus, and supplementary schedules, and (2) other financial data such as earnings summaries, sales and earnings tables, historical financial information, etc.

Financial Statements

5. The responsibility of the accountant in respect to financial statements used in registration statements and prospectuses has been discussed in several opinions of the Securities and Exchange Commission and is the subject of a number of its rules. Specifically, the accountant is responsible for the examination and review of those financial statements used in the registration as to which he undertakes to express his expert opinion. His responsibility relates not only to the propriety of what is set forth, but also to the inclusion of such information as is necessary to make the statements not misleading. The Commission's statements accompanying Amendment 3 to Regulation S-X[1] discusses in detail the Commission's requirements in respect to the accountant's opinion. Rule 2-02 of Regulation S-X now provides:

"(a) Technical requirements

"The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.

"(b) Representations as to the audit

"The accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made including, if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their

[1]SEC Accounting Series Release No. 21.

omission; (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

"In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed.

"Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

" (c) Opinions to be expressed

"The accountant's certificate shall state clearly:

" (i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein;

" (ii) the opinion of the accountant as to any changes in accounting principles or practices, or adjustments of the accounts, required to be set forth by rule 3-07; and

" (iii) the nature of, and the opinion of the accountant as to, any significant differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

" (d) Exceptions

"Any matters to which the accountant takes exception shall be clearly identified, the exception therto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given."[2]

6. These rules are not subject to any interpretation that the accountant is primarily responsible for such financial statements as are covered by his opinion or that he has prepared them. As has

[2]Reprinted in *Statements on Auditing Procedure*, No. 6, pages 51-52.

been frequently enunciated by the American Institute of Accountants, the financial statements are primarily the statements and representations of the company. The fact that the statements are accompanied by the report of an independent public accountant does not alter the situation. The accountant's representations are confined to and expressed in his report, or opinion, upon the statements. 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 accountant'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.

7. The position of the Securities and Exchange Commission is not in conflict with this view that the accountant is responsible as an expert only in respect to his opinions as expressed by his certificate or report. The Commission has said:

"The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting."[3]

and again (in requiring certification as to observance of auditing standards)

". . . accountants may not be able to certify as to the correctness of the figures appearing on the financial statements in the sense of guaranteeing or warranting their correctness but can merely express their opinion with respect to them . . ."[4]

8. In view of the clarity with which the responsibilities of a person acting in his professional capacity as an independent accountant have thus been defined and enunciated, it is important that the language used in registration statements and prospectuses to iden-

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[3] 4 SEC 721 (1939).

[4] See *Statements on Auditing Procedure*, No. 6, page 50.

tify the financial representations contained therein should be equally clear in characterizing the accountant's relationship to those representations. When financial statements are thus referred to by the registrant, language comparable to the following should be used:

> "The following financial statements and schedules have been examined by ...., independent certified public accountants, whose report with respect thereto appears on the following page."

This statement might be supplemented, if desired, by a phrase "and such financial statements and schedules have been made a part of this registration statement in reliance upon the report of such firm as experts" or "and such financial statements and schedules have been made a part of this registration statement with the authority of the report of such firm as experts." The purpose is to state that the accountant in his capacity as an independent expert has examined the financial statements which are, however, the representations of the registrant and to direct attention to the expert opinion of the accountant which should be read in conjunction with those representations. The language to be used should avoid such phrases as "has been prepared by ...., independent accountants" or "are stated on the authority of such firm as experts" for they may be interpreted as imputing to the accountant greater responsibility in respect to the financial statements than has been contemplated by the Act, or is intended to be assumed by the accountant.

Earnings Summaries, Etc.

9. Earnings summaries, sales and earning tables, historical financial information, etc., as included in registration statements and prospectuses are, for the most part, extracts or summaries of information contained in financial statements included therein, or in previous reports issued by the company. While no rules or opinions of the Commission have been directed to the accountant's responsibility and possible liability for such representations, it seems apparent that it could not be greater than his responsibility with respect to the financial statements upon which they are based. As the accountant cannot assume the primary responsibility for financial statements but can only express an expert opinion upon them, it follows that the accountant's responsibility for earnings summaries, historical financial information, etc., should be limited to those opinions expressed or reflected by his report or certificate and his consent.

10. As in the assertions made by the registrant to identify financial statements, it is important that the references identifying such representations as sales and earnings tables, historical financial information, etc., clearly reflect the responsibility intended to be placed on the accountant in respect to those representations. Statements such as the following may be used.

(1) "The following summary of earnings has been prepared, for the years. . . , . . . and. . . from income statements examined by. . . . . . independent certified public accountants, as contained elsewhere in this prospectus and should be read in conjunction with those statements and related notes, and the opinions of the independent certified public accountants; for earlier years the information has been taken from the income statements contained in the annual reports of the company to stockholders."

(2) "The summary of earnings shown below, which has been prepared from the statement of profit and loss for the three years ended . . . included in the financial statements appearing elsewhere in this prospectus, has been reviewed by . . . ., as experts, and should be read in conjunction with such financial statements and related notes, and the certificate of . . . ."

Such language directs attention to the fact that, in so far as the data have been prepared from financial statements which have been examined by the accountant, such data should be used and interpreted in conjunction with the complete financial statements and the expert opinions of the accountant as they are reflected in his reports related thereto or elsewhere contained in the prospectus. Language which suggests that the summary "has been prepared by . . . ., independent accountants" or is given "on their authority as experts" might, when linked with or specifically referred to in his consent to the use of his name, be interpreted as meaning that the accountant had other responsibilities in respect to the representations made and such terminology should, therefore, not be used.

11. Wherever the accountant consents to the use of his name in reference to summaries of earnings, other summaries, or historical financial information, he should take the responsibility for a fair summarization or presentation. In certain circumstances this may involve more than a cross-reference to the detailed statements. The basic objective, of course, is that the summary should be constructed in such manner that there will be no materially different interpretation thereof from that obtained in the consideration of the detailed statements. In any case where the accountant's name is used in reference to summaries of earnings for prior years not included in the registration statement, he should review the results for those years to determine whether the information previously published requires change due to substantial retroactive adjustments and whether explanatory footnotes may be necessary.

COMMITTEE ON AUDITING PROCEDURE

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Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York 17, N. Y.

No. 23

December 1947

Clarification of Accountant's Report When Opinion Is Omitted

1. The presentation of financial statements on the stationery or in a report of an independent public accountant without a definitive expression clearly indicating the representations he is making as to their fairness tends to create uncertainties in the minds of those who do not have special information regarding the preparation of the financial statements. In such cases, these third parties have no basis for determining what inferences are warranted by the association of the accountant's name with the financial statements and may place undue reliance upon them.

2. Illustrative of the practices which frequently give rise to such uncertainties are the following:

(a) The presentation of financial statements on the stationery of the accountant without comment, opinion, or signature; or with the assertion that the statements are "for management purposes only."

(b) The omission of an expression of opinion or of a specific disclaimer of an opinion in a report of an accountant in which financial statements and comments on the scope of the audit are included.

3. In the first case it is not clear whether, by his silence, the accountant intends to express unequivocal satisfaction with the financial statements or whether he intends to disclaim any opinion at all. The assertion that the statements are "for management purposes only" leaves the reader in doubt as to whether it indicates a limitation on the scope of the audit examination, whether it merely designates the form in which fully-approved statements are presented, or whether it has some other significance. In the second case, there is a review of the accountant's procedures, but it is not clear whether those procedures were sufficient to permit the expression of an opinion.

4. Since the accountant cannot effectively control the use to which financial statements accompanied by his name may be put, the adoption of practices which will minimize the possibilities of uncertainties and misinterpretations by third parties is obviously to the interest of all concerned and should aid in the avoidance of embarrassment and damage to the profession. The committee on auditing procedure, therefore, recommends that, whenever financial statements appear on the stationery or in a report of an independent certified public accountant, there should be a clear-cut indication of the character of the examination, if any, made by the accountant in relation to the statements, and either an expression of opinion regarding the statements, taken as a whole, or an assertion to the effect that such an opinion cannot be expressed. When the accountant is unable to express an over-all opinion, the reasons therefor should be stated. When the accountant considers it appropriate to comment further regarding compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an over-all opinion, he should be careful to indicate clearly the limitations of such comments.

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5. On September 19, 1939, the membership of the American Institute of Accountants approved a report of this committee entitled "Extensions of Auditing Procedure" which stated, in part:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

6. The views now being enunciated by the committee entail the modification and extension of this position. It is, therefore, recommended that the above-quoted paragraph, which appears on page 5 of Statements on Auditing Procedure No. 1, "Extensions of Auditing Procedure," be amended to read as follows:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary **to express an opinion on the statements taken as a whole.** In such circumstances, the independent certified public accountant should ~~(limit his report to a statement of his findings and, if appropriate, his reason for omitting an expression of opinion)~~ **state that he is not in a position to express an opinion on the financial statements and indicate clearly his reasons therefor. He may also, if appropriate, comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an over-all opinion."** (Bold face type indicates new wording; cross-out indicates old wording eliminated.)

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7. In view of the formal adoption of the report, "Extensions of Auditing Procedure," it is believed appropriate that any modification thereof should likewise be placed before the membership for formal consideration. Accordingly, council has directed that this statement be placed on the agenda of the next annual meeting of the Institute for discussion and action by the membership, and has authorized its issuance as a committee statement so that the membership may have an opportunity to consider it prior to its presentation to the annual meeting for formal action.

COMMITTEE ON AUDITING PROCEDURE (1946-1947)

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Statements on Auditing Procedure

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

No. 23 (Revised)

December 1949

Clarification of Accountant's Report When Opinion Is Omitted

The committee on auditing procedure of the American Institute of Accountants in December, 1947, issued Statements on Auditing Procedure No. 23, Clarification of Accountant's Report When Opinion Is Omitted, *in which it proposed an amendment to* Extensions of Auditing Procedure *designed to improve current reporting practices. Following the issuance of Statement No. 23, it became evident that there was considerable misunderstanding in the profession as to the objectives of the proposed amendment and its application in practice. Accordingly, the proposed amendment was revised in May, 1949, to explain more fully the committee's views on the subject. The amendment, as thus revised, was submitted to the annual meeting of the American Institute of Accountants in November, 1949, and was formally adopted.*

This statement is a revision of Statements on Auditing Procedure No. 23, incorporating the amendment as adopted by the membership. It supersedes the original Statement No. 23.

1. The presentation of financial statements on the stationery or in a report of an independent public accountant without a definitive expression clearly indicating the representations he is making as to their fairness tends to create uncertainties in the minds of those who do not have special information regarding the preparation of the financial statements. In such cases, these third parties have no basis for determining what inferences are warranted by the association of the accountant's name with the financial statements and may place undue reliance upon them.

2. Illustrative of the practices which frequently give rise to such uncertainties are the following:

(a) The presentation of financial statements on the stationery of the accountant without comment, opinion, or signature; or with the assertion that the statements are "for management purposes only."

(b) The omission of an expression of opinion or of a specific disclaimer of an opinion in a report of an accountant in which financial statements and comments on the scope of the audit are included.

3. In the first case it is not clear whether, by his silence, the accountant intends to express unequivocal satisfaction with the financial statements or whether he intends to disclaim any opinion at all. The assertion that the statements are "for management purposes only" leaves the reader in doubt as to whether it indicates a limitation on the scope of the audit examination, whether it merely designates the form in which fully-approved statements are presented, or whether it has some other significance. In the second case, there is a review of the accountant's procedures, but it is not clear whether those procedures were sufficient to permit the expression of an opinion.

4. Since the accountant cannot effectively control the use to which financial statements accompanied by his name may be put, the adoption of practices which will minimize the possibilities of uncertainties and misinterpretations by third parties is obviously to the interest of all concerned and should aid in the avoidance of embarrassment and damage to the profession. The committee on auditing procedure, therefore, recommends that, whenever financial statements appear on the stationery or in a report of an independent certified public accountant, there should be a clear-cut indication of the character of the examination, if any, made by the accountant in relation to the statements, and either an expression of opinion regarding the statements, taken as a whole, or an assertion to the effect that such an opinion cannot be expressed. When the accountant is unable to express an over-all opinion, the reasons therefor should be stated. When the accountant considers it appropriate to comment further regarding compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an over-all opinion, he should be careful to indicate clearly the limitations of such comments.

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5. On September 19, 1939, the membership of the American Institute of Accountants approved a report of this committee entitled *Extensions of Auditing Procedure* which stated, in part:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

6. The views now being enunciated by the committee entail the modification and extension of this position. It is, therefore, recommended that the above-quoted paragraph, which appears on page 5 of Statements on Auditing Procedure No. 1, *Extensions of Auditing Procedure,* be amended to read as follows:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements taken as a whole and should indicate clearly his reasons therefor. 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. The purpose of these assertions by the accountant is to indicate clearly the degree of responsibility he is taking.

"Whenever the accountant permits his name to be associated with financial statements, he should determine whether, in the particular circumstances, it is proper for him to (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole. 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; if they are such as to negative an opinion on the statements taken as a whole he should clearly disclaim such an opinion. His conclusions in this respect should be stated in writing either in an informal manner, as in a letter of transmittal bound with the financial statements, or in the more conventional short-form or long-form report. However, when financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning, such as *Prepared from the Books Without Audit,* appearing prominently on each page of the financial statements is considered sufficient.

"It is not contemplated that the disclaimer of an opinion should assume a standardized form. Any expression which clearly states that an opinion has been withheld and gives the reasons why would be suitable for this purpose. However, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the accountant's opinion regarding the statements taken as a whole. It is incumbent upon the accountant, not upon the reader of his report, to evaluate these matters as they affect the significance of his examination and the fairness of the financial statements."

7. It should be remembered that *Extensions of Auditing Procedure* for 10 years has precluded the expression of any opinion on the financial statements taken as a whole when the accountant's exceptions or qualifications were such as to negative the opinion. That provision is continued under the amendment. The change is concerned solely with improving current reporting practices by providing that, in such cases, the accountant should henceforth clearly indicate that he is not in a position to express an opinion on the financial statements taken as a whole, and give his reasons why.

COMMITTEE ON AUDITING PROCEDURE (1948-1949)

ALVIN R. JENNINGS, *Chairman*

J. A. BOULAY
GARRETT T. BURNS
CHARLES F. COATES
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CARMAN G. BLOUGH
Director of Research

Statements on Auditing Procedure

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Issued by the
Committee on Auditing Procedure,
American Institute of Accountants,
13 East 41st Street, New York 17, N. Y.

No. 24
October 1948

Revision in Short-Form Accountant's Report or Certificate

1. The special report of the committee on auditing procedure on "Auditing Standards—Their Generally Accepted Significance and Scope" was issued in October, 1947. The summarized statement of auditing standards appearing on page 11 of the special report was approved in a resolution adopted by the council of the American Institute of Accountants in May, 1948. In accordance with that resolution, the summary of auditing standards was submitted for approval to the members attending the annual meeting of the Institute in September, 1948, and was approved. The resolution adopted by the members present is appended to this statement.

2. The foregoing actions give an official status to the meaning of the term "generally accepted auditing standards" which has been used for several years in the accountant's short-form report or certificate. It is the view of the committee on auditing procedure that the clarification thus accomplished makes it possible to simplify and improve the first paragraph of the short-form of accountant's report or certificate.

3. The committee believes that the first paragraph of the short-form report or certificate should be amended in the following respects:

(a) Exclude reference to the examination of the system of internal control.

(b) Exclude reference to the omission of a detailed audit of the transactions.

(c) Correct the inconsistent expression relating to auditing standards applicable in the circumstances.

4. The committee believes that it is no longer necessary or desirable to mention the examination of the system of internal control inasmuch as one of the generally accepted auditing standards is stated to be:

> "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."

5. The test character of examinations by independent accountants has been made clear in the special report on auditing standards and in other literature published during the past several years. Therefore, it is the view of the committee that the words "and accordingly included such tests of the accounting records" in the second sentence of the first paragraph of the report or certificate as revised, is sufficient declaration of the test nature of the examination.

6. The last of the foregoing amendments was covered by a recommendation of the committee in its special report on auditing standards. This suggested change has already been adopted by a majority of the accounting profession in the reports or certificates relating to the year 1947.

7. The recommended revised short-form of accountant's report or certificate is presented below:

> **"We have examined the balance-sheet of X Company as of December 31, 19— and the related statement(s) of income and surplus for the year then ended. 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.**
>
> **"In our opinion, the accompanying balance-sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 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."**

APPENDIX

The following resolution was adopted by the members present at the annual meeting of the American Institute of Accountants in September, 1948:

WHEREAS the committee on auditing procedure of the American Institute of Accountants in a special report [*Tentative Statement of Auditing Standards*] issued in October, 1947, among other things has stated that

> "While it is not practicable, because of the wide variance of conditions encountered, to issue anything like an 'all-purpose' program of auditing procedures it is possible to formulate a pronouncement with regard to the auditing standards requiring observance by the accountant in his judgment exercise as to procedures selected and the extent of the application of such procedures through selective testing." (Paragraph 6, page 7)

and that:

> "Auditing standards may be said to be differentiated from auditing procedures in that the latter relate to acts to be performed, whereas the former deal with measures of the quality of the performance of those acts, and the objectives to be attained in the employment of the procedures undertaken. Auditing standards as thus distinct from auditing procedures concern themselves not only with the auditor's professional qualities but also with his judgment exercise in the conduct of his examination and in his reporting thereon." (Part of the first paragraph, page 9)

and has presented the following brief summary of the meaning of generally accepted auditing standards (page 11):

> "General Standards
>
> 1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
> 2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
> 3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.
>
> "Standards of Field Work
>
> 1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
> 2. 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.
> 3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.
>
> "Standards of Reporting
>
> 1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

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

NOW THEREFORE BE IT RESOLVED, That:

(a) The foregoing excerpts from the committee's report are hereby approved and adopted,

(b) The use of "generally accepted auditing standards" in the reports or certificates of independent auditors shall be deemed to refer to the standards or principles set forth in the foregoing summary, and

(c) The references on pages 10 and 12 of *Extensions of Auditing Procedure* [Statement on Auditing Procedure No. 1] to the Institute's 1936 bulletin *Examination of Financial Statements* are no longer applicable.

* * *

The statement entitled "Revision in Short-Form Accountant's Report or Certificate" was adopted by the assenting votes of sixteen members of the committee. One member, Mr. Harrington, dissented.

Mr. Harrington opposes the issuance of the statement because he questions the desirability of excluding from the accountant's report reference to the omission of a complete check of transactions. Notwithstanding his agreement with the other members of the committee that auditing standards ordinarily do not require a complete check of transactions, Mr. Harrington believes that a statement in the auditor's report to the effect that a detailed audit was not made is of continuing value as educating readers to a better appreciation of the character of the accountant's examination.

COMMITTEE ON AUDITING PROCEDURE (1947-1948)

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J. A. BOULAY
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NORMAN H. S. VINCENT
KARL R. ZIMMERMANN

CARMAN G. BLOUGH
Director of Research

American Institute of Accountants

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

January 18, 1949.

TO THE MEMBERS OF THE

AMERICAN INSTITUTE OF ACCOUNTANTS:

GENTLEMEN:

The New York Stock Exchange, under date of January 10, 1949, issued a letter to the presidents of corporations having securities listed on the Exchange. At the request of the committee on accounting procedure, that letter, signed by Mr. Emil Schram, president of the Stock Exchange, is reproduced on the reverse side of this sheet.

Sincerely yours,

CARMAN G. BLOUGH

Director of Research

NEW YORK STOCK EXCHANGE

ELEVEN WALL STREET

OFFICE OF THE
PRESIDENT

January 10, 1949.

To the Presidents of Corporations having securities listed on the New York Stock Exchange:

The method of determining and reporting net income has been and is continually being studied by various interested groups. It is recognized that the reporting of earnings within the confines of a single year necessitates the exercise of judgment and the results, as reported, are based upon opinion of the management, supported by the opinion of its independent accountants as expressed in their certificate on the basis of objective accounting standards.

Due to the rapid price changes which have occurred over the past few years, there is a variety of opinion in relation to reporting net income or making appropriations of net income to be considered, particularly those relating to inventories and fixed assets. It would appear that until such varied opinions have become reconciled, the primary figures of the earnings or earnings per share reported to security holders and the investing public should be the net income for the year determined in accordance with generally accepted practice at the present time. It would then appear logical to include such other information concerning the need for the retention of earnings to maintain a continuing business enterprise as may be desired.

Your coöperation in following this procedure not only in the text of your annual report but also in any releases which you may make in relation to a report of earnings for the year would be appreciated.

There is enclosed for your information a copy of Accounting Research Bulletin No. 35, issued by the committee on accounting procedure of the American Institute of Accountants, relating to the presentation of income and earned surplus.

Very truly yours,

EMIL SCHRAM