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How to protect your EDP records

Richard A. Levine

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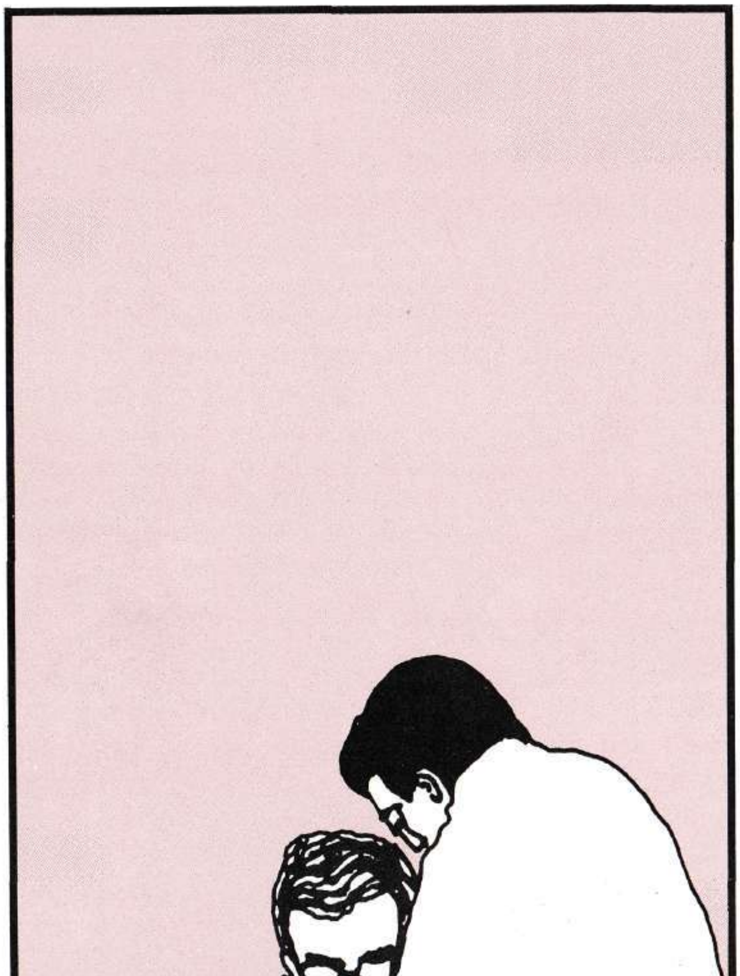
RELIANCE ON OTHER AUDITORS – UNITED STATES PRACTICE

by Raymond E. Perry



The auditor's report on the financial statements of a business is sometimes based on the work of *more than one auditor*. In the typical situation one of the auditors, called the primary auditor, assumes the responsibility for issuing an audit report based, in part, on work performed by one or more secondary auditors. The primary auditor may or may not refer to the secondary auditor in his report, depending on the circumstances of the engagement.

The employment of a secondary auditor may be initiated by either the primary auditor or the management of the company. The secondary auditor's work may be a complete examination in accord with generally accepted auditing standards or it may involve only specified and limited procedures. For example, the secondary auditor may be employed to audit an autonomously operated subsidiary company, or he may be employed merely to observe the taking of a physical inventory.

In most cases the accounts audited by the secondary auditor will be combined or consolidated with the accounts audited by the primary auditor, and the financial statements audited by the secondary auditor will not appear separately in the report. This is usually the case when the secondary auditor is employed to verify specific accounts at distant locations, or to audit a consolidated subsidiary or unincorporated division. At other times the secondary auditor may be employed to audit the accounts of an unconsolidated subsidiary, in which case the financial statements of that subsidiary would be presented in the report separately from those of the parent company and any consolidated subsidiaries.

Secondary auditors are most often engaged in either of two situations. *A business may employ a secondary auditor when it has operations located at a distance from the closest office of the primary auditor*—whether in the primary auditor's country or in a foreign country.

Or following the consummation of a business combination, the auditor of the acquired company will sometimes continue as secondary auditor for one or more years after the combination. But as time passes there is an increasing tendency to transfer the audit of the acquired company to the primary auditor.

The Varied Relationships Between Auditors

The relationship between the primary auditor and the secondary auditor may take one of four forms:

—Agency for a specific engagement
—Continuing relationships with a correspondent firm
—Unilateral assumption of agency
—No agency, either actual or implied.

Under the typical agency relationship the primary auditor assumes responsibility for the secondary auditor's work as if he had performed it himself. *The primary auditor employs the secondary auditor so that the secondary auditor reports directly to him and collects his fee from him.*

In many cases two or more auditing firms maintain a continuing relationship so work arising in a geographic area not served by one firm may be referred to a related firm. Some of these relationships operate within the United States; others are international.

The details of the legal and working relationships among such firms vary, as do the terms of designation. The member firms of such groups may be associates, affiliates, licensees, agents or correspondents.

Since the continuing relationship among a group of firms is a form of agency, the primary auditor generally assumes full responsibility for the work of the others.

(To simplify presentation, the terms "associates" or "associated firms" are used throughout this paper to include all of the various continuing relationships among groups of auditing firms.)

The unilateral assumption of agency may be said to occur when a primary auditor accepts the work of another auditor even though no arrangement had been made before the audit by the secondary auditor. Under these circumstances the secondary auditor's report is issued to the company and his fee is paid by the company rather than by the primary auditor. This situation may arise following a business combination.

In other cases when a secondary auditor is employed, there may be no agency relationship involved—either actual or implied. In this situation the primary auditor does not accept responsibility for the work of the secondary auditor.

There are no statutory enactments governing responsibilities of the auditor. Therefore, audits are performed under a contractual relationship between the auditor and the audited company, but there is seldom an exchange of written communications that set forth the specific terms of the engagement in the sense of a legal contract.

Securities legislation does not specifically cover reliance on other auditors. Securities and Exchange Commission Regulation S-X governs the form and content of most financial statements required to be filed with the commission. However, the only reference to reliance on other auditors in Regulation S-X pertains to reporting requirements.

Therefore, the responsibilities of the primary auditor are governed almost entirely by pronouncements of the American Institute of CPAs.

The code of professional ethics of the Institute says:

> "In obtaining sufficient information to warrant expression of an opinion [a member or associate] . . . may utilize, in part, to the extent appropriate in the circumstances, the reports or other evidence of auditing work performed by another certified public accountant, or firm of public accountants, at least one of whom is a certified public accountant, who is authorized to practice in a state or territory of the United States or the District of Columbia, and whose independence and professional reputation he has ascertained to his satisfaction.
>
> "A member or associate may also utilize, in part, to the extent appropriate in the circumstances the work of public accountants in other countries, but the member or associate so doing must satisfy himself that the person or firm is qualified and independent, that such work is performed in accordance with generally accepted auditing standards, as prevailing in the United States, and that financial statements are prepared in accordance with generally accepted accounting principles, as prevailing in the United States, or are accompanied by the information necessary to bring the statements into accord with such principles." (from Art. 2.01)

Requirements under the code of professional ethics are covered in Statements on Auditing Procedure (Statement No. 33, Chapter 10, Paragraphs 32 through 36) and are explained in the rest of this article.

Three Degrees of Responsibility for Work of Secondary Auditor

The responsibility that the primary auditor assumes for the work of the secondary auditor is indicated by the way he uses the secondary auditor's work in his report on the combined financial statements. He may accept responsibility in one of three degrees:

—The primary auditor may not be willing to take any responsibility for the secondary auditor's work. He shows this by issuing a qualified opinion or a disclaimer of opinion because of the inclusion of data not audited by him.

—The primary auditor may be willing to assume full responsibility for work of the secondary auditor. He usually indicates this degree of acceptance by omitting from his report any reference to the secondary auditor. Alternatively, but infrequently, the primary auditor may disclose in his report that a portion of the audit was performed by another auditor and either omit any reference to reliance on the other auditor's report or state that he is accepting full responsibility.

—While not willing to assume full responsibility for the work of the secondary auditor, the primary auditor may be willing to issue an opinion on the consolidated financial statements as a whole based in part on the secondary auditor's report. This is done by the primary auditor's saying in his report that he is relying solely upon the report of the secondary auditor for the portion of the enterprise audited by the secondary auditor. Under these circumstances the primary auditor's responsibility with respect to the work performed by the secondary auditor is limited to—

a) gaining satisfaction as to the independence and professional reputation of the secondary auditor and
b) determining that his work and that of the secondary auditor are properly coordinated.

When the secondary auditor's major practice is outside of the United States, the primary auditor is responsible for determining that the work of the secondary auditor is performed in accordance with United States auditing standards. The primary auditor is also responsible under such circumstances for determining that the financial statements conform with prevailing accounting principles in the United States or are accompanied by information necessary to bring the statements into accord with such principles.

Responsibility Under Common Law

The responsibilities of primary auditors described in the American Institute pronouncements are subject to interpretation by the courts. There is only one reported court decision in the United States in which the question of reliance upon other auditors was at issue. (Beardsley vs. Ernst, 47 Ohio App. 241, 191 NE 808.) This 1934 decision related to financial statements for the year ended December 31, 1929, upon which the auditors reported:

> "We hereby certify that we have examined the books of account and records of International Match Corporation and its American Subsidiary company at December 31, 1929, and have received statements from abroad with respect to the foreign constituent companies as of the same date. Based upon our examination and information submitted to us it is our opinion that the annexed Consolidated Balance Sheet sets forth the financial condition of the combined companies at the date stated, and that the related Consolidated Income and Surplus Account is correct."

Because of deficiencies in the financial statements of the foreign subsidiaries, it turned out that the consolidated income for the year was substantially overstated. However, the court held that the United States auditor was not liable for damages suffered by the plaintiff who had bought securities by relying on the consolidated financial statements. In reaching its decision the court cited the statement included in the auditor's certification, writing that they "were based upon statements from abroad with respect to the foreign constituent companies" and stated that "such statements give rise to the indisputable inference that the accountants have not examined the records of the foreign constituent companies."

Independence and Professional Reputation of Secondary Auditor

Pronouncements of the AICPA require that the primary auditor be satisfied with the independence and professional reputation of the secondary auditor. The secondary auditor must meet all of the independence requirements regarding both the segment that he is auditing and the total enterprise upon which the primary auditor is reporting. The procedures the primary auditor can follow in gaining such satisfaction are not specified and must be determined by the primary auditor's judgment.

In many cases the primary auditor will be well acquainted with the reputation of the secondary auditor, having relied on his work in prior years or having worked with him in professional activities. When the primary auditor is not acquainted with the secondary auditor, the usual practice is for the primary auditor to ask for information from bankers, attorneys or others acquainted with the professional work and reputation of the secondary auditor.

Whatever the circumstances, the primary auditor is expected to actively seek out evidence as to the professional reputation of the secondary auditor and not rely merely on the fact that he has heard no derogatory information about him.

Once the primary auditor is satisfied with the professional reputation of the secondary auditor, he will determine from the secondary auditor that he is independent with respect to the engagement under consideration. Although the practice is not universal, many primary auditors receive or arrange for the client to receive written representations from the secondary auditor stating that he is independent. Many auditors make a practice of arranging that the secondary auditor send such a letter of independence for each specific engagement. Other primary auditors require written letters of independence only for the first engagement with each company.

Coordination of the Examinations of the Primary and Secondary Auditors

The primary auditor is responsible for coordinating his activities with those of the secondary auditor. This is important because the financial statements for the segments of the enterprise examined by the secondary auditor must be properly combined or consolidated with the segments examined by the primary auditor.

Among other things, coordination of the auditors' activities requires making arrangements for properly evaluating elimination of intercompany or interdivision transactions and assuring that appropriate uniform accounting practices are applied in all segments of the enterprise. Normally this will involve one or more meetings between the primary and secondary auditors or correspondence between the two. The extent of such meetings or correspondence depends on the completeness of the company's accounting manual.

In a typical domestic situation a meeting between the primary and secondary auditors will be arranged prior to beginning the work. Here the primary auditor will generally discuss the requirements of the engagement and explain how the secondary auditor's work will be used. There may be one or more discussions between the auditors during the course of the examination. When the secondary auditor has completed his work and has issued his report, there may be final discussions to enable the primary auditor to combine properly the financial statements of the segments examined by the secondary auditor with the rest of the enterprise. Sometimes the secondary auditor will prepare a detailed special report for this purpose. Some secondary auditors request a written statement from the primary auditor stating that he is not aware of any matter that would affect the financial statements reported upon by the secondary auditor.

However, it should be noted that the frequency of contact between the primary and secondary auditors and the extent of detailed instructions issued by the primary auditor will vary considerably from one engagement to another.

Comfort Letter on Review of Subsequent Events by Secondary Auditor

Occasionally the audit by the secondary auditor is completed much earlier than examination by the primary auditor. This often happens, for example, when a foreign subsidiary's financial statements as of November 30 are included in consolidated financial statements as of December 31. Such an event might occur also when the primary auditor's examination extends far beyond the time originally contemplated. Occasionally an extended interval occurs between completion of the primary auditor's and the secondary auditor's examinations when the secondary auditor's examination is for a prior year which is now being included in consolidated financial statements for the first time. The changes may be the result of a change in consolidation practices or because of a business combination. Under such circumstances it is normally necessary for the secondary auditor to make a post balance sheet review from the date of his original report up to the date of the primary auditor's opinion. This review is to determine whether any subsequent events require disclosure or modification of the financial statements. The usual procedure is for the secondary auditor to issue a letter to the primary auditor stating that he has performed such a subsequent review and explaining whether any significant events have occurred to affect the financial statements.

The need for such post balance sheet reviews is particularly likely to occur when the financial statements are being included in a registration statement under the Securities Act of 1933. Under this act the primary auditor must continue his review of post balance sheet events up to the effective date of the registration statement. The time between the effective date of the registration statement and the date of the original filing is normally at least a month, and, in many cases is much longer.

While membership in a professional organization is not a prerequisite to obtaining a license to practice, the majority of CPAs in public practice in the United States belong to both the American Institute and to their state society. Still, many practicing CPAs belong to only one organization—usually their state society. The requirements for relying on other auditors under the codes of ethics of the state societies are similar to those for the American Institute of CPAs. State societies do not issue pronouncements similar to the AICPA statements on auditing procedure. Because of this, the AICPA pronouncements are normally followed by CPAs whose only professional membership is in a state society.

A primary auditor will rarely rely on the work of an American secondary auditor who does not belong to either the American Institute or to a state society. If he elects to do so, the primary auditor would, nevertheless, insist that the secondary auditor adhere to the professional standards of the American Institute.

The Secondary Auditor as a Member of an Overseas Professional Body

When the secondary auditor's practice is outside the United States, the American primary auditor must make certain that the work of the overseas auditor conforms to generally accepted auditing standards prevailing in the United States. Also the primary United States auditor must determine, in such cases, that the financial statements are prepared in conformity with generally accepted accounting principles prevailing in the United States. When the secondary auditor is an associated firm, it will usually not be necessary to make special arrangements to determine that the secondary auditor is conversant with United States practice. This will have been accomplished by the numerous contacts involved in establishing and maintaining the associated relationship. Where such established relationships do not exist, the primary auditor must specifically communicate to the secondary auditor. The United States auditor may receive written assurances from the secondary auditor and must make whatever review he considers necessary to be satisfied that accounting and auditing practices as prevailing in the United States have been followed.

Review of Secondary Auditor's Work

When the primary auditor decides to accept full responsibility for the audit by the secondary auditor, he must be fully satisfied with the secondary auditor's work. The primary auditor may gain such satisfaction by reviewing the secondary auditor's work. In rare cases the primary auditor may have to perform an overriding examination.

Under the American Institute pronouncements, the primary auditor may be willing to assume full responsibility when:

- —The primary auditor has engaged the secondary auditor as his agent;
- —The secondary auditor is an associate whose work is usually accepted by the primary auditor;
- —The primary auditor has made sufficient review of the secondary auditor's work to justify accepting full responsibility;
- —The amounts are immaterial.

Except when amounts are immaterial, the primary auditor will review the audit program and the working papers prepared by the secondary auditor.

Generally the primary auditor establishes a detailed audit program before the audit work begins, or the secondary auditor sets up a program which is reviewed and approved by the primary auditor.

The extent of review of working papers required will vary depending on the circumstances surrounding the engagement of the secondary auditor and the nature of the company being audited. The primary auditor's review is apt to be limited when the secondary auditor is well known to the primary auditor or when the secondary auditor is an associate. This would be the case because the primary auditor would have established relationships with the secondary auditor and have complete familiarity with, and confidence in, his work. If the primary auditor is unilaterally assuming an agency relationship with a secondary auditor employed by the client company or if the primary auditor has not previously worked with the secondary auditor —the tendency is for the primary auditor's review to be intensive.

Depending upon the extent of the review desired and time requirements, the review of working papers by the primary auditor may take place as the examination progresses or may be done after the work by the secondary auditor is completed.

In isolated cases, the primary auditor may actively supervise the work of the secondary auditor.

Usually primary auditors assume full responsibility only when the segments audited by the secondary auditor represent a minor portion of the total enterprise. Practice varies as to how large a percentage of the consolidated amounts the primary auditor will permit to be audited by a secondary auditor when the primary auditor is to assume full responsibility. Some auditors set the maximum at 30% of the total enterprise; others are more stringent. Yet sometimes auditors may accept complete responsibility when half or more of the enterprise is audited by a secondary auditor.

Overriding Examination of Work Performed by Secondary Auditor

In unusual circumstances the primary auditor goes much further than merely reviewing the work of the secondary auditor to be able to accept full responsibility. This situation might occur when, after completion of the work on prior periods by the secondary auditor, it is discovered that the secondary auditor is not independent. Under these circumstances it would be impossible for the primary auditor to accept the work of the secondary auditor as equivalent to his own work. Accordingly, it would be necessary for the primary auditor to perform a certain amount of independent auditing procedures. Then the work of the secondary auditor would be treated as if performed by an internal auditor.

In extreme cases the review by the primary auditor may reveal such serious deficiencies in the secondary auditor's work that the primary auditor must perform additional work to overcome the deficiencies.

Wording of the Primary Auditor's Report

When the primary auditor accepts full responsibility, there are no reporting problems since his report will read as it would if he had performed the full examination. But the primary auditor must modify his audit report if he either relies in part on the report of the secondary auditor or if he refuses to accept the secondary auditor's report.

It is unusual for financial statements to be prepared when a segment of the total enterprise has been audited by a secondary auditor whose report the primary auditor is unwilling to use. Certainly such a development would not normally be contemplated at the commencement of the examination. However, when such circumstances do occur, the primary auditor is required to qualify his opinion or disclaim an opinion on the financial statements since they include amounts which, from his point of view, have not been audited.

Whether the primary auditor issues a qualified opinion or disclaims an opinion depends on the materiality of the amounts included in the consolidated statements which he has not audited. If such amounts are so material as to negate the meaning of a positive opinion, then the auditor must issue a disclaimer. If the amounts are not so material as to require a disclaimer, then the auditor should issue a qualified opinion. In either case the opinion should include an explanation of the reason for qualification or disclaimer with a disclosure of the percentages of consolidated assets and revenues which are not audited. Such an auditor's opinion might be:

Scope Paragraph

We have examined the consolidated balance sheet of X Company and subsidiaries as of December 31, 1967, and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances except that we did not examine the financial statements of B Company, a consolidated subsidiary. The amounts for B Company relative to the consolidated amounts are ....% of assets, ...% of liabilities, ...% of revenues, and ......% of costs and expenses.

Qualified Opinions Paragraph

In our opinion, the consolidated financial statements described above, except insofar as they relate to B Company, present fairly the consolidated financial position of X Company at December 31, 1967, and the consolidated results of their operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Disclaimer of Opinion Paragraph

Because of the materiality of the accounts of B Company which we did not audit, we are unable to and do not express an opinion on the consolidated financial statements described above.

In some circumstances the primary auditor may be unwilling to express an opinion on the consolidated financial statements, not because he has any reservation as to the audit by the secondary auditor but rather because the primary auditor has not done a sufficiently large portion of the total enterprise. For example there may be a time when three auditors are involved in the audit of a business and none of them has done a majority of the total enterprise. In such circumstances one of the auditors may express an opinion on the compilation of the consolidated financial statements. An example of the wording of such a report under the assumption that A Company is the parent, and B and C Companies are subsidiaries where each subsidiary is approximately equal in size to the parent, and where each of the three companies has been audited by a different auditor is:

We have reviewed, as to compilation only, the accompanying consolidated balance sheet of A Company and its subsidiaries, B Company, and C Company, at December 31, 1967, and the related consolidated statements of earnings and retained earnings for the year then ended. These statements were compiled on the basis described in Note 1 to such statements from the audited statements of A Company which are covered by our report presented herein separately and upon the audited statements of B Company and C Company covered by the reports of other auditors which are also presented herein separately.

In our opinion, the consolidated financial statements referred to above have been properly compiled on the basis described in Note 1 to such statements.

Here the separate audit reports on A Company, B Company and C Company would also be presented. Ordinarily this approach would be used only when the component companies were each audited by different auditors prior to being brought together in a business combination. This would not be considered a satisfactory approach under normal circumstances.

When the primary auditor is willing to express an opinion on the consolidated financial statements on the basis of relying on the secondary auditor's report, the form of the accountant's report is normally:

Scope Paragraph

We have examined the consolidated balance sheet of X Company and subsidiaries as of December 31, 1967, and the consolidated statements of income and retained earnings 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. We did not examine the financial statements of B Company, a consolidated subsidiary, which statements were examined by other certified public accountants whose report thereon has been furnished to us.

Opinion Paragraph

In our opinion, based upon our examination and the aforementioned report of other certified public accountants, the financial statements present fairly . . .

A common variation of this reporting format is the inclusion of an additional sentence at the end of the previously illustrated scope paragraph:

> Our opinion expressed herein, insofar as it relates to the amounts included for B Company, is based solely upon such reports.

When this approach is used, the opinion paragraph is in the form of a standard unqualified opinion without including further reference to the secondary auditors.

Although it is permissible, there is no requirement that the primary auditor identify the secondary auditor by name. In normal practice such identification is usually omitted. Also, the primary auditor may disclose the amounts of assets, liabilities, revenues and expenses audited by the secondary auditor.

In published annual reports to stockholders, the general practice is to omit the separate reports of the secondary auditor. However, when financial statements are included in registration statements filed under the Securities Acts, the separate opinions of the secondary auditors must be included.

In virtually all cases the separate financial statements of the segment of the business audited by the secondary auditor are omitted. But when the secondary auditor is employed to audit an unconsolidated subsidiary, still different reporting practices may be used.

If the unconsolidated subsidiary is of major significance, the normal practice is to include complete, separate financial statements of the unconsolidated subsidiary and the secondary auditor's report in the annual report to stockholders. This is a supplement to the financial statements of the parent company or the parent company and consolidated subsidiaries. Under the Securities Acts the inclusion of the separate statements and auditor's report thereon is generally required when the unconsolidated subsidiary's assets or revenues amount to 15% of the respective consolidated amounts.

When the complete separate statements of the unconsolidated subsidiary and the secondary auditor's report are presented, the primary auditor's responsibility for the unconsolidated subsidiary is not clear if he makes no reference to the secondary auditor in his opinion on the parent company. If the primary auditor does not choose to assume full responsibility for the audit of the unconsolidated subsidiary, he should so state in his report on the parent company financial statements.

When the unconsolidated subsidiary is not of major importance, it may be appropriate to include condensed financial statements of the unconsolidated subsidiary in a footnote to the parent company financial statements. Under these circumstances the most common practice is for the primary auditor to modify his report with respect to the data presented in the footnote on the unconsolidated subsidiary. The absence of such a modification means that the primary auditor is accepting full responsibility for the data on the unconsolidated subsidiary.

The above is a summary of present practice in the United States; however, as is true in most areas of accounting and auditing, practice in this area continues to evolve. Also, the American Institute's Committee on Auditing Procedures currently has the subject of reliance under study.