

10-1939

Report of Subcommittee on Independent Audits and Audit Procedure, Committee on Stock List

New York Stock Exchange

Follow this and additional works at: <https://egrove.olemiss.edu/jofa>



Part of the [Accounting Commons](#)

Recommended Citation

New York Stock Exchange (1939) "Report of Subcommittee on Independent Audits and Audit Procedure, Committee on Stock List," *Journal of Accountancy*. Vol. 68: Iss. 4, Article 4.

Available at: <https://egrove.olemiss.edu/jofa/vol68/iss4/4>

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Report of Subcommittee on Independent Audits and Audit Procedure, Committee on Stock List

NEW YORK STOCK EXCHANGE

To the Members of the Committee on Stock List:

THE following report is respectfully submitted by your subcommittee on independent audits and audit procedure, appointed to review recent developments and trends of thought in auditing matters, with special reference to independent audits of the type which by Exchange requirement must accompany reports to stockholders of listed companies. The Exchange has for many decades worked with notable success for the extension of recognized accounting procedures, and for the ever-widening disclosure of sound and understandable information on corporate affairs. The introduction of requirements by the Exchange played an important rôle in making the independent auditor's report the customary accompaniment of annual financial statements to stockholders of leading American companies.

The broad improvement which has taken place over the years in American corporation accounting and in reporting to stockholders has been a gradual development marked by the consolidation of each advance, a progression in which abrupt and ill-considered changes have largely been avoided. It is with a certain historical sense and a strong conviction of the soundness of such a well integrated development that your subcommittee prefaces its report with the reminder that accounting and auditing procedures are in their very nature not final but evolutionary, both in themselves and in their adaptation to a con-

tinuously evolving business world, and that new developments should be introduced only where their practicability is reasonably established.

The most striking aspect of recent discussions is the discrepancy which exists between what the public seems to expect of independent auditors in making the customary audits for statements to stockholders, and what the auditors themselves, and the corporations, say is feasible to do within even the most extensive reasonable limits of expense to stockholders. Considerable portions of the public apparently believe that the reports of independent auditors are certificates of complete assurance, almost in the nature of guaranties. In a recent questionnaire addressed to a representative group of stockholders, only eleven per cent knew that the auditor's statement does not act as a guarantee of the financial statement. It is the considered opinion of your subcommittee, on the other hand, that independent audits cannot under complex modern business conditions give conclusive assurance against all possibilities of error and fraud. Assurance must be a matter of degree. This does not mean that audits are not of great value as independent checks of the correctness of the judgments of management and of the credibility of its representations, nor that they do not have an important deterrent effect.

It would be an error, however, to think that expressions of dissatisfaction with audits have come entirely from persons who entertain misconceptions of this kind. Many appreciate that there must be some limitations inherent in all audits, but claim that these limitations might be more explicitly stated in the

NOTE. — This report, adopted August 23, 1939, was distributed by the New York Stock Exchange to all listed corporations and to all members of the Exchange. It was also released to the press.

auditor's report; or they go farther and ask for more extensive procedures either within the corporation or in the independent audit as regular practices on which the public can depend. The Exchange, which has done much in coöperation with the American Institute of Accountants to help bring about and to improve the independently audited report, must be equally interested in furthering the understanding which is a precedent of intelligent use. It is important that the investor should not either overestimate or underestimate the kind and degree of assurance which the independent audit can properly give. It has been the duty of your subcommittee, therefore, to consider three specific aspects of the subject:

- (1) Extensions in the scope and methods of audit practice.
- (2) Means by which the limitations which necessarily exist in audits may most effectively be drawn to the attention of stockholders, through the auditor's report or otherwise.
- (3) Changes in certain relevant corporate procedures, which may improve internal accounting or facilitate the work of independent auditors.

Your subcommittee was appointed to examine not the accounting phase, but the audit phase of the work of the independent public accountant. Nevertheless, it seems that a few words must first be devoted to the accounting portion of the work in order to reestablish a proper balance of emphasis. For there seem to be those who, when faced with certain inevitable limitations and qualifications in the audit phase, entertain doubts as to the value of the entire independent audit. They seem for the moment to overlook the importance of the accounting phase. This is partly, of course, the result of the recent McKesson & Robbins case, in which the fraud rested on the falsity of the factual matter which

is the basis of all accounts. It may be worth noting, however, that a distortion of emphasis may result also from a circumstance of terminology; the same word "audit" is used for the entire procedure, and also for one of its two phases. In discussion, the audit phase is sometimes confused with the entire procedure. In any case, the real importance of the accounting phase should not be overlooked in public discussion, even when attention centers, for the moment, on auditing checks.

It may seem elementary, but it is apparently necessary and important to emphasize again and again that financial statements of industrial companies are not statistical presentations of fact fixed in the form which the stockholder reads. While properly based on facts, these statements represent the judgments of the company's management in the application of conventional methods of stating assets and liabilities and in appropriate allocations of income and outgo items to specific periods of time. For example, plant and property are usually stated on the basis of cost, or on some other conventional basis—and not at a figure supposed to reflect present-day value. Other items are usually stated at going concern values, and profits are calculated on this basis.

The importance of a periodic review by outside experts to see that these numerous judgments have been made in accordance with accepted accounting principles consistently followed by the company must be apparent to every one—entirely apart from any methods the business world may employ to assure itself of the authenticity of the data underlying the accounts. The independent public accountant is thoroughly qualified to make such a review. For this he has been specially trained. The public is entitled to rely upon his opinion regarding the soundness and consistency of the accounting judgments made by the company in the preparation of its reports to stockhold-

ers. If the independent public accountant does not concur in the results of these judgments, he will take exception to the company's method by a statement in his auditor's opinion accompanying the financial statements. If his exception is of sufficient importance he will express no opinion, and explain in his report why it is withheld. The independent public accountants' opinion on the soundness of judgments and consistency of methods is of real importance—for even with correct factual data at the base, the possibilities of accounting errors and misrepresentations are very great.

THE AUDIT PHASE

From facts so far available, it appears that the McKesson & Robbins fraud rested primarily on the falsity of the underlying documents purporting to represent certain assets and transactions, which have been found to be entirely fictitious. This report is particularly concerned with the auditing phase, which seeks to establish the correctness of the bookkeeping and of the underlying factual material which form the bases for the exercise of accounting judgment and for the resulting accounts. What assurances can be given to the stockholder that entries upon the books have been properly made so as to classify and reflect the records presented by the underlying documents: the vouchers, bills of lading, time books, etc.? And what assurance can be given that these underlying documents in turn authentically reflect genuine assets, liabilities and transactions? Is the independent auditor, from his examination, able to give complete assurance that the records are anchored in fact?

Where companies are small and business is not complex, an exhaustive detailed examination of all transactions can be made, and an independent auditor is able to give a greater measure of assurance that the data—the "statistics" of the accounts—are accurate. But

while such small companies are more numerous, they are not, generally speaking, the companies whose securities are listed on the Exchange. In the case of large modern companies, the aggregate expense to industry of extremely detailed examinations of the voluminous material, by independent accountants, would be out of all proportion to the possible benefits to be gained in the occasional detection of irregularities in a few concerns. Most companies are honestly run, and the huge expense which would be incurred by all for detection of occasional misrepresentations in the few would in the aggregate be an economic waste to investors and to the public.

Even when this cost is not weighed in relation to American business as a whole, but only in relation to a single large modern concern, it is doubtful if even a most detailed examination would be a complete safeguard. The recent audit of McKesson & Robbins ordered by the trustee following disclosure of the Coster-Musica frauds is probably one of the most detailed audits ever made of a large industrial concern by independent public accountants. Independent engineers were retained to examine and test check the quantity, quality, and pricing of the inventory, and many months were spent in an examination of hundreds of thousands of items and tens of thousands of pages of records. Even this audit could not cover all transactions, and the independent auditor's report included the customary phrase: "But we did not make a detailed audit of the transactions." We mention this only to indicate the burden which would be placed on corporations if all transactions were to be audited in detail. It is hardly necessary to point out that the time factor involved in such audits would likewise make anything even remotely similar, impracticable for preparation in time for the stockholders' meeting which follows the close of the fiscal year.

The primary responsibility for the accuracy of the records lies with the management, and many large corporations have recognized the complexity of the problem as well as their responsibility by maintaining extensive systems of internal control, by which the records kept by any one person are automatically checked by one or more other persons in unrelated departments, and of internal audit, by which tests are continuously made of the efficacy of internal control. It seems a fair statement to say that such devices, especially when properly applied by an internal auditor or controller whose work is performed independently of officials, are in large companies apt to be more efficacious in uncovering irregularities than are the less frequent examinations by an independent auditor. The latter, however, assumes responsibility in making an additional check, which, if occasional and less detailed, derives great value from the independence and from the accumulated general experience of the auditor.

SCOPE OF INDEPENDENT AUDITOR'S EXAMINATION

Under sound corporation accounting practice, no restrictions are imposed on the freedom of access of the independent certified public accountant to any records that he considers necessary in order to express his professional opinion that the financial statements present fairly the position of the company and the results of its operations. The extent of the examinations and tests to be made within this broad field of access must vary with the circumstances of each case, and must be determined by the judgment of the auditor. An auditor cannot properly give an opinion when the extent of his examination is less than he considers necessary. Your subcommittee believes that the primary responsibility for establishing standards of the scope of the independent auditor's examination must rest with the

accounting profession. The Exchange can cooperate with the profession in efforts to improve and extend auditing procedure, balancing the need for the widest protection of the investing public with considerations of practicability and cost to the stockholder.

The more detailed audit procedure which is practicable in small concerns is modified to a method of "test checking" or sampling in the case of sizable companies. It may be said in the most general way that the amount of test checking done by the auditor in a particular company has tended to vary inversely with the degree of internal control effectively maintained by the company itself; so that, speaking very broadly, the tendency has been to make relatively more numerous test checks in the smaller, less complex companies where in fact the checks were more practicable, and less numerous ones in the larger, more complex companies where extensive systems of internal control exist. However, even in this it is difficult to generalize, as practice has varied also, as already indicated, with considerations of necessity and practicability in the particular company, as well as with considerations of internal control and of size. In all cases where systems of internal control exist, it has been general practice to make an audit study of the adequacy and effectiveness of the system as a basis for determining the character and extent of sampling and testing to be applied.

The American Institute of Accountants, in collaboration with state professional societies, trade organizations, and others, has been engaged in a review of all phases of auditing procedure. Although the standard bulletin of the Institute as to audit scope—*Examination of Financial Statements*—is in the process of revision, first attention has been given to inventories and receivables, the principal points of discussion since the McKesson & Robbins case.

It appears from a recent report of the

special committee on auditing procedure of the Institute and from later studies that have been made by the accounting societies and accountants generally that the profession will adopt as generally accepted procedures, more extensive practices in the examination of inventories and receivables. It is expected that generally accepted procedure will include closer physical contact with inventories, where they are material, either through the independent accountant's presence at inventory taking or by the making of physical tests under his observation. Where the amount of inventories in outside warehouses is material, confirmation in writing will be supplemented by further inquiries. It is expected that the procedure of confirming receivables by direct communication with debtors will be more widely used wherever practicable. Your subcommittee endorses these extensions of generally recognized auditing procedure.

Both the auditing and the accounting phases of the profession of accountancy are not static—methods are constantly being developed to keep pace with the evolution of business. The Exchange will continue to welcome coöperation in its efforts to improve auditing methods, from the accounting profession and from listed corporations, who, in turn, must answer to the desires of their stockholders. The accounting profession and business itself have excellent reasons for extending audit procedure to the limits of practicability and reasonable economy.

While no final appraisal of the extensions of auditing procedure now under consideration can properly be made by your subcommittee until they have been observed in practice, a common sense consideration of certain circumstances may throw some light on their probable applicability to certain types of companies. Three matters should be kept in mind: first, that the independent accountant is not by training qualified

nor does he claim to be able to make such tests as would enable him to express an opinion on the condition of inventories, nor, in certain cases, can his observations of inventory count carry much significance if the materials which are being counted are of such a nature that a technical knowledge of their form and substance is essential; secondly, that the complexity and far-flung operations of many large concerns, in addition to frequent technical difficulties, would make detailed physical checking under the observation of the auditor enormously expensive; and, thirdly, that there is an important practical limitation of time upon such investigations—the report must be prepared in a few months at most after the close of the fiscal period. It may safely be said that the usefulness of the extensions will vary greatly in different companies and in different industries, and that, in many large corporations, the system of internal control, as independently checked, will probably remain the principal source of assurance that the book-keeping records are correct. On the other hand, the proposed extensions of audit procedure have substance in that they place increased emphasis on independent contact with the underlying facts.

Before leaving this subject of auditing procedure, your subcommittee feels that, as a result of recent disclosures, too great an emphasis may currently be placed upon the inventory and receivables phases of the accountant's work. While the auditing of assets of this type is admittedly important in most companies, the various procedures followed in the examination of other asset items may often be of equal or greater significance. A well rounded audit, designed to cover all phases of a company's business, obviously would afford greater safeguards in the majority of cases than one where excessive emphasis is placed on certain phases of the audit to the possible neglect of others.

In recommending extensions of audit scope, the Institute of Accountants rightly emphasizes that complete responsibility on the audit side is not thereby being approached. The report of its special committee says: "To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions." We know that in many corporations practical limitations will not permit the checking of any but a small part of the transactions. We come back, therefore, to the dilemma mentioned in our first few paragraphs—how to acquaint the investing public with the limitations which must exist on the audit side, while emphasizing at the same time the true value and proper use of independent audits; i.e., as independent examinations of accounting methods, for which the auditor is expected to assume responsibility, and as independent additional checks on factual data, of considerable if not of conclusive value.

FORM OF AUDITOR'S REPORT OR CERTIFICATE

The auditor's certificate, or "auditor's report," as the profession prefers, is the statement by the independent public accountant with respect to the financial statements which, according to the listing requirements of the Exchange, must accompany these statements in the annual reports to stockholders of listed companies (except railroads operating under the supervision of the Interstate Commerce Commission). This report affords a method of acquainting the general public with some indication of the scope and limitations of the audit.

Your subcommittee believes that as a general rule, the auditor's certificate should not be a long and detailed report obscured by lengthy explanations of technical procedures. It believes that the short form heretofore used may well

be improved and is in accord with many of the changes recently suggested in the report of the American Institute of Accountants' special committee. It is expected that the Institute will adopt a standard form of report at its annual meeting in September, when final consideration is given to current suggestions with respect to extensions of audit procedure. When the profession has crystallized its views on the details of the standard form of certificate your subcommittee may submit a further report. In the meantime it is coöperating with the American Institute and others in the profession to develop the most concise, unequivocal, and illuminating form which can be agreed upon. It is no easy task to express in a few words the description of the character of the examination followed in the audit of a company.

It is generally conceded that a program of general education of the public in the significance and necessary limitations of financial statements and audits is highly desirable. In recent accountants' speeches and reports, widely quoted in newspapers and periodicals, very explicit statements are made of the meaning, value, and inevitable limitation of independent audits. Your subcommittee urges more widespread familiarity with the Institute's bulletin, *Examination of Financial Statements*; the "Report on Independent Audits," made to the board of governors of the Exchange in 1933; "Extensions of Auditing Procedure," the most recent report of the Institute; and the April, May, and June, 1939, issues of *THE JOURNAL OF ACCOUNTANCY*, which include enlightening summaries of parts of the recent S. E. C. hearings following the McKesson & Robbins case, at which the views of twelve leading members of the accounting profession were given on numerous questions of auditing procedure. These summaries are not long, and the views expressed are worded so that even those with little technical

knowledge may get a broad view of present-day auditing problems and experience.

RECOMMENDATIONS AS TO CORPORATE PROCEDURES

Your subcommittee regards the responsibilities of corporations in auditing matters as twofold: to institute such corporate procedures as will make its system of bookkeeping, and of internal control and audit, as efficient as possible; and to facilitate in every reasonable way the work of the independent auditor. Of a large number of proposals considered in these connections, your subcommittee has selected four as sufficiently important and practicable to warrant endorsement by the New York Stock Exchange. These recommendations are made subject to consideration of applicability in the particular case, and in the knowledge that their usefulness in connection with audits might have to be weighed against other disadvantages.

1. Strengthening the Position of the Independent Public Accountant.

This might best be accomplished through the general assumption by boards of directors of direct responsibility for either the appointment of the auditors or for their selection and recommendation to the stockholders for approval. Where practicable, the selection of the auditors by a special committee of the board composed of directors who are not officers of the company appears desirable.

The results of the auditor's examination should always be available to the board of directors, his report should be addressed to the stockholders, and he should be afforded the opportunity to appear at any stockholders' meeting.

2. Increasing the Responsibility, Authority, and Facilities of the Controller or Internal Auditor.

More emphasis should be placed on the responsibility of the controller and the assurance to him of adequate authority and facilities. The scope of his

responsibilities should be fixed by the board of directors, and he should report periodically to them, in addition to making his customary reports to the operating management.

The controller or chief financial officer should sign the published financial statements of his company, even in those cases where the statements are accompanied by the report of the independent public accountant.

Independent and efficient accounting and internal auditing departments are a vital factor in assuring the accuracy of the books and published reports. The importance of the controller or internal auditor in these connections is paramount and the board of directors should take an active interest in his selection.

3. Adoption of Natural Business Year in Lieu of Calendar Year.

The natural business year of the industry in which a company is engaged is recommended, unless impracticable for special reasons, as the fiscal year of the company instead of the calendar year. The more general adoption of the natural business year by companies in each industry would to a large extent smooth out the huge peaks of audit work which now occur in the early part of each calendar year. By adopting a natural business year which conforms to the true business cycle of the particular industry, corporations may simplify their problems of year-end adjustment and reduce the cost of stocktaking, besides permitting a more efficient and more economical audit. The income account of a company based on a completed cycle of a normal year's operations would give the investor a fairer picture of the operations of his company. Reports of companies in the same field of business would be directly comparable, as almost all industries have their own clearly defined natural business years.

4. Appointment of the Independent Public Accountants Early in the Fiscal Year.

The appointment of the independent auditor early in the fiscal year appears eminently desirable, so that part of his work may be done during the year and

Independent Audits and Audit Procedure

he may be free to make an examination of any phase of the company's operations at any time.

In conclusion, your subcommittee desires to call attention again to the evolutionary character of accounting and auditing procedures and to recommend that the Exchange continue as it has in the past to welcome collaboration from corporations, professional accountants, controllers, and others engaged in formulating improvements in practices. We believe that such activity will in the future as it has in the past, add to the safeguards provided to investors in listed companies.

Respectfully submitted,
Subcommittee on Audits and Audit Procedure

WILLIAM K. BECKERS, *Chairman*
JOSEPH KLINGENSTEIN
August 11, 1939.

The committee on stock list adopts the report and recommendations of the subcommittee on independent audits and audit procedure. The committee on stock list directs that copies of this report be printed and transmitted to the members of the board of governors, with the recommendation that it be adopted at the next regular meeting of the board and distribution made to the presidents of listed companies and to the members of the New York Stock Exchange.

Committee on Stock List

JOHN M. HANCOCK, *Chairman*

JOHN HASKELL

Vice-President and Director

August 15, 1939.

Adopted by the Board of Governors,
August 23, 1939

CHARLES KLEM, *Assistant Secretary*