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American Institute of Certified Public Accountants

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AICPA PROFESSIONAL STANDARDS

VOLUME 1

AUDITING

MANAGEMENT ADVISORY SERVICES

TAX PRACTICE

AS OF JULY 1, 1976

COMMERCE CLEARING HOUSE, INC.
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TABLE OF CONTENTS

HOW TO USE THIS VOLUME

Scope of the Volume . . .

This volume, which is a reprint of volume 1, the looseleaf edition of *AICPA Professional Standards*, includes the currently effective Statements on Auditing Standards, Commentaries by the Auditing Standards Executive Committee, Auditing Interpretations issued by the AICPA staff, Statements on Management Advisory Services, and Statements on Responsibilities in Tax Practice.

How this Volume is arranged . . .

The contents of this volume are arranged as follows:

- Statements on Auditing Standards
  - Introduction
  - The General Standards
  - The Standards of Field Work
  - The First, Second, and Third Standards of Reporting
  - The Fourth Standard of Reporting
  - Other Types of Reports
  - Special Topics
  - Special Reports of the Committee on Auditing Procedure
  - Auditing Commentaries
  - Auditing Interpretations
- Statements on Management Advisory Services
- Statements on Responsibilities in Tax Practice

How to use this Volume . . .

The arrangement of material in this volume is indicated in the general table of contents at the front of the volume. There is a detailed table of contents covering the material within each major division.

The major divisions are divided into sections, each with its own section number. Each paragraph within a section is decimally numbered. For example, AU section 210.04 refers to the fourth paragraph of section 210, Training and Proficiency of the Independent Auditor, of the Auditing division of the volume.

Auditing Commentaries are located in AU section 1000, following the Statements on Auditing Standards.

Auditing Interpretations are numbered in the 9000 series with the last three digits indicating the section to which the Interpretation relates. For example, Interpretations related to section 560 are numbered 9560.

There are six appendixes related to auditing standards as follows:

Appendix A provides the historical background for the present Statements on Auditing Standards.

Appendix B is a list of Statements on Auditing Procedure Nos. 1-54, and Statements on Auditing Standards issued to date.

Appendix C provides a list of sources of sections in the current text.

Appendix D indicates sections and paragraphs of the text cross-referenced to Auditing Interpretations.

Appendix E provides a list of AICPA Industry Audit Guides and Statements of Position.

Appendix F provides a schedule of changes in Statements on Auditing Standards since the issuance of Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, Nos. 33 through 54.

A separate topical index is provided for the Auditing division.

Statements on Management Advisory Services appear with the prefix MS in their section numbers. A table of contents and a topical index are furnished for the Management Advisory Services division.

Statements on Responsibilities in Tax Practice appear with the prefix TX in their section numbers. A table of contents and a topical index are supplied for the Tax Practice division.

Topical indexes use the key word method to facilitate reference to the pronouncements. The indexes are arranged alphabetically by subject with references to major division, section, and paragraph numbers. Each index is identified as either an AU Index, MS Index, or TX Index to indicate the major division.

AU Section 100

STATEMENTS ON AUDITING STANDARDS – Introduction

Statements on Auditing Standards are issued by the Auditing Standards Executive Committee, the senior technical committee of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Ethics requires adherence to the applicable generally accepted auditing standards promulgated by the Institute. It recognizes Statements on Auditing Standards as interpretations of generally accepted auditing standards, and requires that members be prepared to justify departures from such Statements.

. . . responsibilities and functions of independent auditor . . . generally accepted auditing standards . . . quality control considerations . . .

TABLE OF CONTENTS

The next page is 61.

AU Section 110

Responsibilities and Functions of the Independent Auditor

Issue date, unless otherwise indicated: November, 1972

.01 The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his examination has been made in accordance with generally accepted auditing standards. These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles and whether such principles have been consistently applied in the preparation of the financial statements of the current period in relation to those of the preceding period.

Distinction Between Responsibilities of Auditor and Management

.02 Management has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements. The transactions which should be reflected in the accounts and in the financial statements are matters within the direct knowledge and control of management. The auditor's knowledge of such transactions is limited to that acquired through his examination. Accordingly, the fairness of the representations made through financial statements is an implicit and integral part of management's responsibility. The independent auditor may make suggestions as to the form or content of financial statements or he may draft them in whole or in part, based on management's accounts and records. However, his responsibility for the statements he has examined is confined to the expression of his opinion on them. The financial statements remain the representations of management.

Professional Qualifications

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

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

Detection of Fraud

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

.06 Reliance for the prevention and detection of fraud should be placed principally upon an adequate accounting system with appropriate internal control. The well-established practice of the independent auditor of evaluating the adequacy and effectiveness of the system of internal control by testing the accounting records and related data and by relying on such evaluation for the selection and timing of his other auditing procedures has generally proved sufficient for making an adequate examination. If an objective of an independent auditor's examination were the discovery of all fraud, he would have to extend his work to a point where its cost would be prohibitive. Even then he could not give assurance that all types of fraud had been detected, or that none existed, because items such as unrecorded transactions, forgeries, and collusive fraud would not necessarily be uncovered. Accordingly, it is generally recognized that good internal control and fidelity bonds provide protection more economically and effectively. In the case of fidelity bonds, protection is afforded not only by the indemnification for discovered defalcations but also by the possible deterrent effect upon employees; the presence of fidelity bonds, however, should not affect the scope of the auditor's examination.

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

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

Responsibility to the Profession

.09 The independent auditor also has a responsibility to his profession, the responsibility to comply with the standards accepted by his fellow practitioners. In recognition of the importance of such compliance, the American Institute of Certified Public Accountants has adopted, as part of its Code of Professional Ethics, rules which support the standards and provide a basis for their enforcement.

The next page is 81.

AU Section 150

Generally Accepted Auditing Standards

Issue date, unless otherwise indicated: November, 1972

.01 Auditing standards differ from auditing procedures in that "procedures" relate to acts to be performed, whereas "standards" deal with measures of the quality of the performance of those acts and the objectives to be attained by the use of the procedures undertaken. *Auditing standards* as distinct from *auditing procedures* concern themselves not only with the auditor's professional qualities but also with the judgment exercised by him in the performance of his examination and in his report.

.02 The generally accepted auditing standards as approved and adopted by the membership of the American Institute of Certified Public Accountants are as follows:

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 accounting principles.
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.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

.03 These standards to a great extent are interrelated and interdependent. Moreover, the circumstances which are germane to a determination of whether one standard is met may apply equally to another. The elements of "materiality" and "relative risk" underlie the application of all the standards, particularly the standards of field work and reporting.

.04 The concept of materiality is inherent in the work of the independent auditor. There should be stronger grounds to sustain the independent auditor's opinion with respect to those items which are relatively more important and with respect to those in which the possibilities of material error are greater than with respect to those of lesser importance or those in which the possibility of material error is remote. For example, in an enterprise with few, but large, accounts receivable, the accounts individually are more important and the possibility of material error is greater than in another enterprise that has a great number of small accounts aggregating the same total. In industrial and merchandising enterprises, inventories are usually of great importance to both financial position and results of operations and accordingly may require relatively more attention by the auditor than would the inventories of a public utility company. Similarly, accounts receivable usually will receive more attention than prepaid insurance.

.05 The degree of risk involved also has an important bearing on the nature of the examination. Cash transactions are more susceptible to irregularities than inventories, and the work undertaken on cash may therefore have to be carried out in a more conclusive manner without necessarily implying a greater expenditure of time. Arm's-length transactions with outside parties are usually subjected to less detailed scrutiny than intercompany transactions or transactions with officers and employees, where the same degree of disinterested dealing cannot be assumed. The effect of internal control on the scope of an examination is an outstanding example of the influence on auditing procedures of a greater or lesser degree of risk of error; i.e., the stronger the internal control, the less the degree of risk.

Examination of Interim Financial Statements

.06 Generally accepted auditing standards applicable to examinations of annual financial statements are also applicable to examinations of interim financial statements.

The next page is 91.

AU Section 160

Quality Control Considerations for a Firm of Independent Auditors

Issue date, unless otherwise indicated: December, 1974

Introduction

.01 Rule 202 of the Rules of Conduct of the Code of Professional Ethics of the American Institute of Certified Public Accountants * requires members, when they are associated with financial statements, to comply with the applicable generally accepted auditing standards. Those standards have to do primarily with the characteristics and conduct of individual auditors. A need has arisen to identify policies and procedures of a firm of independent auditors (referred to hereinafter as "a firm" or "the firm") that may affect the quality of work in its audit engagements. This section sets forth certain considerations in establishing policies and procedures that will provide the firm with reasonable assurance of conforming with generally accepted auditing standards.

Quality Control Considerations

.02 Complying with generally accepted auditing standards is a basic objective of every firm conducting an audit practice. While each of the elements of quality control applies to all firms, the extent to which policies and procedures apply will depend on a variety of factors, such as the size and organizational structure of the firm and its philosophy as to the degree of operating autonomy appropriate for its people.

.03 The considerations that affect the quality of a firm's audit work are discussed in paragraphs .05 through .22. The considerations are interrelated. Thus, a firm's hiring practices affect its policies as to training. Training practices affect policies as to promotion. Practices in both categories affect policies as to the nature and extent of super-

* See ET section 202, Volume 2, *AICPA Professional Standards.*

vision. Practices as to supervision, in turn, affect policies as to training and promotion. Although some policies and procedures, such as those with respect to hiring and advancement of personnel, may be considered primarily or at least partly administrative matters, they affect the quality of audit work and consequently are discussed in this section.

Elements of Quality Control

.04 Because of the significance of the variables stated in paragraphs .02 and .03, it would be inappropriate to impose requirements as to the matters discussed in this section. In the paragraphs that follow, the sentences generally worded, "Policies and procedures should be established . . ." and the examples of policies and procedures are presented only as guidelines, no one of which is necessarily applicable to any one firm. A firm may find it convenient to keep records concerning its quality control policies and procedures. However, keeping such records is not an element of quality control.

.05 ***Independence.*** *Policies and procedures should be established to provide reasonable assurance that persons at all organizational levels maintain independence in fact and in appearance.* Rule 101 of the Rules of Conduct * contains examples of instances wherein a firm's independence will be considered to be impaired.[1]

.06 *Examples of policies and procedures.* In pursuing its quality control objectives with respect to independence, a firm may use policies and procedures such as maintaining records showing which partners or employees were previously employed by clients or have relatives holding key positions with clients, notifying personnel as to the names of audit clients (and their affiliates) having publicly held securities, confirming periodically with personnel that prohibited relationships do not exist, and emphasizing independence of mental attitude in training programs and in supervision and review of work.

.07 ***Assigning Personnel to Engagements.*** *Policies and procedures for assigning personnel to engagements should be established to provide reasonable assurance that audit work will be performed by persons having the degree of technical training and proficiency required in the circumstances.* In making assignments, the nature and

* See ET section 101, Volume 2, *AICPA Professional Standards.*

[1] The Securities and Exchange Commission has established formal requirements for the independence of accountants who practice before it.

extent of supervision to be provided should be taken into account. Generally, the more able and experienced the personnel assigned to a particular engagement, the less is the need for direct supervision.

.08 *Examples of policies and procedures.* In pursuing its quality control objectives with respect to assigning personnel to engagements, a firm may use policies and procedures such as requiring timely identification of the staffing requirements of specific engagements so that enough qualified personnel can be made available, planning for the total personnel needs of all the firm's audit engagements, and using time budgets to establish manpower requirements and to schedule audit field work.

.09 ***Consultation.*** *Policies and procedures for consultation should be established to provide reasonable assurance that auditors will seek assistance on accounting and auditing questions, to the extent required, from persons having appropriate levels of knowledge, competence, judgment, and authority.* The nature of the arrangements for consultation will depend on a number of factors, including the size of the accounting firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work.

.10 *Examples of policies and procedures.* In pursuing its quality control objectives with respect to consultation, a firm may use policies and procedures such as designating individuals having expertise in matters related to the Securities and Exchange Commission to provide advice concerning financial statements and auditors' reports to be included in filings with the Commission; designating individuals having specialized experience in a particular industry to provide advice on accounting and auditing questions that arise in audits of companies in that industry; designating senior qualified personnel to provide advice on accounting or auditing questions in general; referring questions to a division or group in the AICPA or a state CPA society established to handle technical inquiries; maintaining a technical reference library or a technical services or research staff within the firm to assist in the resolution of practice problems; and requiring that appropriate use be made of available consultation and reference services.

.11 ***Supervision.*** *Policies and procedures for the conduct and supervision of work at all organizational levels should be established to provide reasonable assurance that the work performed meets the firm's standards of quality.* The extent of supervision and review appropriate in a given instance depends on many factors, including the complexity of the subject matter, the qualifications of the persons performing the work, and the extent of consultation available and used. The responsibility of a firm for establishing procedures for supervision is distinct from the responsibility of an auditor to comply with the first standard of field work when he is in charge of the work on a particular engagement.

.12 *Examples of policies and procedures.* In pursuing its quality control objectives with respect to supervision, a firm may use policies and procedures such as providing direction as to the form and content of working papers and as to the nature and extent of instructions to be included in an audit program; developing and using standard audit forms, checklists, and questionnaires; requiring that working papers be reviewed by supervisory personnel; and requiring that auditors' reports and the accompanying financial statements be reviewed by qualified personnel for conformity with generally accepted auditing standards and generally accepted accounting principles.

.13 ***Hiring.*** *Policies and procedures for hiring should be established to provide reasonable assurance that those employed possess the appropriate characteristics to enable them to perform competently.* The quality of a firm's work ultimately depends on the integrity, competence, and motivation of the persons who perform and supervise the work. Thus, a firm's recruiting programs are factors in maintaining audit quality.

.14 *Examples of policies and procedures.* In pursuing its quality control objectives with respect to hiring of personnel, a firm may use policies and procedures such as establishing a policy for recruiting at beginning levels to include standards or objectives as to minimum academic preparation and accomplishment; establishing for more advanced positions standards and objectives as to practical experience; requiring a background investigation of new personnel; and applying special procedures when new personnel enter the firm from other than the usual recruitment channels, such as by recruitment of higher level personnel or through merger or acquisition of an accounting practice, to assure that those personnel become familiar with and conform to the firm's practices and procedures.

.15 ***Professional Development.*** *Policies and procedures for professional development should be established to provide reasonable assurance that personnel will have the knowledge required to enable* *them to fulfill responsibilities assigned.* Continuing professional education and training activities enable a firm to provide personnel with the knowledge required to fulfill responsibilities assigned to them and to progress within the firm.

.16 *Examples of policies and procedures.* In pursuing its quality control objectives with respect to professional development, a firm may use policies and procedures such as providing instruction during the performance of engagements; requiring personnel to attend training programs or seminars conducted by the firm, by a college or university, or by the AICPA or a state CPA society; distributing written communications containing technical information on the firm's policies and procedures to professional personnel; and making available to professional personnel information as to current developments in accounting and auditing.

.17 ***Advancement.*** *Policies and procedures for advancing professional personnel should be established to provide reasonable assurance that the people selected will have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.* Practices in advancing personnel have important implications for the quality of audit work. Qualifications that people selected for advancement should possess include, but are not limited to, character, intelligence, judgment, and motivation.

.18 *Examples of policies and procedures.* In pursuing its quality control objectives with respect to advancement, a firm may use policies and procedures such as requiring supervisory personnel to furnish periodically appraisals of the work of assistants, increasing gradually the extent of responsibility given to professional personnel, and appointing committees of partners to review the qualifications of individuals being considered for promotion.

.19 ***Acceptance and Continuance of Clients.*** *Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity.* Suggesting that there should be procedures for this purpose does not imply that an auditor vouches for the integrity or reliability of a client, nor does it imply that an auditor has a duty to anyone but himself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that an auditor be selective in determining his professional relationships.

.20 *Examples of policies and procedures.* In pursuing its quality control objectives with respect to the acceptance and continuance of clients, a firm may use policies and procedures such as reviewing financial statements of a proposed client; inquiring of third parties, such as the proposed client's previous auditors, its banks, legal counsel, and investment bankers, and others in the financial and business community as to the reputation of the proposed client; evaluating its ability to service the client properly (see Rule 201 of the Rules of Conduct *), with particular reference to industry expertise, size of engagement, and manpower available to staff the engagement; and periodically reevaluating clients for continuance.

.21 ***Inspection.*** *Policies and procedures for inspection should be established to provide reasonable assurance that the other procedures designed to maintain the quality of the firm's auditing practice are being effectively applied.* Procedures for inspection may be developed and performed by persons acting on behalf of the firm's management. The type of inspection procedures used will depend on the controls a firm establishes in the areas of responsibility discussed in this section.

.22 *Examples of policies and procedures.* In pursuing its quality control objectives with respect to inspection, a firm may use policies and procedures such as designating persons to make inspections at the office in which they regularly practice or at other offices; developing "checklists" or "evaluation forms" for such persons to use in reviewing the activities of the reviewed offices in areas for which the firm has established practices and procedures in accordance with this section; and providing for follow-up to determine that recommendations have been implemented.

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* See ET section 201, Volume 2, *AICPA Professional Standards.*

AU Section 200

THE GENERAL STANDARDS

. . . nature of standards . . . training and proficiency of auditor . . . independence . . . performance of work . . .

TABLE OF CONTENTS

The next page is 141.

AU Section 201

Nature of the General Standards

Issue date, unless otherwise indicated: November, 1972

.01 The general standards are personal in nature and are concerned with the qualifications of the auditor and the quality of his work as distinct from those standards which relate to the performance of his field work and to his reporting. These personal, or general, standards apply alike to the areas of field work and reporting.

The next page is 151.

AU Section 210

Training and Proficiency of the Independent Auditor

Issue date, unless otherwise indicated: November, 1972

.01 The first general standard is:

> The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

.02 This standard recognizes that however capable a person may be in other fields, including business and finance, he cannot meet the requirements of the auditing standards without proper education and experience in the field of auditing.

.03 In the performance of the examination which leads to an opinion, the independent auditor holds himself out as one who is proficient in accounting and auditing. The attainment of that proficiency begins with the auditor's formal education and extends into his subsequent experience. The independent auditor must undergo training adequate to meet the requirements of a professional man. This training must be adequate in technical scope and should include a commensurate measure of general education. The junior assistant, just entering upon an auditing career, must obtain his professional experience with the proper supervision and review of his work by a more experienced superior. The nature and extent of supervision and review must necessarily reflect wide variances in practice. The auditor charged with final responsibility for the engagement must exercise a seasoned judgment in the varying degrees of his supervision and review of the work done and judgment exercised by his subordinates, who in turn must meet the responsibility attaching to the varying gradations and functions of their work.

.04 The independent auditor's formal education and professional experience complement one another; each auditor exercising authority upon an engagement should weigh these attributes in determining the extent of his supervision of subordinates and review of their work. It should be recognized that the training of a professional man includes a continual awareness of developments taking place in business and in his profession. He must study, understand, and apply new pronouncements on accounting principles and auditing procedures as they are developed by authoritative bodies within the accounting profession.

.05 In the course of his day-to-day practice, the independent auditor 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 financial statements of a business because, through his training and experience, he has become skilled in accounting and auditing and has acquired the ability to consider objectively and to exercise independent judgment with respect to the information recorded in books of account or otherwise disclosed by his examination. [As amended July, 1975 by Statement on Auditing Standards No. 5.] (See section 411.)

The next page is 161.

AU Section 220

Independence

Issue date, unless otherwise indicated: November, 1972

.01 The second general standard is:

> In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

.02 This standard requires that the auditor be independent; aside from being in public practice (as distinct from being in private practice), he must be without bias with respect to the client under audit, since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be. However, independence does not imply the attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors.

.03 It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To *be* independent, the auditor must be intellectually honest; to be *recognized* as independent, he must be free from any obligation to or interest in the client, its management, or its owners. For example, an independent auditor auditing a company of which he was also a director might be intellectually honest, but it is unlikely that the public would accept him as independent since he would be in effect auditing decisions which he had a part in making. Likewise, an auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased. Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.

.04 The profession has established, through the Institute's Code of Professional Ethics, precepts to guard against the *presumption* of loss of independence. "Presumption" is stressed because the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests. Insofar as these precepts have been incorporated in the profession's code of ethics, they have the force of professional law for the independent auditor.

.05 The Securities and Exchange Commission has likewise emphasized the importance of independence.

.06 The independent auditor should administer his practice within the spirit of these precepts and rules if he is to achieve a proper degree of independence in the conduct of his work.

.07 To emphasize independence from management, many corporations follow the practice of having the independent auditor appointed by the board of directors or elected by the stockholders.

The next page is 171.

AU Section 230

Due Care in the Performance of Work

Issue date, unless otherwise indicated: November, 1972

.01 The third general standard is:

> Due professional care is to be exercised in the performance of the examination and the preparation of the report.

.02 This standard requires the independent auditor to perform his work with due care. Due care imposes a responsibility upon each person within an independent auditor's organization to observe the standards of field work and reporting. Exercise of due care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the examination.

.03 A paragraph appearing in *Cooley On Torts* often cited by attorneys in discussing due care merits quotation here:

> Every man who offers his service to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is prerequisite, if one offers his service, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and, if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error. He undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.

.04 The matter of due care concerns what the independent auditor does and how well he does it. For example, due care in the matter of working papers requires that their content be sufficient to provide an important support for the auditor's opinion, including his representation as to compliance with auditing standards.

AU Section 300

THE STANDARDS OF FIELD WORK

. . . planning and timing . . . predecessor and successor auditors . . . internal control . . . statistical sampling . . . effects of EDP on evaluation of internal control . . . effect of internal audit function on scope of examination . . . evidential matter . . . related parties . . . using work of specialist . . . inquiry of client's lawyer . . . working papers . . .

TABLE OF CONTENTS

The next page is 231.

AU Section 310

Adequacy of Planning and the Timing of Field Work

Issue date, unless otherwise indicated: November, 1972

.01 The first standard of field work is:

> The work is to be adequately planned and assistants, if any, are to be properly supervised.

.02 Some aspects of the independent auditor's responsibility for supervising his assistants have been discussed in section 210. Planning of the field work and the timing of auditing procedures are discussed here.

Appointment of the Independent Auditor

.03 Consideration of the first standard of field work recognizes that early appointment of the independent auditor has many advantages to both the auditor and his client. Early appointment enables the auditor to plan his work so that it may be done expeditiously and to determine the extent to which it can be done before the balance-sheet date. It is particularly helpful with respect to planning for the observation of the taking of physical inventories. Preliminary work by the auditor benefits the client in that it permits the examination to be performed in a more efficient manner and to be completed at an early date after the year end. The performance of some of the audit work during the year likewise permits early consideration of accounting problems affecting the financial statements and early modification of accounting procedures that the auditor thinks might be improved.

Appointment of Auditor Near or After The Year-End Date

.04 Although early appointment is preferable, an independent auditor may accept an engagement near or after the close of the fiscal year. In such instances, before accepting the engagement, he should ascertain whether circumstances are likely to permit an adequate examination and expression of an unqualified opinion and, if they will not, he should discuss with the client the possible necessity for a qualified opinion or disclaimer of opinion. Sometimes the audit limitations present in such circumstances can be remedied. For example, the taking of the physical inventory can be postponed or another physical inventory can be taken which the auditor can observe. (See section 331.09–.13.)

Timing of Audit Work

.05 Many audit tests can be conducted at almost any time during the year. In the course of interim work, the independent auditor makes tests of the client's records, procedures, and representations to determine the extent to which he may rely on them. His conclusions assist him to determine the audit procedures to be undertaken to complete the examination. It is acceptable practice for the auditor to carry out substantial parts of the examination at interim dates.

.06 When a significant part of the examination is carried out during the year and internal control is found to be effective, year-end audit procedures may consist mainly of comparisons of year-end balances with balances at prior dates and of review and investigation of unusual transactions and significant fluctuations. The auditor must satisfy himself, however, that the internal control procedures are still effective at the year end. This does not mean that he must again test the records and transactions unless his inquiries and observations lead him to believe that conditions have changed significantly.

.07 Tests of procedures are particularly appropriate in the examination of accounts representing a great number of transactions. Examination of accounts which represent an accumulation of a relatively few transactions, on the other hand, may place more emphasis on substantiation of account balances than on tests of procedures.

.08 The timing of the performance of auditing procedures involves the proper synchronizing of their application and thus comprehends the possible need for simultaneous examination of, for example, cash on hand and in banks, securities owned, bank loans, and other related items. It may also require an element of surprise, establishment of audit control over assets readily negotiable, and establishment of a proper cutoff at a date other than the balance-sheet date. All these matters are to be resolved in the light of the effectiveness of internal control in a particular situation.

.09 The need for proper timing in carrying out audit procedures is apparent, for example, in the application of procedures for inventory observation. Review of proposed inventory count procedures, as planned by the client, is as essential for this purpose as is the review of the client's procedures for establishing a proper cutoff of sales and purchases in the books of account. Another example is found in the examination of negotiable securities. When the negotiable securities are of considerable volume, planning is necessary to guard against the substitution of securities already counted for other securities which should be on hand but are not.

The next page is 235.

AU Section 315

Communications Between Predecessor and Successor Auditors

(Supersedes section 543.18)

Effective November 30, 1975, unless otherwise indicated *

.01 The purpose of this section is to provide guidance on communications between predecessor and successor auditors when a change of auditors has taken place or is in process. The term "predecessor auditor" refers to an auditor who has resigned or who has been notified that his services have been terminated. The term "successor auditor" refers to an auditor who has accepted an engagement or an auditor who has been invited to make a proposal for an engagement. This section applies whenever an independent auditor has been retained, or is to be retained, to make an examination of financial statements in accordance with generally accepted auditing standards.

.02 The initiative in communicating rests with the successor auditor. The communication may be either written or oral. Both the predecessor and successor auditors should hold in confidence information obtained from each other. This obligation applies whether or not the successor accepts the engagement.

.03 Prior to acceptance of the engagement, the successor auditor should attempt certain communications that are described in paragraphs .04 through .07. Other communications between the successor and the predecessor, described in paragraphs .08 and .09 are advisable. However, their timing is more flexible. The successor may attempt these other communications either prior to acceptance of the engagement or subsequent thereto.

Communications Before Successor Accepts Engagement

.04 Inquiry of the predecessor auditor is a necessary procedure because the predecessor may be able to provide the

* See paragraph .12.

successor with information that will assist him in determining whether to accept the engagement. The successor should bear in mind that, among other things, the predecessor and the client may have disagreed about accounting principles, auditing procedures, or similarly significant matters.

.05 The successor auditor should explain to his prospective client the need to make an inquiry of the predecessor and should request permission to do so. Except as permitted by the Rules of Conduct, an auditor is precluded from disclosing confidential information obtained in the course of an audit engagement unless the client consents. Thus, the successor auditor should ask the prospective client to authorize the predecessor to respond fully to the successor's inquiries. If a prospective client refuses to permit the predecessor to respond or limits the response, the successor auditor should inquire as to the reasons and consider the implications of that refusal in deciding whether to accept the engagement.

.06 The successor auditor should make specific and reasonable inquiries of the predecessor regarding matters that the successor believes will assist him in determining whether to accept the engagement. His inquiries should include specific questions regarding, among other things, facts that might bear on the integrity of management; on disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters; and on the predecessor's understanding as to the reasons for the change of auditors.

.07 The predecessor auditor should respond promptly and fully, on the basis of facts known to him, to the successor's reasonable inquiries. However, should he decide, due to unusual circumstances such as impending litigation, not to respond fully to the inquiries, he should indicate that his response is limited. If the successor auditor receives a limited response, he should consider its implications in deciding whether to accept the engagement.

Other Communications

.08 When one auditor succeeds another, the successor auditor must obtain sufficient competent evidential matter to afford a reasonable basis for expressing his opinion on the financial statements he has been engaged to examine as well as on the consistency of the application of accounting principles in that year as compared with the preceding year. This may be done by applying appropriate auditing procedures to the account balances at the beginning of the period under examination and in some cases to transactions in prior periods. The successor auditor's examination may be facilitated by (a) making specific inquiries of the predecessor regarding matters that the successor believes may affect the conduct of his examination, such as audit areas that have required an inordinate amount of time or audit problems that arose from the condition of the accounting system and records and (b) reviewing the predecessor auditor's working papers. In reporting on his examination, however, the successor auditor should not make reference to the report or work of the predecessor auditor as the basis, in part, for his own opinion.

.09 The successor auditor should request the client to authorize the predecessor to allow a review of the predecessor's working papers. It is customary in such circumstances for the predecessor auditor to make himself available to the successor auditor for consultation and to make available for review certain of his working papers. The predecessor and successor auditors should agree on those working papers that are to be made available for review and those that may be copied. Ordinarily, the predecessor should permit the successor to review working papers relating to matters of continuing accounting significance, such as the working paper analysis of balance sheet accounts, both current and noncurrent, and those relating to contingencies. Valid business reasons, however, may lead the predecessor auditor to decide not to allow a review of his working papers. Further, when more than one successor auditor is considering acceptance of an engagement, the predecessor auditor should not be expected to make himself or his working papers available until the successor has accepted the engagement.

Financial Statements Reported on by Predecessor

.10 If during his examination the successor auditor becomes aware of information that leads him to believe that financial statements reported on by the predecessor auditor may require revision, he should request his client to arrange a meeting among the three parties to discuss this information and attempt to resolve the matter.[1] If the client refuses or if the successor is not satisfied with the result, the successor auditor may be well advised to consult with his attorney in determining an appropriate course of further action.

.11 When a predecessor auditor is to reissue his report on financial statements and he has not examined the financial statements for the most recent audited period, he should obtain a letter of representation from the successor auditor. This letter should state whether the successor's examination revealed any matters that, in the successor's opinion, might have a material effect on the financial statements reported on by the predecessor auditor.

Effective Date

.12 Statements on Auditing Standards generally are effective at the time of their issuance. However, since this Statement provides for practices that may differ in certain respects from practices heretofore considered acceptable it will be effective with respect to changes in auditors in which the successor auditor's consideration of acceptance of an engagement begins after November 30, 1975.

The next page is 241.

[1] See sections 561 and 710.10—.11 for guidance on action to be taken by the predecessor auditor.

AU Section 320

The Auditor's Study and Evaluation of Internal Control

Issue date, unless otherwise indicated: November, 1972

Introduction

.01 The second standard of field work is:

> 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.

Experience has demonstrated the soundness of the basic concepts and rationale comprehended in this standard. The purpose of this section is to amplify and clarify the application of these concepts in the light of subsequent developments in business and in the profession.

.02 The increasing trend for certified public accountants to provide management advisory or consulting services involving the study, evaluation, and improvement of management information systems increases the need to clearly distinguish between these special services and those audit services required for compliance with the auditing standard for study and evaluation of internal control incident to an examination of financial statements.

.03 The increasing use of computers for processing accounting and other business information has introduced additional problems in reviewing and evaluating internal control for audit purposes, as well as in making the distinction between audit services and special services referred to in the preceding paragraph.

.04 Closely related to the increasing use of computers is the trend toward integrating accounting information required for financial and other operating purposes into coordinated management information systems. This development increases the need to clearly identify the elements of the total system that are comprehended in the auditing standard concerning internal control.

.05 These developments and distinctions are important not only for the purposes of defining the nature and scope of the auditor's study and evaluation of internal control but also in clarifying any reports he may issue thereon. This need is accentuated by the increasing requests for reports on internal control for use by management or by regulatory agencies[1] and sometimes for inclusion in published reports.

Purpose of Auditor's Study and Evaluation

.06 The purpose of the auditor's study and evaluation of internal control, as expressed in the auditing standard quoted in paragraph .01, is to establish a basis for reliance thereon in determining the nature, extent, and timing of audit tests to be applied in his examination of the financial statements.

.07 The study and evaluation made for this purpose frequently provide a basis for constructive suggestions to clients concerning improvements in internal control.

.08 Although auditors are interested in both of the foregoing aspects of their study and evaluation of internal control, it is important to recognize an essential difference between them. The study and evaluation contemplated by generally accepted auditing standards should be performed for each audit to the extent the auditor considers necessary for that purpose as discussed further herein. Although constructive suggestions to clients for improvements in internal control incident to an audit engagement are desirable, the scope of any additional study made to develop such suggestions is not covered by generally accepted auditing standards. The scope of an auditor's study pursuant to a special engagement will depend on the terms of the engagement.

[1] As used here, regulatory agencies include both governmental and other agencies, such as stock exchanges, that exercise regulatory, supervisory, or other public administrative functions.

Definitions and Basic Concepts

Previous Definitions

.09 In 1948 the Committee on Auditing Procedure made a comprehensive study of internal control and published its results in 1949 as a special report entitled *Internal Control–Elements of a Coordinated System and Its Importance to Management and the Independent Public Accountant.* In that special report, internal control was defined as follows:

> Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognizes that a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments.

.10 To clarify the scope of the auditor's review as it pertains to his examination leading to the expression of an opinion on financial statements, the Committee issued Statement on Auditing Procedure No. 29 in October 1958, which subdivided internal control as follows:

> Internal control, in the broad sense includes . . . controls which may be characterized as either accounting or administrative as follows:
>
> a. Accounting controls comprise the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, the safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing.
>
> b. Administrative controls comprise the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls.

.11 The foregoing subdivision of internal control into accounting controls and administrative controls was made for the purpose of clarifying the scope of study contemplated under generally accepted auditing standards. The Committee's conclusions in that respect, incorporated in Chapter 5 of Statement No. 33 in 1963, were as follows:

> The independent auditor is primarily concerned with the accounting controls. Accounting controls . . . generally bear directly and importantly on the reliability of financial records and require evaluation by the auditor. Administrative controls . . . ordinarily relate only indirectly to the financial records and thus would not require evaluation. If the independent auditor believes, however, that certain administrative controls may have an important bearing on the reliability of the financial records, he should consider the need for evaluating such controls. For example, statistical records maintained by production, sales, or other operating departments may require evaluation in a particular instance.

.12 The overriding criterion inherent in the preceding excerpt is the bearing which particular controls have on the reliability of financial statements, regardless of their classification as accounting or administrative controls. For practical purposes, this is tantamount to including within the definition of accounting controls any administrative controls that have an important bearing on the reliability of the financial statements; consequently, this concept is adopted in the revised definitions in this section.

Need for Clarification

.13 Clarification of the previous definition of accounting control is desirable because of possible differences in interpretation with respect to the two key elements comprehended in it: the safeguarding of assets and the reliability of financial records. These differences and the Committee's conclusions concerning them are discussed in the following paragraphs.

Safeguarding of Assets

.14 One meaning of "safeguarding" that appears relevant in the context of the previous definition of accounting control is "a means of protection against something undesirable."[1] Use of this definition

[1] *Webster's Third New International Dictionary of the English Language Unabridged* (1961), page 1998.

conceivably could lead to a broad interpretation that the protection of existing assets and acquisition of additional assets is the primary function of management and, therefore, that any procedures or records entering into management's decision-making processes are comprehended in this element of the definition. Under this concept, for example, a management decision to sell a product at a price that proves to be unprofitable might be regarded as a failure to protect existing assets and, therefore, as evidence of inadequate accounting control. The same interpretation might be applied to a decision to incur expenditures for equipment that proves to be unnecessary or inefficient, for materials that prove to be unsatisfactory in production, for merchandise that proves to be unsaleable, for research that proves to be unproductive, for advertising that proves to be ineffective, and to similar management decisions.

.15 A second possible interpretation is that safeguarding of assets refers only to protection against loss arising from intentional and unintentional errors in processing transactions and handling the related assets. Unintentional errors include such as the following: understatement of sales through failure to prepare invoices or through incorrect pricing or computation; overpayments to vendors or employees arising from inaccuracies in quantities of materials or services, prices or rates, or computations; and physical loss of assets such as cash, securities, or inventory. In some situations, unintentional errors might also include improper allocations of certain costs, which would result in failure to recover these costs from customers.

.16 A third possible interpretation is that safeguarding of assets refers only to protection against loss arising from intentional errors. These include defalcations and similar irregularities, and the latter includes falsification of records for the purpose of causing improper computation of commissions, profit-sharing bonuses, royalties, and similar payments based on the recording of other transactions.

Reliability of Financial Records

.17 Possible differences in interpretation concerning the reliability of financial records as used in the previous definition of accounting control arise from the two separate purposes for which the financial records may be used: internal management and external reporting. One interpretation would extend the scope of accounting control to include reliability of the financial records for both of these purposes, while another would restrict it to external reporting purposes only.

.18 To illustrate the foregoing distinction, the degree and accuracy of classifications, details, and allocations required to provide reliability of records for such internal management purposes as establishing sales policies and prices, estimating future costs, and measuring performance by divisions, products, or other lines of responsibility ordinarily are greater than those required to provide reliability for external reporting purposes.

Flow of Transactions

.19 The Committee believes the previous definition of accounting control extended only to the safeguarding of assets against loss from unintentional or intentional errors or irregularities (see paragraph .15) and to the reliability of financial records for external reporting purposes (see paragraph .17). A revised definition expressed in relation to the functions involved in the flow of transactions is presented in paragraph .28 to provide the clarification needed in this respect.

.20 Transactions are the basic components of business operations and, therefore, are the primary subject matter of internal control. In the context of this section, transactions include exchanges of assets or services with parties outside the business entity and transfers or use of assets or services within it. The primary functions involved in the flow of transactions and related assets include the authorization, execution, and recording of transactions and the accountability for resulting assets.

.21 The ultimate authority for business transactions rests with stockholders or other classes of owners except as circumscribed by law and is delegated by them to directors, trustees, officers, and other management personnel. The delegation of authority to different levels and to particular persons in an organization is a management function. As used herein, authorization of transactions refers to management's decision to exchange, transfer, or use assets for specified purposes under specified conditions.

.22 Authorization may be general in that it relates to any transactions that conform to the specified conditions, or it may be specific with reference to a single transaction. Examples of general authorization include the establishment of sales prices for products to be sold to any customer, requirements to be met in setting the credit limit for any customer, automatic reorder points for material or merchandise, the number and type of personnel to be employed, and similar decisions. The basic characteristic of general authorization is that it is concerned with the definition or identification of the general conditions under which transactions are authorized without regard to the specific parties or transactions. Specific authorization, on the other hand, comprehends both the conditions and the parties involved; examples include authorizations for a specific sale or purchase, the employment of a specific person, the use of specific materials or employees for a particular production order, and similar transactions.

.23 Execution of transactions includes the entire cycle of steps necessary to complete the exchange of assets between the parties or the transfer or use of assets within the business. The execution of transactions frequently involves separate steps or stages. For example, the typical sale would involve acceptance of an order, shipment and billing of the product, and collection of the billing. A similar cycle of steps for the typical purchase of material or services may include requisitioning of the material, issuance of the order, receipt of the material, and payment of the purchase price. In this section, authorization applies to the complete cycle of steps; authorization is distinguished from approval in that the latter applies to a particular step and indicates only that the conditions specified or implied in the authorization have been satisfied insofar as they apply to that step.

.24 Recording of transactions comprehends all records maintained with respect to the transactions and the resulting assets or services and all functions performed with respect to such records. Thus, the recording of transactions includes the preparation and summarization of records and the posting thereof to the general ledger and subsidiary ledgers.

.25 The accountability function follows assets from the time of their acquisition in one transaction until their disposition or use in another. This function requires maintenance of records of accountability for assets and periodic comparison of these records with the related assets. Examples include the reconciliation of recorded cash balances with bank statements and reconciliation of perpetual inventory records with physical inventory counts.

Revised Definitions

.26 Based on the foregoing discussion, administrative control and accounting control are defined as indicated in the following two paragraphs.

.27 *Administrative control* includes, but is not limited to, the plan of organization and the procedures and records that are concerned with the decision processes leading to management's authorization of transactions.[1] Such authorization is a management function directly associated with the responsibility for achieving the objectives of the organization and is the starting point for establishing accounting control of transactions.

.28 *Accounting control* comprises the plan of organization and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records and consequently are designed to provide reasonable assurance that:

a. Transactions are executed in accordance with management's general or specific authorization.

b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.

c. Access to assets is permitted only in accordance with management's authorization.

d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

.29 The foregoing definitions are not necessarily mutually exclusive because some of the procedures and records comprehended in accounting control may also be involved in administrative control. For example, sales and cost records classified by products may be

[1] This definition is intended only to provide a point of departure for distinguishing accounting control and, consequently, is not necessarily definitive for other purposes.

used for accounting control purposes and also in making management decisions concerning unit prices or other aspects of operations. Such multiple uses of procedures or records, however, are not critical for the purposes of this section because it is concerned primarily with clarifying the outer boundary of accounting control. Examples of records used solely for administrative control are those pertaining to customers contacted by salesmen and to defective work by production employees maintained only for evaluating personnel performance.

Basic Concepts

.30 The basic concepts discussed under this caption are implicit in the definition of accounting control. (The discussion in paragraphs .31 through .34 applies to the definition generally, while the discussion in paragraphs .35 through .48 applies to essential characteristics of internal accounting control.) These concepts are applicable generally, but the organizational and procedural means of applying them may differ considerably from case to case because of the variety of circumstances involved. Therefore, it is not considered feasible to discuss these matters in detail in this section.

Management Responsibility

.31 The establishment and maintenance of a system of internal control is an important responsibility of management. The basic concepts implicit in the definition of accounting control are discussed in the context of that responsibility. The system of internal control should be under continuing supervision by management to determine that it is functioning as prescribed and is modified as appropriate for changes in conditions.

Reasonable Assurance

.32 The definition of accounting control comprehends reasonable, but not absolute, assurance that the objectives expressed in it will be accomplished by the system. The concept of reasonable assurance recognizes that the cost of internal control should not exceed the benefits expected to be derived. The benefits consist of reductions in the risk of failing to achieve the objectives implicit in the definition of accounting control. Although the cost-benefit relationship is the primary conceptual criterion that should be considered in designing a system of accounting control, precise measurement of costs and benefits usually is not possible; accordingly, any evaluation of the cost-benefit relationship requires estimates and judgments by management. Because of the cost-benefit relationship, accounting control procedures may appropriately be applied on a test basis in some circumstances.

Methods of Data Processing

.33 Since the definition and related basic concepts of accounting control are expressed in terms of objectives, they are independent of the method of data processing used; consequently, they apply equally to manual, mechanical, and electronic data processing systems. However, the organization and procedures required to accomplish those objectives may be influenced by the method of data processing used.[1]

Limitations

.34 There are inherent limitations that should be recognized in considering the potential effectiveness of any system of accounting control. In the performance of most control procedures, there are possibilities for errors arising from such causes as misunderstanding of instructions, mistakes of judgment, and personal carelessness, distraction, or fatigue. Furthermore, procedures whose effectiveness depends on segregation of duties obviously can be circumvented by collusion. Similarly, procedures designed to assure the execution and recording of transactions in accordance with management's authorizations may be ineffective against either errors or irregularities perpetrated by management with respect to transactions or to the estimates and judgments required in the preparation of financial statements. In addition to the limitations discussed above, any projection of a current evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with the procedures may deteriorate.

[1] For special considerations relating to electronic data processing systems, see section 321, *The Effects of EDP on the Auditor's Study and Evaluation of Internal Control.*

Personnel

.35 Reasonable assurance that the objectives of accounting control are achieved depends on the competence and integrity of personnel, the independence of their assigned functions, and their understanding of the prescribed procedures. Although these factors are important, their contribution is to provide an environment conducive to accounting control rather than to provide assurance that it necessarily will be achieved. Accounting control procedures may be performed by personnel in any appropriate organizational position. In smaller organizations such procedures may be performed by the owner-manager. In these circumstances, however, some of the limitations discussed in paragraph .34 may be particularly applicable.

Segregation of Functions

.36 Incompatible functions for accounting control purposes are those that place any person in a position both to perpetrate and to conceal errors or irregularities in the normal course of his duties.[1] Anyone who records transactions or has access to assets ordinarily is in a position to perpetrate errors or irregularities. Accordingly, accounting control necessarily depends largely on the elimination of opportunities for concealment. For example, anyone who records disbursements could omit the recording of a check, either unintentionally or intentionally. If the same person also reconciles the bank account, the failure to record the check could be concealed through an improper reconciliation. This example illustrates the concept that procedures designed to detect errors and irregularities should be performed by persons other than those who are in a position to perpetrate them—i.e., by persons having no incompatible functions. Procedures performed by such persons are described hereinafter as being performed independently.

Execution of Transactions

.37 Obtaining reasonable assurance that transactions are executed as authorized requires independent evidence that authorizations are issued by persons acting within the scope of their authority and that transactions conform with the terms of the authorizations.

[1] In this section "errors" refers to unintentional mistakes, and "irregularities" refers to intentional distortions of financial statements and to defalcations.

These terms may be either explicit or implicit, the latter being in the form of company policies or usual business practices applicable to the transactions involved. In some cases the required evidence is obtained by independent comparison of transaction documents with specific authorizations. For example, receiving reports and vendors' invoices may be compared with purchase orders in approving vouchers for payments; further, paid checks may be compared with approved vouchers, either individually or collectively, through reconciliations and related procedures. In other cases, such comparisons may be made with general authorizations such as general price lists, credit policies, or automatic reorder points. Such comparisons may be made manually or by computers. Reasonable assurance may sometimes be obtained by comparison of recorded transactions with budgets or standard costs, but the effectiveness of this alternative depends on the extent to which variations are identified and investigated. In some cases the only practicable means for obtaining reasonable assurance is by periodic surveillance of the personnel engaged in the execution of transactions.

Recording of Transactions

.38 The objective of accounting control with respect to the recording of transactions requires that they be recorded at the amounts and in the accounting periods in which they were executed and be classified in appropriate accounts. For this purpose accounting periods refer to the periods for which financial statements are to be prepared. In the definition of accounting control this objective is expressed in terms of permitting, rather than assuring, the preparation of financial statements in conformity with generally accepted accounting principles or any other applicable criteria. This distinction recognizes that, beyond the necessary recording of transactions, management's judgment is required in making estimates and other decisions required in the preparation of such statements.

.39 The possibilities for obtaining assurance that transactions have been properly recorded depend largely on the availability of some independent source of information that will provide an indication that the transactions have been executed. These possibilities vary widely with the nature of the business and the transactions, as illustrated by the following examples. At one extreme, comparison of paid checks returned by a bank with the recorded disbursements would reveal any unrecorded paid checks. Similarly, examination of documents supporting recorded disbursements would reveal those for which an accountability for resulting assets should be recorded concurrently. Where shipping documents are used, comparison of such documents with sales records would reveal unrecorded sales. A more indirect possibility with respect to sales is to estimate the aggregate amount that should be recorded by applying sales prices or gross profit rates to quantities or costs of inventory disposed of during a period. The degree of accuracy from such estimates depends on the variability of the pricing structure, the product mix, and other circumstances; in any event, however, such estimates ordinarily would not provide specific identification of any unrecorded sales that may be indicated. Assurance that collections on receivables are recorded rests primarily on the controls exercised over the records of receivables since these show the aggregate accountability for such collections. Accountability for collections of interest and dividends ordinarily can be established readily from securities records and independent published sources, while that for contributions from the general public ordinarily is more difficult to establish or estimate. The foregoing examples are not intended to be comprehensive in scope nor exhaustive in treatment but only illustrative of the general nature of the concepts and the variety of circumstances involved in obtaining assurance that transactions are properly recorded.

.40 Transactions with outside parties are necessarily recorded individually and should be recorded as promptly as practicable when the recording is necessary to maintain accountability for assets such as cash, securities, and others that are susceptible to loss from errors or irregularities. In this context, recording refers to the initial record, document, or copy evidencing the transaction and not to subsequent summarization. As to such summarization and as to the initial recording of other transactions, the time of recording within the appropriate accounting period may be determined on the basis of convenience and processing efficiency.

.41 The foregoing timing considerations apply also to the recording of internal transfers or use of assets or services. However, come transfers and cost allocations need not be recorded individually if the aggregate amounts can be determined satisfactorily. For example, cost of sales may be determined by applying gross profit rates to sales, and material usage may be determined by reference to production reports and bills of material.

Access to Assets

.42 The objective of safeguarding assets requires that access to assets be limited to authorized personnel. In this context, access to assets includes both direct physical access and indirect access through the preparation or processing of documents that authorize the use or disposition of assets. Access to assets is required, of course, in the normal operations of a business and, therefore, limiting access to authorized personnel is the maximum constraint that is feasible for accounting control purposes in this respect. The number and caliber of personnel to whom access is authorized should be influenced by the nature of the assets and the related susceptibility to loss through errors and irregularities. Limitation of direct access to assets requires appropriate physical segregation and protective equipment or devices. Limitation of indirect access requires procedures similar to those discussed in paragraph .36.

Comparison of Recorded Accountability With Assets

.43 The purpose of comparing recorded accountability with assets is to determine whether the actual assets agree with the recorded accountability, and, consequently, it is closely related to the foregoing discussion concerning the recording of transactions. Typical examples of this comparison include cash and securities counts, bank reconciliations, and physical inventories.

.44 If the comparison reveals that the assets do not agree with the recorded accountability, it provides evidence of unrecorded or improperly recorded transactions. The converse, however, does not necessarily follow. For example, agreement of a cash count with the recorded balance does not provide evidence that all cash received has been properly recorded. This illustrates an unavoidable distinction between fiduciary and recorded accountability: the former arises immediately upon acquisition of an asset; the latter arises only when the initial record of the transaction is prepared.

.45 As to assets that are susceptible to loss through errors or irregularities, the comparison with recorded accountability should be made independently.

.46 The frequency with which such comparison should be made for the purpose of safeguarding assets depends on the nature and amount of the assets involved and the cost of making the comparison. For example, it may be reasonable to count cash daily but not reasonable to take a physical inventory at that interval. However, a daily inventory of products in the custody of route salesmen, for example, may be practicable as a means of determining their accountability for sales. Similarly, the value and vulnerability of some products may make frequent complete inventories worthwhile.

.47 The frequency with which the comparison of recorded accountability with assets should be made for the purpose of achieving reliability of the records for preparing financial statements depends on the materiality of the assets and their susceptibility to loss through errors or irregularities.

.48 The action that may be appropriate with respect to any discrepancies revealed by the comparison of recorded accountability with assets will depend primarily on the nature of the asset, the system in use, and the amount and cause of the discrepancy. Appropriate action may include adjustment of the accounting records, filing of insurance claims, revision of procedures, or administrative action to improve the performance of personnel.

Study of System

Scope of Study

.49 As defined in paragraphs .27 through .29, accounting control is within the scope of the study and evaluation of internal control contemplated by generally accepted auditing standards, while administrative control is not.

.50 The study to be made as the basis for the evaluation of internal control includes two phases: (a) knowledge and understanding of the procedures and methods prescribed and (b) a reasonable degree of assurance that they are in use and are operating as planned. These two phases of study are referred to as the review of the system and tests of compliance, respectively. Although these phases are discussed separately, they are closely related in that some portions of each may be performed concurrently and may contribute to the auditor's evaluation of the prescribed procedures and of the compliance with them.

Review of System

.51 The review of the system is primarily a process of obtaining information about the organization and the procedures prescribed and is intended to serve as the basis for tests of compliance and for evaluation of the system. The information required for this purpose ordinarily is obtained through discussion with appropriate client personnel and reference to documentation such as procedure manuals, job descriptions, flowcharts, and decision tables.

.52 In order to clarify their understanding of information obtained from such sources, some auditors follow the practice of tracing one or a few of the different types of transactions involved through the related documents and records maintained. This practice may be useful for the purpose indicated and may be considered as a part of the tests of compliance as discussed later in this section.

.53 Information concerning the system may be recorded by the auditor in the form of answers to a questionnaire, narrative memoranda, flowcharts, decision tables, or any other form that suits the auditor's needs or preferences.

.54 Upon completion of the review of the system, the auditor should be able to make a preliminary evaluation assuming satisfactory compliance with the prescribed system, and it is usually desirable to do so at this time. Concepts to be considered in making either a preliminary or final evaluation are discussed in paragraphs .64 through .68.

Tests of Compliance

.55 The purpose of tests of compliance is to provide reasonable assurance that the accounting control procedures are being applied as prescribed. Such tests are necessary if the prescribed procedures are to be relied upon in determining the nature, timing, or extent of substantive tests of particular classes of transactions or balances, as discussed later in paragraphs .57–.63, but are not necessary if the procedures are not to be relied upon for that purpose. The auditor may decide not to rely on the prescribed procedures because he concludes either (a) that the procedures are not satisfactory for that purpose or (b) that the audit effort required to test compliance with the procedures to justify reliance on them in making substantive tests would exceed the reduction in effort that could be achieved by such reliance. The latter conclusion may result from consideration of the nature or amount of the transactions or balances involved, the data processing methods being used, and the auditing procedures that can be applied in making substantive tests. The discussion of tests of compliance in the remainder of this section applies only to those portions of the system of internal accounting control that are to be relied upon in determining the nature, timing, or extent of substantive tests.

.56 The nature of accounting control procedures and of the available evidence of compliance necessarily determines the nature of the tests of compliance and also influences the timing and extent of such tests as discussed under the respective captions that follow. Although tests of compliance are discussed separately under these captions, they are closely interrelated with substantive tests as discussed in paragraph .70; in practice, auditing procedures often concurrently provide evidence of compliance with accounting control procedures as well as evidence required for substantive purposes.

Nature of Tests

.57 Accounting control requires not only that certain procedures be performed but that they be performed properly and independently. Tests of compliance, therefore, are concerned primarily with these questions: Were the necessary procedures performed, how were they performed, and by whom were they performed?

.58 Some aspects of accounting control require procedures that are not necessarily required for the execution of transactions. This class of procedures includes the approval or checking of documents evidencing transactions. Tests of such procedures require inspection of the related documents to obtain evidence in the form of signatures, initials, audit stamps, and the like, to indicate whether and by whom they were performed and to permit an evaluation of the propriety of their performance.

.59 Other aspects of accounting control require a segregation of duties so that certain procedures are performed independently, as discussed in paragraph .36. The performance of these procedures is largely self-evident from the operation of the business or the existence of its essential records; consequently, tests of compliance with such procedures are primarily for the purpose of determining whether they were performed by persons having no incompatible functions. Examples of this class of procedures may include the receiving, depositing, and disbursing of cash, the recording of transactions, and the posting of customers' accounts. Since such procedures frequently leave no audit trail of documentary evidence as to who performed them, tests of compliance in these situations necessarily are limited to inquiries of different personnel and observation of office personnel and routines to corroborate the information obtained during the initial review of the system. While reconciliations, confirmations, or other audit tests performed in accordance with the auditing standard relating to evidential matter may substantiate the accuracy of the underlying records, these tests frequently provide no affirmative evidence of segregation of duties because the records may be accurate even though maintained by persons having incompatible functions.

Timing and Extent of Tests

.60 As indicated in paragraph .50, the purpose of tests of compliance with accounting control procedures is to provide "a reasonable degree of assurance that they are in use and are operating as planned." What constitutes a "reasonable" degree of assurance is a matter of auditing judgment; the "degree of assurance" necessarily depends on the nature, timing, and extent of the tests and on the results obtained.

.61 As to accounting control procedures that leave an audit trail of documentary evidence of compliance, tests of compliance as described in paragraph .58 ideally should be applied to transactions executed throughout the period under audit because of the general sampling concept that the items to be examined should be selected from the entire set of data to which the resulting conclusions are to be applied. Independent auditors often make such tests during interim work. When this has been done, application of such tests throughout the remaining period may not be necessary. Factors to be considered in this respect include (a) the results of the tests during the interim period, (b) responses to inquiries concerning the remaining period, (c) the length of the remaining period, (d) the nature and amount of the transactions or balances involved, (e) evidence of compliance within the remaining period that may be obtained from substantive tests performed by the independent auditor or from tests performed by internal auditors, and (f) other matters the auditor considers relevant in the circumstances.

.62 Tests of compliance may be applied on either a subjective or statistical basis. Statistical sampling may be a practical means for expressing in quantitative terms the auditor's judgment concerning reasonableness and for determining sample size and evaluating sample results on that basis. For the guidance of auditors who are interested in using statistical sampling, this section includes two appendices.[1]

.63 As to accounting control procedures that depend primarily on segregation of duties and leave no audit trail, the inquiries described in paragraph .59 should relate to the entire period under audit, but the observations described therein ordinarily may be confined to the periods during which the auditor is present on the client's premises in conducting other phases of his audit.

Evaluation of System

.64 From the viewpoint of management, the purposes of accounting control are stated in the definition given previously. These purposes apply equally to the independent auditor, but they were stated somewhat differently in Chapter 5 of Statement No. 33 as follows:

> A function of internal control, from the viewpoint of the independent auditor, is to provide assurance that errors and irregularities may be discovered with reasonable promptness, thus assuring the reliability and integrity of the financial records. The independent auditor's review of the system of internal control assists him in determining other auditing procedures appropriate to the formulation of an opinion on the fairness of the financial statements.

.65 A conceptually logical approach to the auditor's evaluation of accounting control, which focuses directly on the purpose of preventing or detecting material errors and irregularities in financial statements, is to apply the following steps in considering each significant class of transactions and related assets involved in the audit:

a. Consider the types of errors and irregularities that could occur.

b. Determine the accounting control procedures that should prevent or detect such errors and irregularities.

c. Determine whether the necessary procedures are prescribed and are being followed satisfactorily.

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[1] See sections 320A, "Relationship of Statistical Sampling to Generally Accepted Auditing Standards," and 320B, "Precision and Reliability for Statistical Sampling in Auditing."

d. Evaluate any weaknesses—i.e., types of potential errors and irregularities not covered by existing control procedures—to determine their effect on (1) the nature, timing, or extent of auditing procedures to be applied and (2) suggestions to be made to the client.

.66 In the practical application of the foregoing approach, the first two steps are performed primarily through the development of questionnaires, checklists, instructions, or similar generalized material used by the auditor. However, professional judgment is required in interpreting, adapting, or expanding such generalized material as appropriate in particular situations. The third step is accomplished through the review of the system and tests of compliance and the final step through the exercise of professional judgment in evaluating the information obtained in the preceding steps.

.67 This suggested approach emphasizes the possibilities for, and controls against, particular types of errors and irregularities concerning particular classes of transactions and related assets. Controls and weaknesses affecting different classes of transactions are not offsetting in their effect. For example, weaknesses in cash receipts procedures are not mitigated by controls in cash disbursements procedures; similarly, weaknesses in billing procedures are not mitigated by controls in collection procedures. The auditor's review of the system of accounting control and his tests of compliance should be related to the purposes of his evaluation of the system. For this reason, generalized or overall evaluations are not useful for auditors because they do not help the auditor decide the extent to which auditing procedures may be restricted. On the other hand, the auditor ordinarily would confine his evaluation to broad classes of transactions, such as disbursements and sales; he ordinarily would not evaluate separately procedures that result in entries to particular accounts and he usually would not apply his procedures differently within a class of transactions. For example, disbursements may be examined by selecting from all disbursements, without considering the accounts to which the disbursements are charged, and in his examination the auditor would be concerned with validity and approval of supporting documents without regard to the nature of the documentation or the particular individual authorized to approve the disbursement. There may be circumstances, however, in which a more narrow evaluation may be appropriate because control over a class of transactions may be good except as to certain transactions within the class, and it may be more efficient to extend auditing procedures as to only those kinds of transactions. For example, control of cash disbursements may be good except for disbursements for advertising, and it may be more efficient to extend procedures relating to advertising disbursements than to extend procedures relating to all cash disbursements.

.68 The auditor's evaluation of accounting control with reference to each significant class of transactions and related assets should be a conclusion as to whether the prescribed procedures and compliance therewith are satisfactory for his purpose. The procedures and compliance should be considered satisfactory if the auditor's review and tests disclose no condition he believes to be a material weakness for his purpose. In this context, a material weakness means a condition in which the auditor believes the prescribed procedures or the degree of compliance with them does not provide reasonable assurance that errors or irregularities in amounts that would be material in the financial statements being audited would be prevented or detected within a timely period by employees in the normal course of performing their assigned functions. These criteria may be broader than those that may be appropriate for evaluating weaknesses in accounting control for management or other purposes.

Correlation With Other Auditing Procedures

.69 Since the purpose of the evaluation required by the second auditing standard of field work is to provide a basis "for the determination of the resultant extent of the tests to which auditing procedures are to be restricted," it is clear that its ultimate purpose is to contribute to the "reasonable basis for an opinion" comprehended in the third standard of field work, which is as follows:

> 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.[1]

[1] Section 150.02.

.70 The evidential matter required by the third standard is obtained through two general classes of auditing procedures: (a) tests of details of transactions and balances and (b) analytical review of significant ratios and trends and resulting investigation of unusual fluctuations and questionable items. These procedures are referred to in this section as "substantive tests." The purpose of these procedures is to obtain evidence as to the validity and the propriety of accounting treatment of transactions and balances or, conversely, of errors or irregularities therein. Although this purpose differs from that of compliance tests, both purposes often are accomplished concurrently through tests of details.

.71 The second standard does not contemplate that the auditor will place complete reliance on internal control to the exclusion of other auditing procedures with respect to material amounts in the financial statements. This interpretation is appropriate for several reasons. First, the connotation of "restricted" in this context does not imply "eliminated." Second, the third standard includes no language suggesting complete reliance on internal control. Finally, the inherent limitations on the effectiveness of accounting control as discussed in paragraph .34 are the fundamental reasons underlying this interpretation.

.72 In considering the more difficult question as to the extent of restriction contemplated in the second and third standards, the following excerpts from section 320A provide a useful conceptual analysis of the intricate relationship between these standards:

> .14 . . . [T]he ultimate risk against which the auditor and those who rely on his opinion require reasonable protection is a combination of two separate risks. The first of these is that material errors will occur in the accounting process by which the financial statements are developed. The second is that any material errors that occur will not be detected in the auditor's examination.
>
> .15 The auditor relies on internal control to reduce the first risk, and on his tests of details and his other auditing procedures to reduce the second. The relative weight to be given to the respective sources of reliance . . . are matters for the auditor's judgment in the circumstances.
>
> .19 The second standard of field work recognizes that the extent of tests required to constitute sufficient evidential matter under the third standard should vary inversely with the auditor's reliance on internal control. These standards taken together imply that the combination of the auditor's reliance on internal control and on

his auditing procedures should provide a reasonable basis for his opinion in all cases, although the portion of reliance derived from the respective sources may properly vary between cases.

.73 The foregoing excerpts recognize not only that the reliance on substantive tests may properly vary inversely with the reliance on internal accounting control, but also that the relative portions of the reliance on substantive tests that are derived from tests of details and from analytical review procedures may properly vary. Regardless of the extent of reliance on internal accounting control, the auditor's reliance on substantive tests may be derived from tests of details, from analytical review procedures, or from any combination of both that he considers appropriate in the circumstances. Variations in this respect may arise from differences in circumstances bearing on the expected effectiveness and efficiency of the respective types of procedures. In this context, effectiveness refers to the audit satisfaction that can be obtained from the procedures, and efficiency refers to the audit time and effort required to perform the procedures. Effectiveness necessarily is the overriding consideration, but efficiency is an appropriate consideration in choosing between procedures of similar effectiveness. The differences in circumstances having a bearing on expected effectiveness and efficiency may include factors such as the nature of the transactions or balances involved, the availability and stability of experience or other criteria for use in analytical review procedures, the availability of records required for effective tests of details, the volume of such records and the nature of the tests to which they are susceptible, and the timing of the analytical review and/or tests of details in relation to the end of the period being audited.

[.74] [Superseded, December 1975, by Statement on Auditing Standards No. 9.] (See section 322.)

.75 Substantive tests of details may be applied on either a subjective or a statistical basis. Statistical sampling may be a practical means for expressing in quantitative terms the auditor's judgment concerning the reliance to be derived from such tests and for determining sample size and evaluating sample results on that basis.[1]

The next page is 281.

[1] See Appendices A and B (sections 320A and 320B).

AU Section 320A

Appendix A—Relationship of Statistical Sampling to Generally Accepted Auditing Standards[1]

Issue date, unless otherwise indicated: November, 1972

Introduction

.01 The Committee on Statistical Sampling issued a special report entitled "Statistical Sampling and the Independent Auditor" in February 1962. This report dealt with the general nature of statistical sampling and its applicability to auditing, and concluded with the following paragraph:

> A broader education in and knowledge of statistical sampling and further research as to its applicability on the part of the profession is desirable.

.02 In line with this conclusion, the committee has given further attention to the relationship of statistical sampling to generally accepted auditing standards and believes that publication of its views on this matter may serve a useful purpose.

.03 The following excerpts from the special report are quoted to provide some background to the subsequent reference to statistical sampling by the Committee on Auditing Procedure and to serve as an introduction to the matters discussed in this report:

> The committee is of the opinion that the use of statistical sampling is permitted under generally accepted auditing standards.
>
> Statistical samples are evaluated in terms of "precision," which is expressed as a range of values, plus and minus, around the sample result, and "reliability" (or confidence), which is expressed as the proportion of such ranges from all possible similar samples of the same size that would include the actual population value.

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[1] This Appendix is a reprint of "A Special Report by the Committee on Statistical Sampling of the American Institute of Certified Public Accountants," which was published in *The Journal of Accountancy*, in slightly altered form (July 1964), pp. 56-58.

Although statistical sampling furnishes the auditor with a measure of precision and reliability, statistical techniques do not define for the auditor the values of each required to provide audit satisfaction.

Specification of the precision and reliability necessary in a given test is an auditing function and must be based upon judgment in the same way as is the decision as to audit satisfaction required when statistical sampling is not used.

.04 In December 1963, the Committee on Auditing Procedure issued *Auditing Standards and Procedures* (Statement on Auditing Procedure No. 33), which included the following comments concerning statistical sampling:

> In determining the extent of a particular audit test and the method of selecting items to be examined, the auditor might consider using statistical sampling techniques which have been found to be advantageous in certain instances. The use of statistical sampling does not reduce the use of judgment by the auditor but provides certain statistical measurements as to the results of audit tests, which measurements may not otherwise be available (section 330.14).

.05 The two sources from which the foregoing excerpts were taken make it clear that statistical sampling is not a fundamentally different audit approach, and that its use is permissive rather than mandatory under generally accepted auditing standards.

.06 The committee believes that interest in the use of statistical sampling is increasing. Accordingly, this report is issued to discuss more specifically a way in which statistical precision and reliability can be related to generally accepted auditing standards and to point out some of the factors to be considered by the auditor in deciding what degree or level of each is satisfactory for a particular sample; it is not issued to propose definitive numerical criteria for these measurements nor to discuss their mathematical aspects.

Generally Accepted Auditing Standards

.07 The auditing standards to which statistical sampling is most directly related are the three 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 (section 150.02.)

.08 Since the ultimate objective of the first and second of these standards is to contribute to the "reasonable basis for an opinion" which is comprehended in the third, the three standards are discussed in reverse order in this report.

Third Standard—Evidential Matter

.09 The opinion referred to in the third standard of field work ordinarily is to the effect that the financial statements present fairly the financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Materiality is implicit in the concept of fair presentation. Similarly, some degree of uncertainty is implicit in the concept of a reasonable basis for an opinion.

.10 Although "precision" and "reliability" are statistically inseparable, the committee believes that one of the ways in which these measurements can be usefully adapted to the auditor's purposes is by relating precision to materiality and reliability to the reasonableness of the basis for his opinion.

Materiality and Sampling Precision

.11 Evaluation of the precision of an audit sample in monetary terms contributes directly to the auditor's ultimate purpose since such evaluation can be related to his judgment as to the monetary amount of errors that would be material. Evaluation of precision in terms of the frequency of deviations from internal control procedures or of other errors not evaluated in monetary terms contributes to the auditor's ultimate purpose by influencing his judgment as to the reliability of the records and the likelihood of errors having a material effect.

.12 In making decisions with respect to the results of a sample, the auditor should consider the precision of the sample as well as the estimate derived from it. For the purpose of some audit tests, the auditor may be concerned with both the upper and lower precision limits; for others, he may be concerned with only one of these limits. For example, if a sample results in an estimate that an asset is overstated by $10,000 with an upper precision limit of $12,000 at the reliability level desired by the auditor, he usually would be concerned with the estimate of $10,000 and the upper limit of $12,000 because his primary interest in such circumstances would center on the maximum amount by which the asset might be overstated.

.13 The auditor's decision as to the monetary amount or frequency of errors that would be considered material should be based on his judgment in the circumstances in the particular case. In addition to the statistical evaluation, the auditor should also consider the nature and cause of errors revealed by the sample and their possible relation to other phases of his examination.

Reasonableness and Sampling Reliability

.14 For the purpose of relating sampling reliability to the reasonableness of the basis for an opinion, it should be understood that the ultimate risk against which the auditor and those who rely on his opinion require reasonable protection is a combination of two separate risks. The first of these is that material errors will occur in the accounting process by which the financial statements are developed. The second is that any material errors that occur will not be detected in the auditor's examination.

.15 The auditor relies on internal control to reduce the first risk, and on his tests of details and his other auditing procedures to reduce the second. The relative weight to be given to the respective sources of reliance and, accordingly, the sampling reliability desired for his tests of details are matters for the auditor's judgment in the circumstances. The committee believes that reliability levels used in sampling applications in other fields are not necessarily relevant in determining appropriate levels for applications in auditing because the auditor's reliance on sampling is augmented by other sources of reliance that may not be available in other fields.

Sufficiency and Sample Size

.16 After the auditor's judgment has been expressed by specifying the precision and reliability desired, statistical formulas or tables can be used in determining the sample size that will be sufficient to achieve these objectives. In this manner, statistical sampling can be related to compliance with the third standard of field work concerning the sufficiency of evidential matter to be obtained.

Competence and Sample Evaluation

.17 The competence of evidential matter as referred to in the third standard of field work is solely a matter of auditing judgment that is not comprehended in the statistical design and evaluation of an audit sample. In a strict sense, the statistical evaluation relates only to the probability that items having certain characteristics in terms of monetary amounts, quantities, errors, or other features of interest will be included in the sample–not to the auditor's treatment of such items. Consequently, the use of statistical sampling does not directly affect the auditor's decisions as to the auditing procedures to be performed, the acceptability of the evidential matter obtained with respect to individual items in the sample, or the action which might be taken in the light of the nature and cause of particular errors.

Second Standard—Internal Control

.18 The second standard of field work requires an evaluation of internal control as a basis for determining the extent of audit tests. Compliance with this standard involves two problems: (a) evaluating the internal control, and (b) relating the extent of tests to this evaluation.

Extent of Tests

.19 The second standard of field work recognizes that the extent of tests required to constitute sufficient evidential matter under the third standard should vary inversely with the auditor's reliance on internal control. These standards taken together imply that the combination of the auditor's reliance on internal control and on his auditing procedures should provide a reasonable basis for his opinion in all cases, although the portion of reliance derived from the respective sources may properly vary between cases. For statistical samples designed to test the validity or bona fides of accounting data and to be evaluated in monetary terms, the committee believes the foregoing concept should be applied by specifying reliability levels that vary inversely with the subjective reliance assigned to internal control and to any other auditing procedures or conditions relating to the particular matters to be tested by such samples.

Evaluation of Internal Control

.20 The evaluation of internal control involves two phases, as indicated in the following excerpt from *section 320.50*: "(a) knowledge and understanding of the procedures and methods prescribed and (b) a reasonable degree of assurance that they are in use and are operating as planned."

.21 The auditor's knowledge of the procedures prescribed by the client ordinarily is obtained by inquiry or reference to written instructions, and his understanding of their function and limitations is based on his training, experience, and judgment. On this basis, the auditor makes a preliminary evaluation of the effectiveness of the prescribed procedures, assuming that compliance with them is satisfactory. Statistical sampling is not applicable to this phase of the evaluation.

.22 As to the second phase, statistical sampling may be applied to test compliance with internal control procedures that leave an audit trail in the form of documentary evidence of compliance. This evidence may consist of signatures, initials, and the like, which indicate preparation, checking, or approval of documents such as purchase orders, receiving reports, vouchers, checks, sales invoices, and credit memorandums. The committee believes that samples taken for this purpose should be evaluated in terms of the frequency and nature of deviations from any procedures the auditor considers essential to his preliminary evaluation of internal control, and that their influence on his final evaluation of internal control should be based on his judgment as to the effect of such deviations on the risk of material errors in the financial statements. Since samples taken for this purpose are intended to provide a basis for relying on compliance with internal control procedures, the committee believes they should be evaluated at a reliability level the auditor considers reasonable in the light of factors other than the procedures themselves.

.23 On the other hand, statistical sampling generally is not applicable to tests of compliance with internal control procedures that depend primarily on appropriate segregation of duties and leave no audit trail of documentary evidence in this respect. Although statistical sampling may be applied to test the accuracy of records such as bank reconciliations, customers' accounts, footings, and postings, these tests provide no affirmative evidence concerning the segregation of duties because the related records may very well be accurate even in the absence of this element of internal control. Consequently, in the absence of documentary evidence in the form of signatures, initials, and the like, evidence of appropriate segregation of duties is usually obtained by the auditor through his original inquiries or reference to written instructions and through supplemental corroborative inquiries and observation of office personnel and routines.

First Standard—Audit Planning and Supervision

.24 The committee believes the foregoing discussion of matters to be considered in applying statistical sampling and in correlating it with other aspects of an audit demonstrates that proper use of statistical sampling requires audit planning and supervision as comprehended in the first standard of field work. In addition to the statistical problems involved in designing, selecting, and evaluating samples, audit planning and supervision are required in defining errors or other features of interest for sample purposes, specifying sample objectives in terms of reliability and precision related to such purposes, applying the definition of errors or other features of interest in examining sample items, and deciding on the significance of sample evaluations in relation to other information obtained during an audit.

This report presents the considered opinion of the nine members of the Committee on Statistical Sampling, reached on a formal vote after examination of the subject matter by the committee and the technical services division. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the statements rests upon the general acceptability of the opinions so reached.

The next page is 291.

AU Section 320B

Appendix B—Precision and Reliability for Statistical Sampling in Auditing

Issue date, unless otherwise indicated: November, 1972

Introduction

.01 Section 320 reiterates the position expressed in prior pronouncements to the effect that the use of statistical sampling is compatible with, but not required by, generally accepted auditing standards. Because statistical sampling is relevant to the subject matter of section 320, this Appendix has been included for the guidance of auditors who have made an informed judgment to use statistical sampling. For a complete understanding of the terms and concepts in this Appendix, it should be read in conjunction with section 320, "The Auditor's Study and Evaluation of Internal Control" and with section 320A, "Relationship of Statistical Sampling to Generally Accepted Auditing Standards."

.02 Statistical sampling is one of the techniques available to the auditor to accomplish his objectives. In determining which technique is appropriate in a particular set of circumstances, the auditor should carefully consider the audit effectiveness and efficiency of the alternatives available.

.03 Although the precision and reliability required for statistical sampling necessarily is a matter of audit judgment, the discussion and examples included in this Appendix are intended to facilitate the exercise of judgment concerning these requirements. This material, however, is not intended to be applied in a mechanical fashion nor to impinge upon audit judgment in any respect.

.04 This Appendix does not discuss any of the statistical theory or techniques required to execute a valid statistical sample and should therefore be used only by auditors who have adequate statistical knowledge to (a) decide when statistical audit samples may be appropriate, (b) design and select a valid sample, (c) evaluate the audit evidence from the sample, and (d) apply the evaluation in the overall context of the audit. For matters of statistical theory and technique, the auditor should refer to standard reference sources.

.05 This Appendix applies only to statistical samples for audit purposes; it does not apply to those used to determine basic accounting information.

Audit Tests and Uncertainty

.06 In the examination of financial statements, the auditor is concerned both with the accuracy of the underlying data and with management's decisions relating to accounting principles, estimates and judgments with respect to future events, and other representations implicit in the financial statements. Audit tests of details of transactions and balances are concerned primarily with the processing and accuracy of the data and may also provide information relevant to the decisions made by management and to those required by the auditor. However, information relevant to such decisions may also be obtained by other auditing procedures. Although some uncertainty is inherent both in audit tests of details and in other auditing procedures, references to uncertainty in the remainder of this Appendix are restricted to the uncertainty relating to tests of details.

.07 The justification for accepting some uncertainty in audit tests arises from the relationship between such factors as the cost and time required to examine the data and the adverse consequences of possible erroneous decisions based on the resulting conclusions. Where these factors do not justify the acceptance of some uncertainty, the only alternative is a complete examination.[1] Since this is seldom the case, the basic concept of testing is well established in generally accepted auditing standards.

.08 Whether audit tests of details are applied by statistical or nonstatistical sampling, the common purpose of both is to form a conclusion about an entire population by examining only a part of it. The distinguishing feature of statistical sampling is that it provides a means for measuring mathematically the degree of uncertainty that results from examining only a part of the data. Auditors who prefer

[1] Complete examination obviously would eliminate the uncertainty that would arise solely from testing; however, it would not eliminate the uncertainty attributable to possible failure of the auditor to recognize errors in the data examined or in management's decisions implicit in the financial statements.

statistical sampling believe that its principal advantage flows from this unique feature. By mathematical measurement of such uncertainty, the auditor can determine the sample sizes necessary to confine the uncertainty to limits that he considers acceptable in any particular situation.

.09 The measurement of uncertainty or of assurance associated with statistical samples is expressed in terms of two parameters or dimensions: "precision" and "reliability." The meaning and interdependence of these terms has been explained in section 320A.03 as follows:

> Statistical samples are evaluated in terms of "precision," which is expressed as a range of values, plus and minus, around the sample result, and "reliability" (or confidence), which is expressed as the proportion of such ranges from all possible similar samples of the same size that would include the actual population value.

Stated somewhat less technically, precision expresses the range or limits within which the sample result is expected to be accurate, while reliability expresses the mathematical probability of achieving that degree of accuracy. In this context, "sample result" refers to the estimate of the actual but unknown quantity (number or amount, expressed in absolute or relative terms) of the feature of interest in the population. For example, a sample concerned with the amount of an account balance and evaluated at a particular reliability level might result in an estimate of the population total of $1,000,000, a "precision" of plus or minus $100,000, a "lower precision limit" of $900,000, and an "upper precision limit" of $1,100,000, all based on the sample.

.10 In this Appendix, precision and reliability refer to these parameters as finally determined upon evaluation of the information obtained from the sample. These parameters are discussed further in subsequent segments relating to audit tests for specific purposes.

Audit Judgment and Statistical Sampling

.11 Section 320A.03 includes the following comments concerning the need for audit judgment in applying statistical sampling:

> Although statistical sampling furnishes the auditor with a measure of precision and reliability, statistical techniques do not define for the auditor the values of each required to provide audit satisfaction.

> Specification of the precision and reliability necessary in a given test is an auditing function and must be based upon judgment in the same way as is the decision as to audit satisfaction required when statistical sampling is not used.

.12 This excerpt, as well as the experience of auditors who have used statistical sampling, should allay the concern of some auditors that its use impinges on the province of audit judgment. Such judgment necessarily becomes explicit in determining the precision and reliability to be used for statistical samples, but it is implicit in nonstatistical samples.

.13 The determination of precision and reliability desired for statistical samples is in the realm of audit judgment because no mathematical basis for definitive criteria is available and no authoritative pronouncement has been issued. As mentioned in paragraph .11, statistical sampling techniques provide a means for computing precision and reliability but not for determining the adequacy of these parameters for the auditor's purposes. Although it is evident that definitive criteria cannot be established or proven mathematically, the discussion and examples in this Appendix should provide useful guidance for the exercise of further judgment by auditors who are interested in applying statistical sampling in particular situations.

.14 Section 320A.10 indicates the general framework within which audit judgment should be exercised in designing and evaluating statistical samples:

> Although "precision" and "reliability" are statistically inseparable,[1] the committee believes that one of the ways in which these measurements can be usefully adapted to the auditor's purposes is by relating precision to materiality and reliability to the reasonableness of the basis for his opinion.

Some of the considerations involved in the application of this concept in designing and evaluating audit samples to test compliance with internal accounting control procedures and to test the substantive aspects of transactions and balances are discussed under those captions in the remainder of this Appendix. Although discussed

[1] Precision and reliability are "statistically inseparable" only in the sense that they are computationally interdependent and that both should be stated in expressing the results of a statistical sample. This does not imply, however, that the respective measurements cannot be related to separate aspects of the auditor's examination, as suggested in the excerpt quoted above.

separately, a single sample can be designed to serve both of these purposes as explained further in paragraph .37. Because generalized or overall evaluations of internal control are not useful to the auditor, as explained in section 320.67, the discussion that follows presumes the samples are designed to test the compliance and/or substantive aspects of particular classes of transactions or balances.

Compliance Tests

.15 The discussion in section 320 concerning the purpose, nature, and extent of tests of compliance with internal accounting control procedures applies also to the discussion of those matters in this Appendix. Samples designed for this purpose should be evaluated in terms of deviations from, or compliance with, pertinent procedures tested, either as to the number of such deviations or the monetary amount of the related transactions. In this context, pertinent procedures are those which, if not purported to be in use, would have affected adversely the auditor's preliminary evaluation of the system prior to his tests of compliance.

.16 In addition to the statistical evaluation of the quantitative significance of deviations from pertinent procedures, consideration should be given to the qualitative aspects of the deviations. These include (a) the nature and cause of errors, such as whether they are errors in principle or in application, are deliberate or unintentional, are due to misunderstanding of instructions or to careless compliance, and the like and (b) the possible relationship of errors to other phases of the audit.

Precision for Compliance Tests

.17 The evaluation of a sample designed to test compliance with internal accounting control procedures would provide, at the reliability level specified, an estimate of the procedural deviations in the population from which the sample was selected and precision limits with respect to such estimate. The precision limits would depend on the size of the sample and on the procedural deviations found. The auditor's evaluation of compliance would include a statistical conclusion that the procedural deviations in the population did not exceed the upper precision limit obtained or, alternatively, were within the precision range obtained.

.18 In considering the precision desired for compliance tests, it is important to recognize the relationship of procedural deviations to (a) the accounting records being audited, (b) any related accounting control procedures, and (c) the purpose of the auditor's evaluation.

.19 While procedural deviations increase the risk of material errors and irregularities in the accounting records, such errors and irregularities do not necessarily result from procedural deviations. For example, a disbursement that does not show evidence of required approval may nevertheless be a valid transaction that was properly recorded. Procedural deviations would result in errors or irregularities remaining undetected in the accounting records to be audited only if the procedural deviations and the errors or irregularities occurred on the same transactions. Consequently, procedural deviations of any given percentage ordinarily would not be expected to result in substantive errors or irregularities of the same magnitude in the accounting records.

.20 In some situations, the primary control against a particular type of error or irregularity may be provided by a single procedure or a set of related procedures; in others, auxiliary control that is overlapping or to some degree duplicative may be provided by another procedure or set of related procedures. In either situation, a set of two or more procedures necessary for a single purpose should be regarded as a single procedure, and deviations from any procedure in the set should be evaluated on that basis. For the auditor's purpose, the significance of deviations from primary control procedures is affected by the potential effectiveness of, and compliance with, any auxiliary control procedures.

.21 As indicated in section 320.71, the auditor's reliance on internal accounting control may result in his restricting, but not eliminating, his application of other auditing procedures. Therefore, the impact of procedural deviations on the auditor's evaluation for this purpose is somewhat less than it would be if complete reliance on internal control were contemplated.

.22 As discussed later in this Appendix, the upper precision limit for compliance tests necessary to justify reliance on internal accounting control in performing substantive tests depends on factors such as the importance of the pertinent procedures (including the matters discussed in paragraph .20), the qualitative aspects of the procedural deviations (see paragraph .16), the nature and amount of any related substantive errors, and the extent of reliance to be placed on the procedures. The precision limits discussed in this paragraph for compliance tests relate only to deviations from pertinent procedures, which may or may not result in substantive errors in the accounting records (see paragraph .19); substantive errors should be considered separately in evaluating substantive tests in relation to the precision considered necessary for that purpose. Based on consideration of the general matters discussed in paragraphs .19 through .21 and of the specific factors mentioned in this paragraph, an auditor may decide, for example, that an upper precision limit of 10 percent for compliance tests would be reasonable; if substantial reliance is to be placed upon the procedures, he may decide, for example, that a limit of 5 percent or possibly lower would be reasonable.

Reliability for Compliance Tests

.23 As indicated in the preceding discussion, the precision obtained is related to the condition of the population being tested. In contrast, the reliability level is related to the probability that the auditor's conclusion based on this precision will be correct. Thus, the choice of reliability level establishes the level of confidence the auditor desires; it is the complement of the level of sampling risk he is willing to assume that his conclusion will be incorrect.

.24 To illustrate this concept of reliability, assume that the auditor decided, for example, that a 95 percent reliability level would be reasonable for a sample designed to test compliance with a particular procedure or set of related procedures. Based on this decision, an audit sample may result in an upper precision limit of 6 percent at the related reliability level of 95 percent. If the actual but unknown rate of procedural deviations in the population exceeds 6 percent, at least 95 percent of all possible samples of the same size that could be selected from the same population would result in upper precision limits that would exceed 6 percent. Therefore, at least 95 percent of such samples would protect the auditor against the risk of overevaluating the degree of compliance with the procedures. Similarly, if the auditor decides that a 90 percent reliability level would be reasonable, at least 90 percent of all samples would protect the auditor against the risk of overevaluating the degree of compliance with the procedures.

Substantive Tests

.25 The discussion in section 320 concerning the purpose and nature of substantive tests applies also to the discussion of those matters in this Appendix. The feature of audit interest in performing substantive tests of details is the monetary amount of errors that would affect the financial statements being audited. In this paragraph and in those that follow, "errors" include both unintentional errors and intentional irregularities.

.26 The foregoing discussion of the interpretation of precision and reliability with reference to compliance tests applies also to substantive tests, with the understanding that the term "upper precision limit" refers to the monetary amount of error stated as an absolute value. Although compliance tests and substantive tests are discussed separately herein, the same sample can serve both purposes as explained in paragraph .37.

Precision for Substantive Tests

.27 The upper precision limit for errors in an individual substantive test should be established so as to be consistent with the overall audit objective to obtain reasonable assurance that the financial statements taken as a whole are not materially in error. Since materiality is an accounting as well as an auditing concept and is beyond the scope of section 320, the committee expresses no further views on that subject at this time.

Reliability for Substantive Tests

.28 A narrow range of reliability levels was illustrated in the foregoing discussion of tests of compliance. This was considered appropriate for such tests because the evidence obtained from them is the primary source of the auditor's reliance with respect to compliance. This is not the case, however, in determining the reliability level for substantive tests because the reliance on these tests is to be combined with the reliance on internal accounting control. This concept is expressed in section 320A.19 as follows:

> . . . These standards [the second and third standards of field work] taken together imply that the combination of the auditor's reliance on internal control and on his auditing procedures should provide a reasonable basis for his opinion in all cases, although the portion of

> reliance derived from the respective sources may properly vary between cases. For statistical samples designed to test the validity or bona fides of accounting data and to be evaluated in monetary terms, the committee believes the foregoing concept should be applied by specifying reliability levels that vary inversely with the subjective reliance assigned to internal control and to any other auditing procedures or conditions relating to the particular matters to be tested by such samples.

The foregoing reference to "subjective reliance assigned to internal control" introduces another element on which judgment is required. Considerations relevant to the exercise of judgment in this respect are discussed in the paragraphs that follow.

.29 The risks to be considered in determining ". . . the combination of the auditor's reliance on internal control and on his auditing procedures [that] should provide a reasonable basis for his opinion in all cases . . ." are described in section 320A as follows:

> .14 . . . [T]he ultimate risk against which the auditor and those who rely on his opinion require reasonable protection is a combination of two separate risks. The first of these is that material errors will occur in the accounting process by which the financial statements are developed. The second is that any material errors that occur will not be detected in the auditor's examination.
>
> .15 The auditor relies on internal control to reduce the first risk and on his tests of details and his other auditing procedures to reduce the second.

The combined risk of both of the related adverse events occurring jointly is the product of the respective individual risks, and the combined reliability is the complement of such combined risk.

.30 The risk that material errors will not be detected in the auditor's examination is measured by the complement of the reliability level used if the auditor compares the upper precision limit of monetary error to the amount he considers material. This is the basis for the discussion pertaining to reliability in subsequent paragraphs. On the other hand, if the auditor adopts the decision rule to accept the book value as materially correct only if it is included in the statistical precision range, this constitutes a hypothesis test and he should interpret the following paragraphs in that context.

.31 The reliability levels discussed in the following paragraphs refer to the auditor's substantive tests as a whole for particular classes of transactions or balances. As indicated in section 320, the reliance on substantive tests may be derived from tests of details, from analytical review procedures, or from any combination of both that is appropriate in the circumstances. This concept is consistent with the references to "other auditing procedures" in the excerpts from section 320A in paragraphs .28 and .29. Consequently, the reliability levels mentioned later may be achieved by combining the reliability from one or more statistical samples that serve a particular audit purpose with the "subjective reliance assigned to . . . any other auditing procedures" that serve the same purpose. The combined reliability is the complement of the combined risk that none of the procedures would accomplish the particular audit purpose, and the combined risk is the product of such risks for the respective individual procedures. While the combination of statistical and subjective reliance as discussed in this paragraph is conceptually sound, there is a practical problem in reasonable quantification of subjective reliance. This problem, however, does not arise from the use of statistical sampling but is implicit in any event in the process of evaluating audit evidence and reaching conclusions.

.32 If the auditor's evaluation indicates that little if any reliance should be assigned to internal accounting control for the purpose of particular substantive tests, he may decide after considering other relevant factors that a reliability level of 95 percent, for example, would be reasonable for those substantive tests.

.33 If the auditor's evaluation indicates that both the prescribed procedures and the degree of compliance with them are satisfactory, the other extreme would be to assign all of the desired reliance to internal accounting control and require none from substantive tests. As indicated in section 320.71, however, generally accepted auditing standards contemplate that other procedures will be restricted, but not eliminated, through reliance on internal accounting control. This position recognizes that the maximum potential effectiveness even of satisfactory procedures is something less than complete because of the inherent limitations discussed in section 320.34. The focal point for judgment in determining the reliance to be assigned to satisfactory internal accounting control is the portion of the risk of occurrence of material errors that may reasonably be expected to be eliminated by such control. The remaining risk is the portion reasonably attributable to the inherent limitations of such control.

.34 The auditor's judgment concerning the reliance to be assigned to internal accounting control and other relevant factors should determine the reliability level to be used for substantive tests. Such reliability should be set so that the combination of it and the subjective reliance on internal accounting control and other relevant factors will provide a combined reliability level conceptually equal to that which would be used in the circumstances described in paragraph .32. Thus, the reliability level for substantive tests for particular classes of transactions or balances is not an independent or isolated decision; it is a direct consequence of the auditor's evaluation of internal accounting control, and cannot be construed properly out of this context.

.35 The concept expressed in paragraph .34 can be applied by use of the following formula:

$$S = 1 - \frac{(1-R)}{(1-C)}$$

Where

S = Reliability level for substantive tests.

R = Combined reliability level desired (e.g., 95 percent as illustrated in paragraph .32).

C = Reliance assigned to internal accounting control and other relevant factors.

This concept is illustrated in the following table, for which the combined reliability level desired is assumed, for illustrative purposes, to be 95 percent:

Auditor's Judgment Concerning Reliance to Be Assigned to Internal Accounting Control and Other Relevant Factors	Resulting Reliability Level for Substantive Tests
90%	50%
70%	83%
50%	90%
30%	93%

.36 A final factor that is important in considering the reasonableness of the reliability levels mentioned herein for substantive tests is the risk of occurrence of material errors in financial statements in the absence of satisfactory internal accounting control. Because the magnitude of this risk is unknown, it has been treated implicitly and conservatively as being 100 percent in deriving such reliability levels, although audit experience indicates clearly that it is substantially lower. Consequently, the effective combined reliability levels are greater than those mentioned herein.

Dual-Purpose Tests

.37 Compliance tests and substantive tests have been discussed separately because of the different considerations relating to each. In practice, however, the same sample often can be taken and evaluated for both purposes. The only additional requirement in designing a dual-purpose sample is to determine that it will be adequate to provide the more stringent precision and reliability for the two purposes. In evaluating such samples, procedural deviations and substantive monetary errors should be evaluated separately, using the reliability level applicable for the respective purposes.

The next page is 307.

AU Section 321

The Effects of EDP on the Auditor's Study And Evaluation of Internal Control

Issue date, unless otherwise indicated: December, 1974

Introduction

.01 Section 320, "The Auditor's Study and Evaluation of Internal Control," defines internal control in terms of administrative control and accounting control.[1] That section also sets forth the basic concepts of accounting control and concludes that accounting control is within the scope of the study and evaluation of internal control contemplated by generally accepted auditing standards, while administrative control is not.

.02 Section 320.33 discusses methods of data processing as follows:

> Since the definition and related basic concepts of accounting control are expressed in terms of objectives, they are independent of the method of data processing used; consequently, they apply equally to manual, mechanical, and electronic data processing systems. However, the organization and procedures required to accomplish those objectives may be influenced by the method of data processing used.

Because the method of data processing used may influence the organization and procedures employed by an entity to accomplish the objectives of accounting control, it may also influence the procedures employed by an auditor in his study and evaluation of accounting control to determine the nature, timing, and extent of audit procedures to be applied in his examination of financial statements.

.03 A data processing system may be wholly manual or may include a combination of manual activities, mechanical activities, and electronic data processing (EDP) activities. EDP applications vary considerably, from routine applications that process a small payroll to complex, integrated applications that process accounting, production, marketing, and administrative information simultaneously. In some data processing systems, accounting control procedures are performed

[1] See section 320.09-.29.

by people in one or more departments. In EDP systems, many or even most of these control procedures may be performed by the EDP process itself. When EDP is used in significant accounting applications,[2] the auditor should consider the EDP activity in his study and evaluation of accounting control. This is true whether the use of EDP in accounting applications is limited or extensive and whether the EDP facilities are operated under the direction of the auditor's client or a third party.

.04 The first general auditing standard is as follows: "The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor."[3] If a client uses EDP in its accounting system, whether the application is simple or complex, the auditor needs to understand the entire system sufficiently to enable him to identify and evaluate its essential accounting control features. Situations involving the more complex EDP applications ordinarily will require that the auditor apply specialized expertise in EDP in the performance of the necessary audit procedures.

.05 This section describes the effects of the use of EDP on the various characteristics of accounting control and on an auditor's study and evaluation thereof. It is intended to be read in conjunction with section 320. The concepts in this Statement are expressed in general terms. An auditor likely will need to refer to other sources of information to apply the concepts in particular audit situations.[4] Those sources include continuing education courses, data processing manuals, current textbooks, and current professional literature.

EDP Accounting Control Procedures

.06 Some EDP accounting control procedures relate to all EDP activities (general controls) and some relate to a specific accounting task, such as preparation of account listings or payrolls (application controls).

.07 General controls comprise (a) the plan of organization and operation of the EDP activity, (b) the procedures for documenting,

[2] Significant accounting applications are those that relate to accounting information that can materially affect the financial statements the auditor is examining.

[3] Section 150.02.

[4] This section is intended to provide a framework for the development of further guidance concerning auditing procedures in examining financial statements of entities that use EDP in accounting applications.

reviewing, testing and approving systems or programs and changes thereto, (c) controls built into the equipment by the manufacturer (commonly referred to as "hardware controls"), (d) controls over access to equipment and data files, and (e) other data and procedural controls affecting overall EDP operations. Weaknesses in general controls often have pervasive effects. When general controls are weak or absent, the auditor should consider the effect of such weakness or absence in the evaluation of application controls.

.08 Application controls relate to specific tasks performed by EDP. Their function is to provide reasonable assurance that the recording, processing, and reporting of data are properly performed. There is considerable choice in the particular procedures and records used to effect application controls. Application controls often are categorized as "input controls," "processing controls," and "output controls."

a. Input controls are designed to provide reasonable assurance that data received for processing by EDP have been properly authorized, converted into machine sensible form and identified, and that data (including data transmitted over communication lines) have not been lost, suppressed, added, duplicated, or otherwise improperly changed. Input controls include controls that relate to rejection, correction, and resubmission of data that were initially incorrect.

b. Processing controls are designed to provide reasonable assurance that electronic data processing has been performed as intended for the particular application; i.e., that all transactions are processed as authorized, that no authorized transactions are omitted, and that no unauthorized transactions are added.

c. Output controls are designed to assure the accuracy of the processing result (such as account listings or displays, reports, magnetic files, invoices, or disbursement checks) and to assure that only authorized personnel receive the output.

.09 EDP accounting control procedures may be performed within an EDP organization, a user department, or a separate control group. The department or unit in which accounting control procedures are performed is less significant than the performance of the procedures by persons having no incompatible functions for accounting control purposes and the effectiveness of the procedures.

The Effects of EDP on the Characteristics of Accounting Control

.10 The objectives and the essential characteristics of accounting control do not change with the method of data processing. However, organization and control procedures used in electronic data processing may differ from those used in manual or mechanical data processing. For example, electronic data processing of sales, billings, and accounts receivable may perform the ancillary function of verifying invoice totals and extensions, a control that usually is established in manual data processing through independent clerical calculations. Further, in some EDP systems (such as one using direct terminal input as the basic source of data to be processed in a payroll, cost accounting, or inventory control application) control functions that otherwise would be performed by several individuals and departments may be concentrated within the EDP activity. Paragraphs .11 through .23 describe the effects of EDP on the essential characteristics of accounting control.[5]

Segregation of Functions

.11 As set forth in section 320.36, incompatible functions for accounting control purposes are those that place any person in a position both to perpetrate and to conceal errors or irregularities in the normal course of his duties. Many EDP systems not only process accounting data but also include procedures for detecting errors and irregularities and for providing specific authorization for certain kinds of transactions. Since the procedures may be combined, incompatible functions may be more likely to be combined in an EDP activity than in a manual activity.

.12 Frequently, functions that would be considered incompatible if performed by a single individual in a manual activity are performed through the use of an EDP program or series of programs. A person having the opportunity to make unapproved changes to any such programs performs incompatible functions in relation to the EDP activity. For example, a program for an accounts-payable application may have been designed to process for payment a vendor's invoice only if accompanied by a purchase-order record agreeing with the invoice as to prices and quantities and a receiving record indicating receipt of

[5] Those characteristics are described in section 320.35-.48.

the goods or services. In the absence of adequate control over program changes, an unapproved revision might change the application so that unsubstantiated payments could be made to vendors.

.13 EDP data files frequently are basic records of an accounting system. They cannot be read or changed without the use of EDP, but they can be changed through the use of EDP without visible evidence that a change has occurred. A person in a position to make unapproved changes in EDP data files performs incompatible functions. In the example of the accounts-payable application in the preceding paragraph, an individual who could make unapproved changes in the files containing purchase orders and receiving reports might be able to add spurious records purporting to represent purchase orders and receiving reports to the files, thereby causing the program to process for payment unapproved vendor invoices.

.14 Supervisory programs are used in some EDP systems to perform generalized functions for more than one application program. Supervisory programs include (a) "operating systems," which control EDP equipment that may process one or more application programs at a given time and (b) "data management systems," which perform standardized data handling functions for one or more application programs. An individual who can make unapproved changes in supervisory programs has opportunities to initiate unauthorized transactions that are like those of a person who can make unapproved changes in application programs or data files; he therefore performs incompatible functions.

.15 Paragraphs .11 through .14 discuss incompatible functions related to matters such as assignment of duties, changes in programs, maintenance of data files, and operating or data management systems. If individuals involved perform incompatible functions, compensating controls may be applied. For example, a plan of organization and operation may contain controls over access to EDP equipment, effective library controls and provisions for effective supervision and rotation of personnel Also, user departments or other control groups may establish independent document counts or totals of significant data fields. Compensating controls frequently are supplemented by internal audit procedures.

Execution of Transactions

.16 The extent to which EDP is used to execute steps in a transaction cycle varies. For example, EDP may be used in an accounting application for reordering materials: (a) to determine items to be ordered and prepare the purchase orders, (b) to identify items that require replenishment and prepare a notification list for use by purchasing department personnel, or (c) to prepare inventory listings for review by purchasing department personnel.

.17 To the extent that EDP is used to execute steps in a transaction cycle, the EDP application program usually includes accounting control procedures designed to assure that the steps are executed in conformity with specific or general authorizations issued by persons (including, in advanced systems, customers or other persons not employed by the entity) acting within the scope of their authority. Those procedures might include checks to recognize data that fall outside predetermined limits and tests for overall reasonableness.

Recording of Transactions

.18 Accounting control is concerned with recording of transactions at the amounts and in the accounting periods in which they were executed and with their classification in appropriate accounts. The use of EDP to process or initiate and record transactions may affect the source and extent of possible errors.

.19 To be usable in EDP, data are converted into machine-sensible form. The initial recording of the transactions or the initiation of transactions by the processing of previously recorded data may introduce errors that could affect balances and reports unless data input is properly controlled. Procedures of various types are used to maintain accounting control over data conversion. Some are manual, some are an integral part of the EDP program, and some are built into the EDP equipment by the manufacturer.

.20 The use of EDP often provides an opportunity to improve accounting control relating to the recording of transactions. For example, EDP equipment is not subject to errors caused by fatigue or carelessness. It processes and records like transactions in a like manner. It may be programmed to detect certain types of invalid or unusual transactions. The procedures for these purposes may be more comprehensive, effective, and efficient than manual control procedures having the same objectives. On the other hand, a transaction may be processed incorrectly by EDP if the EDP program does not provide for the particular set of relevant circumstances, whereas the same transaction might be questioned in a manual system.

.21 The effectiveness of accounting control over the recording of transactions by EDP depends on both (a) the functioning of the EDP procedures that record the transactions and produce the output (such as account listings or displays, summaries, magnetic files, and exception reports) and (b) the follow-up or other actions of users of the output. For example, an EDP program might reject from further processing invoices with improperly coded customer numbers. However, if users who receive exception reports on those items do not correct the customer numbers and resubmit the invoices for processing, accounts receivable and sales will be understated.

Access to Assets

.22 EDP personnel have access to assets[6] if the EDP activity includes the preparation or processing of documents that lead to the use or disposition of the assets. EDP personnel have direct access to cash, for example, if the EDP activity includes the preparation and signing of disbursement checks. Sometimes access by EDP personnel to assets may not be readily apparent because the access is indirect. For example, EDP may generate payment orders authorizing issuance of checks, shipping orders authorizing release of inventory, or transfer orders authorizing release of customer-owned securities. Controls such as those discussed in paragraph .15 should be established to minimize the possibility of unauthorized access to assets by EDP personnel.

Comparison of Recorded Accountability With Assets

.23 EDP frequently is used to compare recorded accountability with assets. For example, EDP may summarize physical counts of inventories or securities and compare the recorded quantities with the summarized counts. If EDP is so used, conditions under which errors or irregularities may occur should be considered. For example, there may be opportunities to overstate physical counts, insert fictitious physical counts, or suppress the printout of differences. Many

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[6] See section 320.42.

of the considerations described in paragraphs .18 through .21 may also apply.

Review of the System

.24 An auditor's review of a client's system of accounting control should encompass all significant and relevant manual, mechanical, and EDP activities and the interrelationship between EDP and user departments. The review should comprehend both the control procedures related to transactions from origination or source to recording in the accounting records and the control procedures related to recorded accountability for assets. The objectives of the auditor's review of accounting control within EDP are similar to those for manual and mechanical processing. The review is an information-gathering process that depends on knowledgeable inquiries directed to client personnel, observation of job assignments and operating procedures, and reference to available documentation related to accounting control.

.25 The preliminary phase of an auditor's review should be designed to provide an understanding of the flow of transactions[7] through the accounting system, the extent to which EDP is used in each significant accounting application, and the basic structure of accounting control. During the preliminary phase, the auditor may identify some of the specific accounting control procedures relating to each application and may become aware of apparent material weaknesses in the procedures. The auditor's preliminary understanding ordinarily is obtained by inquiry, but it also may be obtained by observing client personnel and reviewing documentation. Such preliminary understanding of EDP procedures normally relates to the general controls and application controls discussed in paragraphs .06 through .09.

.26 After completing the preliminary phase of his review as described in paragraph .25, for each significant accounting application the auditor should be in a position to assess the significance of accounting control within EDP in relation to the entire system of accounting control and therefore to determine the extent of his review of EDP accounting control.

[7] For a description of the flow of transactions, see section 320.19-.25.

a. The auditor may conclude that accounting control procedures within the EDP portions of the application or applications appear to provide a basis for reliance thereon and for restricting the extent of his substantive tests. In that event, unless the auditor chose to follow the procedures described in paragraph .26c, he would complete his review of the EDP accounting control procedures, perform related tests of compliance, and evaluate the control procedures to determine the extent of his reliance thereon and the extent to which substantive tests may be restricted.

b. The auditor may conclude that there are weaknesses in accounting control procedures in the EDP portions of the application or applications sufficient to preclude his reliance on such procedures. In that event, he would discontinue his review of those EDP accounting control procedures and forgo performing compliance tests related to those procedures; *he would not be able to rely* on those EDP accounting control procedures. The auditor would assess the potential impact on the financial statements he is examining of such weaknesses as have come to his attention, and would accomplish his audit objectives by other means.

c. The auditor may decide not to extend his preliminary review and not to perform tests of compliance related to accounting control procedures (either in general or as to certain procedures) within the EDP portions of the application or applications even though he concludes that the controls appear adequate. In that event, *he would not be able to rely* on those EDP accounting control procedures. Situations of this type could be those in which –

   (1) The auditor concludes that the audit effort required to complete his review and test compliance would exceed the reduction in effort that could be achieved by reliance upon the EDP accounting controls.

   (2) The auditor concludes that certain EDP accounting control procedures are redundant because other accounting control procedures are in existence.

Tests of Compliance

.27 The purpose of tests of compliance is to provide reasonable assurance that accounting control procedures are being applied as prescribed. Tests of compliance are concerned primarily with the questions: (a) Were the necessary procedures performed? (b) How were they performed? (c) By whom were they performed?

.28 Some accounting control procedures within the EDP activity leave visible evidence indicating that the procedures were performed. An example of such evidence is a file documenting (a) program changes for each EDP application and (b) approval of the changes. Other examples are EDP-generated error listings and exception reports.

.29 Some accounting control procedures within the EDP activity, especially those in programs that are designed to detect erroneous or invalid data, leave no visible evidence indicating that the procedures were performed. Then, the auditor should test these controls by reviewing transactions submitted for processing[8] to determine that no transactions tested have unacceptable conditions or that unacceptable conditions present were reported and appropriately resolved. The review may be done manually if conditions permit, or the auditor may be able or find it necessary to use EDP to detect unacceptable conditions, either by using his own independent programs or by using copies of the client's programs that the auditor has independently determined to be adequate for his purposes. An alternative approach to testing compliance with accounting control procedures in computer programs is to review and test the programs and then to perform tests to provide assurance that the tested programs actually were used for processing. However, the auditor should be aware that this approach can be used only when effective controls exist over access and changes to programs used for processing.

.30 Some accounting control procedures within the EDP activity leave neither visible nor machine-readable evidence. For example, one of the major characteristics of accounting control is the proper segregation of functions. Evidence that such accounting control procedures are functioning is obtained by observing client personnel and making corroborative inquiries.

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[8] For a discussion of timing and extent of tests, see section 320.60-.63.

Evaluation of the System

.31 Evaluation of the EDP aspects of a system of accounting control is not different conceptually from the evaluation of other aspects of the system and should be an integral part of the auditor's evaluation of the system.[9] Accounting control procedures performed both within the EDP activity and by user departments influence the effectiveness of the system and should be considered together by the auditor. The effects of the auditor's evaluation on the extent of his other auditing procedures are described in section 320.69-.75.

The next page is 319.

[9] See section 320.64-.68, for a description of the auditor's approach to the evaluation of accounting control.

AU Section 322

The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination

(Supersedes section 320.74)

Issue date, unless otherwise indicated: December, 1975

.01 The work of internal auditors cannot be substituted for the work of the independent auditor; however, the independent auditor should consider the procedures, if any, performed by internal auditors in determining the nature, timing, and extent of his own auditing procedures. This section provides guidance on the factors that affect an independent auditor's consideration of the work of internal auditors in an examination made in accordance with generally accepted auditing standards.

.02 Internal auditors often perform a number of services for management, including, but not limited to, studying and evaluating internal accounting control,[1] reviewing operating practices to promote increased efficiency and economy, and making special inquiries at management's direction. This section is applicable to the inde-

[1] See section 320.50, for an explanation of the two phases of the study of internal accounting control.

pendent auditor's consideration, in making his study and evaluation of internal accounting control, of the work performed by internal auditors. The section applies whether the work performed by internal auditors is part of their normal duties or is performed at the request of the independent auditor. It also applies to situations in which internal auditors perform work directly for the independent auditor (see paragraph .10).

.03 When internal auditors study and evaluate internal accounting control or perform substantive tests of the details of transactions and balances, they serve a special function. They are not part of internal accounting control in the same manner as would be an individual who verifies the mathematical accuracy of all invoices; instead, they act as a separate, higher level of control to determine that the system is functioning effectively. This section is not applicable to personnel with the title "internal auditor" who do not perform such a function. Conversely, personnel with other titles who perform such a function should be considered internal auditors for purposes of this section.

.04 The independent auditor should acquire an understanding of the internal audit function as it relates to his study and evaluation of internal accounting control. The work performed by internal auditors may be a factor in determining the nature, timing, and extent of the independent auditor's procedures. If the independent auditor decides that the work performed by internal auditors may have a bearing on his own procedures, he should consider the competence and objectivity of internal auditors and evaluate their work.

Reviewing the Competence and Objectivity of Internal Auditors

.05 Section 320.35, regarding the role of client personnel who perform accounting and related work with respect to accounting control, states in part:

> Reasonable assurance that the objectives of accounting control are achieved depends on the competence and integrity of personnel, the

independence of their assigned functions, and their understanding of the prescribed procedures.

.06 When considering the competence of internal auditors, the independent auditor should inquire about the qualifications of the internal audit staff, including, for example, consideration of the client's practices for hiring, training, and supervising the internal audit staff.

.07 When considering the objectivity of internal auditors, the independent auditor should consider the organizational level to which internal auditors report the results of their work and the organizational level to which they report administratively. This frequently is an indication of the extent of their ability to act independently of the individuals responsible for the functions being audited. One method for judging internal auditors' objectivity is to review the recommendations made in their reports.

Evaluating the Work of Internal Auditors

.08 In evaluating the work of internal auditors, the independent auditor should examine, on a test basis, documentary evidence of the work performed by internal auditors and should consider such factors as whether the scope of the work is appropriate, audit programs are adequate, working papers adequately document work performed, conclusions reached are appropriate in the circumstances, and any reports prepared are consistent with the results of the work performed. The independent auditor should also perform tests of some of the work of internal auditors. The extent of these tests will vary depending on the circumstances, including the type of transactions and their materiality. These tests may be accomplished by either (a) examining some of the transactions or balances that internal auditors examined or (b) examining similar transactions or balances but not those actually examined by internal auditors. The independent auditor should compare the results of his tests with the results of the internal auditors' work in reaching conclusions on that work.

Arrangements With Internal Auditors

.09 When the work of internal auditors is expected to be significant to the independent auditor's study and evaluation of internal accounting control, the independent auditor should, at the outset of the engagement, inform internal auditors of the reports and working papers he will need. He should also consult with internal auditors concerning work they are performing, since work not yet completed may also have a bearing on his examination. Also, work done by internal auditors will frequently be more useful to the independent auditor if plans for the work are discussed in advance.

Using Internal Auditors to Provide Direct Assistance to the Independent Auditor

.10 The independent auditor may make use of internal auditors to provide direct assistance in performing an examination in accordance with generally accepted auditing standards. Internal auditors may assist in performing substantive tests or tests of compliance. When the independent auditor makes such use of internal auditors, he should consider their competence and objectivity and supervise and test their work to the extent appropriate in the circumstances.

Judgments on Audit Matters

.11 When the independent auditor considers the work of internal auditors in determining the nature, timing, and extent of his own audit procedures or when internal auditors provide direct assistance in the performance of his work, judgments as to the effectiveness of internal accounting control, sufficiency of tests performed, materiality of transactions, and other matters affecting his report on the financial statements must be those of the independent auditor.

The next page is 325.

AU Section 330

Evidential Matter

Issue date, unless otherwise indicated: November, 1972

.01 The third standard of field work is:

> 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.

.02 Most of the independent auditor's work in formulating his opinion on financial statements consists of obtaining and examining evidential matter. The measure of the validity of such evidence for audit purposes lies in the judgment of the auditor; in this respect audit evidence differs from legal evidence, which is circumscribed by rigid rules. Evidential matter varies substantially in its influence on the auditor as he develops his opinion with respect to financial statements under examination. The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.

Nature of Evidential Matter

.03 Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor.

.04 The books of original entry, the general and subsidiary ledgers, related accounting manuals, and such informal and memorandum records as work sheets supporting cost allocations, computations, and reconciliations all constitute evidence in support of the financial statements. By itself, accounting data cannot be considered sufficient support for financial statements; on the other hand, without adequate attention to the propriety and accuracy of the underlying accounting data, an opinion on financial statements would not be warranted.

.05 Corroborating evidential matter includes documentary material such as checks, invoices, contracts, and minutes of meetings; confirmations and other written representations by knowledgeable people; information obtained by the auditor from inquiry, observation, inspection, and physical examination; and other information developed by, or available to, the auditor which permits him to reach conclusions through valid reasoning.

.06 The auditor tests underlying accounting data by analysis and review, by retracing the procedural steps followed in the accounting process and in developing the work sheets and allocations involved, by recalculation, and by reconciling related types and applications of the same information. In a soundly conceived and carefully maintained system of accounting records, there is an internal integrity and interrelationship discoverable through such procedures that constitutes persuasive evidence that the financial statements do present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.

.07 The pertinent documentary material to support entries in the accounts and representations in the financial statements ordinarily is on hand in the company's files and available to the auditor for examination. Both within the company's organization and outside it are knowledgeable people to whom the auditor can direct inquiries. Assets having physical existence are available to the auditor for his inspection. Activities of company personnel can be observed. Based on certain conditions as he observes them, conditions of internal control for example, he can reason to conclusions with respect to the validity of various representations in the financial statements.

Competence of Evidential Matter

.08 To be competent, evidence must be both valid and relevant. The validity of evidential matter is so dependent on the circumstances under which it is obtained that generalizations about the reliability of various types of evidence are subject to important exceptions. If the possibility of important exceptions is recognized, however, the following presumptions, which are not mutually exclusive, about the validity of evidential matter in auditing have some usefulness:

a. When evidential matter can be obtained from independent sources outside an enterprise, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the enterprise.

b. When accounting data and financial statements are developed under satisfactory conditions of internal control, there is more assurance as to their reliability than when they are developed under unsatisfactory conditions of internal control.

c. Direct personal knowledge of the independent auditor obtained through physical examination, observation, computation, and inspection is more persuasive than information obtained indirectly.

Sufficiency of Evidential Matter

.09 The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his professional judgment after a careful study of the circumstances in the particular case. In making such decisions, he should consider the nature of the item under examination; the materiality of possible errors and irregularities; the degree of risk involved, which is dependent on the adequacy of the internal control and susceptibility of the given item to conversion, manipulation, or misstatement; and the kinds and competence of evidential matter available.

.10 The independent auditor's objective is to obtain sufficient competent evidential matter to provide him with a reasonable basis for forming an opinion under the circumstances. In the great majority of cases, the auditor finds it necessary to rely on evidence that is persuasive rather than convincing. Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole present fairly, in conformity with generally accepted accounting principles, the financial position, results of operations, and changes in financial position are of such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being examined.

.11 To the extent the auditor remains in substantial doubt as to any assertion of material significance, he must refrain from formulating an opinion until he has obtained sufficient competent evidential matter to remove such substantial doubt, or he must express a qualified opinion or a disclaimer of opinion.

.12 An auditor typically works within economic limits; his opinion, to be economically useful, must be formulated within a reasonable length of time and at reasonable cost. The auditor must decide, again exercising professional judgment, whether the evidential matter available to him within the limits of time and cost is sufficient to justify formulation and expression of an opinion.

.13 As a guiding rule, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. In determining the usefulness of evidence, relative risk may properly be given consideration. The matter of difficulty and expense involved in testing a particular item is not in itself a valid basis for omitting the test.

.14 In determining the extent of a particular audit test and the method of selecting items to be examined, the auditor might consider using statistical sampling techniques which have been found to be advantageous in certain instances. The use of statistical sampling does not reduce the use of judgment by the auditor but provides certain statistical measurements as to the results of audit tests, which measurements may not otherwise be available.

.15 The independent auditor should be thorough in his search for evidential matter and objective in its evaluation. In selecting procedures to obtain competent evidential matter, he should recognize the possibility that the financial statements may not be presented fairly in conformity with generally accepted accounting principles. In developing his opinion, the auditor must give consideration to relevant evidential matter regardless of whether it appears to support or to contradict the representations made in the financial statements.

The next page is 331.

AU Section 331

Evidential Matter for Receivables and Inventories

Issue date, unless otherwise indicated: November, 1972

.01 Confirmation of receivables and observation of inventories are generally accepted auditing procedures. The independent auditor who issues an opinion when he has not employed them must bear in mind that he has the burden of justifying the opinion expressed.

.02 The purpose of this section is to provide guidelines for the independent auditor in confirming receivables and observing inventories. This section relates only to confirmation of receivables and observation of inventories and does not deal with other important auditing procedures which generally are required for the independent auditor to satisfy himself as to these assets.

Receivables

.03 Confirmation of receivables requires direct communication with debtors either during or after the period under audit; the confirmation date, the method of requesting confirmations, and the number to be requested are determined by the independent auditor. Such matters as the effectiveness of internal control, the apparent possibility of disputes, inaccuracies or irregularities in the accounts, the probability that requests will receive consideration or that the debtor will be able to confirm the information requested, and the materiality of the amounts involved are factors to be considered by the auditor in selecting the information to be requested and the form of confirmation, as well as the extent and timing of his confirmation procedures.

.04 Two forms of confirmation request are (a) the "positive" form of request, wherein the debtor is asked to respond whether or not he is in agreement with the information given, and (b) the "negative" form of request, wherein the debtor is asked to respond only if he disagrees with the information given.

.05 Because the use of the positive form results in either (a) the receipt of a response from the debtor constituting evidence regarding the debt or (b) the use of other procedures to provide evidence as to the validity and accuracy of significant[1] non-responding accounts, the use of the positive form is preferable when individual account balances are relatively large or when there is reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. The negative form is useful particularly when internal control surrounding accounts receivable is considered to be effective, when a large number of small balances are involved, and when the auditor has no reason to believe the persons receiving the requests are unlikely to give them consideration. If the negative rather than the positive form of confirmation is used, the number of requests sent or the extent of the other auditing procedures applied to the receivable balance should normally be greater in order for the independent auditor to obtain the same degree of satisfaction with respect to the accounts receivable balance.

.06 In many situations a combination of the two forms may be appropriate, with the positive form used for large balances and the negative form for small balances.

.07 Confirmation procedures may be directed toward account balances with debtors or toward individual items included in such balances. The latter procedure may be particularly useful when the nature of the accounts or the debtors' records are not likely to permit successful confirmation of account balances.

.08 When the independent auditor sets out to confirm receivables by means of positive requests, he should generally follow up with a second and sometimes an additional request to those debtors from

[1] In this context, "significant" refers to those confirmation requests that the auditor believes would be likely to influence his evaluation of the accounts selected for confirmation. In making his decision in this respect, the auditor should be mindful that such evaluation is to be extended to the accounts receivable as a whole and therefore he should consider the basis on which he determined the number and amount of confirmations requested, the method of selection of the particular accounts, and any unusual factors relevant in the circumstances.

whom he receives no reply. The auditor should employ such alternative procedures as are practicable to obtain adequate evidence necessary to satisfy himself as to those significant[1] requests for which he receives no replies. These procedures may include examination of evidence of subsequent cash receipts, cash remittance advices, sales and shipping documents, and other records.

Inventories

.09 When inventory quantities are determined solely by means of a physical count, and all counts are made as of the balance-sheet date or as of a single date within a reasonable time before or after the balance-sheet date, it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests, and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client's representations about the quantities and physical condition of the inventories.

.10 When the well-kept perpetual inventory records are checked by the client periodically by comparisons with physical counts, the auditor's observation procedures usually can be performed either during or after the end of the period under audit.

.11 In recent years, some companies have developed inventory controls or methods of determining inventories, including statistical sampling, which are highly effective in determining inventory quantities and which are sufficiently reliable to make unnecessary an annual physical count of each item of inventory. In such circumstances, the independent auditor must satisfy himself that the client's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year. The auditor must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used. If statistical sampling methods are used by the client in the taking of the physical inventory, the auditor must be satisfied that the sampling plan has statistical validity, that it has been properly applied, and that the resulting precision and reliability, as defined statistically,[2] are reasonable in the circumstances.

[1] See definition of "significant" in footnote 1 to paragraph .05.

[2] See section 320A, "Relationship of Statistical Sampling to Generally Accepted Auditing Standards."

.12 When the independent auditor has not satisfied himself as to inventories in the possession of the client through the procedures described in paragraphs .09–.11, tests of the accounting records alone will not be sufficient for him to become satisfied as to quantities; it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions. This should be coupled with a review of the records of any client's counts and procedures relating to the physical inventory on which the balance-sheet inventory is based.

.13 The independent auditor may be asked to make an examination of financial statements covering the current period and one or more periods for which he had not observed or made some physical counts of prior inventories. He may, nevertheless, be able to become satisfied as to such prior inventories through appropriate procedures, such as tests of prior transactions, reviews of the records of prior counts, and the application of gross profit tests, provided that he has been able to become satisfied as to the current inventory.

Inventories Held in Public Warehouses[1]

.14 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 the custodians is acceptable provided that, where the amount involved represents a significant proportion of the current assets or the total assets, supplemental inquiries are made to satisfy the independent auditor as to the bona fides of the situation.

.15 The supplemental inquiries include the following steps to the extent the auditor considers necessary in the circumstances:

a. Discussion with the owner as to owner's control procedures in investigating the warehouseman, and tests of related evidential matter.
b. Review of the owner's control procedures concerning performance of the warehouseman, and tests of related evidential matter.
c. Observation of physical counts of the goods wherever practicable and reasonable.

[1] See section 901 for Special Report of Committee on Auditing Procedure.

d. Where warehouse receipts have been pledged as collateral, confirmation (on a test basis, where appropriate) from lenders as to pertinent details of the pledged receipts.

Effect on the Auditor's Report

.16 For a discussion of the circumstances relating to receivables and inventories affecting the independent auditor's report, see sections 509.12 and 542.05. [As amended, effective for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2.] (See section 509.)

The next page is 341.

AU Section 332

Evidential Matter for Long-Term Investments

Issue date, unless otherwise indicated: November, 1972

.01 The purpose of this section is to furnish guidance in applying generally accepted auditing standards to examinations of the financial statements of companies with long-term investments accounted for under either the cost method or the equity method. Such investments may be represented by capital stock or other equity interests, bonds and similar debt obligations, and loans and advances that are in the nature of investments. This section is concerned with evidential matter which should be examined by the auditor in corroboration of (a) amounts at which long-term investments are stated in financial statements of the investor, (b) amounts reported as the investor's share of earnings or losses and other transactions of the investee, and (c) related disclosures.

Objectives of Examination

.02 The independent auditor should ascertain whether long-term investments are accounted for in conformity with generally accepted accounting principles consistently applied and whether the related disclosures are adequate. He should, therefore, examine sufficient competent evidential matter supporting the existence, ownership, cost, and carrying amount of investments, income and losses attributable to such investments and any related disclosures in the investor's financial statements. With respect to investments accounted for under the equity method, he should also examine such evidential matter regarding the investor's accounting for its share of capital and other transactions of the investee.

.03 With respect to the carrying amount of investments, a loss in value which is other than a temporary decline should be recognized in the financial statements of an investor.* The independent auditor should, therefore, also examine sufficient competent evi-

* See AC section 5132, *Accounting for Certain Marketable Securities.*

dential matter to the extent he deems necessary to determine whether such a loss in value has occurred.

Types of Evidence

.04 Evidential matter pertaining to the existence, ownership, and cost of long-term investments includes accounting records and documents of the investor relating to their acquisition. In the case of investments in the form of securities (such as stocks, bonds, and notes), this evidential matter should be corroborated by inspection of the securities, or in appropriate circumstances, by written confirmation from an independent custodian of securities on deposit, pledged, or in safekeeping. In the case of loans, advances, and registered bonds and similar debt obligations, evidential matter obtained from accounting records and documents also should be corroborated by written confirmation from the debtor or trustee.

.05 Evidential matter pertaining to the carrying amount of long-term investments, income and losses attributable to such investments, and capital and other transactions of the investee may be available in the following forms:

a. Audited Financial Statements

Financial statements of the investee generally constitute sufficient evidential matter as to the equity in underlying net assets and results of operations of the investee when such statements have been examined by the investor's auditor or by another independent auditor whose report is satisfactory, for this purpose, to the investor's auditor. Audited financial statements also constitute one of the items of evidential matter that may be used with respect to investments in bonds and similar debt obligations, loans, and advances.

b. Unaudited Financial Statements

(i) Unaudited financial statements, reports issued on examination by regulatory bodies and taxing authorities, and similar data provide information and evidence but are not by themselves sufficient as evidential matter.

(ii) By application of auditing procedures to the financial statements of an investee, the auditor obtains evidential matter as to the equity in underlying net assets and results of operations of the investee. The auditor for the investor may utilize the investee's auditor for this purpose. The materiality of the investment in relation to the financial statements of the investor is a factor which should be considered in determining the extent and nature of such procedures.

c. Market Quotations

If market quotations of security prices are based on a reasonably broad and active market, they ordinarily constitute sufficient competent evidential matter as to the current market value of unrestricted securities.

d. Other Evidential Matter

(i) When the carrying amount of an investment reflects (a) factors (such as mineral rights, growing timber, patents, and goodwill) which are not recognized in financial statements of the investee or (b) fair values of assets which are materially different from the investee's carrying amounts, evidential matter may be available in the form of current evaluations of these factors. Evaluations made by persons within the investor or within the investee may be acceptable; evaluations made by persons independent of these companies will usually provide greater assurance of reliability than evaluations made by persons within the companies.

(ii) Negotiable securities, real estate, chattels, or other property are often assigned as collateral for investments in bonds, notes, loans, or advances. If the collateral is an important factor in considering collectibility of the obligation, the auditor should satisfy himself regarding the existence and transferability of such collateral and should obtain evidential matter as to its value (such as market quotations, the amount of underlying net assets, or appraisals) as may be appropriate in the circumstances.

Equity Method of Accounting

.06 Paragraph 17 of Accounting Principles Board Opinion No. 18 [AC section 5131.17] states that the equity method of accounting for an investment in common stock should be used by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. It also provides several criteria to be considered in determining whether the investor has the ability to exercise significant influence. Paragraph 16 of Opinion No. 18 [AC section 5131.16] states that the equity method should also be followed for investments in common stock of corporate joint ventures.

.07 The auditor has a responsibility to satisfy himself with respect to the appropriateness of the accounting method adopted for investments in voting stock of an investee. Inquiry should be made of the investor's management as to (a) whether the investor has the ability to exercise significant influence over operating and financial policies of the investee under the criteria set forth in paragraph 17 of Opinion No. 18 [AC section 5131.17] and (b) the attendant circumstances which serve as a basis for management's conclusion. The auditor should evaluate the information received on the basis of facts otherwise obtained by him in the course of his audit.

.08 When an investor accounts for an investment in an investee contrary to the applicable presumption contained in paragraph 17 of Opinion No. 18[1] [AC section 5131.17], the auditor should examine sufficient competent evidential matter to satisfy himself that such presumption has been overcome and that appropriate disclosure is made regarding the reasons for not accounting for the investment in keeping with the presumption.[2]

.09 The refusal of an investee to furnish necessary financial data to the investor is evidence (but not necessarily conclusive evidence) that the investor does not have the ability to exercise significant influence over operating and financial policies of the investee such as to justify the application of the equity method of

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[1] Paragraph 17 states: ". . . an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such an ability can be demonstrated."

[2] See Accounting Principles Board Opinion No. 18, paragraph 20, footnote 13 [AC section 5131.20, footnote 13].

accounting for investments in 50% or less owned companies in accordance with the provisions of Opinion No. 18 [AC section 5131].

.10 An investor should include its proportionate share of an investee's results of operations based on data obtained from the investee's most recent reliable financial statements, which may be its audited year-end statements.

.11 An investor may include its proportionate share of the results of operations of an investee based on the investee's unaudited interim financial statements. An example of this would be a situation in which an investor whose year ends on June 30 includes its equity in earnings of an investee based on the investee's financial statements for the six-month period ended December 31 and the six-month period ended June 30. In such situations, the auditor for the investor should recognize that although the investee's financial statements for the year ended December 31 may have been audited, the financial statements as of June 30 and for the year then ended represent unaudited data because neither six-month period is covered by an auditor's report. Auditing procedures (see paragraph .05 b(ii)) should be applied to such unaudited financial statements to the extent considered necessary in view of their materiality in relation to the financial statements of the investor.

.12 In many instances there will be a time lag in reporting between the dates of the financial statements of the investor and those of the investee. A time lag in reporting should be consistent from period to period. If a change in time lag occurs which the auditor deems to have a material effect on the investor's financial statements, he should express in his opinion an exception as to consistency.

.13 With respect to events and transactions of the investee from the date of the investee's financial statements to the date of the report of the auditor of the investor, the auditor should read available interim financial statements of the investee and make appropriate inquiries of the investor. Further, the auditor should ascertain through such inquiries that the investor has made itself aware of any material events or transactions arising subsequent to the date of the investee's financial statements. Such events or transactions of the type contemplated by section 560.05–.06, which are material in relation to the financial statements of the investor, should be disclosed in the notes to the investor's financial statements and (where applicable) labeled as unaudited information. For the purpose of recording the investor's share of the results of operations of the investee, recognition should be given to events or transactions of the type contemplated by section 560.03 which are material in relation to the financial statements of the investor.

.14 In certain circumstances, events or transactions during the period between the date of the investee's financial statements and the date of the investor's financial statements may be of such a nature and significance as to cause a loss in value of the investment which should be recognized in the investor's financial statements (see paragraph 19h of Opinion No. 18) [AC section 5131.19h].

.15 For investments accounted for under the equity method, data relating to transactions between the investor and investee should be obtained for purposes of determining the proper elimination of unrealized intercompany profits and losses. Normally, such data are not shown separately in the financial statements of the investee and may have to be obtained from the investee. If the amounts of unrealized intercompany profits or losses could reasonably be expected to be material in relation to the investor's financial position or results of operations, unaudited data obtained from the investee ordinarily should be subjected to auditing procedures (see paragraph .05 b(ii)).

Effect on the Auditor's Report

.16 For a discussion of circumstances relating to long-term investments affecting the independent auditor's report, see sections 542.06 and 543.14. [As amended, effective for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2.] (See section 509.)

The next page is 355.

AU Section 335

Related Party Transactions

Issue date, unless otherwise indicated: July, 1975

.01 This section provides guidance on procedures that should be considered by the auditor when he is performing an examination of financial statements in accordance with generally accepted auditing standards to identify related party transactions and to satisfy himself as to the substance of and accounting for such transactions, including financial statement disclosure.[1] The procedures set forth herein should not be considered all inclusive. Also, not all of them may be required in every examination.

.02 For purposes of this section, the term *related parties* means the reporting entity; its affiliates;[2] principal owners, management, and members of their immediate families;[3] entities for which investments are accounted for by the equity method; and any other party with which the reporting entity may deal when one party has the ability to significantly influence the management or operating policies of the other, to the extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Related parties also exist when another entity has the ability to significantly influence the management or operating policies of the transacting parties or

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[1] When financial statements are presented on a consolidated or combined basis, this section does not apply to transactions that are eliminated in the preparation of the financial statements.

[2] The term *affiliate* means a party that directly or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with, a specified party. *Control* means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a specified party whether through ownership, by contract, or otherwise.

[3] The term *principal owner* means the owner(s) of record or known beneficial owner(s) of more than 10% of the voting interests of the reporting entity. The term *management* means any person(s) having responsibility for achieving the objectives of the organization and the concomitant authority to establish the policies and make the decisions by which such objectives are to be pursued. It would normally include members of the board of directors, the president, secretary, treasurer, any vice president in charge of a principal business function (such as sales, administration, or finance), and any other individual person who performs similar policy making functions.

when another entity has an ownership interest in one of the transacting parties and the ability to significantly influence the other, to the extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

.03 Examples of related party transactions include transactions between a parent company and its subsidiaries, transactions between or among subsidiaries of a common parent, and transactions in which the reporting entity participates with other affiliated businesses, with management[4] or with principal stockholders (or other ownership interests). Transactions between or among the foregoing parties are considered to be related party transactions even though they may not be given accounting recognition. For example, an entity may provide services to a related party without charge.

.04 Sometimes two or more entities are under common ownership or management control, but they do not transact business between or among themselves. Mere existence of common control, however, may result in operating results or financial position significantly different from those that would have been obtained if the entities were autonomous. For example, two or more entities in the same line of business may be commonly controlled by a party with the ability to increase or decrease the volume of business done by each. Consequently, the nature of the common control should be disclosed.

.05 An entity may be economically dependent on one or more parties with which it transacts a significant volume of business, such as a sole or major customer, supplier, franchisor, franchisee, distributor, general agent, borrower, or lender. Such parties should not be considered related parties solely by virtue of economic dependency unless one of them clearly exercises significant management or ownership influence over the other. Disclosure of economic dependency may, however, be necessary for a fair presentation of financial position, results of operations, or changes in financial position in conformity with generally accepted accounting principles.

[4]Compensation arrangements, expense allowances, and other similar items in the ordinary course of business are not deemed to be related party transactions for purposes of this section.

Accounting Considerations

.06 Except for the disclosure requirements of the Securities and Exchange Commission's Regulation S-X and the accounting treatment prescribed by certain Opinions of the Accounting Principles Board when related parties are involved, established accounting principles ordinarily do not require transactions with related parties to be accounted for on a basis different from that which would be appropriate if the parties were not related. Until such time as applicable accounting principles are established by appropriate authoritative bodies, the auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure of the existence of such transactions and their significance in the financial statements of the reporting entity. He should be aware that the substance of a particular transaction could be significantly different from its form.[5]

.07 Generally, financial statements should recognize the economic substance of transactions rather than merely their legal form. Accounting Principles Board Statement No. 4, paragraph 35 [AC section 1022.27], states: "Although financial accounting is concerned with both the legal and economic effects of transactions and other events and many of its conventions are based on legal rules, the economic substance of transactions and other events are usually emphasized when economic substance differs from legal form."

.08 Examples of transactions that raise questions as to their substance and that may be indicative of the existence of related parties are the following:

a. Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below current market rates.

b. Selling real estate at a price that differs significantly from its appraised value.

[5] The importance of recognizing substance, when it differs from form, of various transactions and presentations has been established in authoritative pronouncements. Those pronouncements specify criteria for determining, presenting, and accounting for the substance of certain transactions and events. Examples include (a) presenting consolidated financial statements instead of separate statements of the component legal entities (ARB No. 51) [AC section 2051]; (b) capitalizing leases (APB Opinion No. 5) [AC section 5351]; and (c) imputing an appropriate interest rate when the face amount of a note does not reasonably represent the present value of the consideration given or received in exchange therefor (APB Opinion No. 21) [AC section 4111].

c. Exchanging property for similar property in a nonmonetary transaction.

d. Making loans with no scheduled terms as to when or how the funds will be repaid.

Audit Procedures

.09 An examination made in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered. Nevertheless, during the course of his examination, the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements. Many of the procedures outlined in the following paragraphs are normally performed in an examination in accordance with generally accepted auditing standards, even if the auditor has no reason to suspect that related party transactions exist. Other audit procedures set forth herein are specifically directed to related party transactions.

.10 In determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component to the total entity. He should evaluate internal accounting controls over management activities, and he should consider the business purpose served by the various components of the entity. Normally, the business structure and style of operating are based on the abilities of management, tax and legal considerations, product diversification, and geographical location. Experience has shown, however, that business structure and operating style are occasionally deliberately designed to obscure related party transactions.

.11 In the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business. The auditor should, however, be aware of the possibility that transactions with related parties may have been motivated solely, or in large measure, by conditions similar to the following:

a. Lack of sufficient working capital or credit to continue the business.

b. An urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's stock.

c. An overly optimistic earnings forecast.

d. Dependence on a single or relatively few products, customers, or transactions for the ongoing success of the venture.

e. A declining industry characterized by a large number of business failures.

f. Excess capacity.

g. Significant litigation, especially litigation between stockholders and management.

h. Significant obsolescence dangers because the company is in a high-technology industry.

Determining the Existence of Related Parties

.12 The auditor should place emphasis on auditing material transactions with parties he knows are related to the reporting entity. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of specific audit procedures which may include the following:

a. Evaluate the company's procedures for identifying and properly accounting for related party transactions.

b. Inquire of appropriate management personnel as to the names of all related parties and whether there were any transactions with these parties during the period.

c. Review filings by the reporting entity with the Securities and Exchange Commission and other regulatory agencies for the names of related parties and for other businesses in which officers and directors occupy directorship or management positions.

d. Determine the names of all pension and other trusts established for the benefit of employees and the names of the officers and trustees thereof.[6]

e. Review stockholder listings of closely held companies to identify principal stockholders.

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[6]If the trusts are managed by or under the trusteeship of management, they should be deemed to be related parties for purposes of this section.

f. Review prior years' workpapers for the names of known related parties.

g. Inquire of predecessor, principal, or other auditors of related entities as to their knowledge of existing relationships and the extent of management involvement in material transactions.

h. Review material investment transactions during the period under examination to determine whether the nature and extent of investments during the period create related parties.

Identifying Transactions With Related Parties

.13 The following procedures are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships:

a. Provide audit personnel performing segments of the examination or examining and reporting separately on the accounts of related components of the reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their examinations.

b. Review the minutes of meetings of the board of directors and executive or operating committees for information as to material transactions authorized or discussed at their meetings.

c. Review proxy and other material filed with the Securities and Exchange Commission and comparable data filed with other regulatory agencies for information as to material transactions with related parties.

d. Review "conflict-of-interests" statements obtained by the company from its management.[7]

e. Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships.

f. Consider whether transactions are occurring, but are not being given accounting recognition, such as receiving or providing ac-

[7]Conflict-of-interests statements are intended to provide the board of directors with information as to the existence or nonexistence of relationships between the reporting persons and parties with whom the company transacts business.

counting, management, or other services at no charge or a major stockholder absorbing corporate expenses.

g. Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.

h. Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.

i. Review invoices from law firms that have performed regular or special services for the company for indications of the existence of related parties or related party transactions.

j. Review confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.

Examining Identified Related Party Transactions

.14 After identifying related party transactions, the auditor should apply the procedures he considers necessary to obtain satisfaction as to the purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management. Procedures that should be considered include the following:

a. Obtain an understanding of the business purpose of the transaction.[8]

b. Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents.

c. Determine whether the transaction has been approved by the board of directors or other appropriate officials.

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[8]Until the auditor understands the business sense of material transactions, he cannot complete his examination. If he lacks sufficient specialized knowledge to understand a particular transaction, he should consult with persons who do have the requisite knowledge.

d. Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements.

e. Arrange for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with an appropriate exchange of relevant information.

f. Inspect or confirm and obtain satisfaction as to the transferability and value of collateral.

.15 When necessary to fully understand a particular transaction, the following procedures which might not otherwise be deemed necessary to comply with generally accepted auditing standards should be considered:[9]

a. Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.

b. Inspect evidence in possession of the other party or parties to the transaction.

c. Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.

d. Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.

e. With respect to material uncollected balances, guarantees, and other obligations, obtain information as to the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

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[9]Arrangements for certain procedures should be made or approved in advance by appropriate client officials.

Disclosure

.16 To satisfy himself as to the adequacy of disclosure with respect to a specific related party transaction, the auditor should determine whether he has obtained sufficient competent evidential matter to enable him to understand the relationship of the parties, the substance of the transaction, which may differ from its form, and the effects of the transaction on the financial statements. He should then evaluate all the information available to him with respect to the transaction and satisfy himself on the basis of his professional judgment that the transaction is adequately disclosed in the financial statements (see section 430.02).

.17 Disclosure in financial statements of a reporting entity that has participated in related party transactions that are material, individually or in the aggregate, should include the following:

a. The nature of the relationship(s).

b. A description of the transactions (summarized when appropriate) for the period reported on, including amounts, if any, and such other information as is deemed necessary to an understanding of the effects on the financial statements.

c. The dollar volume of transactions and the effects of any change in the method of establishing terms from that used in the preceding period.

d. Amounts due from or to related parties and, if not otherwise apparent, the terms and manner of settlement.

.18 Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or, assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, representations to the effect that a transaction was consummated on terms no less favorable than those that would have been obtained if the transaction had been with an unrelated party are difficult to substantiate. If such a representation is included in the financial statements and the auditor is unable to reach a conclusion as to the propriety thereof, he should consider including in his report a comment to that effect and expressing a qualified opinion or disclaiming an opinion (see section 509.10-.12). If he believes that the representation is misleading, the auditor should express a qualified or adverse opinion, depending on materiality (see section 509.15 and 509.16).

Effective Date

.19 Statements on Auditing Standards generally are effective at the time of their issuance. Since this section, however, provides for practices that may differ in certain respects from practices heretofore considered acceptable, this section will be effective for examinations of financial statements for periods ending on or subsequent to December 26, 1975.

→ *The next page is 371.* ←

* [Editor's Note: See section 509.27.]

AU Section 336

Using the Work of a Specialist

Issue date, unless otherwise indicated: December, 1975

.01 The purpose of this section is to provide guidance to the auditor who uses the work of a specialist in performing an examination of financial statements in accordance with generally accepted auditing standards.[1] For purposes of this section, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. Examples of such specialists include actuaries, appraisers, attorneys, engineers, and geologists.[2]

Decision to Use the Work of a Specialist

.02 The auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. During his examination, however, an auditor may encounter matters potentially material to the fair presentation of financial statements in conformity with generally accepted accounting principles that require special knowledge and that in his judgment require using the work of a specialist.

[1] This section does not apply to using the work of a specialist who is a member of the auditor's staff, or to the form or content of letters of audit inquiry concerning litigation, claims, or assessments and lawyers' responses thereto.

[2] For purposes of this section, a person whose special skill or knowledge relates to the internal affairs or business practices of the client, such as a credit or plant manager, is not considered a specialist.

.03 Examples of the types of matters that the auditor may decide require him to consider using the work of a specialist include, but are not limited to, the following:

a. Valuation (e.g., works of art, special drugs, and restricted securities).
b. Determination of physical characteristics relating to quantity on hand or condition (e.g., mineral reserves or materials stored in piles above ground).
c. Determination of amounts derived by using specialized techniques or methods (e.g., certain actuarial determinations).
d. Interpretation of technical requirements, regulations, or agreements (e.g., the potential significance of contracts or other legal documents, or legal title to property).

.04 In performing an examination of financial statements in accordance with generally accepted auditing standards, the auditor may use the work of a specialist as an audit procedure to obtain competent evidential matter. The circumstances surrounding the use of a specialist differ. Although the familiarity of individual auditors with the work performed by certain types of specialists may differ, the auditing procedures necessary to comply with generally accepted auditing standards need not vary as a result of the extent of the auditor's knowledge.

Selecting a Specialist

.05 The auditor should satisfy himself concerning the professional qualifications and reputation of the specialist by inquiry or other procedures, as appropriate. The auditor should consider the following:

a. The professional certification, license, or other recognition of the competence of the specialist in his field, as appropriate.
b. The reputation and standing of the specialist in the views of his peers and others familiar with his capability or performance.
c. The relationship, if any, of the specialist to the client.

.06 Ordinarily, the auditor should attempt to obtain a specialist who is unrelated to the client. However, when the circumstances so warrant, work of a specialist having a relationship to the client may be acceptable (see paragraph .08). Work of a specialist unrelated to the client will usually provide the auditor with greater assurance of reliability because of the absence of a relationship that might impair objectivity.

.07 An understanding should exist among the auditor, the client, and the specialist as to the nature of the work to be performed by the specialist. Preferably, the understanding should be documented and should cover the following:

a. The objectives and scope of the specialist's work.
b. The specialist's representations as to his relationship, if any, to the client.
c. The methods or assumptions to be used.
d. A comparison of the methods or assumptions to be used with those used in the preceding period.
e. The specialist's understanding of the auditor's corroborative use of the specialist's findings in relation to the representations in the financial statements.
f. The form and content of the specialist's report that would enable the auditor to make the evaluation described in paragraph .08.

Using the Findings of the Specialist

.08 Although the appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist, the auditor should obtain an understanding of the methods or assumptions used by the specialist to determine whether the findings are suitable for corroborating the representations in the financial statements. The auditor should consider whether the specialist's findings support the related representations in the financial statements and make appropriate tests of accounting data provided by the client to the specialist. Ordinarily, the auditor would use the work of the specialist unless his procedures lead him to believe that the findings are unreasonable in the circumstances. If the specialist is related to the client (see paragraph .06), the auditor should consider performing additional procedures with respect to some or all of the related specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or engage an outside specialist for that purpose.

Effect of the Specialist's Work on the Auditor's Report

.09 If the auditor determines that the specialist's findings support the related representations in the financial statements, he may reasonably conclude that he has obtained sufficient competent evidential matter. If there is a material difference between the specialist's findings and the representations in the financial statements, or if the auditor believes that the determinations made by the specialist are unreasonable, he should apply additional procedures. If after applying any additional procedures that might be appropriate he is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved will ordinarily cause the auditor to conclude that he should qualify his opinion or disclaim an opinion because the inability to obtain sufficient competent evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation (see section 509.10-.11).

.10 The auditor may conclude after performing additional procedures, including possibly obtaining the opinion of another specialist, that the representations in the financial statements are not in conformity with generally accepted accounting principles. In that event, he should express a qualified or adverse opinion (see section 509.15-.17).

Reference to the Specialist in the Auditor's Report

.11 When expressing an unqualified opinion, the auditor should not refer to the work or findings of the specialist. Such a reference in an unqualified opinion might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.

.12 If the auditor decides to modify his opinion (see paragraphs .09 and .10) as a result of the report or findings of the specialist, reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the modification.

The next page is 381.

AU Section 337

Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments[1]

Issue date, unless otherwise indicated: January, 1976

.01 This section provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for satisfying himself as to the financial accounting and reporting for such matters when he is performing an examination in accordance with generally accepted auditing standards.

Accounting Considerations

.02 Management is responsible for adopting policies and procedures to identify, evaluate, and account for litigation, claims, and assessments as a basis for the preparation of financial statements in conformity with generally accepted accounting principles.

[1] This section supersedes the commentary, "Lawyers' Letters," January 1974 (AU section 1001), and auditing interpretations of section 560.12 on lawyers' letters, January 1975 (AU section 9560.01-.26). It amends section 560.12(d) to read as follows: "Inquire of client's legal counsel concerning litigation, claims, and assessments (see section 337)."

.03 The standards of financial accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments, are set forth in Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies."[2]

Auditing Considerations

.04 With respect to litigation, claims, and assessments, the independent auditor should obtain evidential matter relevant to the following factors:

a. The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments.
b. The period in which the underlying cause for legal action occurred.
c. The degree of probability of an unfavorable outcome.
d. The amount or range of potential loss.

Audit Procedures

.05 Since the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

a. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
b. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the

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[2] Pertinent portions are reprinted in Exhibit I, section 337B. [The full text of FASB Statement No. 5 is in AC section 4311, Volume 3, *AICPA Professional Standards*.] Statement No. 5 also describes the standards of financial accounting and reporting for gain contingencies. The auditor's procedures with respect to gain contingencies are parallel to those described in this SAS for loss contingencies.

balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel, and obtain assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by Statement of Financial Accounting Standards No. 5.

c. Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.

d. Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5. Also the auditor, with the client's permission, should inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.[3]

.06 An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention. Accordingly, the auditor should request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

.07 The independent auditor's examination normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments. Examples of such procedures are as follows:

a. Reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being examined.

b. Reading contracts, loan agreements, leases, and correspondence

[3] An example of a separate letter is as follows: We are writing to inform you that (name of company) has represented to us that (except as set forth below and excluding any such matters listed in the letter of audit inquiry) there are no unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 in its financial statements at (balance sheet date) and for the (period) then ended. (List unasserted possible claims, if any.) Such a letter should be signed and sent by the auditor.

from taxing or other governmental agencies, and similar documents.

c. Obtaining information concerning guarantees from bank confirmation forms.

d. Inspecting other documents for possible guarantees by the client.

Inquiry of a Client's Lawyer[4]

.08 A letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.[5] Evidential matter obtained from the client's inside general counsel or legal department may provide the auditor with the necessary corroboration. However, evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish.

.09 The matters that should be covered in a letter of audit inquiry include, but are not limited to, the following:

a. Identification of the company, including subsidiaries, and the date of the examination.

b. A list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.

c. A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome, with respect to which the lawyer has been engaged and to which he

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[4] An illustrative inquiry letter to legal counsel is contained in the Appendix (section 337A).

[5] It is not intended that the lawyer be requested to undertake a reconsideration of all matters upon which he was consulted during the period under examination for the purpose of determining whether he can form a conclusion regarding the probability of assertion of any possible claim inherent in any of the matters so considered.

has devoted substantive attention on behalf of the company in the form of legal consultation or representation.

d. As to each matter listed in item b, a request that the lawyer either furnish the following information or comment on those matters as to which his views may differ from those stated by management, as appropriate:
   (1) A description of the nature of the matter, the progress of the case to date, and the action the company intends to take (for example, to contest the matter vigorously or to seek an out-of-court settlement).
   (2) An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.
   (3) With respect to a list prepared by management, an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

e. As to each matter listed in item c, a request that the lawyer comment on those matters as to which his views concerning the description or evaluation of the matter may differ from those stated by management.

f. A statement by the client that the client understands that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client should disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5.

g. A request that the lawyer confirm whether the understanding described in item f is correct.

h. A request that the lawyer specifically identify the nature of and reasons for any limitation on his response.

Inquiry need not be made concerning matters that are not considered material, provided the client and the auditor have reached an understanding on the limits of materiality for this purpose.

.10 In special circumstances, the auditor may obtain a response concerning matters covered by the audit inquiry letter in a conference, which offers an opportunity for a more detailed discussion and explanation than a written reply. A conference may be appropriate when the evaluation of the need for accounting for or disclosure of litigation, claims, and assessments involves such matters as the evaluation of the effect of legal advice concerning unsettled points of law, the effect of uncorroborated information, or other complex judgments. The auditor should appropriately document conclusions reached concerning the need for accounting for or disclosure of litigation, claims, and assessments.

.11 In some circumstances, a lawyer may be required by his Code of Professional Responsibility to resign his engagement if his advice concerning financial accounting and reporting for litigation, claims, and assessments is disregarded by the client. When the auditor is aware that a client has changed lawyers or that a lawyer engaged by the client has resigned, the auditor should consider the need for inquiries concerning the reasons the lawyer is no longer associated with the client.

Limitations on the Scope of a Lawyer's Response [6]

.12 A lawyer may appropriately limit his response to matters to which he has given substantive attention in the form of legal consultation or representation. Also, a lawyer's response may be limited to matters that are considered individually or collectively material to the financial statements, provided the lawyer and auditor have reached an understanding on the limits of materiality for this purpose. Such limitations are not limitations on the scope of the auditor's examination.

.13 A lawyer's refusal to furnish the information requested in an

[6] The American Bar Association has approved a "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," which explains the concerns of lawyers and the nature of the limitations an auditor is likely to encounter. That Statement of Policy is reprinted as Exhibit II(section337C) for the convenience of readers, but is not an integral part of this Statement.

inquiry letter either in writing or orally (see paragraphs .09 and .10) would be a limitation on the scope of the auditor's examination sufficient to preclude an unqualified opinion (see section 509.10-.11).[7] A lawyer's response to such an inquiry and the procedures set forth in paragraph .05 provide the auditor with sufficient evidential matter to satisfy himself concerning the accounting for and reporting of pending and threatened litigation, claims and assessments. The auditor obtains sufficient evidential matter to satisfy himself concerning reporting for those unasserted claims and assessments required to be disclosed in financial statements from the foregoing procedures and the lawyer's specific acknowledgement of his responsibility to his client in respect of disclosure obligations (see paragraph .09g). This approach with respect to unasserted claims and assessments is necessitated by the public interest in protecting the confidentiality of lawyer-client communications.

Other Limitations on a Lawyer's Response

.14 A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome may sometimes not be within a lawyer's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available; and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, a lawyer may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor ordinarily will conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event which is not susceptible of reasonable estimation. If the effect of the matter on the financial statements could be material, the auditor ordinarily will conclude that he is unable to express an unqualified opinion (see section 509.21-.26).

The next page is 389.

[7] A refusal to respond should be distinguished from an inability to form a conclusion with respect to certain matters of judgment (see paragraph .14). Also, lawyers outside the United States sometimes follow practices at variance with those contemplated by this section to the extent that different procedures from those outlined herein may be necessary. In such circumstances, the auditor should exercise judgment in determining whether alternative procedures are adequate to comply with the requirements of this section.

AU Section 337A

Appendix — Illustrative Audit Inquiry Letter to Legal Counsel

Issue date, unless otherwise indicated: January, 1976

.01 In connection with an examination of our financial statements at (balance sheet date) and for the (period) then ended, management of the Company has prepared, and furnished to our auditors (name and address of auditors), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

Pending or Threatened Litigation (excluding unasserted claims)

[Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments (considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

[Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.]

AU Section 337B

Exhibit I — Excerpts from Statement of Financial Accounting Standards No. 5: Accounting for Contingencies*

March, 1975

The following excerpts are reprinted with the permission of the Financial Accounting Standards Board.

Introduction

1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss[1] (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. . . .

3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable, reasonably possible,* and *remote* to identify three areas within that range, as follows:

a) *Probable.* The future event or events are likely to occur.

b) *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.

c) *Remote.* The chance of the future event or events occurring is slight. . . .

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[1] The term *loss* is used for convenience to include many charges against income that are commonly referred to as *expenses* and others that are commonly referred to as *losses.*

*The full text of FASB Statement No. 5 is in AC section 4311, Volume 3, *AICPA Professional Standards.*

Standards of Financial Accounting and Reporting

Accrual of Loss Contingencies

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income[3] if *both* of the following conditions are met:

a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.[4] It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b) The amount of loss can be reasonably estimated.

Disclosure of Loss Contingencies

9. Disclosure of the nature of an accrual[5] made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.[6] The disclosure shall indicate the nature of the contingency and shall give an estimate of the

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[3] Paragraphs 23-24 of *APB Opinion No. 9*, "Reporting the Results of Operations," describe the "rare" circumstances in which a prior period adjustment is appropriate. Those paragraphs are not amended by this Statement.

[4] *Date of the financial statements* means the end of the most recent accounting period for which financial statements are being presented.

[5] Terminology used shall be descriptive of the nature of the accrual (see paragraphs 57-64 of *Accounting Terminology Bulletin No. 1*, "Review and Resume").

[6] For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(a) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements.

possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

11. After the date of an enterprise's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, e.g., an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, e.g., threat of expropriation of assets after the date of the financial statements or the filing for bankruptcy by an enterprise whose debt was guaranteed after the date of the financial statements. In none of the cases cited in this paragraph was an asset impaired or a liability incurred at the date of the financial statements, and the condition for accrual in paragraph 8(a) is, therefore, not met. Disclosure of those kinds of losses or loss contingencies may be necessary, however, to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements shall indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements where the amount of asset impairment or liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical financial statements. . . .

Litigation, Claims, and Assessments

33. The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with re-

spect to pending or threatened litigation and actual or possible claims and assessments:

a) The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.

b) The degree of probability of an unfavorable outcome.

c) The ability to make a reasonable estimate of the amount of loss.

34. As a condition for accrual of a loss contingency, paragraph 8(a) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for litigation, claims, or assessments whose underlying cause is an event or condition occurring after the date of financial statements but before those financial statements are issued, for example, a suit for damages alleged to have been suffered as a result of an accident that occurred after the date of the financial statements. Disclosure may be required, however, by paragraph 11.

35. On the other hand, accrual may be appropriate for litigation, claims, or assessments whose underlying cause is an event occurring on or before the date of an enterprise's financial statements even if the enterprise does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statements. If those financial statements have not been issued, accrual of a loss related to the litigation, claim, or assessment would be required if the probability of loss is such that the condition in paragraph 8(a) is met and the amount of loss can be reasonably estimated.

36. If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(a) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion

that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(a) is met.

37. The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(a) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement.

38. With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10.

39. As a condition for accrual of a loss contingency, paragraph 8(b) requires that the amount of loss can be reasonably estimated.

In some cases, it may be determined that a loss was incurred because an unfavorable outcome of the litigation, claim, or assessment is probable (thus satisfying the condition in paragraph 8(a)), but the range of possible loss is wide. For example, an enterprise may be litigating an income tax matter. In preparation for the trial, it may determine that, based on recent decisions involving one aspect of the litigation, it is probable that it will have to pay additional taxes of $2 million. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the enterprise may have to pay taxes of $8 million over and above the $2 million. In that case, paragraph 8 requires accrual of the $2 million if that is considered a reasonable estimate of the loss. Paragraph 10 requires disclosure of the additional exposure to loss if there is a reasonable possibility that additional taxes will be paid. Depending on the circumstances, paragraph 9 may require disclosure of the $2 million that was accrued.

AU Section 337C

Exhibit II—American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information

Preamble

The public interest in protecting the confidentiality of lawyer-client communications is fundamental. The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general

NOTE: This document, in the form herein set forth, was approved by the Board of Governors of the American Bar Association in December 1975, which official action permitted its release to lawyers and accountants as the standard recommended by the American Bar Association for the lawyer's response to letters of audit inquiry.

inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.

Consistent with the foregoing public policy considerations, it is believed appropriate to distinguish between, on the one hand, litigation which is pending or which a third party has manifested to the client a present intention to commence and, on the other hand, other contingencies of a legal nature or having legal aspects. As regards the former category, unquestionably the lawyer representing the client in a litigation matter may be the best source for a description of the claim or claims asserted, the client's position (e.g., denial, contest, etc.), and the client's possible exposure in the litigation (to the extent the lawyer is in a position to do so). As to the latter category, it is submitted that, for the reasons set forth above, it is not in the public interest for the lawyer to be required to respond to general inquiries from auditors concerning possible claims.

It is recognized that the disclosure requirements for enterprises subject to the reporting requirements of the Federal securities laws are a major concern of managements and counsel, as well as auditors. It is submitted that compliance therewith is best assured when clients are afforded maximum encouragement, by protecting lawyer-client confidentiality, freely to consult counsel. Likewise, lawyers must be keenly conscious of the importance of their clients being competently advised in these matters.

Statement of Policy

NOW, THEREFORE, BE IT RESOLVED that it is desirable and in the public interest that this Association adopt the following Statement of Policy regarding the appropriate scope of the lawyer's response to the auditor's request, made by the client at the request of the auditor, for information concerning matters referred to the lawyer during the course of his representation of the client:

(1) *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5, promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying Commentary), to the extent hereinafter set forth, subject to the following:

(a) Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.

(b) In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.

(c) Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.

(d) In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

(2) *Limitation on Scope of Response.* It is appropriate for the lawyer to set forth in his response, by way of limitation, the scope of his engagement by the client. It is also appropriate for the lawyer to indicate the date as of which information is furnished and to disclaim any undertaking to advise the auditor of changes which may thereafter be brought to the lawyer's attention. *Unless the lawyer's response*

*indicates otherwise, (a) it is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation and, where appropriate, legal representation since the beginning of the period or periods being reported upon, and (b) if a law firm or a law department, the auditor may assume that the firm or department has endeavored, to the extent believed necessary by the firm or department, to determine from lawyers currently in the firm or department who have performed services for the client since the beginning of the fiscal period under audit whether such services involved substantive attention in the form of legal consultation concerning those loss contingencies referred to in Paragraph 5(a) below but, beyond that, no review has been made of any of the client's transactions or other matters for the purpose of identifying loss contingencies to be described in the response.**

(3) *Response may be Limited to Material Items.* In response to an auditor's request for disclosure of loss contingencies of a client, it is appropriate for the lawyer's response to indicate that the response is limited to items which are considered individually or collectively material to the presentation of the client's financial statements.

(4) *Limited Responses.* Where the lawyer is limiting his response in accordance with this Statement of Policy, his response should so indicate (see Paragraph 8). If in any other respect the lawyer is not undertaking to respond to or comment on particular aspects of the inquiry when responding to the auditor, he should consider advising the auditor that his response is limited, in order to avoid any inference that the lawyer has responded to all aspects; otherwise, he may be assuming a responsibility which he does not intend.

(5) *Loss Contingencies.* When properly requested by the client, it is appropriate for the lawyer to furnish to the auditor information concerning the following matters if the lawyer has been engaged by the client to represent or advise the client professionally with respect thereto and he has devoted substantive attention to them in the form of legal representation or consultation:

(a) *overtly threatened or pending litigation,* whether or not specified by the client;

(b) *a contractually assumed obligation* which the client has specifically identified and upon which the client has specifically re-

* As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

quested, in the inquiry letter or a supplement thereto, comment to the auditor;

(c) *an unasserted possible claim or assessment* which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor.

With respect to clause (a), overtly threatened litigation means that a potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote. With respect to clause (c), where there has been no manifestation by a potential claimant of an awareness of and present intention to assert a possible claim or assessment, consistent with the considerations and concerns outlined in the Preamble and Paragraph 1 hereof, the client should request the lawyer to furnish information to the auditor only if the client has determined that it is probable that a possible claim will be asserted, that there is a reasonable possibility that the outcome (assuming such assertion) will be unfavorable, and that the resulting liability would be material to the financial condition of the client. Examples of such situations might (depending in each case upon the particular circumstances) include the following: (i) a catastrophe, accident or other similar physical occurrence in which the client's involvement is open and notorious, or (ii) an investigation by a government agency where enforcement proceedings have been instituted or where the likelihood that they will not be instituted is remote, under circumstances where assertion of one or more private claims for redress would normally be expected, or (iii) a public disclosure by the client acknowledging (and thus focusing attention upon) the existence of one or more probable claims arising out of an event or circumstance. In assessing whether or not the assertion of a possible claim is probable, it is expected that the client would normally employ, by reason of the inherent uncertainties involved and insufficiency of available data, concepts parallel to those used by the lawyer (discussed below) in assessing whether or not an unfavorable outcome is probable; thus, assertion of a possible claim would be considered probable only when the prospects of its being asserted seem reasonably certain (i.e., supported by extrinsic evidence strong enough to establish a presumption that it will happen) and the prospects of non-assertion seem slight.

It would not be appropriate, however, for the lawyer to be requested to furnish information in response to an inquiry letter or supplement thereto if it appears that (a) the client has been required to specify unasserted possible claims without regard to the standard suggested in the preceding paragraph, or (b) the client has been required to specify all or substantially all unasserted possible claims as to which legal advice may have been obtained, since, in either case, such a request would be in substance a general inquiry and would be inconsistent with the intent of this Statement of Policy.

The information that lawyers may properly give to the auditor concerning the foregoing matters would include (to the extent appropriate) an identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client.

In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote"; for purposes of any such judgment it is appropriate to use the following meanings:

(i) *probable*—an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.

(ii) *remote*—an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.

If, in the opinion of the lawyer, considerations within the province of his professional judgment bear on a particular loss contingency to the degree necessary to make an informed judgment, he may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is "probable" or "remote," applying the above meanings. No inference should be drawn, from the absence of such a judgment, that the client will not prevail.

The lawyer also may be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

The considerations bearing upon the difficulty in estimating loss (or range of loss) where pending litigation is concerned are obviously even more compelling in the case of unasserted possible claims. In most cases, the lawyer will not be able to provide any such estimate to the auditor.

As indicated in Paragraph 4 hereof, the auditor may assume that all loss contingencies specified by the client in the manner specified in clauses (b) and (c) above have received comment in the response, unless otherwise therein indicated. The lawyer should not be asked, nor need the lawyer undertake, to furnish information to the auditor concerning loss contingencies except as contemplated by this Paragraph 5.

(6) *Lawyer's Professional Responsibility.* Independent of the scope of his response to the auditor's request for information, the lawyer, depending upon the nature of the matters as to which he is engaged, may have as part of his professional responsibility to his client an obligation to advise the client concerning the need for or advisability of public disclosure of a wide range of events and circumstances. The lawyer has an obligation not knowingly to participate in any violation by the client of the disclosure requirements of the securities laws. In appropriate circumstances, the lawyer also may be required under the Code of Professional Responsibility to resign his engagement if his advice concerning disclosures is disregarded by the client. The auditor may properly assume that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements* of FAS 5.

(7) Limitation on Use of Response. Unless otherwise stated in the lawyer's response, it shall be solely for the auditor's information in connection with his audit of the financial condition of the client and is not to be quoted in whole or in part or otherwise referred to in

* Under FAS 5, when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment, disclosure of an unasserted possible claim is required only if the enterprise concludes that (i) it is probable that a claim will be asserted, (ii) there is a reasonable possibility, if the claim is in fact asserted, that the outcome will be unfavorable, and (iii) the liability resulting from such unfavorable outcome would be material to its financial condition.

*any financial statements of the client or related documents, nor is it to be filed with any governmental agency or other person, without the lawyer's prior written consent.** *Notwithstanding such limitation, the response can properly be furnished to others in compliance with court process or when necessary in order to defend the auditor against a challenge of the audit by the client or a regulatory agency, provided that the lawyer is given written notice of the circumstances at least twenty days before the response is so to be furnished to others, or as long in advance as possible if the situation does not permit such period of notice.**

(8) *General.* This Statement of Policy, together with the accompanying Commentary (which is an integral part hereof), has been developed for the general guidance of the legal profession. In a particular case, the lawyer may elect to supplement or modify the approach hereby set forth. If desired, this Statement of Policy may be incorporated by reference in the lawyer's response by the following statement: "This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any 'loss contingencies' is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement)."

The accompanying Commentary is an integral part of this Statement of Policy.

Commentary

Paragraph 1 (Client Consent to Response)

In responding to any aspect of an auditor's inquiry letter, the lawyer must be guided by his ethical obligations as set forth in the Code of Professional Responsibility. Under Canon 4 of the Code of Professional Responsibility a lawyer is enjoined to preserve the client's confidences (defined as information protected by the attorney-client privilege under applicable law) and the client's secrets (defined as

* As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client). The observance of this ethical obligation, in the context of public policy, ". . . not only facilitates the full development of facts essential to proper representation of the client but also encourages laymen to seek early legal assistance." (Ethical Consideration 4-1).

The lawyer's ethical obligation therefore includes a much broader range of information than that protected by the attorney-client privilege. As stated in Ethical Consideration 4-4: "The attorney-client privilege is more limited than the ethical obligation of a lawyer to guard the confidences and secrets of his client. This ethical precept, unlike the evidentiary privilege, exists without regard to the nature or source of information or the fact that others share the knowledge."

In recognition of this ethical obligation, the lawyer should be careful to disclose fully to his client any confidence, secret or evaluation that is to be revealed to another, including the client's auditor, and to satisfy himself that the officer or agent of a corporate client consenting to the disclosure understands the legal consequences thereof and has authority to provide the required consent.

The law in the area of attorney-client privilege and the impact of statements made in letters to auditors upon that privilege has not yet been developed. Based upon cases treating the attorney-client privilege in other contexts, however, certain generalizations can be made with respect to the possible impact of statements in letters to auditors.

It is now generally accepted that a corporation may claim the attorney-client privilege. Whether the privilege extends beyond the control group of the corporation (a concept found in the existing decisional authority), and if so, how far, is yet unresolved.

If a client discloses to a third party a part of any privileged communication he has made to his attorney, there may have been a waiver as to the whole communication; further, it has been suggested that giving accountants *access* to privileged statements made to attorneys may waive any privilege as to those statements. Any disclosure of privileged communications relating to a particular subject matter may have the effect of waiving the privilege on other communications with respect to the same subject matter.

To the extent that the lawyer's knowledge of unasserted possible claims is obtained by means of confidential communications from the client, any disclosure thereof might constitute a waiver as fully as if the communication related to pending claims.

A further difficulty arises with respect to requests for evaluation of either pending or unasserted possible claims. It might be argued that any evaluation of a claim, to the extent based upon a confidential communication with the client, waives any privilege with respect to that claim.

Another danger inherent in a lawyer's placing a value on a claim, or estimating the likely result, is that such a statement might be treated as an admission or might be otherwise prejudicial to the client.

The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between lawyers and auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.

Paragraph 2 (Limitation on Scope of Response)

In furnishing information to an auditor, the lawyer can properly limit himself to loss contingencies which he is handling on a substantive basis for the client in the form of legal consultation (advice and other attention to matters not in litigation by the lawyer in his professional capacity) or legal representation (counsel of record or other direct professional responsibility for a matter in litigation). Some auditors' inquiries go further and ask for information on matters of which the lawyer "has knowledge." Lawyers are concerned that such a broad request may be deemed to include information coming from a variety of sources including social contact and third-party contacts as well as professional engagement and that the lawyer might be criticized or subjected to liability if some of this information is forgotten at the time of the auditor's request.

It is also believed appropriate to recognize that the lawyer will not necessarily have been authorized to investigate, or have investigated, all legal problems of the client, even when on notice of some facts which might conceivably constitute a legal problem upon exploration and development. Thus, consideration in the form of preliminary or passing advice, or regarding an incomplete or hypothetical state of facts, or where the lawyer has not been requested to give studied attention to the matter in question, would not come within the concept of "substantive attention" and would therefore be excluded. Similarly excluded are matters which may have been mentioned by the client but which are not actually being handled by the lawyer. Paragraph 2 undertakes to deal with these concerns.

Paragraph 2 is also intended to recognize the principle that the appropriate lawyer to respond as to a particular loss contingency is the lawyer having charge of the matter for the client (e.g., the lawyer representing the client in a litigation matter and/or the lawyer having overall charge and supervision of the matter), and that the lawyer not having that kind of role with respect to the matter should not be expected to respond merely because of having become aware of its existence in a general or incidental way.

The internal procedures to be followed by a law firm or law department may vary based on factors such as the scope of the lawyer's engagement and the complexity and magnitude of the client's affairs. Such procedures could, but need not, include use of a docket system to record litigation, consultation with lawyers in the firm or department having principal responsibility for the client's affairs or other procedures which, in light of the cost to the client, are not disproportionate to the anticipated benefit to be derived. Although these procedures may not necessarily identify all matters relevant to the response, the evolution and application of the lawyer's customary procedures should constitute a reasonable basis for the lawyer's response.

As the lawyer's response is limited to matters involving his professional engagement as counsel, such response should not include information concerning the client which the lawyer receives in another role. In particular, a lawyer who is also a director or officer of the client would not include information which he received as a director or officer unless the information was also received (or, absent the dual role, would in the normal course be received) in his capacity as legal counsel in the context of his professional engagement. Where the auditor's request for information is addressed to a law firm as a firm, the law firm may properly assume that its response is not expected to include any information which may have been communicated to the particular individual by reason of his serving in the capacity of director or officer of the client. The question of the individual's duty, in his role as a director or officer, is not here addressed.

Paragraph 3 (Response May Cover only Material Items in Certain Cases)

Paragraph 3 makes it clear that the lawyer may optionally limit his responses to those items which are individually or collectively material to the auditor's inquiry. If the lawyer takes responsibility for making a determination that a matter is not material for the purposes of his response to the audit inquiry, he should make it clear that his response is so limited. The auditor, in such circumstance, should properly be entitled to rely upon the lawyer's response as providing him with the necessary corroboration. It should be emphasized that the employment of inside general counsel by the client should not detract from the acceptability of his response since inside general counsel is as fully bound by the professional obligations and responsibilities contained in the Code of Professional Responsibility as outside counsel. If the audit inquiry sets forth a definition of materiality but the lawyer utilizes a different test of materiality, he should specifically so state. The lawyer may wish to reach an understanding with the auditor concerning the test of materiality to be used in his response, but he need not do so if he assumes responsibility for the criteria used in making materiality determinations. Any such understanding with the auditor should be referred to or set forth in the lawyer's response. In this connection, it is assumed that the test of materiality so agreed upon would not be so low in amount as to result in a disservice to the client and an unreasonable burden on counsel.

Paragraph 4 (Limited Responses)

The Statement of Policy is designed to recognize the obligation of the auditor to complete the procedures considered necessary to satisfy himself as to the fair presentation of the company's financial condition and results, in order to render a report which includes an opinion not qualified because of a limitation on the scope of the audit. In this connection, reference is made to SEC Accounting Series Release No. 90, in which it is stated:

> "A 'subject to' or 'except for' opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The 'subject to' qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matters which cannot be resolved at statement date."

Paragraph 5 (Loss Contingencies)

Paragraph 5 of the Statement of Policy summarizes the categories of "loss contingencies" about which the lawyer may furnish information to the auditor. The term loss contingencies and the categories relate to concepts of accounting accrual and disclosure specified for the accounting profession in Statement of Financial Accounting Standards No. 5 ("FAS 5") issued by the Financial Accounting Standards Board in March, 1975.

5.1 *Accounting Requirements*

To understand the significance of the auditor's inquiry and the implications of any response the lawyer may give, the lawyer should be aware of the following accounting concepts and requirements set out in FAS 5:*

(a) A "loss contingency" is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more events occur or fail to occur. Resolutions of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability.

(Para. 1)

(b) When a "loss contingency" exists, the likelihood that a future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. There are three areas within that range, defined as follows:

(i) *Probable*—"The future event or events are likely to occur."

(ii) *Reasonably possible*—"The chance of the future event or events occurring is more than remote but less than likely."

(iii) *Remote*—"The chance of the future event or events occurring is slight."

(Para. 3)

(c) *Accrual* in a client's financial statements by a charge to income of the period will be required if *both* the following conditions are met:

(i) "Information available prior to issuance of the financial statements indicates that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be *probable* that one or more future events will occur confirming the fact of the loss." (emphasis added; footnote omitted)

(ii) "The amount of loss can be reasonably estimated."

(Para. 8)

(d) If there is no *accrual* of the loss contingency in the client's financial statements because one of the two conditions outlined in

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* Citations are to paragraph numbers of FAS 5.

(c) above are not met, *disclosure* may be required as provided in the following:

"If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, *disclosure* of the contingency *shall be made when there is at least a reasonable possibility* that a loss or an additional loss may have been incurred. *The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of* a loss contingency involving *an unasserted claim* or assessment *when there has been no manifestation by potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.*" (emphasis added; footnote omitted)

(Para. 10)

(e) The accounting requirements recognize or specify that (i) the opinions or views of counsel are not the sole source of evidential matter in making determinations about the accounting recognition or treatment to be given to litigation, and (ii) the fact that the lawyer is not able to express an opinion that the outcome will be favorable does not necessarily require an accrual of a loss. Paragraphs 36 and 37 of FAS 5 state as follows:

"If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(a) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(a) is met.

"The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(a) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement."

(f) Paragraph 38 of FAS 5 focuses on certain examples concerning the determination by the enterprise whether an assertion of an *unasserted possible claim* may be considered probable:

"With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10."

For a more complete presentation of FAS 5, reference is made to Exhibit I, section 337B, in which are set forth excerpts selected by the AICPA as relevant to a Statement on Auditing Standards, issued by its Auditing Standards Executive Committee, captioned "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments."

5.2 Lawyer's Response

Concepts of probability inherent in the usage of terms like "probable" or "reasonably possible" or "remote" mean different things in different contexts. Generally, the outcome of, or the loss which may result from, litigation cannot be assessed in any way that is comparable to a statistically or empirically determined concept of "probability" that may be applicable when determining such matters as reserves for warranty obligations or accounts receivable or loan losses when there is a large number of transactions and a substantial body of known historical experience for the enterprise or comparable enterprises. While lawyers are accustomed to counseling clients during the progress of litigation as to the possible amount required for settlement purposes, the estimated risks of the proceedings at particular times and the possible application or establishment of points of law that may be relevant, such advice to the client is not possible at many stages of the litigation and may change dramatically depending upon the development of the proceedings. Lawyers do not generally quantify for clients the "odds" in numerical terms; if they do, the quantification is generally only undertaken in an effort to make meaningful, for limited purposes, a whole host of judgmental factors applicable at a particular time, without any intention to depict "probability" in any statistical, scientific or empirically-grounded sense. Thus, for example, statements that litigation is being defended vigorously and that the client has meritorius defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense.

Likewise, the "amount" of loss—that is, the total of costs and damages that ultimately might be assessed against a client—will, in most litigation, be a subject of wide possible variance at most stages; it is the rare case where the amount is precise and where the question is whether the client against which claim is made is liable either for all of it or none of it.

In light of the foregoing considerations, it must be concluded that, as a general rule, it should not be anticipated that meaningful quantifications of "probability" of outcome or amount of damages can be given by lawyers in assessing litigation. To provide content to the definitions set forth in Paragraph 5 of the Statement of Policy, this Commentary amplifies the meanings of the terms under discussion, as follows:

> *"probable"*—An unfavorable outcome is normally "probable" if, but only if, investigation, preparation (including development of the factual data and legal research) and progress of the matter have reached a stage where a judgment can be made, taking all relevant factors into account which may affect the outcome, that it is extremely doubtful that the client will prevail.
>
> *"remote"*—The prospect for an unfavorable outcome appears, at the time, to be slight; i.e., it is extremely doubtful that the client will not prevail. Normally, this would entail the ability to make an unqualified judgment, taking into account all relevant factors which may affect the outcome, that the client may confidently expect to prevail on a motion for summary judgment on all issues due to the clarity of the facts and the law.

In other words, for purposes of the lawyer's response to the request to advise auditors about litigation, an unfavorable outcome will be "probable" only if the chances of the client prevailing appear slight and of the claimant losing appear extremely doubtful; it will be "remote" when the client's chances of losing appear slight and of not winning appear extremely doubtful. It is, therefore, to be anticipated that, in most situations, an unfavorable outcome will be neither "probable" nor "remote" as defined in the Statement of Policy.

The discussion above about the very limited basis for furnishing judgments about the outcome of litigation applies with even more force to a judgment concerning whether or not the assertion of a claim not yet asserted is "probable." That judgment will infrequently be one within the professional competence of lawyers and therefore the lawyer should not undertake such assessment except where such judgment may become meaningful because of the presence of special circumstances, such as catastrophes, investigations and previous public disclosure as cited in Paragraph 5 of the Statement of Policy, or similar extrinsic evidence relevant to such assessment. Moreover, it is unlikely, absent relevant extrinsic evidence, that the client or anyone else will be in a position to make an informed judgment that assertion of a possible claim is "probable" as opposed to "reasonably possible" (in which event disclosure is not required). In light of the legitimate concern that the public interest would not be well served by resolving uncertainties in a way that invites the assertion of claims or otherwise causes unnecessary harm to the client and its stockholders, a decision to treat an unasserted claim as "probable" of assertion should be based only upon compelling judgment.

Consistent with these limitations believed appropriate for the lawyer, he should not represent to the auditor, nor should any inference from his response be drawn, that the unasserted possible claims identified by the client (as contemplated by Paragraph 5(c) of the Statement of Policy) represent all such claims of which the lawyer may be aware or that he necessarily concurs in his client's determination of which unasserted possible claims warrant specification by the client; within proper limits, this determination is one which the client is entitled to make—and should make—and it would be inconsistent with his professional obligations for the lawyer to volunteer information arising from his confidential relationship with his client.

As indicated in Paragraph 5, the lawyer also may be asked to estimate the potential loss (or range) in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the lawyer would provide an estimate only if he believes that the probability of inaccuracy of the estimate of the range or amount is slight. What is meant here is that the estimate of amount of loss presents the same difficulty as assessment of outcome and that the same formulation of "probability" should be used with respect to the determination of estimated loss amounts as should be used with respect to estimating the outcome of the matter.

In special circumstances, with the proper consent of the client, the lawyer may be better able to provide the auditor with information concerning loss contingencies through conferences where there is opportunity for more detailed discussion and interchange. However, the principles set forth in the Statement of Policy and this Commentary are fully applicable to such conferences.

Subsumed throughout this discussion is the ongoing responsibility of the lawyer to assist his client, at the client's request, in complying with the requirements of FAS 5 to the extent such assistance falls within his professional competence. This will continue to involve, to the extent appropriate, privileged discussions with the client to provide a better basis on which the client can make accrual and disclosure determinations in respect of its financial statements.

In addition to the considerations discussed above with respect to the making of any judgment or estimate by the lawyer in his response to the auditor, including with respect to a matter specifically identified by the client, the lawyer should also bear in mind the risk that the furnishing of such a judgment or estimate to any one other than the client might constitute an admission or be otherwise prejudicial to the client's position in its defense against such litigation or claim (see Paragraph 1 of the Statement of Policy and of this Commentary).

Paragraph 6 (Lawyer's Professional Responsibility)

The client must satisfy whatever duties it has relative to timely disclosure, including appropriate disclosure concerning material loss contingencies, and, to the extent such matters are given substantive attention in the form of legal consultation, the lawyer, when his engagement is to advise his client concerning a disclosure obligation, has a responsibility to advise his client concerning its obligations in this regard. Although lawyers who normally confine themselves to a legal specialty such as tax, antitrust, patent or admiralty law, unlike lawyers consulted about SEC or general corporate matters, would not be expected to advise generally concerning the client's disclosure obligations in respect of a matter on which the lawyer is working, the legal specialist should counsel his client with respect to the client's obligations under FAS 5 to the extent contemplated herein. Without regard to legal specialty, the lawyer should be mindful of his professional responsibility to the client described in Paragraph 6 of the Statement of Policy concerning disclosure.

The lawyer's responsibilities with respect to his client's disclosure obligations have been a subject of considerable discussion and there may be, in due course, clarification and further guidance in this regard. In any event, where in the lawyer's view it is clear that (i) the matter is of material importance and seriousness, and (ii) there can be no reasonable doubt that its non-disclosure in the client's financial statements would be a violation of law giving rise to material claims, rejection by the client of his advice to call the matter to the attention of the auditor would almost certainly require the lawyer's withdrawal from employment in accordance with the Code of Professional Responsibility. (See, e.g., Disciplinary Rule 7-102 (A)(3) and (7), and Disciplinary Rule 2-110 (B)(2).) Withdrawal under such circumstances is obviously undesirable and might present serious problems for the client. Accordingly, in the context of financial accounting and reporting for loss contingencies arising from unasserted claims, the standards for which are contained in FAS 5, clients should be urged to disclose to the auditor information concerning an unasserted possible claim or assessment (not otherwise specifically identified by the client) where in the course of the services performed for the client it has become clear to the lawyer that (i) the client has no reasonable basis to conclude that assertion of the claim is not probable (employing the concepts hereby enunciated) and (ii) given the probability of assertion, disclosure of the loss contingency in the client's financial statements is beyond reasonable dispute required.

Paragraph 7 (Limitation on Use of Response)

Some inquiry letters make specific reference to, and one might infer from others, an intention to quote verbatim or include the substance of the lawyer's reply in footnotes to the client's financial statements. Because the client's prospects in pending litigation may shift as a result of interim developments, and because the lawyer should have an opportunity, if quotation is to be made, to review the footnote in full, it would seem prudent to limit the use of the lawyer's reply letter. Paragraph 7 sets out such a limitation.

Paragraph 7 also recognizes that it may be in the client's interest to protect information contained in the lawyer's response to the auditor, if and to the extent possible, against unnecessary further disclosure or use beyond its intended purpose of informing the auditor. For example, the response may contain information which could prejudice efforts to negotiate a favorable settlement of a pending litigation described in the response. The requirement of consent to further disclosure, or of reasonable advance notice where disclosure may be required by court process or necessary in defense of the audit, is designed to give the lawyer an opportunity to consult with the client as to whether consent should be refused or limited or, in the case of legal process or the auditor's defense of the audit, as to whether steps can and should be taken to challenge the necessity of further disclosure or to seek protective measures in connection therewith. It is believed that the suggested standard of twenty days advance notice would normally be a minimum reasonable time for this purpose.

Paragraph 8 (General)

It is reasonable to assume that the Statement of Policy will receive wide distribution and will be readily available to the accounting profession. Specifically, the Statement of Policy has been reprinted as Exhibit II to the Statement on Auditing Standards, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," issued by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants. Accordingly, the mechanic for its incorporation by reference will facilitate lawyer-auditor communication. The incorporation is intended to include not only limitations, such as those provided by Paragraphs 2 and 7 of the Statement of Policy, but also the explanatory material set forth in this Commentary.

Annex A

[Illustrative forms of letters for full response by outside practitioner or law firm and inside general counsel to the auditor's inquiry letter. These illustrative forms, which are not part of the Statement of Policy, have been prepared by the Committee on Audit Inquiry Responses solely in order to assist those who may wish to have, for reference purposes, a form of response which incorporates the principles of the Statement of Policy and accompanying Commentary. Other forms of response letters will be appropriate depending on the circumstances.]

Illustrative form of letter for use by outside practitioner or law firm:

[Name and Address of Accounting Firm]

Re: [Name of Client] [and Subsidiaries]

Dear Sirs:

By letter dated [*insert date of request*] Mr. [*insert name and title of officer signing request*] of [*insert name of client*] [(the "Company") or (together with its subsidiaries, the "Company")] has requested us to furnish you with certain information in connection with your examination of the accounts of the Company as at [*insert fiscal year-end*].

[Insert description of the scope of the lawyer's engagement; the following are sample descriptions:]

While this firm represents the Company on a regular basis, our engagement has been limited to specific matters as to which we were consulted by the Company.

[or]

We call your attention to the fact that this firm has during the past year represented the Company only in connection with certain [*Federal income tax matters*] [*litigation*] [*real estate transactions*] [*describe other specific matters, as appropriate*] and has not been engaged for any other purpose.

Subject to the foregoing and to the last paragraph of this letter, we advise you that since [*insert date of beginning of fiscal period under audit*] we have not been engaged to give substantive attention to, or represent the Company in connection with, [*material*]* loss

* *NOTE:* See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If the inquiry letter requests information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations:]

With respect to the matters specifically identified in the Company's letter and upon which comment has been specifically requested, as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, we advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] [as of [*insert date*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and we disclaim any undertaking to advise you of changes which thereafter may be brought to our attention.

[Insert information with respect to outstanding bills for services and disbursements.]

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,

Illustrative form of letter for use by inside general counsel:

[Name and Address of Accounting Firm]

Re: [Name of Company] [and Subsidiaries]

Dear Sirs:

As General Counsel* of [*insert name of client*] [(the "Company")] [(together with its subsidiaries, the "Company")], I advise you as follows in connection with your examination of the accounts of the Company as at [*insert fiscal year-end*].

I call your attention to the fact that as General Counsel * for the Company I have general supervision of the Company's legal affairs. [*If the general legal supervisory responsibilities of the person signing the letter are limited, set forth here a clear description of those legal matters over which such person exercises general supervision, indicating exceptions to such supervision and situations where primary reliance should be placed on other sources.*] In such capacity, I have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where I have deemed appropriate.

Subject to the foregoing and to the last paragraph of this letter, I advise you that since [*insert date of beginning of fiscal period under audit*] neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, [material]** loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations is to be supplied:]

* It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel in which event this letter should be appropriately modified.

** *NOTE:* See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

With respect to matters which have been specifically identified as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, I advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [[as of the date of this letter] as of [*insert date*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and I disclaim any undertaking to advise you of changes which thereafter may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision.

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,

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The next page is 441.

AU Section 338

Working Papers

Issue date, unless otherwise indicated: November, 1972

.01 This section provides guidance for the independent auditor regarding working papers for examinations of financial statements or for other engagements to which any of the generally accepted auditing standards apply. There is no intention to specify the form or details of content of working papers since they should be designed to meet the circumstances and the auditor's needs on the individual engagement; nor is there any intention to imply that the auditor would be precluded from supporting his opinion and his representation as to compliance with the auditing standards by other means in addition to working papers.

Functions and Nature of Working Papers

.02 Working papers serve mainly to:

a. Aid the auditor in the conduct of his work.

b. Provide an important support for the auditor's opinion, including his representation as to compliance with the generally accepted auditing standards.

.03 Working papers are the records kept by the independent auditor of the procedures he followed, the tests he performed, the information he obtained, and the conclusions he reached pertinent to his examination. Working papers, accordingly, may include work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor.

.04 Working papers should fit the circumstances and the auditor's needs on the engagement to which they apply. The factors affecting the independent auditor's judgment as to the quantity, type, and content of the working papers desirable for a particular engagement include (a) the nature of the auditor's report, (b) the nature of the financial statements, schedules, or other information upon which the auditor is reporting, (c) the nature and condition of the client's records and internal controls, and (d) the needs in the particular circumstances for supervision and review of the work performed by any assistants.

Guidelines

.05 Although the quantity, type, and content of working papers will vary with the circumstances, they generally would include or show:

a. Data sufficient to demonstrate that the financial statements or other information upon which the auditor is reporting were in agreement with (or reconciled with) the client's records.

b. That the engagement had been planned, such as by use of work programs, and that the work of any assistants had been supervised and reviewed, indicating observance of the first standard of field work.

c. That the client's system of internal control had been reviewed and evaluated in determining the extent of the tests to which auditing procedures were restricted, indicating observance of the second standard of field work.

d. The auditing procedures followed and testing performed in obtaining evidential matter, indicating observance of the third standard of field work. The record in these respects may take various forms, including memoranda, check lists, work programs, and schedules, and would generally permit reasonable identification of the work done by the auditor.

e. How exceptions and unusual matters, if any, disclosed by the independent auditor's procedures were resolved or treated.

f. Appropriate commentaries prepared by the auditor indicating his conclusions concerning significant aspects of the engagement.

Ownership and Custody of Working Papers

.06 Working papers are the property of the independent auditor, and in a number of states there are statutes which designate the auditor as the owner of working papers. The auditor's rights of ownership of the working papers, however, are subject to those ethical limitations designed to prevent improper disclosures by the auditor of confidential matters relating to his clients' affairs.

.07 While the independent auditor's working papers may serve as a useful reference source from time to time for his client, the working papers should not be regarded as constituting a part of, or as a substitute for, the client's accounting records.

.08 The independent auditor should adopt reasonable procedures for safe custody of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal requirements of records retention.

AU Section 400

THE FIRST, SECOND, AND THIRD STANDARDS OF REPORTING

. . . adherence to principles . . . meaning of present fairly . . . application of principles . . . informative disclosure . . .

TABLE OF CONTENTS

The next page is 481.

AU Section 410

Adherence to Generally Accepted Accounting Principles

Issue date, unless otherwise indicated: November, 1972

.01 The first standard of reporting is:

> The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

.02 The term "generally accepted accounting principles" as used in reporting standards is construed to include not only accounting principles and practices but also the methods of applying them. The first reporting standard is construed not to require a statement of fact by the auditor but an opinion as to whether the financial statements are presented in conformity with such principles. If limitations on the scope of the auditor's examination make it impossible for him to form an opinion as to such conformity, appropriate qualification of his report is required.

[.03-.04] [Superseded July 1975 by Statement on Auditing Standards No. 5.] (See section 411.)

The next page is 485.

AU Section 411

The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report

(Supersedes section 410.03-.04[1])

Issue date, unless otherwise indicated: July, 1975

.01 An independent auditor's unqualified opinion usually reads as follows:

> In our opinion, the financial statements referred to above present fairly the financial position of X Company as of (at) December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

The purpose of this section is to explain the meaning of the phrase "present fairly . . . in conformity with generally accepted accounting principles" in the independent auditor's report.[2]

.02 The first standard of reporting requires an auditor who has examined financial statements in accordance with generally accepted auditing standards to state in his report whether the statements are presented in accordance with generally accepted accounting principles. The phrase "generally accepted accounting principles" is a technical accounting term which encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures (see paragraph 138 of Statement No. 4 of the Accounting Principles Board)[AC section 1026.02*]. Those conventions, rules, and procedures provide a standard by which to measure financial presentations.

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[1] This section amends the text of section 210.05 by deletion of the last sentence to that section.

[2] This section clarifies and explains matters relating to the form of auditor's report presently in use; the section is not a result of a reconsideration of the form itself.

* Volume 3, *AICPA Professional Standards.*

.03 The independent auditor's judgment concerning the "fairness" of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles. Without that framework the auditor would have no uniform standard for judging the presentation of financial position, results of operations, and changes in financial position in financial statements.

.04 The auditor's opinion that financial statements present fairly an entity's financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles should be based on his judgment as to whether (a) the accounting principles selected and applied have general acceptance (see paragraphs .05 and .06); (b) the accounting principles are appropriate in the circumstances (see paragraphs .07-.09); (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation (see section 430); (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed (see section 430); and (e) the financial statements reflect the underlying events and transactions in a manner that presents the financial position, results of operations, and changes in financial position stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.[3]

.05 Generally accepted accounting principles are relatively objective; that is, they are sufficiently established so that independent auditors usually agree on their existence. Nevertheless, the identification of an accounting principle as generally accepted in particular circumstances requires judgment. No single source of reference exists for all established accounting principles. Rule 203 of the AICPA Code of Professional Ethics requires compliance with accounting principles promulgated by the body designated by Council to establish such principles, unless due to unusual circumstances the financial statements would otherwise be misleading (see section 509.18 and 509.19). The pronouncements comprehended by Rule 203 are statements and interpretations issued by the Financial Accounting Standards Board, APB opinions, and AICPA accounting research bulletins.

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[3] The concept of materiality is inherent in the auditor's judgments. That concept involves qualitative as well as quantitative judgments (see section 150.04, and section 509.16).

.06 In the absence of pronouncements comprehended by Rule 203, the auditor should consider other possible sources of established accounting principles, such as AICPA accounting interpretations, AICPA industry audit guides and accounting guides, and industry accounting practices. Depending on their relevance in the circumstances, the auditor may also wish to refer to APB statements, AICPA statements of position, pronouncements of other professional associations and regulatory agencies, such as the Securities and Exchange Commission, and accounting textbooks and articles (see paragraphs 205 and 206 of Statement No. 4 of the APB) [AC section 1028.04 and 1028.05*]. Independent auditors should be alert to pronouncements that change accounting principles. They should also be alert to changes that become acceptable as a result of common usage in business, rather than as a result of pronouncements.

.07 Generally accepted accounting principles recognize the importance of recording transactions in accordance with their substance.[4] The auditor should consider whether the substance of transactions differs materially from their form.

.08 The auditor should be familiar with alternative accounting principles that may be applicable to the transaction or facts under consideration and realize that an accounting principle may have only limited usage but still have general acceptance. On occasion, established accounting principles may not exist for recording and presenting a specific event or transaction because of developments such as new legislation or the evolution of a new type of business transaction. In certain instances, it may be possible to account for the event or transaction on the basis of its substance by selecting an accounting principle that appears appropriate when applied in a manner similar to the application of an established principle to an analogous event or transaction.

.09 Specifying the circumstances in which one accounting principle should be selected from among alternative principles is the function of bodies having authority to establish accounting principles. When criteria for selection among alternative accounting principles have not been established to relate accounting methods to circumstances, the auditor may conclude that more than one accounting principle

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[4] See section 110.02, for an explanation of the distinction between the responsibilities of an auditor and the client's management.

*Volume 3, *AICPA Professional Standards*.

is appropriate in the circumstances.[5] The auditor should recognize, however, that there may be unusual circumstances in which the selection and application of specific accounting principles from among alternative principles may make the financial statements taken as a whole misleading.

The next page is 491.

[5] For example, at the time of issuance of this section, established accounting principles do not include criteria for relating the choice among some alternative methods, such as inventory methods or depreciation methods, to the circumstances of a particular company.

AU Section 420

Consistency of Application of Generally Accepted Accounting Principles

Issue date, unless otherwise indicated: November, 1972

.01 The second standard of reporting (referred to herein as the consistency standard) is:

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

.02 The objective of the consistency standard is (a) to give assurance that the comparability of financial statements between periods has not been materially affected by changes in accounting principles, which include not only accounting principles and practices but also the methods of applying them, or (b) if comparability has been materially affected by such changes, to require appropriate reporting by the independent auditor regarding such changes. It is implicit in the objective that such principles have been consistently observed within each period.

.03 Proper application of the consistency standard by the independent auditor requires an understanding of the relationship of consistency to comparability. Although lack of consistency may cause lack of comparability, other factors unrelated to consistency may also cause lack of comparability.[1]

.04 A comparison of the financial statements of an entity between years may be affected by (a) accounting changes, (b) an error in previously issued financial statements, (c) changes in classification, and (d) events or transactions substantially different from those accounted for in previously issued statements. Accounting

[1] For a discussion of comparability of financial statements of a single enterprise, see paragraphs 95 through 97 of Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises."

change, as defined in APB Opinion No. 20 [AC section 1051], means a change in (1) an accounting principle, (2) an accounting estimate, or (3) the reporting entity (which is a special type of change in accounting principle).

.05 Changes in accounting principle having a material effect on the financial statements require recognition in the independent auditor's opinion as to consistency. Other factors affecting comparability in financial statements may require disclosure, but they would not ordinarily be commented upon in the independent auditor's report.

Accounting Changes Affecting Consistency

Change in Accounting Principle

.06 "A change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term *accounting principle* includes not only accounting principles and practices but also the methods of applying them."[1] A change in accounting principle includes, for example, a change from the straight-line method to the declining balance method of depreciation for all assets in a class or for all newly acquired assets in a class, and a change from expensing research and development costs to amortizing such costs over the estimated period benefited. The consistency standard is applicable to this type of change and requires recognition in the auditor's opinion as to consistency.

Change in the Reporting Entity

.07 Since a change in the reporting entity is a special type of change in accounting principle, the consistency standard is applicable. Changes in reporting entity that require recognition in the auditor's opinion include:

a. Presenting consolidated or combined statements in place of statements of individual companies.

b. Changing specific subsidiaries comprising the group of companies for which consolidated statements are presented.

c. Changing the companies included in combined financial statements.

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[1] Accounting Principles Board Opinion No. 20, paragraph 7 [AC section 1051.07].

d. Changing among the cost, equity, and consolidation methods of accounting for subsidiaries or other investments in common stock.

.08 A business combination accounted for by the pooling-of-interests method also results in a change in reporting entity. The application of the consistency standard to this type of change is discussed in section 546.12–.13.

.09 For purposes of application of the consistency standard, a change in reporting entity does not result from the creation, cessation, purchase, or disposition of a subsidiary or other business unit.

Correction of an Error in Principle

.10 A change from an accounting principle that is not generally accepted to one that is generally accepted, including correction of a mistake in the application of a principle, is a correction of an error. Although this type of change in accounting principle should be accounted for as the correction of an error,[1] the change requires recognition in the auditor's opinion as to consistency.[2]

Change in Principle Inseparable From Change in Estimate

.11 The effect of a change in accounting principle may be inseparable from the effect of a change in estimate.[3] Although the accounting for such a change is the same as that accorded a change only in estimate, a change in principle is involved. Accordingly, this type of change requires recognition in the independent auditor's opinion as to consistency.

Changes Not Affecting Consistency

Change in Accounting Estimate

.12 Accounting estimates (such as service lives and salvage values of depreciable assets and provisions for warranty costs, uncollectible receivables, and inventory obsolescence) are necessary in the preparation of financial statements. Accounting estimates change as new events occur and as additional experience and information are acquired. This type of accounting change is required

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[1] See paragraphs 13, 36, and 37 of Accounting Principles Board Opinion No. 20 [AC section 1051.13, 36 and 37].

[2] **The appropriate form of reporting on consistency in such circumstances is similar to that illustrated in section 546.02.**

[3] See paragraph 11 of Accounting Principles Board Opinion No. 20 [AC section 1051.11].

by altered conditions that affect comparability but do not involve the consistency standard. The independent auditor, in addition to satisfying himself with respect to the conditions giving rise to the change in accounting estimate, should satisfy himself that the change does not include the effect of a change in accounting principle. Provided he is so satisfied, he need not comment on the change in his report because it does not affect his opinion as to consistency.[1] However, an accounting change of this type having a material effect on the financial statements may require disclosure in a note to the financial statements.[2]

Error Correction Not Involving Principle

.13 Correction of an error in previously issued financial statements resulting from mathematical mistakes, oversight, or misuse of facts that existed at the time the financial statements were originally prepared does not involve the consistency standard if no element of accounting principles or their application is included. Accordingly, the independent auditor need not recognize the correction in his opinion as to consistency.[3]

Changes in Classification and Reclassifications

.14 Classifications in the current financial statements may be different from classifications in the prior year's financial statements. Although changes in classification are usually not of sufficient importance to necessitate disclosure, material changes in classification should be indicated and explained in the financial statements or notes. These changes and material reclassifications made in previously issued financial statements to enhance comparability with

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[1] With respect to financial statements filed with the Securities and Exchange Commission, Regulation S-X requires the independent auditor to express an opinion as to any change in accounting principle or practice that materially affects *comparability*. These requirements may be met by the use of a middle paragraph in the auditor's report in which he describes the change and expresses his view thereon; when this is done, there should not be a reference to the change in the opinion paragraph if the consistency standard is not involved.

[2] See paragraph 33 of Accounting Principles Board Opinion No. 20 [AC section 1051.33].

[3] If the independent auditor had previously reported on the financial statements containing the error, he should refer to section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report."

current financial statements ordinarily would not affect the independent auditor's opinion as to consistency and need not be referred to in his report.

Variations in Format and Presentation of Statement of Changes in Financial Position

.15 In paragraph 8 of APB Opinion No. 19 [AC section 2021.08], the Accounting Principles Board concluded that ". . . the statement summarizing changes in financial position should be based on a broad concept embracing all changes in financial position. . . ." In paragraph 9 of that Opinion, however, the Board recognized ". . . the need for flexibility in form, content, and terminology . . ." of the statement of changes. Accordingly, variations between periods in the format of the statement of changes, such as changing to or from a balanced form, are deemed to be reclassifications. If such variations materially affect comparability, they should be disclosed in the financial statements and ordinarily will not be referred to in the independent auditor's report.

.16 However, variations between periods in the terms used to express changes in financial position, such as changing from cash to working capital, constitute a change in the application of accounting principles and involve the consistency standard. When such a change occurs and the independent auditor deems it to be material, he should express in his opinion an exception as to consistency. An entity making such a change in the current period may present comparative financial statements for a prior period that have been restated to conform with those of the current period. Such a restatement places both periods on the same basis with respect to the use and application of accounting principles. The restatement should be disclosed and the auditor should refer to it in his report.

Substantially Different Transactions or Events

.17 Accounting principles are adopted when events or transactions first become material in their effect. Such adoption, as well as modification or adoption of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring, do not involve the consistency standard although disclosure in the notes to the financial statements may be required.

Changes Expected to Have a Material Future Effect

.18 If an accounting change has no material effect on the financial statements in the current year, but the change is reasonably certain to have substantial effect in later years, the change should be disclosed in the notes to the financial statements whenever the statements of the period of change are presented, but the independent auditor need not recognize the change in his opinion as to consistency.

Disclosure of Changes Not Affecting Consistency

.19 While the matters discussed in paragraphs .12–.15 and .17–.18 do not require recognition in the independent auditor's report as to consistency, the auditor should qualify his report as to the disclosure matter if necessary disclosures are not made. (See section 430.04.)

Periods to Which the Consistency Standard Relates

.20 When the independent auditor reports only on the current period, he should report on the consistency of the application of accounting principles in relation to the preceding period, regardless of whether financial statements for the preceding period are presented. (The term "current period" means the most recent year, or period of less than one year, upon which the independent auditor is reporting.) When the independent auditor reports on two or more years, he should report on the consistency of the application of accounting principles between such years and also on the consistency of such years with the year prior thereto if such prior year is presented with the financial statements being reported upon.

Consistency Expression

.21 When the independent auditor is expressing an opinion on the financial statements of a single year, the phrase "on a basis consistent with that of the preceding year" is appropriate; however, if the financial statements are for the initial accounting period of a company, he should not refer to consistency because no previous period exists with which to make a comparison. If the auditor's report covers two or more years, language similar to "applied on a consistent basis" should be used. In such cases, if the year preceding the earliest year being reported upon is also presented, language similar to "consistently applied during the period and on a basis consistent with that of the preceding year" should be used.

The next page is 521.

AU Section 430

Adequacy of Informative Disclosure

Issue date, unless otherwise indicated: November, 1972

.01 The third standard of reporting is:

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

.02 The fairness of presentation of financial statements in conformity with generally accepted accounting principles comprehends the adequacy of disclosures involving material matters. These matters relate to the form, arrangement, and content of the financial statements with their appended notes; the terminology used; the amount of detail given; the classification of items in the statements; the bases of amounts set forth, for example, with respect to such assets as inventories and plants; liens on assets; dividend arrearages; restrictions on dividends; contingent liabilities; and the existence of affiliated or controlling interests and the nature and volume of transactions with such interests. This enumeration is not intended to be all inclusive but simply indicative of the nature and type of disclosures necessary to make financial statements sufficiently informative.

.03 Verbosity should not be mistaken for adequate disclosure. What constitutes a matter requiring disclosure is for the independent auditor to decide in the exercise of his judgment in light of the circumstances and facts of which he is aware at that time. That later events may give greater importance to matters which at the time appeared to be of minor consequence does not, of itself, impugn the soundness of his judgment. Foresight and hindsight cannot be admitted to be of equal weight in passing upon conclusions reached at the earlier time; hindsight should be eliminated from the factors by which the soundness of past conclusions is judged.

.04 If matters which the independent auditor believes require disclosure are omitted from the financial statements, the matters should be included in his report and he should appropriately qualify his opinion. (See section 545.)

.05 Disclosure should not be considered to require publicizing certain kinds of information that would be detrimental to the company or its stockholders. For example, the threat of a patent infringement suit might impel a conscientious management to set up an ample reserve for possible loss, even though it would expect to fight the issue vigorously. But publicity given to such a loss provision might inure to the harm of the company or its stockholders, for courts have held that a reserve for patent infringement constituted an allocation of infringement profits (where ready determination otherwise was not feasible) notwithstanding a refusal on the part of the company or its management to concede that such an amount might be an equitable allotment of the profits in dispute.

.06 Somewhat related to the matter of disclosure is the matter of information which the auditor receives in confidence akin to the status of privileged communication. Without such confidence, the auditor might at times find it difficult to obtain information necessary for him in the formulation of his opinion. If the information received does not, in his judgment, require disclosure for the financial statements not to be misleading, this standard does not require disclosure of such information. The matter of disclosure of events occurring subsequent to the balance-sheet date is discussed in section 560.

AU Section 500

THE FOURTH STANDARD OF REPORTING

. . . reports on audited financial statements . . . unaudited financial statements . . . reporting when Certified Public Accountant is not independent . . . negative assurance . . . reports on a limited review . . . dating of independent auditor's report . . . conditions precluding application of necessary auditing procedures . . . part of examination made by other independent auditors . . . lack of conformity with GAAP . . . inadequate disclosure . . . reporting on inconsistency . . . other information in documents containing audited financial statements . . . subsequent events . . . subsequent discovery of facts . . .

TABLE OF CONTENTS

The next page is 631.

AU Section 509

Reports on Audited Financial Statements

(Supersedes sections 510.01-515.10, 535.01-542.04, 544.01 and 547.01-547.04)

Effective for reports issued on financial statements for periods ending on or after December 31, 1974, unless otherwise indicated [1]

Introduction

.01 This section applies to auditors' reports issued in connection with examinations of financial statements that are intended to present financial position, results of operations or changes in financial position in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides examples.[2]

.02 This section does not apply to unaudited financial statements that an accountant has been engaged to prepare or assist in preparing (see section 516), nor does it apply to reports on incomplete or capsule financial information or on other special presentations (see section 620).

.03 Justification for the expression of the auditor's opinion rests on the conformity of his examination with generally accepted auditing standards and on his findings. Generally accepted auditing standards include four standards of reporting. (See section 150.02.)

This section is concerned primarily with the relationship of the fourth reporting standard to the language of the auditor's report.

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[1] See paragraph .50.

[2] This section clarifies and explains matters relating to the form of auditor's standard report presently in use; the section is not a result of a reconsideration of the form itself.

.04 The fourth standard of reporting is as follows:

> The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons should be stated. In all cases wherein an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

.05 The objective of the fourth standard is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his name is associated with financial statements. Reference in the fourth reporting standard to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement, for example, to a balance sheet. The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances call for this treatment.

Auditor's Standard Report

.06 The auditor's report customarily is used in connection with the basic financial statements — balance sheet, statement of income, statement of retained earnings and statement of changes in financial position. If these financial statements are accompanied by a separate statement of changes in stockholders' equity accounts, it should be identified in the scope paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are included in the presentation of results of operations and changes in financial position.

.07 The auditor's standard report consists of a statement describing the nature of the examination, usually in an opening or "scope" paragraph, and an expression of the auditor's opinion, usually in a closing or "opinion" paragraph. The form of the standard report is as follows:

(Scope paragraph)

> We have examined the balance sheet of X Company as of [at] December 31, 19XX, and the related statements of income, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the ac-

counting records and such other auditing procedures as we considered necessary in the circumstances.

(Opinion paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.08 The report may be addressed to the company whose financial statements are being examined or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to examine the financial statements of a company that is not his client; in such a case, the report customarily is addressed to the client and not to the directors or stockholders of the company whose financial statements are being examined.

Circumstances Resulting in Departure From Auditor's Standard Report

.09 The circumstances that result in a departure from the auditor's standard report[3] are as follows:

a. The scope of the auditor's examination is affected by conditions that preclude the application of one or more auditing procedures he considers necessary in the circumstances.
b. The auditor's opinion is based in part on the report of another auditor.
c. The financial statements are affected by a departure from a generally accepted accounting principle.
d. The financial statements are affected by a departure from an accounting principle promulgated by the body designated by the AICPA Council to establish such principles.
e. Accounting principles have not been applied consistently.

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[3] As to circumstances in which the auditor is not independent, see section 517.

f. The financial statements are affected by uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation at the date of the auditor's report.

g. The auditor wishes to emphasize a matter regarding the financial statements.

Scope Limitation

.10 The auditor can determine that he is able to express an unqualified opinion only if his examination has been conducted in accordance with generally accepted auditing standards and if he therefore has been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of his examination, whether imposed by the client or by circumstances such as the timing of his work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require him to qualify his opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

.11 The auditor's decision to qualify his opinion or disclaim an opinion because of a scope limitation depends on his assessment of the importance of the omitted procedure(s) to his ability to form an opinion on the financial statements examined. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved.

.12 Common restrictions on the scope of the auditor's examination include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors,[4] but restrictions may concern other phases of the audit (for example, see section 542.06). Restrictions on the application of these or other audit procedures to important elements of the

[4] Circumstances such as the timing of his work may make it impracticable or impossible for the auditor to accomplish these procedures. In such case, if he is able to satisfy himself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of his work, and his report need not include reference to the omission of the procedures or to the use of alternative procedures.

financial statements require the auditor to decide whether he has examined sufficient competent evidential matter to permit him to express an unqualified or qualified opinion, or whether he should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on the financial statements.

.13 The auditor may be asked to report on one basic financial statement and not on the others. For example, he may be asked to report on the balance sheet and not on the statements of income, retained earnings or changes in financial position. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if he applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

Opinion Based in Part on Report of Another Auditor

.14 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his opinion, he should disclose this fact in stating the scope of his examination and should refer to the report of the other auditor in expressing his opinion. These references indicate division of responsibility for performance of the examination. Although they are departures from the standard report language, they do not constitute a qualification of the auditor's opinion. (See section 543.)

Departure From a Generally Accepted Accounting Principle

.15 *General.* When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has examined the statements in accordance with generally accepted auditing standards, he should express a qualified or an adverse opinion (see paragraphs .29 and .41). The basis for such opinion should be stated in his report.

.16 In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or an adverse opinion, one factor to be considered is the dollar magnitude of the effects. However, materiality does not depend entirely on relative size: the concept involves qualitative as well as quantitative judgments. The significance of an item to a particular enterprise (e.g., inventories to a manufacturing company), the pervasiveness of the misstatement (e.g., whether it affects the amounts and presentation of numerous financial statement items), and the impact of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

.17 *Inadequate disclosure.* Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements. If the client declines to disclose essential data in a financial statement, the auditor should provide it in his report if practicable and should express a qualified or adverse opinion because the information has been omitted from the financial statements. (See sections 430.01-430.06 regarding the adequacy of informative disclosure, and sections 545.04-545.05 regarding the omission of a statement of changes in financial position.)

Departure From a Promulgated Accounting Principle

.18 Rule 203 of the AICPA Code of Professional Ethics[5] states:

> A member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the body designated by Council to establish such principles which has a material effect on the statements taken as a whole, unless the member can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. In such cases his report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

.19 When the circumstances contemplated by Rule 203 are present, the auditor's report should include, in a separate paragraph or paragraphs, the information required by the rule. In such a case, it is appropriate for him then to express an unqualified opinion with respect to the conformity of the financial statements with generally accepted accounting principles unless there are other reasons, not

[5] This rule supersedes the Special Bulletin of the Council of the AICPA, issued in October 1964 and referred to in the text of sections 545.04 and 546.12. [As amended July, 1975 by Statement on Auditing Standards No. 5.]

associated with the departure from a promulgated principle, to modify his report.

Accounting Principles Not Consistently Applied

.20 When there has been a change in accounting principles, the auditor should modify his opinion as to consistency. Section 546, discusses variations in report language that are appropriate when accounting principles have not been applied consistently.

Uncertainties

.21 In preparing financial statements, management is expected to use its estimates of the outcome of future events. Estimates customarily are made in connection with matters such as the useful lives of depreciable assets, the collectibility of accounts receivable, the realizable value of inventory items, and the amount of a liability for product warranty. In most cases, the auditor is able to satisfy himself regarding the reasonableness of management's estimates by considering various types of audit evidence, including the historical experience of the entity, and the relevance of the evidence in estimating the effects of future events. Matters are not to be regarded as uncertainties for purposes of this section unless their outcome is not susceptible of reasonable estimation, as discussed in paragraph .22. If the auditor, on the basis of evidence available to him, disagrees with management's determination, and if the effects on the financial statements are material, he should express a qualified or an adverse opinion because of a departure from generally accepted accounting principles.

.22 In certain instances, the outcome of matters that may affect the financial statements or the disclosures required therein is not susceptible of reasonable estimation; such matters are to be regarded as uncertainties for purposes of this section. When such uncertainties exist, it cannot be determined whether the financial statements should be adjusted, or in what amount.

.23 There may be uncertainties with respect to specific matters whose possible effects on the financial statements can be isolated and therefore readily understood. Examples are the recoverability of a deferred cost or the likelihood that a material amount will become collectible or payable because of income tax adjustments or litigation. Also, there may be multiple uncertainties or uncertainties whose possible effects are complex and whose impact on the financial statements consequently is difficult for a reader to assess. Examples of conditions indicating the existence of uncertainties of the latter kind are recurring operating losses, serious deficiencies in working capital, an inability to obtain financing sufficient for continued business operations, and failure to comply with the terms of loan agreements. In some situations an adverse outcome of matters in either category could imperil the continued existence of the entity.[6] In any event, if the effects of the matters on the financial statements could be material, their nature and their possible effects should be disclosed in the statements.

.24 Evidence as to the resolution of an uncertainty cannot be expected to exist at the time of the auditor's examination because the resolution, and therefore the evidence, is prospective. The auditor's function in forming an opinion on financial statements does not include estimating the outcome of future events if management is unable to do so. When there are material uncertainties, the outcome of which is not susceptible of reasonable estimation, the auditor should consider whether to express an unqualified opinion or to qualify his opinion as discussed in paragraph .25.[7] The auditor need not modify his opinion because of the existence of an uncertainty when he concludes that there is only a minimal likelihood that resolution of the uncertainty will have a material effect on the financial statements.

.25 In cases involving uncertainties, the auditor should be able to form an opinion whether the financial statement items affected have been stated in conformity with generally accepted accounting principles in all respects other than those contingent on the outcome of the uncertainties. If he is satisfied that they have been so stated, he may appropriately express an opinion qualified by reason of the uncertainties (see paragraphs .35 and .39).[8] If the auditor believes that

[6] In such circumstances, the auditor is concerned with the recoverability and classification of recorded asset amounts and with the amounts and classification of liabilities.

[7] The auditor may disclaim an opinion as discussed in footnote 8.

[8] The Committee believes that the explanation of the uncertainties and the qualification of the auditor's opinion contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an

the financial statement items affected by uncertainties reflect the application of accounting principles that are not generally accepted, he also should modify his report to state his reservations regarding departures from generally accepted accounting principles.

.26 The subsequent resolution of an uncertainty that has led to a modification of the auditor's opinion will (a) result in adjustment of the financial statements as to which his report originally was modified (b) be recognized in the financial statements of a subsequent period, or (c) result in a conclusion that the matter has no monetary effect on the financial statements of any period. The qualifying expression in the opinion paragraph of the auditor's report should be the same regardless of the accounting treatment that is expected to be accorded the resolution of the uncertainty.

Emphasis of a Matter

.27 In some circumstances, the auditor may wish to emphasize a matter regarding the financial statements, but nevertheless intends to express an unqualified opinion. For example, he may wish to point out that the entity is a component of a larger business enterprise or that it has had significant transactions with related parties,* or he may wish to call attention to an unusually important subsequent event or to an accounting matter affecting the comparability of the financial statements with those of the preceding period. Such explanatory information may be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type.

Unqualified Opinion

.28 An unqualified opinion states that the financial statements present fairly financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles (which include adequate disclosure) consistently applied (see paragraph .07). This conclusion may be expressed only

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opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (see paragraph .23), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (see paragraph .45).

* [Editor's Note: See section 335.]

when the auditor has formed such an opinion on the basis of an examination made in accordance with generally accepted auditing standards.

Qualified Opinion

General

.29 A qualified opinion states that, "except for" or "subject to" the effects of the matter to which the qualification relates, the financial statements present fairly financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles consistently applied. Such an opinion is expressed when a lack of sufficient competent evidential matter or restrictions on the scope of the auditor's examination have led him to conclude that he cannot express an unqualified opinion, or when the auditor believes, on the basis of his examination, that

a. the financial statements contain a departure from generally accepted accounting principles, the effect of which is material,
b. there has been a material change between periods in accounting principles or in the method of their application, or
c. there are significant uncertainties affecting the financial statements,

and he has decided not to express an adverse opinion or to disclaim an opinion.

.30 Ordinarily the auditor should not modify the language of the opinion paragraph of the standard report unless he is qualifying his opinion. However, reference to another auditor's report as a basis, in part, of the principal auditor's opinion is not considered to be a qualification (see paragraph.14).

.31 Financial statements, including the accompanying notes, sometimes contain unaudited information, pro forma calculations or other similar disclosures. These disclosures may be required in connection with a particular transaction (e.g., a business combination) or may otherwise be considered informative (e.g., in connection with subsequent events). If such disclosures are appropriately identified as "unaudited" or as "not covered by auditor's report," the auditor need not refer to them in his report. The reporting criteria stated in sections 516.06, 516.07, and 710.09 apply to such data. If the unaudited information (e. g., an investor's share, material in amount, of an investee's earnings recognized on the equity method) is such that it should be subjected to auditing procedures in order for the auditor to form an opinion with respect to the financial statements taken as a whole, and the auditor has not been able to apply the procedures he considers necessary, he should qualify his opinion or disclaim an opinion because of a limitation on the scope of his examination.

Report Form

.32 When the auditor intends to express a qualified opinion, he should disclose all the substantive reasons in a separate explanatory paragraph(s) of his report, and should include, in the opinion paragraph, the appropriate qualifying language and a reference to the explanatory paragraph(s). The requirement for an explanatory paragraph does not apply when the opinion paragraph has been modified because of a change in accounting principle (see paragraph .20).

.33 The explanatory paragraph(s) should disclose the principal effects of the subject matter of the qualification on financial position, results of operations and changes in financial position, if reasonably determinable. If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the explanatory paragraph(s) may be shortened by referring to it. The explanatory paragraph(s) also should make clear whether the matter is (a) one as to which there is a difference of opinion between the auditor and his client and for which the auditor believes an adjustment should be made or (b) one involving an uncertainty that cannot presently be resolved because the outcome depends on future events. If an auditor wishes to emphasize a matter or disclosure regarding the financial statements but does not intend to qualify his opinion (see paragraph .27), he should not refer to this information in the opinion paragraph of his report.

.34 When a qualified opinion results from a limitation on the scope of the examination or an insufficiency of evidential matter, the situation should be described in the explanatory paragraph and referred to in both the scope and opinion paragraphs of the auditor's report. It is not appropriate for the auditor to request that the scope of his examination be explained in a note to the financial statements, inasmuch as the description of the scope is the auditor's representation and not that of his client.

Qualifying Language

.35 A qualified opinion should include the word "except" or "exception" in a phrase such as "except for" or "with the exception of" unless the qualification arises because of an uncertainty affecting the financial statements; then the expression "subject to" should be used. Phrases such as "with the foregoing explanation" are not clear or forceful enough and should not be used. Since accompanying notes are deemed to be part of the financial statements, wording such as "fairly presented when read in conjunction with Note 1" is likely to be misunderstood and likewise should not be used.

.36 An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

(Separate paragraph)

The Company has excluded from property and debt in the accompanying balance sheet certain lease obligations, which, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$......, long-term debt by \$......, and retained earnings by \$......as of December 31, 19XX, and net income and earnings per share would be increased (decreased) by \$...... and \$...... respectively for the year then ended.

(Opinion paragraph)

In our opinion, except for the effects of not capitalizing lease obligations, as discussed in the preceding paragraph, the financial statements present fairly. . . .

.37 If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph of the auditor's report in the circumstances illustrated in paragraph .36 might read as follows:

(Separate paragraph)

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheet. In our opinion, generally accepted accounting principles require that such obligations be included in the balance sheet.

.38 If a qualification arises because of lack of consistency in the application of accounting principles, the qualifying language should be positioned in the opinion paragraph so as to make this clear. (See section 546.)

.39 An example of a report qualified because of an uncertainty affecting the financial statements follows:

(Separate paragraph)

As discussed in Note X to the financial statements, the Company is defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. Company officers and counsel believe the Company has a good chance of prevailing, but the ultimate outcome of the lawsuits cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

(Opinion paragraph)

In our opinion, subject to the effects, if any, on the financial statements of the ultimate resolution of the matter discussed in the preceding paragraph, the financial statements referred to above present fairly. . . .

or

In our opinion, subject to the effects of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the financial statements referred to above present fairly. . . .

.40 When an auditor qualifies his opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. An example regarding inventories (assuming the effects of the limitation are not such that the auditor has concluded a disclaimer of opinion is appropriate — see paragraph .11) follows:

(Scope paragraph)

Except as explained in the following paragraph, our examination . . . and such other auditing procedures as we considered necessary in the circumstances. . . .

(Separate paragraph)

We did not observe the taking of the physical inventories as of December 31, 19XX (stated at $. . . . . .), and December 31, 19X1 (stated at $. . . . . .), since those dates were prior to the time we were initially engaged as auditors for the Company. Due to the nature of the Company's records, we were unable to satisfy ourselves as to the inventory quantities by means of other auditing procedures.[9]

(Opinion paragraph)

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to observe the physical inventories. . . .

Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our examination . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements, and therefore is unacceptable.

Adverse Opinion

.41 An adverse opinion states that financial statements do not present fairly the financial position, results of operations or changes in financial position in conformity with generally accepted accounting principles. Such an opinion is expressed when, in the auditor's judgment (see paragraph .16), the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles.

.42 When the auditor expresses an adverse opinion, he should disclose in a separate paragraph(s) of his report (a) all the substantive reasons for his adverse opinion and (b) the principal effects of the subject matter of the adverse opinion on financial position, results of operations and changes in financial position, if reasonably determinable. If the effects are not reasonably determinable, the report should so state. The report also should state any reservations the auditor has regarding fair presentation in conformity with generally accepted accounting principles other than those giving rise to the adverse opinion.

.43 When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.

[9] If the auditor has been unable also to carry out other tests, such as those relating to the pricing and clerical accuracy of the inventories, the language in the separate and opinion paragraphs should be modified accordingly.

(Separate paragraph)

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Generally accepted accounting principles, in our opinion, require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided. Because of the departures from generally accepted accounting principles identified above, as of December 31, 19XX, inventories have been increased $...... by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at $...... in excess of an amount based on the cost to the Company; and allocated income tax of $...... has not been recorded; resulting in an increase of $...... in retained earnings and in appraisal surplus of $....... For the year ended December 31, 19XX, cost of goods sold has been increased $...... because of the effects of the depreciation accounting referred to above and deferred income taxes of $...... have not been provided, resulting in an increase in net income and earnings per share of $...... and $...... respectively.

(Opinion paragraph)

In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19XX, or the results of its operations and changes in its financial position for the year then ended.

.44 Because an opinion as to consistency implies the application of generally accepted accounting principles, no reference to consistency should be made in the opinion paragraph when an adverse opinion is issued. However, if the auditor has specific exceptions as to consistency, these exceptions should be expressed in the report.

Disclaimer of Opinion

.45 A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. When the auditor disclaims an opinion, he should state in a separate paragraph(s) of his report all of his substantive reasons for doing so, and also should disclose any other reservations he has regarding fair presentation in conformity with generally accepted accounting principles or the consistency of their application. The disclaimer of opinion is appropriate when the auditor has not performed an examination sufficient in scope to enable him to form an opinion on the financial statements (see paragraphs .10, .11, and .12).[10] A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his examination, that there are material departures from generally accepted accounting principles (see paragraphs .15, .16, and .17).

.46 When expressing a disclaimer because of a significant scope limitation, the auditor should indicate in a separate paragraph(s) the respects in which his examination did not comply with generally accepted auditing standards. He should state that the scope of his examination was not sufficient to warrant the expression of an opinion. The auditor should not indicate the procedures performed; to do so may tend to overshadow the disclaimer.

.47 An example of a disclaimer resulting from an inability to obtain sufficient competent evidential matter follows:

(Scope paragraph)

... Except as set forth in the following paragraph, 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.

(Separate paragraph)

The Company did not take a physical inventory of merchandise, stated at $...... in the accompanying financial statements as of December 31, 19XX, and at $...... as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19XX is no longer available. The Company's records do not permit the application of adequate alternative procedures regarding the inventories or the cost of property and equipment.

(Disclaimer paragraph)

Since the Company did not take physical inventories and we were unable to apply adequate alternative procedures regarding inventories and the cost of property and equipment, as noted in the pre-

[10] A disclaimer may be issued in cases involving uncertainties. See the footnote to paragraph .25.

ceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to above.

Piecemeal Opinion

.48 Piecemeal opinions (expressions of opinion as to certain identified items in financial statements) sometimes have been issued heretofore when the auditor disclaimed an opinion or expressed an adverse opinion on the financial statements taken as a whole.[11] Because piecemeal opinions tend to overshadow or contradict a disclaimer of opinion or an adverse opinion,[12] they are inappropriate and should not be issued in any situation.

Reports on Comparative Statements

.49 When financial statements of the prior year are presented together with those of the current year, the auditor should report on the financial statements of the prior year if he has examined them.[13] (This requirement does not apply to summaries of financial information or other incomplete presentations.) An example of an opinion paragraph covering comparative financial statements for two years follows:

(Opinion paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of X Company as of December 31, 19XX,

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[11] The use of a piecemeal opinion following a disclaimer of opinion has not been permitted when the disclaimer was occasioned by a significant client-imposed restriction on audit scope.

[12] In view of the provisions of this paragraph, the last sentence of section 544.02, having to do with companies whose accounting practices are prescribed by governmental regulatory authorities or commissions, is amended to read as follows:

> An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles.

[13] For this purpose, an auditor who has examined financial statements for a period prior to the recognition of a business combination accounted for as a pooling of interests is not deemed, solely by virtue of having examined those statements, to have examined statements for that period after they have been retroactively revised to recognize the pooling transaction.

and December 31, 19X1, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

If the financial statements of the prior year have been audited by other public accountants whose report is not presented or if they are unaudited, this fact should be disclosed in the financial statements or in the current auditor's report. Any qualification contained in a predecessor auditor's report relating to audited financial statements presented should also be disclosed either in the financial statements or in the current auditor's report. If the auditor has significant exceptions or reservations as to unaudited financial statements presented, he should make appropriate disclosure in his report. (See section 516.11.)

Effective Date

.50 Statements on Auditing Standards generally are effective at the time of their issuance. However, since the provisions of this section change certain reporting practices heretofore considered acceptable, this section will be effective with respect to reports issued on financial statements for periods ending on or after December 31, 1974, and need not be applied retroactively. The Committee understands that arrangements already may have been made for certain engagements, at the conclusion of which the auditor customarily has expressed a piecemeal opinion following a disclaimer of opinion occasioned by scope limitations. In order to provide a period of orderly transition, since the use of piecemeal opinions will no longer be appropriate under the provisions of paragraph .48 of this section, the provisions of that paragraph will be effective with respect to reports issued on financial statements for periods ending on or after January 31, 1975.

The next page is 701.

AU Section 516

Unaudited Financial Statements

Issue date, unless otherwise indicated: November, 1972

.01 A certified public accountant may be engaged to prepare, or to assist his client in preparing, unaudited financial statements. This type of engagement is an accounting service as distinguished from an examination of financial statements in accordance with generally accepted auditing standards. This accounting service, which may include assistance in adjusting and closing the general books, frequently is rendered as an adjunct to the preparation of tax returns. Although the certified public accountant may have prepared, or assisted in preparing, unaudited financial statements, the statements are representations of management, and the fairness of their representation is management's responsibility.

.02 Financial statements are unaudited if the certified public accountant (a) has not applied any auditing procedures to them or (b) has not applied auditing procedures which are sufficient to permit him to express an opinion concerning them as described in section 509. The certified public accountant has no responsibility to apply any auditing procedures to unaudited financial statements. [As amended, for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2.] (See section 509.)

.03 A certified public accountant is associated with unaudited financial statements when he has consented to the use of his name in a report, document, or written communication setting forth or containing the statements. Further, when a certified public accountant submits to his client or others, with or without a covering letter, unaudited financial statements which he has prepared or assisted in preparing, he is deemed to be associated with such statements. This association is deemed to exist even though the certified public accountant does not append his name to the financial statements or uses "plain paper" rather than his own stationery. However, association does not arise if the accountant, as an accommodation to his client, merely types on "plain paper" or reproduces unaudited financial statements so long as he has not prepared or otherwise assisted in preparing the statements and so long as he submits them only to his client.

.04 A disclaimer of opinion should accompany unaudited financial statements with which the certified public accountant is associated. The disclaimer of opinion is the means by which the certified public accountant clearly indicates the fact that he has not audited the financial statements and accordingly does not express an opinion on them. An example of such a disclaimer of opinion is as follows:

> The accompanying balance sheet of X Company as of December 31, 19 .. , and the related statements of income and retained earnings and changes in financial position for the year then ended were not audited by us and accordingly we do not express an opinion on them.
>
> (Signature and date)

The disclaimer of opinion may accompany the unaudited financial statements, or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

.05 A certified public accountant may be retained by his client to perform routine bookkeeping services or to prepare financial statements for the client's internal use only, possibly on a monthly or quarterly basis. For such statements, it might not be necessary to include all footnotes or other disclosures that might otherwise be desirable. Under these circumstances, the accountant should add to the disclaimer of opinion a sentence to the effect that the financial statements are restricted to internal use by the client and therefore do not necessarily include all disclosures that might be required for a fair presentation in conformity with generally accepted accounting principles.

.06 Because unaudited financial statements, by definition, have not been audited by the certified public accountant, he cannot be expected to have an opinion as to whether such statements have been prepared in conformity with generally accepted accounting principles. However, if the certified public accountant concludes on the basis of facts known to him that unaudited financial statements with which he may become associated are not in conformity with generally accepted accounting principles, which include adequate disclosure, he should insist (except under the conditions described in paragraph .05) upon appropriate revision; failing that, he should set forth clearly his reservations in his disclaimer of opinion. The disclaimer should refer specifically to the nature of his reservations and to the effect, if known to him, on the financial statements.

.07 If, under circumstances such as those described in paragraph .06, the client will not agree to the appropriate revision or will not accept the accountant's disclaimer of opinion with the reservations clearly set forth, the accountant should refuse to be associated with the financial statements and, if necessary, withdraw from the engagement. Further, a certified public accountant should refuse to provide typing or reproduction services or to be associated in any way with unaudited financial statements which, on the basis of facts known to him, he concludes are false or intended to mislead.

.08 A certified public accountant may be associated with unaudited financial statements that purport to present financial position and results of operations, but omit the related statement of changes in financial position. In such a case, the accountant is not required to prepare a statement of changes in financial position and include it in his accompanying report. However:

a. When such statements are restricted to internal use by the client, the accountant normally will conclude that the omission requires him to add to his accompanying disclaimer of opinion, in addition to other required information, an indication that the statement of changes has been omitted.
b. When such statements are not so restricted, the accountant normally will conclude that the omission requires him to add to his accompanying disclaimer of opinion, in addition to other information that may be required, an indication that such financial statements do not conform to generally accepted accounting principles because the related statement of changes is not presented.

.09 Any auditing procedures that may have been performed in connection with unaudited financial statements ordinarily should not be described in the accountant's report; to do so might cause the reader to believe that the financial statements have been audited. However, in connection with letters for underwriters (see section

630), or letters pursuant to agreements between a prospective buyer and seller of a business, or in similar circumstances, it may be appropriate for an accountant to describe the limited procedures applied with respect to the unaudited financial statements. The accountant should specify in such letters or reports that their distribution is to be restricted solely to the parties involved. An accountant may also state that a limited review was made when reporting on such a review (see sections 519 and 720). [As amended, May 1976, by Statement on Auditing Standards No. 13.]

.10 Normally the certified public accountant's name would not appear in client-prepared reports setting forth unaudited financial statements. If the accountant is aware that his name is to be included he should request (a) that his name not be included in the report, or (b) that the financial statements be marked as unaudited and that there be a notation that he does not express an opinion on them. If the client does not comply, the accountant should advise him that he has not consented to the use of his name.

.11 Published annual reports of companies customarily include financial statements for the prior year for comparative purposes. Section 509.49 states "If the financial statements of the prior year . . . are unaudited, this fact should be disclosed in the financial statements or in the current auditor's report." If the prior year's statements have not been audited by anyone, they should be clearly and conspicuously marked on each page as unaudited, or the auditor should insert in his report a disclaimer such as the following:

> **We did not examine the financial statements for the year 19....... and accordingly do not express an opinion on them.**

If the prior year's statements are appropriately marked as unaudited, the disclaimer above is not necessary because the report of the independent auditor limits his opinion to the current year's financial statements. The auditor should make appropriate disclosure in his report if he has significant exceptions or reservations as to the prior year's statements. [As amended, effective for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2.] (See section 509.)

.12 A similar situation exists in documents filed with the Securities and Exchange Commission, wherein financial statements covering a number of years and possibly interim periods may be required. Under the rules and regulations of the Commission, certain of these financial statements must be audited by independent public accountants, whereas others may be included in the filings without audit. In such cases, it is not necessary that a disclaimer of opinion accompany the unaudited financial statements. For a discussion of certain responsibilities of accountants resulting from inclusion of their reports in documents filed with the Commission, see section 710.

.13 This section does not apply to tax returns and other data prepared solely for submission to taxing authorities.

The next page is 731.

AU Section 517

Reporting When a Certified Public Accountant is Not Independent

Issue date, unless otherwise indicated: November, 1972

.01 The second general standard of generally accepted auditing standards requires that "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." The independent auditor must be without bias with respect to the client under audit, since otherwise he would lack that impartiality necessary for the dependability of his findings. (See section 220.) When a certified public accountant who is not independent is associated with financial statements (as "associated" is defined in section 516.03), any procedures he might perform would not be in accordance with generally accepted auditing standards, and accordingly he would be precluded from expressing an opinion on such statements.

.02 Under these circumstances the accountant should disclaim an opinion with respect to the financial statements and should state specifically that he is not independent. However, the reason for lack of independence should not be described; including the reason might confuse the reader concerning the importance of the impairment of independence. Whether or not the accountant is independent is something he must decide as a matter of professional judgment.

.03 The recommended disclaimer of opinion, regardless of the extent of services performed, is as follows:

> We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19 ...., and the related statements of income and retained earnings and changes in financial position for the year then ended were not audited by us; accordingly, we do not express an opinion on them.
>
> (Signature and date)

Each page of the financial statements should clearly and conspicuously be marked "Unaudited–see accompanying disclaimer of opinion," unless the disclaimer of opinion appears thereon.

.04 This type of disclaimer applies whenever the certified public accountant is not independent, regardless of the extent of services performed. Thus, it is applicable when the type of disclaimer illustrated in section 516 would otherwise apply.

.05 Any procedures that may have been performed by the accountant in connection with the financial statements should not be described in his report; to do so might cause the reader to believe that the financial statements have been audited.

.06 If the accountant concludes on the basis of facts known to him that financial statements with which he is associated are not in conformity with generally accepted accounting principles, which include adequate disclosure, he should insist upon appropriate revision; failing that, he should set forth clearly his reservations in his disclaimer of opinion. The disclaimer should refer specifically to the nature of his reservations and to the effect, if known to him, on the financial statements. If the client will not agree to the appropriate revision or will not accept the accountant's disclaimer of opinion with the reservations clearly set forth, the accountant should refuse to be associated with the financial statements and, if necessary, withdraw from the engagement.

The next page is 741.

AU Section 518

Negative Assurance

Issue date, unless otherwise indicated: November, 1972

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

.02 However, negative assurances are permissible in letters required by security underwriters in which the independent auditor reports on limited procedures followed with respect to unaudited financial statements or other financial data pertinent to a registration statement filed with the Securities and Exchange Commission. (See section 630, "Letters for Underwriters.")

.03 In situations involving special reports covering data which do not purport to present financial position, results of operations, or changes in financial position, negative assurances may be given provided the procedures followed are appropriate and reasonable in the circumstances and the scope of the examination is described in the report (see section 620, "Special Reports").

The next page is 751.

AU Section 519

Reports on a Limited Review of Interim Financial Information[1]

Issue date, unless otherwise indicated: May, 1976

.01 This section applies to a report by an accountant on a limited review of interim financial information,[2] whether presented in complete or summarized form, that is included in documents issued to stockholders and others or in forms filed with regulatory agencies. The interim financial information may be presented alone or in a note to audited financial statements.

.02 The objective of a limited review differs significantly from the objective of an examination of financial statements in accordance with generally accepted auditing standards. A limited review may bring to the accountant's attention significant matters affecting the interim financial information, but it does not provide assurance that the accountant will become aware of all significant matters which would be disclosed by an audit.

[1] This section amends section 516.09 by the addition of the following sentence: "An accountant may also state that a limited review was made when reporting on such a review (see sections 519 and 720)."

[2] The nature, timing, and extent of procedures that constitute a limited review and the nature of the report that may be issued to the board of directors and management are contained in section 720, "Limited Review of Interim Financial Information."

Interim Financial Information Presented Other Than in a Note to Audited Financial Statements

.03 An accountant may consent to the use of his name and the inclusion of his report in a written communication setting forth interim financial information if he has made a limited review of such information as specified in section 720. If restrictions on the scope of a limited review preclude completion of such a review, the accountant should not consent to the use of his name.[3] Restrictions on the scope of a limited review may be imposed by a client or caused by such circumstances as the timing of the accountant's work, an inadequacy in the accounting records, or a material weakness in internal accounting control procedures.

Form of Accountant's Report

.04 The accountant's report accompanying interim financial information subjected to a limited review should consist of (a) a statement that the limited review was made in accordance with the standards for such reviews, (b) an identification of the interim financial information reviewed, and (c) a statement that an audit was not made and a disclaimer of opinion. The accountant's report should not include any expression of assurance concerning the information subjected to limited review procedures.[4] The report may be addressed to the company, its board of directors, or its stockholders. Generally, the report should be dated as of the date of the completion of the limited review.[5] In addition, each page of the interim financial information should be clearly marked as "unaudited."

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[3] See paragraph .10 concerning a client's representation when the scope of a limited review has been restricted. Also, when the accountant is unable to complete a limited review because of a scope limitation, he should consider the implications of that limitation with respect to the interim financial information issued by the client. In those circumstances, the accountant should refer to sections 720.15, 720.18 and 720.23 for guidance on the appropriate course of action.

[4] The expression of assurance would affect other types of unaudited engagements. This and other matters concerning unaudited financial statements are being studied. However, see also paragraph .11 concerning particular reporting requirements for Form 10-Q of the Securities and Exchange Commission.

[5] Other reporting issues involved in the dating of reports or concerning subsequent events are similar to those encountered in an audit of financial statements (see section 530).

.05 An example of such a report follows:

We have made a limited review, in accordance with standards established by the American Institute of Certified Public Accountants, of (describe the information or statements subjected to such review) of ABC Company and consolidated subsidiaries as of September 30, 19X1 and for the three-month and nine-month periods then ended.[6] Since we did not make an audit, we express no opinion on the (information or statements) referred to above.

.06 The accountant may use and make reference to the report of another accountant on a limited review of interim financial information. This reference indicates a division of responsibility for performance of the limited review.[7] An example of a report including such a reference follows:

We have made a limited review, in accordance with standards established by the American Institute of Certified Public Accountants, of (describe the information or statements subjected to such review) of ABC Company and consolidated subsidiaries as of September 30, 19X1 and for the three-month and nine-month periods then ended.

With regard to the ADE subsidiary whose total assets and revenues constitute 20 percent and 22 percent, respectively, of the related consolidated totals, we were furnished with the report of other accountants[8] on their limited review of the interim financial information of such subsidiary. Since we did not make an audit, we express no opinion on the (information or statements) referred to above.

Circumstances Requiring Modification of the Accountant's Report

.07 The circumstances that require modification of the accountant's report on a limited review differ in some respects from those that

[6] If interim financial information of a prior period is presented with that of the current period and the accountant has performed a limited review of that information, he should report on his review of the prior period. An example of the first sentence of such a report follows: "We have made . . . of ABC Company and consolidated subsidiaries as of September 30, 19X1 and 19XX and for the three-month and nine-month periods then ended."

[7] Section 720.10(e), footnote 3, states: "When an accountant acts as principal auditor . . . and makes use of the work or reports of other auditors in the course of the annual examination . . . he ordinarily will be in a similar position in connection with a limited review. . . ."

[8] This section amends the report included in section 720.22, by substituting the phrase "we were furnished with the report of other accountants" for the phrase "we read the report of other accountants."

would ordinarily preclude the expression of an unqualified opinion on audited financial statements, because the report is not an expression of opinion. Normally, neither an uncertainty nor a lack of consistency in the application of accounting principles affecting interim financial information would cause the accountant to modify his report. Modification of the accountant's report, however, would be required if (a) a change in accounting principle is not in conformity with generally accepted accounting principles or (b) a client did not give effect to a proposed material adjustment or disclosure (see section 720.21).

.08 *Proposed Adjustment.* If the accountant has proposed, but effect has not been given to, a material adjustment, he should modify his report. The modification should describe the nature of the proposed adjustment and state its effect on the interim information. An example of such a modification of the accountant's report follows:

> We have made a limited review, in accordance with standards established by the American Institute of Certified Public Accountants, of (describe the information or statements subjected to such review) of ABC Company and consolidated subsidiaries as of September 30, 19X1, and for the three-month and nine-month periods then ended.
>
> Based on information furnished us by management, we believe that the Company has excluded from property and debt in the accompanying balance sheet certain lease obligations which should be capitalized in order to conform with generally accepted accounting principles. This information indicates that if these lease obligations were capitalized at September 30, 19X1, property would be increased by \$........, and long-term debt by \$........, and net income and earnings per share would be increased (decreased) by \$........, \$........, and \$........, \$........, respectively, for the three-month and nine-month periods then ended. Effect was not given in the accompanying (information or statements) to a proposed adjustment to capitalize these lease obligations.
>
> Since we did not make an audit, we express no opinion on the (information or statements) referred to above.

.09 *Proposed Disclosure.* The information the accountant will conclude is necessary for adequate disclosure will be influenced by the form and context in which the interim financial information is presented. For example, the disclosures considered necessary for interim financial information presented in accordance with the minimum disclosure requirements of APB Opinion No. 28, paragraph 30 [AC section 2071.30], are considerably less extensive than those necessary for annual financial statements that present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.[9] If the accountant has proposed the inclusion of information that he believes is necessary for adequate disclosure in conformity with generally accepted accounting principles and it is not included in the interim financial information, he should modify his report to include the necessary information. An example of such a modification of the accountant's report follows:

> We have made a limited review, in accordance with standards established by the American Institute of Certified Public Accountants, of (describe the information or statements subjected to such review) of ABC Company and consolidated subsidiaries as of September 30, 19X1, and for the three-month and nine-month periods then ended.
>
> Management has informed us that the Company is presently contesting deficiencies in federal income taxes proposed by the Internal Revenue Service for the years 19XX through 19XX in the aggregate amount of approximately \$........, and that the extent of the Company's liability, if any, and the effects on the accompanying (information or statements) are not determinable at this time. The (information or statements) fail to disclose these matters which we believe are required to be disclosed in conformity with generally accepted accounting principles.
>
> Since we did not make an audit, we express no opinion on the (information or statements) referred to above.

Client's Representation Concerning a Limited Review

.10 The accountant may be requested to make a limited review of interim financial information to permit the client to include a representation to that effect in documents issued to stockholders. The client might also elect to make such representation in other documents issued to third parties. If the client represents in such a document setting forth interim financial information that the accountant has made a limited review, the accountant should request that his report be included. If the client will not agree to include the accountant's report or if the accountant has been unable to complete the review (see paragraph .03), the accountant should request that neither his name nor reference to him be associated with the information. If

[9] APB Opinion No. 28, paragraph 32 [AC section 2071.32], states: ". . . there is a presumption that users of summarized interim financial data will have read the latest published annual report, including the financial disclosures required by generally accepted accounting principles and management's commentary concerning the annual financial results, and that the summarized interim data will be viewed in that context."

the client does not comply, the accountant should advise the client that he does not consent either to the use of his name or to reference to him and should consider what other actions might be appropriate.[10]

.11 The accountant may also be requested to make a limited review of interim financial information to permit the client to include a representation to that effect in Form 10-Q, a quarterly report required to be submitted to the Securities and Exchange Commission pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934. The procedures for a limited review set forth in section 720.08–.18, inclusive, constitute the appropriate professional standards and procedures for an accountant's review of interim financial information for that purpose. When these procedures are performed, the client may represent that the accountant has made a limited review of the interim financial information. If such representation is made, the client must state whether effect was given to all adjustments or disclosures proposed by the accountant and, if not, why not. The accountant should request that his report be included as an exhibit to Form 10-Q (see section 720A.02). When an accountant's report is submitted as an exhibit to Form 10-Q, that form requires his confirming or otherwise commenting upon these representations. Accordingly, when the accountant's report is so included and the circumstances requiring modification of his report (paragraphs .07 through .09) are not present, an example of such a report follows:

> We have made a limited review, in accordance with standards established by the American Institute of Certified Public Accountants, of (describe the information or statements subjected to such review) of ABC Company and consolidated subsidiaries as of September 30, 19X1 and for the three-month and nine-month periods then ended. Since we did not make an audit, we express no opinion on the (information or statements) referred to above. To comply with the requirements of the Securities and Exchange Commission, we confirm the Company's representations concerning proposed adjustments and disclosures included in the accompanying Form 10-Q for the period ended September 30, 19X1, in accordance with the related instruction K.

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[10] In considering what actions, if any, may be appropriate in these circumstances, the accountant may wish to consult his legal counsel.

Other Matters

.12 Subsequent to the date of his report, the accountant may become aware that facts existed at the date of his report that might have affected his report had he then been aware of such facts. Because of the variety of conditions that might be encountered, the specific actions to be taken by the accountant in a particular case may vary in the light of the circumstances. In any event, the accountant would be well advised to refer to section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," because certain provisions of that section may be relevant to his consideration of the types of matters discussed in this paragraph.

Interim Financial Information Presented in a Note to Audited Financial Statements

.13 Certain companies are required by Regulation S-X of the Securities and Exchange Commission to include in audited financial statements a note containing selected interim financial information (see section 720A.01). Also, other companies may elect to include similar information in their audited financial statements. In these circumstances, the auditor ordinarily need not modify his report on the audited financial statements to make reference to his limited review or to the selected interim financial information. The interim financial information has not been audited nor is it required for a fair presentation of financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles. Further, when the interim financial information is presented in a note to the audited financial statements, the accountant's report on a limited review required by paragraphs .04 and .05 need not accompany the audited financial statements except as set forth below.

.14 The auditor's report on the audited financial statements should be expanded, however, if the scope of the limited review was restricted (see paragraph .03) or if the interim financial information appears to him not to be presented in conformity with generally accepted accounting principles. The auditor should also expand his report if the interim financial information included in the note was not subjected to a limited review, unless that fact is stated in the note. An example of an expansion of an auditor's report to refer to the restricted scope might be the inclusion of the following separate paragraph:

> Note X, "Unaudited Interim Financial Information," contains information that we did not audit and, accordingly, we do not express an opinion on that information. In addition, we attempted but were unable to make a limited review of such information in accordance with standards established by the American Institute of Certified Public Accountants because we believe that the Company's system for preparing interim financial information does not provide an adequate basis to enable us to complete this review.

.15 The auditor's report on the audited financial statements should also be expanded when interim financial information that has been subjected to the limited review procedures specified in section 720 and included in a note to the financial statements is not appropriately marked as "unaudited." The auditor should also expand his report if the note includes an indication that a limited review was made unless it also indicates that the auditor does not express an opinion on the data presented.

The next page is 771.

AU Section 530

Dating of the Independent Auditor's Report

Issue date, unless otherwise indicated: November, 1972

.01 Generally, the date of completion of the field work should be used as the date of the independent auditor's report. Paragraph .05 describes the procedure to be followed when a subsequent event occurring after the completion of the field work is disclosed in the financial statements.

.02 The auditor has no responsibility to make any inquiry or carry out any auditing procedures for the period after the date of his report.[1] However, with respect to filings under the Securities Act of 1933, reference should be made to section 710.08–.11.

Events Occurring After Completion of Field Work But Before Issuance of Report

.03 In case a subsequent event of the type requiring adjustment of the financial statements (as discussed in section 560.03) occurs after the date of the independent auditor's report but before its issuance, and the event comes to the attention of the auditor, the financial statements should be adjusted or the auditor should qualify his opinion.[2] When the adjustment is made without disclosure of the event, the report ordinarily should be dated in accordance with paragraph .01. However, if the financial statements are adjusted and disclosure of the event is made, or if no

[1] See section 561 regarding procedures to be followed by the auditor who, subsequent to the date of his report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected his report had he then been aware of such facts.

[2] In some cases, a disclaimer of opinion or an adverse opinion may be appropriate.

adjustment is made and the auditor qualifies his opinion,[1] the procedures set forth in paragraph .05 should be followed.

.04 In case a subsequent event of the type requiring disclosure (as discussed in section 560.05) occurs after the date of the auditor's report but before issuance of his report, and the event comes to the attention of the auditor, it should be disclosed in a note to the financial statements or the auditor should qualify his opinion.[2] If disclosure of the event is made, either in a note or in the auditor's report, the auditor would date his report as set forth in the following paragraph.

.05 The independent auditor has two methods available for dating his report when a subsequent event disclosed in the financial statements occurs after completion of his field work but before issuance of his report. He may use "dual dating," for example, "February 16, 19 ...., except for Note .... as to which the date is March 1, 19 ....," or he may date his report as of the later date. In the former instance, his responsibility for events occurring subsequent to the completion of his field work is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the date of his report and, accordingly, the procedures outlined in section 560.12 generally should be extended to that date.

Reissuance of the Independent Auditor's Report

.06 An independent auditor may reissue his report on financial statements contained in annual reports filed with the Securities and Exchange Commission or other regulatory agencies or in a long-form report subsequent to the date on which his report on the financial statements included therein was first issued. An independent auditor may also be requested by his client to furnish additional copies of a previously issued report. Use of the original report date in a reissued report removes any implication that records, transactions, or events after that date have been examined

[1] Ibid.

[2] Ibid.

or reviewed. In such cases, the independent auditor has no responsibility to make further investigation or inquiry as to events which may have occurred during the period between the original report date and the date of the release of additional reports. However, see section 710.03 and section 710.08–.11 as to an auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933.

.07 In some cases, it may not be desirable for the independent auditor to reissue his report in the circumstances described in paragraph .06 because he has become aware of an event that occurred subsequent to the date of his original report that requires adjustment or disclosure in the financial statements. In such cases, adjustment with disclosure or disclosure alone should be made as described in section 560.08. The independent auditor should consider the effect of these matters on his opinion and he should date his report in accordance with the procedures described in paragraph .05.

.08 However, if an event of the type requiring disclosure only (as discussed in sections 560.05 and 560.08) occurs between the date of the independent auditor's original report and the date of the reissuance of such report, and if the event comes to the attention of the independent auditor, the event may be disclosed in a separate note to the financial statements captioned somewhat as follows:

Event (Unaudited) Subsequent to the Date of the
Report of Independent Auditor.

Under these circumstances, the report of the independent auditor would carry the same date used in the original report.

The next page is 831.

AU Section 542

Other Conditions Which Preclude the Application of Necessary Auditing Procedures

Issue date, unless otherwise indicated: November, 1972

Receivables and Inventories

[.01-.04] [Superseded by Statement on Auditing Standards No. 2, effective December 31, 1974.] (See section 509.)

.05 If the independent auditor has not satisfied himself by means of other auditing procedures with respect to opening inventories, he should either disclaim an opinion on the statement of income or qualify his opinion thereon, depending on the degree of materiality of the amounts involved. An illustration of such a disclaimer follows:

(Scope paragraph)

We have examined the balance sheet of X Company as of September 30, 19...2, and the related statements of income and retained earnings and changes in financial position 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 as stated in the following paragraph.

(Middle paragraph)

Because we were not engaged as auditors until after September 30, 19...1, we were not present to observe the physical inventory taken at that date and we have not satisfied ourselves by means of other prccedures concerning inventory quantities. The amount of the inventory at September 30, 19...1, enters materially into the determination of the results of operations and changes in financial position for the year ended September 30, 19...2. Therefore, we do not express an opinion on the accompanying statements of income and retained earnings and changes in financial position for the year ended September 30, 19...2.

(Opinion paragraph)

In our opinion, the accompanying balance sheet presents fairly the financial position of X Company at September 30, 19.. 2, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.[1]

Long-Term Investments

.06 When the effects of accounting for long-term investments are material in relation to financial position or results of operations of the investor, the independent auditor is not in a position to express an unqualified opinion on the investor's financial statements unless he has obtained sufficient competent evidential matter in support of the objectives described in section 332.02. There may be situations where there is an effective limitation on the scope of the auditor's examination because sufficient evidential matter is not available to him. Examples of such scope limitations, generally with respect to investments accounted for under the equity method, would be (a) the auditor not being able to obtain audited financial statements of an investee or to apply auditing procedures to unaudited financial statements of an investee and (b) the auditor not being able to examine sufficient evidential matter relating to the elimination of unrealized profits and losses resulting from transactions between the investor and the investee. In such situations, the auditor should indicate in the scope paragraph of his report the limitations on his work and, depending on materiality of the amounts involved, he should either qualify his opinion or disclaim an opinion.

The next page is 841.

[1] It is assumed that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles (see section 420 for a discussion of consistency).

AU Section 543

Part of Examination Made by Other Independent Auditors

Issue date, unless otherwise indicated: November, 1972

.01 Following are guidelines for reporting on financial statements when the independent auditor (referred to herein as the principal auditor) utilizes the work and reports of other independent auditors who have examined the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented.

Principal Auditor's Course of Action

.02 The auditor in this situation may have performed all but a relatively minor portion of the work, or significant parts of the examination may have been performed by other auditors. In the latter case, he must decide whether his own participation is sufficient to enable him to serve as the principal auditor and to report as such on the financial statements. In deciding this question, the auditor should consider, among other things, the materiality of the portion of the financial statements he has examined in comparison with the portion examined by other auditors, the extent of his knowledge of the overall financial statements, and the importance of the components he examined in relation to the enterprise as a whole.[1]

.03 If the auditor decides that it is appropriate for him to serve as the principal auditor, he must then decide whether to make reference in his report[2] to the examination made by another auditor. If

[1] Nothing in this section should be construed to require or imply that an auditor in deciding whether he may properly serve as principal auditor, without himself auditing particular subsidiaries, divisions, branches, components, or investments of his client, should make that decision on any basis other than his judgment regarding the professional considerations as discussed in paragraphs .02 and .10.

[2] See paragraph .09 for example of appropriate reporting when reference is made to the examination of other auditors.

the principal auditor decides to assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, no reference should be made to the other auditor's examination. On the other hand, if the principal auditor decides not to assume that responsibility, his report should make reference to the examination of the other auditor and should indicate clearly the division of responsibility between himself and the other auditor in expressing his opinion on the financial statements. Regardless of the principal auditor's decision, the other auditor remains responsible for the performance of his own work and for his own report.

Decision Not to Make Reference

.04 If the principal auditor is able to satisfy himself as to the independence and professional reputation of the other auditor (see paragraph .10) and takes steps he considers appropriate to satisfy himself as to the other auditor's examination (see paragraph .12), he may be able to express an opinion on the financial statements taken as a whole without making reference in his report to the examination of the other auditor. If the principal auditor decides to take this position, he should not state in his report that part of the examination was made by another auditor because to do so may cause a reader to misinterpret the degree of responsibility being assumed.

.05 Ordinarily, the principal auditor would be able to adopt this position when:

a. Part of the examination is made by another independent auditor which is an associated or correspondent firm and whose work is acceptable to the principal auditor based on his knowledge of the professional standards and competence of that firm; or

b. The other auditor was retained by the principal auditor and the work was performed under the principal auditor's guidance and control; or

c. The principal auditor, whether or not he selected the other auditor, nevertheless takes steps he considers necessary to satisfy himself as to the other auditor's examination and accordingly is satisfied as to the reasonableness of the accounts for the purpose of inclusion in the financial statements on which he is expressing his opinion; or

d. The portion of the financial statements examined by the other auditor is not material to the financial statements covered by the principal auditor's opinion.

Decision to Make Reference

.06 On the other hand, the principal auditor may decide to make reference to the examination of the other auditor when he expresses his opinion on the financial statements. In some situations, it may be impracticable for the principal auditor to review the other auditor's work or to use other procedures which in the judgment of the principal auditor would be necessary for him to satisfy himself as to the other auditor's examination. Also, if the financial statements of a component examined by another auditor are material in relation to the total, the principal auditor may decide, regardless of any other considerations, to make reference in his report to the examination of the other auditor.

.07 When the principal auditor decides that he will make reference to the examination of the other auditor, his report should indicate clearly, in both the scope and opinion paragraphs, the division of responsibility as between that portion of the financial statements covered by his own examination and that covered by the examination of the other auditor. The report should disclose the magnitude of the portion of the financial statements examined by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly reveals the portion of the financial statements examined by the other auditor. The other auditor may be named but only with his express permission and provided his report is presented together with that of the principal auditor.[1]

.08 Reference in the report of the principal auditor to the fact that part of the examination was made by another auditor is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors who conducted the examinations of various components of the overall

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[1] As to filings with the Securities and Exchange Commission, see Rule 2-05 of Regulation S-X.

financial statements; in addition, it should be understood that an auditor's report which makes reference to the report of another auditor is not to be construed as being inferior in professional standing to a report in which no such reference is made.

.09 An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the examination of the other auditor follows:

> We have examined the consolidated balance sheet of X Company and subsidiaries as of December 31, 19...., and the related consolidated statements of income and retained earnings and changes in financial position 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 reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. These statements were examined by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for B Company, is based solely upon the report of the other auditors.
>
> In our opinion, based upon our examination and the report of other auditors, the accompanying consolidated balance sheet and consolidated statements of income and retained earnings and changes in financial position present fairly . . .

When two or more auditors in addition to the principal auditor participate in the examination, the percentages covered by the other auditors may be stated in the aggregate.

Procedures Applicable to Both Methods of Reporting

.10 Whether or not the principal auditor decides to make reference to the examination of the other auditor, he should make inquiries concerning the professional reputation and independence of the other auditor. He also should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements. These inquiries and other measures may include procedures such as the following:

a. Make inquiries as to the professional reputation and standing of the other auditor to one or more of the following:

  (i) The American Institute of Certified Public Accountants, the applicable state society of certified public accountants and/or the local chapter, or in the case of a foreign auditor, his corresponding professional organization.

  (ii) Other practitioners.

  (iii) Bankers and other credit grantors.

  (iv) Other appropriate sources.

b. Obtain a representation from the other auditor that he is independent under the requirements of the American Institute of Certified Public Accountants and, if appropriate, the requirements of the Securities and Exchange Commission.

c. Ascertain through communication with the other auditor:

  (i) That he is aware that the financial statements of the component which he is to examine are to be included in the financial statements on which the principal auditor will report and that the other auditor's report thereon will be relied upon (and, where applicable, referred to) by the principal auditor.

  (ii) That he is familiar with accounting principles generally accepted in the United States and with the generally accepted auditing standards promulgated by the American Institute of Certified Public Accountants and will conduct his examination and will report in accordance therewith.

  (iii) That he has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with regulatory agencies such as the Securities and Exchange Commission, if appropriate.

  (iv) That a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.

(Inquiries as to matters under a, and c (ii) and (iii) ordinarily would be unnecessary if the principal auditor already knows the professional reputation and standing of the other auditor and if the other auditor's primary place of practice is in the United States.)

.11 If the results of inquiries and procedures by the principal auditor with respect to matters described in paragraph .10 lead him to the conclusion that he can neither assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, nor report in the manner set forth in paragraph .09, he should appropriately qualify his opinion or disclaim an opinion on the financial statements taken as a whole. His reasons therefor should be stated, and the magnitude of the portion of the financial statements to which his qualification extends should be disclosed.

Additional Procedures Under Decision Not to Make Reference

.12 When the principal auditor decides not to make reference to the examination of the other auditor, in addition to satisfying himself as to the matters described in paragraph .10, he should also consider whether to perform one or more of the following procedures:

a. Visit the other auditor and discuss the audit procedures followed and results thereof.

b. Review the audit programs of the other auditor. In some cases, it may be appropriate to issue instructions to the other auditor as to the scope of his audit work.

c. Review the working papers of the other auditor, including his evaluation of internal control and his conclusions as to other significant aspects of the engagement.

.13 In some circumstances the principal auditor may consider it appropriate to participate in discussions regarding the accounts with management personnel of the component whose financial statements are being examined by other auditors and/or to make supplemental tests of such accounts. The determination of the extent of additional procedures, if any, to be applied rests with the principal auditor alone in the exercise of his professional judgment and in no way constitutes a reflection on the adequacy of the other auditor's work. Because the principal auditor in this case assumes responsibility for his opinion on the financial statements on which he is reporting without making reference to the other auditor's examination, his judgment must govern as to the extent of procedures to be undertaken.

Long-Term Investments

.14 With respect to investments accounted for under the equity method, the auditor who uses another auditor's report for the purpose of reporting on the investor's equity in underlying net assets and its share of earnings or losses and other transactions of the investee is in the position of a principal auditor using the work and reports of other auditors. Under these circumstances, the auditor may decide that it would be appropriate to refer to the other auditor's examination in his report on the financial statements of the investor. (See paragraphs .06–.11.) When the work and reports of other auditors constitute a major element of evidence with respect to investments accounted for under the cost method, the auditor may be in a position analogous to that of a principal auditor.

Qualifications in Other Auditor's Report

.15 If the opinion of the other auditor is qualified, the principal auditor should decide whether the subject of the qualification is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require qualification of his own report. If the subject of the qualification is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to the qualification; if the other auditor's report is presented, the principal auditor may wish to make reference to such qualification and its disposition.

Restated Financial Statements of Prior Years Following a Pooling of Interests

.16 Following a pooling-of-interests transaction, an auditor may be asked to report on restated financial statements for one or more prior years when other auditors have examined one or more of the entities included in such financial statements. In some of these situations the auditor may decide that he has not examined a sufficient portion of the financial statements for such prior year or years to enable him to serve as principal auditor (see paragraph .02). Also, in such cases, it often is not possible or it may not be appropriate or necessary for the auditor to satisfy himself with respect to the restated financial statements. In these circumstances it may be appropriate for him to express his opinion solely with respect to the compilation of such statements; however, no opinion should be expressed unless the auditor has examined the statements of at least one of the entities included in the restatement for at least the latest period presented. The following is an illustration of appropriate reporting on compilation which can be presented in an additional paragraph of the auditor's report following the standard scope and opinion paragraphs covering the consolidated financial statements for the current year:

> We previously examined and reported upon the consolidated statements of income and changes in financial position of XYZ Company and subsidiaries for the year ended December 31, 19..., prior to their restatement for the 19..... pooling of interests. The contribution of XYZ Company and subsidiaries to revenues and net income represented .... percent and ..... percent of the respective restated totals. Separate financial statements of the other companies included in the 19.... restated consolidated statements of income and changes in financial position were examined and reported upon separately by other auditors. We also have reviewed, as to compilation only, the accompanying consolidated statements of income and changes in financial position for the year ended December 31, 19..., after restatement for the 19..... pooling of interests; in our opinion, such consolidated statements have been properly compiled on the basis described in Note A of notes to consolidated financial statements.

.17 In reporting on the compilation of restated financial statements as described in the preceding paragraph, the auditor does not assume responsibility for the work of other auditors nor the responsibility for expressing an opinion on the restated financial statements taken as a whole. His review is directed toward procedures which will enable him to express an opinion only as to proper compilation. These procedures include checking the compilation for mathematical accuracy and for conformity of the compilation methods with generally accepted accounting principles.

For example, the auditor should review and make inquiries regarding such matters as the following:

a. Elimination of intercompany transactions and accounts.

b. Combining adjustments and reclassifications.

c. Adjustments to treat like items in a comparable manner, if appropriate.

d. The manner and extent of presentation of disclosure matters in the restated financial statements and notes thereto.

The auditor should also consider the application of procedures contained in paragraph .10.

Predecessor Auditor

[.18] [Superseded by Statement on Auditing Standards No. 7, effective November 30, 1975.] (See section 315.)

→ *The next page is 861.* ←

AU Section 544

Lack of Conformity With Generally Accepted Accounting Principles

Issue date, unless otherwise indicated: November, 1972

[.01] [Superseded by Statement on Auditing Standards No. 2, effective December 31, 1974.] (See section 509.)

Regulated Companies

.02 The basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (Such companies include public utilities, common carriers, insurance companies, financial institutions, and the like.) Accordingly, the first reporting standard is equally applicable to opinions on financial statements of such regulated companies presented for purposes other than filings with their respective supervisory agencies; and material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this will require either a qualified or an adverse opinion on such statements. An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles. [As amended, effective for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2.] (See section 509.)

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

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

The next page is 871.

AU Section 545

Inadequate Disclosure

Issue date, unless otherwise indicated: November, 1972

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

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

(Middle paragraph)

On January 15, 19...2, the company issued debentures in the amount of $.................... for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 19...1.

(Opinion paragraph)

In our opinion, except for the omission of the information in the preceding paragraph, the aforementioned financial statements present fairly . . .

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

Omission of Statement of Changes in Financial Position

.04 If an entity issues financial statements that purport to present financial position and results of operations but omits the related statement of changes in financial position, and if the omission is not sanctioned by Opinion No. 19 [AC section 2021] of the Accounting Principles Board, the omission should be treated in accordance with the provisions of the Special Bulletin of the American Institute of Certified Public Accountants issued in October 1964 relating to diclosures of departures from Opinions of the Accounting Principles Board.[1] Accordingly, the auditor normally will conclude that the omission requires qualification of his opinion.

.05 An entity's failure to disclose required information normally results in the auditor including that information in his report.[2] Although this procedure is appropriate with respect to specific disclosures relating to financial statements that are presented, it is not appropriate to require the auditor to prepare a basic financial statement (a statement of changes in financial position for one or more years) and include it in his report when the client's management has declined to present such a statement. Accordingly, in these cases the auditor should qualify his report, ordinarily in the following manner:

> We have examined the balance sheet of X Company as of December 31, 19......, 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.
>
> The company declined to present a statement of changes in financial position for the year ended December 31, 19....... Presentation of such statement summarizing the company's financing and investing activities and other changes in its financial position is required by Opinion No. 19 of the Accounting Principles Board.

[1] Editor's Note: Effective March 1, 1973, members of the Institute are governed by Rule of Conduct 203 of the Code of Professional Ethics of the Institute in reporting on financial statements materially affected by a departure from an accounting principle promulgated by the body designated bv Council of the Institute to establish generally accepted accounting principles. (See Volumes 2 and 3, AICPA PROFESSIONAL STANDARDS.)

[2] See section 430.04.

In our opinion, except that the omission of a statement of changes in financial position results in an incomplete presentation as explained in the preceding paragraph, the aforementioned financial statements 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.

The next page is 891.

AU Section 546

Reporting on Inconsistency

Issue date, unless otherwise indicated: November, 1972

Change in Accounting Principle

.01 When there is a change in accounting principle, the independent auditor should modify his opinion as to consistency, indicating the nature of the change. The auditor's concurrence with a change is implicit unless he takes exception to the change in expressing his opinion as to fair presentation of the financial statements in conformity with generally accepted accounting principles. Nevertheless, in order to be more informative the auditor should make his concurrence explicit (unless the change is the correction of an error) using the expression "with which we concur." The form of modification of the opinion depends on the method of accounting for the effect of the change, as explained in paragraphs .02 and .03.[1]

.02 If there has been a change in accounting principle which should be reported by restating the financial statements of prior years,[2] the appropriate reference to consistency is that the statements are consistent after giving retroactive effect to the change. Illustrations of appropriate reporting follow:

(Opinion paragraph covering one year)

. . . applied on a basis consistent with that of the preceding year after giving retroactive effect to the change, with which we concur, in the method of accounting for long-term construction contracts as described in Note X to the financial statements.

(Opinion paragraph covering two years)

. . . applied on a consistent basis after restatement for the change,

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[1] With respect to the method of accounting for the effect of a change in accounting principle, see Accounting Principles Board Opinion No. 20 [AC section 1051], including paragraph 4 [AC section 1051.04], which states that methods of accounting for changes in principles have been and will be specified in pronouncements other than Opinion No. 20 [AC section 1051].

[2] With respect to reporting on financial statements after a pooling of interests, see paragraphs .12 and .13 and section 543.16-.17.

> with which we concur, in the method of accounting for long-term construction contracts as described in Note X to the financial statements.

The auditor's report need not refer to a change in accounting principle and restatement made in conformity with generally accepted accounting principles if the statements for the year of change are reported upon together with the financial statements for a year subsequent to the year of change.

.03 If there has been a change in accounting principle which should be reported by means other than by restating the financial statements of prior years and the independent auditor is reporting only on the year during which the change was made, his report should state that accounting principles have been consistently applied except for the change. An example of such reporting follows:

> (Opinion paragraph)
>
> . . . in conformity with generally accepted accounting principles which, except for the change, with which we concur, in the method of computing depreciation as described in Note X to the financial statements, have been applied on a basis consistent with that of the preceding year.

If the independent auditor is reporting on two or more years when reporting on a subsequent year's financial statements, he should make appropriate reference to the change as long as the year of change is included in the years being reported upon. If the year of change was other than the earliest year being reported upon, the following example would be an appropriate form of reporting:

> (Opinion paragraph)
>
> . . . in conformity with generally accepted accounting principles consistently applied during the period except for the change, with which we concur, in the method of computing depreciation as described in Note X to the financial statements.

If the year of change is the earliest year being reported upon, there is no inconsistency in the application of accounting principles during the period subsequent to the change, but the auditor should make reference to the change having been made in such year. Following is an example of appropriate reporting:

> (Opinion paragraph)
>
> . . . in conformity with generally accepted accounting principles consistently applied during the period subsequent to the change, with which we concur, made as of January 1, 19....., in the method

of computing depreciation as described in Note X to the financial statements.

A change in accounting principle made at the beginning of the year preceding the earliest year being reported upon by the auditor does not result in an inconsistency between such preceding year and later years. In reporting on consistency of a later year with such preceding year, reference to a change is not necessary.

Reporting on Changes in Accounting Principle That Are Not in Conformity With Generally Accepted Accounting Principles

.04 The auditor should evaluate a change in accounting principle to satisfy himself that (a) the newly adopted accounting principle is a generally accepted accounting principle, (b) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, and (c) management's justification[1] for the change is reasonable. If a change in accounting principle does not meet these conditions, the auditor's report should so indicate and his opinion should be appropriately qualified as discussed in paragraphs .05 through .11.

Reporting in the Year of Change

.05 If a newly adopted accounting principle is not a generally accepted accounting principle or the method of accounting for the effect of the change is not in conformity with generally accepted accounting principles, the auditor should express a qualified opinion or, if the effect of the change is sufficiently material, the auditor should express an adverse opinion on the financial statements taken as a whole due to a lack of conformity with generally accepted accounting principles. If a qualified opinion is expressed, the qualification would relate both to conformity with generally accepted accounting principles and to the consistency of application. When expressing an adverse opinion in such circumstances, no reference to consistency need be made because the financial statements are not

[1] Accounting Principles Board Opinion No. 20, paragraph 16 [AC section 1051.16], states: "The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable." The requirement for justification is applicable to years beginning after July 31, 1971.

presented in conformity with generally accepted accounting principles.[1] Following is an illustration of reporting where the newly adopted accounting principle is not a generally accepted accounting principle:

(Middle paragraph)

The company previously recorded its land at cost but adjusted the amounts to appraised values during the year, with a corresponding increase in stockholders' equity in the amount of $ .... In our opinion, the new basis on which land is recorded is not in conformity with generally accepted accounting principles.

(Opinion paragraph)

In our opinion, except for the change to recording appraised values as described above, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19 , and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.06 If management has not provided reasonable justification for a change in accounting principles, the independent auditor should express an exception to the change having been made without reasonable justification. Such qualification would relate both to conformity with generally accepted accounting principles and to the consistency of application. An example follows:

(Middle paragraph)

As disclosed in Note X to the financial statements, the company has adopted (description of newly adopted method), whereas it previously used (description of previous method). Although use of the (description of newly adopted method) is in conformity with generally accepted accounting principles, in our opinion the company has not provided reasonable justification for making a change as required by Opinion No. 20 of the Accounting Principles Board.

(Opinion paragraph)

In our opinion, except for the change in accounting principles as stated above, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19 , and the

[1] Footnote disclosure of an inconsistency in accounting principles unrelated to the reason for an adverse opinion is required even though the independent auditor does not refer to the inconsistency in his report. If such an inconsistency is not disclosed, the independent auditor should also qualify his report for this lack of disclosure. (See section 430.04.)

results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Reporting in Subsequent Years

.07 Whenever an accounting change results in an independent auditor expressing a qualified or adverse opinion on the conformity of financial statements with generally accepted accounting principles for the year of change, he should consider the possible effects of that change when reporting on the entity's financial statements for subsequent years, as discussed in paragraphs .08–.11.

.08 If the financial statements for the year of such change are presented with a subsequent year's financial statements, the auditor's report should disclose his reservations with respect to the statements for the year of change.

.09 If an entity has adopted an accounting principle which is not a generally accepted accounting principle, its continued use may have a material effect on the statements of a subsequent year on which the auditor is reporting. In this situation, the independent auditor should express either a qualified or an adverse opinion, depending upon the materiality of the departure in relation to the statements of the subsequent year.

.10 If an entity accounts for the effect of a change prospectively when generally accepted accounting principles require restatement or the inclusion of the cumulative effect of the change in the year of change, a subsequent year's financial statements could improperly include a charge or credit which is material to those statements. This situation also requires that the auditor express a qualified or an adverse opinion.

.11 If management has not provided reasonable justification for a change in accounting principles, the auditor's opinion should express an exception to the change having been made without reasonable justification, as previously indicated. In addition, the auditor should continue to express his exception with respect to the financial statements for the year of change as long as they are presented. However, the auditor's exception relates to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing an exception for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express an exception to use of the newly adopted principle.

Reports Following a Pooling of Interests

.12 When companies have merged or combined in accordance with the accounting concept known as a "pooling of interests," appropriate effect of the pooling should be given in the presentation of financial position, results of operations, changes in financial position, and other historical financial data of the continuing business for the year in which the combination is consummated and, in comparative financial statements, for years prior to the year of pooling, as described in Accounting Principles Board Opinion No. 16 [AC section 1091], "Business Combinations." If prior year financial statements, presented in comparison with current year financial statements, are not restated to give appropriate recognition to a pooling of interests, the comparative financial statements are not presented on a consistent basis. In this case, the inconsistency arises not from a change in the application of an accounting principle in the current year, but from the lack of such application to prior years. Such inconsistency would require a qualification in the independent auditor's report. In addition, failure to give appropriate recognition to the pooling in comparative financial statements is a departure from an Opinion of the Accounting Principles Board. Therefore, the auditor must also give appropriate consideration to the provisions of the Special Bulletin of the American Institute of Certified Public Accountants issued in October 1964 relating to disclosures of departures from Opinions of the Accounting Principles Board.[1]

.13 When single-year statements only are presented for the year in which a combination is consummated, a note to the financial statements should adequately disclose the pooling transaction and state the revenues, extraordinary items, and net income of the constituent companies for the preceding year on a combined basis. In

[1] **Editor's Note**: Effective March 1, 1973, members of the Institute are governed by Rule of Conduct 203 of the Code of Professional Ethics of the Institute in reporting on financial statements materially affected by a departure from an accounting principle promulgated by the body designated by Council of the Institute to establish generally accepted accounting principles. (See Volumes 2 and 3, AICPA PROFESSIONAL STANDARDS.)

such instances, the disclosure and consistency standards are met. Omission of disclosure of the pooling transaction and its effect on the preceding year would require qualifications as to the lack of disclosure and consistency in the independent auditor's report.

First Examinations

.14 When the independent auditor has not examined the financial statements of a company for the preceding year, he should adopt procedures that are practicable and reasonable in the circumstances to assure himself that the accounting principles employed are consistent between the current and the preceding year. Where adequate records have been maintained by the client, it is usually practicable and reasonable to extend auditing procedures sufficiently to give an opinion as to consistency.

.15 Inadequate financial records or limitations imposed by the client may preclude the independent auditor from forming an opinion as to the consistent application of accounting principles between the current and the prior year, as well as to the amounts of assets or liabilities at the beginning of the current year. Where such amounts could materially affect current operating results, the independent auditor would also be unable to express an opinion on the current year's results of operations and changes in financial position. Following is an example of reporting where the records are inadequate:

(Scope paragraph)

. . . and such other auditing procedures as we considered necessary in the circumstances, except as indicated in the following paragraph.

(Middle paragraph)

Because of major inadequacies in the Company's accounting records for the previous year, it was not practicable to extend our auditing procedures to enable us to express an opinion on results of operations and changes in financial position for the year ended (current year) or on the consistency of application of accounting principles with the preceding year.

(Opinion paragraph)

In our opinion, the accompanying balance sheet presents fairly the financial position of X Company as of (current year end) in conformity with generally accepted accounting principles.

.16 If accounting records for prior years were kept on a basis which did not result in a fair presentation of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles for those years, and it is impracticable to restate financial statements for those years,[1] the independent auditor should omit the customary reference to consistency and present his report similar to the following:

(Middle paragraph)

The Company has kept its records and has prepared its financial statements for previous years on the cash basis with no recognition having been accorded accounts receivable, accounts payable, or accrued expenses. At the beginning of the current year the Company adopted the accrual basis of accounting. Although appropriate adjustments have been made to retained earnings as of the beginning of the year, it was not practicable to determine what adjustments would be necessary in the financial statements of the preceding year to restate results of operations and changes in financial position in conformity with the accounting principles used in the current year.

(Opinion paragraph)

In our opinion, the aforementioned financial statements present fairly the financial position of X Company as of October 31, 19....., and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles.

Pro Forma Effects of Accounting Changes

.17 In single-year financial statements, the pro forma effects of retroactive application of certain accounting changes should be disclosed.[2] In such situations, the reporting provisions of section 509.49 are applicable to the prior year data. [As amended, for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2.] (See section 509.)

The next page is 911.

[1] If restatement of prior years' statements is practicable, see section 420.10.

[2] See paragraph 21 of Accounting Principles Board Opinion No. 20 [AC section 1051.21, Volume 3, *AICPA Professional Standards*].

AU Section 550

Other Information in Documents Containing Audited Financial Statements

Issue date, unless otherwise indicated: December, 1975

.01 An entity may publish various documents that contain information (hereinafter, "other information") in addition to audited financial statements and the independent auditor's report thereon. This section provides guidance for the auditor's consideration of other information included in such documents.

.02 This section is applicable only to other information contained in (a) annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Securities Exchange Act of 1934 or (b) other documents to which the auditor, at the client's request, devotes attention.

.03 This section is not applicable when the financial statements and report appear in a registration statement filed under the Securities Act of 1933. The auditor's procedures with respect to 1933 Act filings are unaltered by this section (see sections 630 and 710). Also, this section is not applicable to other information on which the auditor is engaged to express an opinion.[1] The guidance applicable to examining and reporting on certain information other than financial statements intended to be presented in con-

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[1] Mere reading of other information is an inadequate basis for expressing an opinion on that information.

formity with generally accepted accounting principles is unaltered by this section (see sections 610 and 620).

.04 Other information in a document may be relevant to an independent auditor's examination or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[2] If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision. If he concludes that they do not require revision, he should request the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, he should consider other actions such as revising his report to include an explanatory paragraph describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement. The action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

.05 If, while reading the other information for the reasons set forth in paragraph .04, the auditor becomes aware of information that he believes is a material misstatement of fact that is not a material inconsistency as described in paragraph .04, he should discuss the matter with the client. In connection with this discussion, the auditor should consider that he may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion. If the auditor concludes he has a valid basis for concern he should propose that the client consult with

[2] In fulfilling his responsibility under this section, a principal auditor may also request the other auditor or auditors involved in the engagement to read the other information. If a predecessor auditor's report appears in a document to which this section applies, he should read the other information for the reasons described in this paragraph.

some other party whose advice might be useful to the client, such as the client's legal counsel.

.06 If, after discussing the matter as described in paragraph .05, the auditor concludes that a material misstatement of fact remains, the action he takes will depend on his judgment in the particular circumstances. He should consider steps such as notifying his client in writing of his views concerning the information and consulting his legal counsel as to further appropriate action in the circumstances.

→ *The next page is 931.* ←

AU Section 560

Subsequent Events

Issue date, unless otherwise indicated: November, 1972

.01 An independent auditor's report ordinarily is issued in connection with historical financial statements that purport to present financial position at a stated date and results of operations and changes in financial position for a period ended on that date. However, events or transactions sometimes occur subsequent to the balance-sheet date, but prior to the issuance of the financial statements and auditor's report, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements. These occurrences hereinafter are referred to as "subsequent events."

.02 Two types of subsequent events require consideration by management and evaluation by the independent auditor.

.03 The first type consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.

.04 Identifying events that require adjustment of the financial statements under the criteria stated above calls for the exercise of judgment and knowledge of the facts and circumstances. For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy subsequent to the balance-sheet date would be indicative of conditions existing at the balance-sheet date, thereby calling for adjustment of the financial statements before their issuance. On the other hand, a similar loss resulting from a customer's major casualty such as a fire or flood subsequent to the balance-sheet date would not be indicative of conditions existing at the balance-sheet date and adjustment of the financial statements would not be appropriate. The settlement of litigation for an amount different from the liability recorded in the accounts would require adjustment of the financial statements if the events, such as personal injury or patent infringement, that gave rise to the litigation had taken place prior to the balance-sheet date.

.05 The second type consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements.[1] Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading. Occasionally such an event may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements.

.06 Examples of events of the second type that require disclosure in the financial statements (but should not result in adjustment) are:

a. Sale of a bond or capital stock issue.

b. Purchase of a business.

c. Settlement of litigation when the event giving rise to the claim took place subsequent to the balance-sheet date.

d. Loss of plant or inventories as a result of fire or flood.

e. Losses on receivables resulting from conditions (such as a customer's major casualty) arising subsequent to the balance-sheet date.

.07 Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities

[1] This paragraph is not intended to preclude giving effect in the balance sheet, with appropriate disclosure, to stock dividends or stock splits or reverse splits consummated after the balance-sheet date but before issuance of the financial statements.

ordinarily will require adjustment of the financial statements (see paragraph .03) because such events typically represent the culmination of conditions that existed over a relatively long period of time. Subsequent events such as changes in the quoted market prices of securities ordinarily should not result in adjustment of the financial statements (see paragraph .05) because such changes typically reflect a concurrent evaluation of new conditions.

.08 When financial statements are reissued, for example, in reports filed with the Securities and Exchange Commission or other regulatory agencies, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. Events occurring between the time of original issuance and reissuance of financial statements should not result in adjustment of the financial statements[1] unless the adjustment meets the criteria for the correction of an error or the criteria for prior period adjustments set forth in Opinions of the Accounting Principles Board. Similarly, financial statements reissued in comparative form with financial statements of subsequent periods should not be adjusted for events occurring subsequent to the original issuance unless the adjustment meets the criteria stated above.

.09 Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his report an explanatory paragraph directing the reader's attention to the event and its effects. (See section 545.03.)

Auditing Procedures in the Subsequent Period

.10 There is a period after the balance-sheet date with which the auditor must be concerned in completing various phases of his examination. This period is known as the "subsequent period" and is considered to extend to the date of the auditor's report. Its duration will depend upon the practical requirements of each examination and may vary from a relatively short period to one of several months. Also, all auditing procedures are not carried out at the same time and some phases of an examination will be performed during the subse-

[1] However, see paragraph .05 as to the desirability of presenting pro forma financial statements to supplement the historical financial statements in certain circumstances.

quent period, whereas other phases will be substantially completed on or before the balance-sheet date. As an audit approaches completion, the auditor will be concentrating on the unresolved auditing and reporting matters and he is not expected to be conducting a continuing review of those matters to which he has previously applied auditing procedures and reached satisfaction.

.11 Certain specific procedures are applied to transactions occurring after the balance-sheet date such as (a) the examination of data to assure that proper cutoffs have been made and (b) the examination of data which provide information to aid the auditor in his evaluation of the assets and liabilities as of the balance-sheet date.

.12 In addition, the independent auditor should perform other auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles. These procedures should be performed at or near the completion of the field work. The auditor generally should:

a. Read the latest available interim financial statements; compare them with the financial statements being reported upon; and make any other comparisons considered appropriate in the circumstances. In order to make these procedures as meaningful as possible for the purpose expressed above, the auditor should inquire of officers and other executives having responsibility for financial and accounting matters as to whether the interim statements have been prepared on the same basis as that used for the statements under examination.

b. Inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:

   (i) Whether any substantial contingent liabilities or commitments existed at the date of the balance sheet being reported on or at the date of inquiry.

   (ii) Whether there was any significant change in the capital stock, long-term debt, or working capital to the date of inquiry.

(iii) The current status of items, in the financial statements being reported on, that were accounted for on the basis of tentative, preliminary, or inconclusive data.

(iv) Whether any unusual adjustments had been made during the period from the balance-sheet date to the date of inquiry.

c. Read the available minutes of meetings of stockholders, directors, and appropriate committees; as to meetings for which minutes are not available, inquire about matters dealt with at such meetings.

d. Inquire of client's legal counsel concerning litigation, claims, and assessments. [As amended, January 1976, by Statement on Auditing Standards No. 12.] (See section 337.)

e. Obtain a letter of representations, dated as of the date of the auditor's report, from appropriate officials, generally the chief executive officer and chief financial officer, as to whether any events occurred subsequent to the date of the financial statements being reported on by the independent auditor that in the officer's opinion would require adjustment or disclosure in these statements. The auditor may elect to have the client include representations as to significant matters disclosed to the auditor in his performance of the procedures in subparagraphs (a) to (d) above and (f) below.

f. Make such additional inquiries or perform such procedures as he considers necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures, inquiries, and discussions.

The next page is 951.

AU Section 561

Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

Issue date, unless otherwise indicated: November, 1972

.01 The procedures described in this section should be followed by the auditor who, subsequent to the date of his report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected his report had he then been aware of such facts.

.02 Because of the variety of conditions which might be encountered, some of these procedures are necessarily set out only in general terms; the specific actions to be taken in a particular case may vary somewhat in the light of the circumstances. The auditor would be well advised to consult with his attorney when he encounters the circumstances to which this section may apply because of legal implications that may be involved in actions contemplated herein, including, for example, the possible effect of state statutes regarding confidentiality of auditor-client communications.

.03 After he has issued his report, the auditor has no obligation[1] to make any further or continuing inquiry or perform any other auditing procedures with respect to the audited financial statements covered by that report, unless new information which may affect his report comes to his attention. In addition, this section does not apply to situations arising from developments or events occurring after the date of the auditor's report; neither does it apply to situations where, after issuance of the auditor's report, final determinations or resolutions are made of contingencies or other matters

[1] However, see section 710.08–.11 as to an auditor's obligation with respect to audited financial statements included in registration statements filed under the Securities Act of 1933 between the date of the auditor's report and the effective date of the registration statement.

which had been disclosed in the financial statements or which had resulted in a qualification in the auditor's report.

.04 When the auditor becomes aware of information which relates to financial statements previously reported on by him, but which was not known to him at the date of his report, and which is of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his examination, he should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of his report. In this connection, the auditor should discuss the matter with his client at whatever management levels he deems appropriate, including the board of directors, and request cooperation in whatever investigation may be necessary.

.05 When the subsequently discovered information is found both to be reliable and to have existed at the date of the auditor's report, the auditor should take action in accordance with the procedures set out in subsequent paragraphs if the nature and effect of the matter are such that (a) his report would have been affected if the information had been known to him at the date of his report and had not been reflected in the financial statements and (b) he believes there are persons currently relying or likely to rely on the financial statements who would attach importance to the information. With respect to (b), consideration should be given, among other things, to the time elapsed since the financial statements were issued.

.06 When the auditor has concluded, after considering (a) and (b) in paragraph .05, that action should be taken to prevent future reliance on his report, he should advise his client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report. When the client undertakes to make appropriate disclosure, the method used and the disclosure made will depend on the circumstances.

a. If the effect on the financial statements or auditor's report of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report. Generally, only the most recently issued audited financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.[1]

b. When issuance of financial statements accompanied by the auditor's report for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements pursuant to subparagraph (a).[2]

c. When the effect on the financial statements of the subsequently discovered information cannot be determined without a prolonged investigation, the issuance of revised financial statements and auditor's report would necessarily be delayed. In this circumstance, when it appears that the information will require a revision of the statements, appropriate disclosure would consist of notification by the client to persons who are known to be relying or who are likely to rely on the financial statements and the related report that they should not be relied upon, and that revised financial statements and auditor's report will be issued upon completion of an investigation. If applicable, the client should be advised to discuss with the Securities and Exchange Commission, stock exchanges, and appropriate regulatory agencies the disclosure to be made or other measures to be taken in the circumstances.

.07 The auditor should take whatever steps he deems necessary to satisfy himself that the client has made the disclosures specified in paragraph .06.

.08 If the client refuses to make the disclosures specified in paragraph .06, the auditor should notify each member of the board of directors of such refusal and of the fact that, in the absence of disclosure by the client, the auditor will take steps as outlined below to prevent future reliance upon his report. The steps that

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[1] See paragraphs 26 and 27 of Accounting Principles Board Opinion No. 9 [AC section 2010.25-.26] and paragraphs 36 and 37 of Opinion No. 20 [AC section 1051.36-.37] regarding disclosure of adjustments applicable to prior periods.

[2] Ibid.

can appropriately be taken will depend upon the degree of certainty of the auditor's knowledge that there are persons who are currently relying or who will rely on the financial statements and the auditor's report, and who would attach importance to the information, and the auditor's ability as a practical matter to communicate with them. Unless the auditor's attorney recommends a different course of action, the auditor should take the following steps to the extent applicable:

a. Notification to the client that the auditor's report must no longer be associated with the financial statements.

b. Notification to regulatory agencies having jurisdiction over the client that the auditor's report should no longer be relied upon.

c. Notification to each person known to the auditor to be relying on the financial statements that his report should no longer be relied upon. In many instances, it will not be practicable for the auditor to give appropriate individual notification to stockholders or investors at large, whose identities ordinarily are unknown to him; notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the auditor to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure. The Securities and Exchange Commission and the stock exchanges are appropriate agencies for this purpose as to corporations within their jurisdictions.

.09 The following guidelines should govern the content of any disclosure made by the auditor in accordance with paragraph .08 to persons other than his client:

a. If the auditor has been able to make a satisfactory investigation of the information and has determined that the information is reliable:

(i) The disclosure should describe the effect the subsequently acquired information would have had on the auditor's report if it had been known to him at the date of his report and had not been reflected in the financial statements. The disclosure should include a description of the nature of the subsequently acquired information and of its effect on the financial statements.

(ii) The information disclosed should be as precise and factual as possible and should not go beyond that which is reasonably necessary to accomplish the purpose mentioned in the preceding subparagraph (i). Comments concerning the conduct or motives of any person should be avoided.

b. If the client has not cooperated and as a result the auditor is unable to conduct a satisfactory investigation of the information, his disclosure need not detail the specific information but can merely indicate that information has come to his attention which his client has not cooperated in attempting to substantiate and that, if the information is true, the auditor believes that his report must no longer be relied upon or be associated with the financial statements. No such disclosure should be made unless the auditor believes that the financial statements are likely to be misleading and that his report should not be relied on.

.10 The concepts embodied in this section are not limited solely to corporations but apply in all cases where financial statements have been examined and reported on by independent auditors.

AU Section 600

OTHER TYPES OF REPORTS

. . . long-form reports . . . special reports . . . letters for underwriters . . . reports on internal control . . . criteria established by governmental agencies . . .

TABLE OF CONTENTS

→ *The next page is 1061.* ←

AU Section 610

Long-Form Reports

Issue date, unless otherwise indicated: November, 1972

.01 While the accounting profession has generally adopted the short-form report in connection with financial statements intended for publication, auditors also issue a substantial number of so-called long-form reports. In addition to the basic financial statements, these reports ordinarily include details of the items in these statements, statistical data, explanatory comments, other informative material, some of which may be of a nonaccounting nature, and sometimes a description of the scope of the auditor's examination more detailed than the description in the usual short-form reports. In some cases, both a long-form report and a short-form report are issued on the same engagement, but in many cases the long-form report constitutes the only report issued.

.02 The requirement of the fourth reporting standard that ". . . the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking" is applicable to both short-form and long-form reports. The language of the short-form report is generally used in long-form reports. Accordingly, because the usual short-form report covers only the basic financial statements, the auditor should clearly establish his position regarding the other data in the long-form report. This may be accomplished, for example, by an explanation that:

a. his examination has been made primarily for the purpose of formulating an opinion on the basic financial statements, taken as a whole, and

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

.03 If the other data are presented as a separate section of the long-form report, the above explanation may appropriately appear as a preface to it. Regardless of the method of reporting, it is of prime importance to maintain a clear-cut distinction between the management's representations and the auditor's representations.

.04 Where a long-form report is co-existing with a conventional short-form report, the auditor should make sure that:

a. the long-form report does not contain data which, if omitted from the short-form report, might support a contention that the short-form report was misleading because of inadequate disclosure of material facts known to the independent auditor; and

b. none of the comments or other data contained in the long-form report lend themselves to a contention that they constitute exceptions or reservations, as distinguished from mere explanations.

.05 In addition, the auditor must consider whether the long-form report, taken by itself, contains other financial data in such form as to support a contention that he has made *factual* representations with respect to the financial statements or books of account rather than expressed an *opinion* on financial data consisting of management representations.

.06 The concept of management's basic responsibility for financial statements and of the auditor's responsibility being confined to his opinion on such statements has become firmly established since the general adoption of the conventional short-form report. Under this concept, the independent auditor is expressing his professional opinion and is not "certifying" to facts true to his own knowledge. This same basic concept underlies the long-form report, and the auditor should prepare the long-form report in a manner that makes it clear that he is expressing therein the same type of professional opinion as in a short-form report.

The next page is 1081.

AU Section 620

Special Reports

Issue date, unless otherwise indicated: November, 1972

.01 The term "special reports" has reference to reports for which the wording of the usual short-form report may be inappropriate and for which special wording in the opinion section is necessary. Special reports may include:

a. Reports on financial statements of organizations which maintain their accounts and prepare their statements on a cash or other incomplete basis of accounting which is materially at variance with accounting practices customarily followed in preparing accrual basis statements. These organizations may include some organized for profit, particularly those carried on by individuals and partnerships, as well as some not-for-profit organizations.

b. Reports on financial statements of some not-for-profit organizations which follow accounting practices differing in some respects from those followed by business enterprises organized for profit.

c. Reports prepared for limited purposes, such as:

  (i) Reports that relate only to certain aspects of financial statements. These may include reports, sometimes in letter form, relating to special studies, to compliance with certain provisions of bond indentures, or to the determination of the amounts of rentals, royalties, profit-sharing bonuses, and the like.

  (ii) Reports that are filed with various agencies on prescribed forms which provide a uniform statement presentation, in some cases with a preworded opinion or authentication. These may include reports prepared for filing with various governmental authorities or with credit and similar agencies.

.02 The general standards and standards of field work, to the extent appropriate in view of the character of the engagement, are applicable to engagements involving special reports.

.03 The third and fourth reporting standards are applicable to special reports. When the special report relates to statements which purport to present financial position, results of operations, and, where applicable, changes in financial position, the second standard of reporting as to consistency in the application of generally accepted accounting principles is applicable. When the report relates to other matters, reference to consistency is frequently appropriate, depending upon the nature of the matter reported upon. The applicability of the first reporting standard is discussed in the remainder of this section.

.04 The first standard of reporting does not apply to statements which do not purport to present financial position and results of operations. Statements prepared on the basis of cash receipts and disbursements, for example, usually do not purport to present financial position or results of operations. In reporting on statements which do not so purport, the independent auditor should make sure that there is a clear representation of what they do present and of the basis on which they have been prepared. He should express his opinion as to whether or not the statements fairly present the data on the basis indicated. It is generally preferable in these circumstances to avoid the use of the terms "balance sheet," "income statement," or similar titles with respect to such statements.

Cash Basis Statements

.05 In reporting on statements prepared on a cash basis (or substantially so) which may appear to, but do not, present financial position and results of operations, disclosure should be made in the statements or their footnotes or, less preferably, in the independent auditor's report: (a) of the fact that the statements have been prepared on a basis of cash receipts and disbursements and (b) of the general nature of any material items omitted (such as accounts receivable and accounts payable) and, where practicable, of the net effect of such omissions on the statements. The independent auditor's opinion might then be worded somewhat as follows:

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

.06 Where the independent auditor thinks that misleading inferences may still be drawn from the statements, he should include an explanation in his report that the statements do not present financial position and results of operations. This might be accomplished by a middle paragraph worded somewhat as follows:

> Because of the omission of accounts receivable and accounts payable, it is our opinion the aforementioned statements do not present the financial position or results of operations of the company.

Modified Accrual Basis Statements

.07 In reporting on statements prepared on a modified accrual basis of accounting, which purport to present financial position, results of operations, and changes in financial position, the independent auditor may conclude that the resulting statements are materially incomplete or were prepared in accordance with accounting practices materially at variance with those customarily followed in preparing accrual basis statements. In such cases the nature and, where practicable, the amounts of the major variances should be disclosed and the independent auditor should qualify his opinion or express an adverse opinion.

Not-for-Profit Organization Statements

.08 If the statements are those of a not-for-profit organization, they may reflect accounting practices differing in some respects from those followed by enterprises organized for profit. In some cases generally accepted accounting principles applicable to not-for-profit organizations have not been clearly defined. In those areas where the independent auditor believes generally accepted accounting principles have been clearly defined, he may state his opinion as to the conformity of the financial statements either with *generally accepted accounting principles* or (less desirably) with *accounting practices* for not-for-profit organizations in the particular field, and in such circumstances he may refer to financial position and results of operations. In those areas where he believes generally accepted accounting principles have not been clearly defined, the provisions covering special reports as discussed under cash basis and modified accrual basis statements are applicable.

Incomplete Financial Presentations

.09 Special reports in which incomplete financial presentations or no financial presentations are made (e.g., calculations of royalties, profit-sharing bonuses, rentals, etc.) should be drafted with a view to their special purpose and, accordingly, should state what information is presented, the basis on which it was prepared, and whether, in the independent auditor's opinion, it is presented fairly on that basis.

.10 There may be occasions when it is appropriate for the auditor to report upon conformity of incomplete financial presentations with generally accepted accounting principles; for example, the determination of working capital under a bond indenture. There may be other occasions where the independent auditor expresses an opinion as to the adequacy or reasonableness of specific accounts, such as the allowance for doubtful accounts receivable or the liability for income taxes. The usual examination of financial statements is designed for the purpose of formulating an opinion with respect to financial statements taken as a whole and not with respect to incomplete presentations or specific accounts. Accordingly, where the situation is such that an independent auditor considers it appropriate to express an opinion on an incomplete financial presentation, he should be cognizant of the added responsibility he may thereby be assuming and the possible necessity of extending the scope of his examination.

Prescribed Audit Report Forms

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

The next page is 1101.

AU Section 630

Letters for Underwriters

Issue date, unless otherwise indicated: November, 1972

.01 The services of independent certified public accountants include examining financial statements and schedules contained in registration statements filed with the Securities and Exchange Commission (the "SEC") under the Securities Act of 1933 (the "Act"). In connection with this type of service, accountants often are called upon to confer with clients, underwriters, and their respective counsel concerning the accounting and auditing requirements of the Act and of the SEC as well as to perform other services. One of these other services is the issuance of letters for underwriters, commonly called "comfort letters," which are generally concerned with the subjects described in paragraph .06.

.02 Much of the uncertainty and consequent risk of misunderstanding with regard to the nature and scope of comfort letters has arisen from a lack of recognition of the necessarily limited nature of the comments which accountants can properly make with respect to financial information, in a registration statement, that has not been examined in conformity with generally accepted auditing standards and accordingly is not covered by their opinion. Underwriters, in requesting comfort letters, are generally seeking assistance on matters of importance to them. They wish to perform a "reasonable investigation" of financial and accounting data not "expertized" (covered by a report of independent accountants, who consent to be named as experts, based on an examination made in accordance with generally accepted auditing standards) as a defense against possible claims under the Act. Accountants have a corresponding wish, arising in response to the same statutory phrase, "reasonable investigation," with respect to audited financial statements included in a prospectus in reliance on their audit report and their consent.[1] The accountants' reasonable investigation must be

[1] See section 710 for a discussion of certain responsibilities of accountants resulting from inclusion of their reports in registration statements.

premised upon an audit; it cannot be accomplished short of an audit. In contrast, what constitutes a reasonable investigation of unaudited financial and accounting data sufficient to satisfy an underwriter's purposes has never been authoritatively established. It seems clear, however, that the purposes of the investigations are quite different. Accountants normally will be entirely willing to furnish to the underwriters such assistance as is within their professional capabilities; however, the extent of the assistance which accountants can provide by way of comfort letters is subject to limitations. One such limitation is that an independent certified public accountant can properly comment in his professional capacity only upon matters to which his professional expertise is substantially relevant. Another limitation is that procedures short of an audit (which are all that a comfort letter contemplates) by their nature are ordinarily not such as to furnish accountants grounds for expressing an opinion, but, at the most, negative assurance.[1] Finally, it is not practicable to establish standards comparable to generally accepted auditing standards by which the sufficiency of procedures to support negative assurances can be measured; therefore, such assurances in specific situations cannot reasonably imply any definite or uniform degree of certainty regarding the matters to which they relate. Accordingly, there is necessarily a risk that matters against which negative assurance is sought may prove to be present even though negative assurance has been given.

.03 This section deals with several different kinds of matters. First, in a number of areas involving professional standards, it states whether or not it is proper for independent certified public accountants acting in their professional capacity to comment on specified kinds of matters; and if so, what the form of comment should be. Second, suggestions of a practical nature are offered on such matters as forms of comfort letters suitable to various circumstances, the way in which a particular form of letter may be agreed upon, the dating of letters, and what steps may be taken when information which may require special mention in a letter comes to the accoun-

[1] Negative assurance consists of a statement by accountants to the effect that nothing came to their attention as a result of specified procedures that caused them to believe that specified matters do not meet a specified standard (e.g., that unaudited financial statements were not prepared in conformity with generally accepted accounting principles consistently applied).

tants' attention.[1] Third, ways are suggested to reduce or avoid the uncertainties described in the preceding paragraph as to the nature and extent of accountants' responsibilities in connection with a comfort letter. As to this and other points not involving professional standards, where the recommendations are intended to reduce risks of misunderstanding, accountants requested to follow a course other than that recommended would do well to consult their counsel.

.04 Comfort letters are not required under the Act and copies are not filed with the SEC. It is nonetheless a common condition of an underwriting agreement in connection with the offering for sale of securities registered with the SEC under the Act that the accountants are to furnish a comfort letter. Some underwriters[2] do not make the receipt of a comfort letter a condition of the underwriting agreement but nevertheless ask for such a letter.

.05 The accountants should suggest to the underwriter that they meet together with the client to discuss the procedures to be followed in connection with a comfort letter; in this connection, the accountants may describe procedures frequently followed (see examples included at the end of this section, paragraphs .45–.53). Because of the accountants' knowledge of the client, such a meeting may substantially benefit the underwriter in reaching his decision as to the procedures to be followed by the accountants. However, because of the lack of clear-cut standards as discussed in paragraph .02, it is advisable to accompany any discussion of procedures with a clear statement that the accountants cannot furnish any assurance as to the sufficiency of the procedures for the underwriter's purposes and it is advisable for the comfort letter to contain a statement to

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[1] It is important to note that although this section furnishes illustrations of procedures which are frequently followed by accountants as a basis for their comments in comfort letters, it does not prescribe such procedures.

[2] Except where the context otherwise requires, the word "underwriter" as used hereinafter refers to the managing, or lead, underwriter who typically negotiates the underwriting agreement for a group of underwriters whose exact composition is not determined until shortly before a registration statement becomes effective. In competitive bidding situations where legal counsel for the underwriters acts as the underwriters' representative prior to the opening and acceptance of the bid, the accountants should carry out the discussions and other communications contemplated by this section with the legal counsel until such time as the underwriter is selected.

this effect. An appropriate way of expressing this is shown in numbered paragraph 4 of Example A.

.06 Comfort letters will generally refer to one or more of the following subjects:

a. The independence of the accountants.

b. Compliance as to form in all material respects of the audited financial statements and schedules with the applicable accounting requirements of the Act and the published rules and regulations thereunder.

c. Unaudited financial statements and schedules in the registration statement.

d. Changes in selected financial-statement items during a period subsequent to the date and period of the latest financial statements in the registration statement.

e. Tables, statistics, and other financial information in the registration statement.

These matters are discussed in greater detail below and are illustrated in the Examples included at the end of this section. Matters dealt with in a particular letter usually are limited to ones specified in the underwriting agreement.

.07 Because the underwriter will be looking to the accountants to furnish a comfort letter of a scope to be specified in the underwriting agreement, the client and the underwriter, when they have tentatively agreed upon a draft of the agreement, are well advised to furnish a copy of it to the accountants so that the latter can indicate whether they will be able to furnish a letter in acceptable form. A desirable practice is for the accountants, promptly after they have received the draft of the agreement (or have been informed that a letter covering specified matters, although not a condition of the agreement, will nonetheless be requested), to prepare a draft of the form of letter that they expect to furnish. To the extent possible, the draft should deal with all matters to be covered in the exact terms to be used in the final letter (subject, of course, to the understanding that the comments in the final letter cannot be determined until the procedures underlying it have been performed). The draft letter should be identified as a draft in order to avoid giving the impression that the procedures described therein have been performed. This practice of furnishing a draft letter at an early point permits the accountants to make clear to the client and the underwriter what they may expect the accountants to furnish, and gives the client and the underwriter an opportunity to change the proposed underwriting agreement if they so desire. The underwriter thus furnished with a draft letter is afforded the opportunity of discussing further with the accountants the procedures that the accountants have indicated they expect to follow, and of requesting any additional procedures which the underwriter may desire. If the additional procedures pertain to matters to which the accountants' professional competence is relevant, the accountants would ordinarily be willing to perform them, and it is desirable for them to furnish the underwriter an appropriately revised draft letter. The accountants may reasonably assume that the underwriter, by indicating his acceptance of the draft comfort letter, and subsequently, by his acceptance of the letter in final form, considers the procedures described sufficient for his purposes. It is important, therefore, that the procedures to be followed by the accountants be clearly set out in the comfort letter, in both draft and final form, so that there will be no misunderstanding as to the basis upon which the accountants' comments have been made and so that the underwriter can decide whether the procedures performed are sufficient for his purposes. For reasons explained in paragraph .02, statements or implications that the accountants are carrying out such procedures as they consider necessary should be avoided since this may lead to misunderstanding about the responsibility for the sufficiency of the procedures for the underwriter's purposes. A suggested form of legend which may be placed on the draft letter for identification and explanation of its purposes and limitations is as follows:

> This draft is furnished solely for the purpose of indicating the form of letter which we would expect to be able to furnish [name of underwriter] in response to their request, the matters expected to be covered in the letter, and the nature of the procedures which we would expect to carry out with respect to such matters. Based on our discussions with [name of underwriter], it is our understanding that the procedures outlined in this draft letter are those they wish us to follow.[1] Unless [name of underwriter] informs us otherwise,

[1] In the absence of any discussions with the underwriter, the accountants should outline in the draft letter those procedures specified in the underwriting agreement which they are willing to perform. In that event, this sentence should be revised as follows: "In the absence of any discussions with [name of underwriter], we have set out in this draft letter those procedures referred to in the draft underwriting agreement (of which we have been furnished a copy) which we are willing to follow."

we shall assume that there are no additional procedures they wish us to follow. The text of the letter itself will depend, of course, upon the results of the procedures, which we would not expect to complete until shortly before the letter is given and in no event before the cutoff date indicated therein.

Dating

.08 The letter ordinarily is dated at or shortly before the "closing date" (the date on which the issuer or selling security holder delivers the securities to the underwriter in exchange for the proceeds of the offering). The underwriting agreement ordinarily specifies the date, often referred to as the "cutoff date," to which the letter is to relate (e.g., a date five business days before the date of the letter); the accountants should see that the cutoff date will not place an unreasonable burden on them. The letter should state that the inquiries and other procedures carried out in connection with the letter did not cover the period from the cutoff date to the date of the letter.

.09 Letters may also be dated at or shortly before the "effective date" (the date on which the registration statement becomes effective) and, on rare occasions, letters have been requested to be dated at or shortly before the "filing date" (the date on which the registration statement is first filed with the SEC). If more than one letter is requested, it will be necessary to carry out the specified procedures and inquiries as of the cutoff date for each letter. Although comments contained in an earlier letter may on occasion conveniently be incorporated by reference in a subsequent letter (see Example C), any subsequent letter should relate only to information in the registration statement as most recently amended as of the cutoff date of the subsequent letter.

Addressee

.10 Because the letter is a result of the underwriter's request, many accountants address the letter only to the underwriter, with a copy furnished to the client. When this is done, the appropriate addressee is the underwriter who has negotiated the underwriting agreement with the client, and with whom the accountants will deal in discussions as to the scope and sufficiency of the letter, rather than the group of underwriters for whom that underwriter acts as representative.[1] Some accountants address the letter instead to the client, or to both the client and the underwriter. If the accountants are requested to address the letter to any person other than the underwriter or the client, they would do well to consult their counsel.

Introductory Paragraph

.11 It is desirable to include an introductory paragraph substantially as follows:

> We have examined the [identify the financial statements and schedules examined] included in the Registration Statement (No. 2-00000) on Form ____ filed by the Company under the Securities Act of 1933 (the "Act"); our reports with respect thereto are also included in such Registration Statement. Such Registration Statement, as amended as of ________________, is herein referred to as the "Registration Statement."

Independence

.12 It is customary for the underwriting agreement to provide for the accountants to make a statement concerning their independence in the letter. This may be done substantially as follows:

> We are independent certified public accountants with respect to The Blank Company, Inc. within the meaning of the Act and the applicable published rules and regulations thereunder and the answer to [identify the item number that refers to the relationship with registrant of experts named in the registration statement; e.g., Item 24 of Form S-1] of the Registration Statement is correct insofar as it relates to us.

(See paragraph .32 regarding instances wherein the accountants' client is not the registrant.)

Compliance With SEC Requirements

.13 The accountants may be requested to express an opinion concerning compliance as to form of the financial statements cov-

[1] An appropriate form of address for this purpose is "XYZ & Company, as Representative of the Several Underwriters."

ered by their report with the pertinent published accounting requirements of the SEC.[1] This may be done substantially as follows:

> In our opinion, [include phrase, "except as disclosed in the Registration Statement," if applicable] the [identify the financial statements and schedules examined] examined by us and included or incorporated by reference in the Registration Statement comply as to form in all material respects with the applicable accounting requirements of the Act and the published rules and regulations thereunder.

If there is a material departure from the pertinent published requirements, the departure should be disclosed in the letter. Normally, representatives of the SEC will have agreed to such departure; when this occurs, such agreement should be mentioned in the comfort letter.[2] An appropriate manner of doing this is shown in Example D.

.14 Since published SEC requirements do not deal with the form of pro forma financial statements or pro forma adjustments applied to historical financial statements, there is no basis for accountants to comment on whether such pro forma information complies as to form with SEC requirements. (See also paragraph .16(g).)

Accountants' Report

.15 Underwriters occasionally request that the accountants repeat in the comfort letter their opinion with respect to the audited financial statements included in the registration statement. Because of the special significance of the date of an accountants' report,[3] the accountants should not repeat their opinion. Underwriters some-

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[1] The word "published" is used because accountants should not be expected to be familiar with, or express assurances as to compliance with, informal requirements that have not been published by the SEC but that may be applied by the SEC staff.

[2] Departures from published SEC requirements which require mention in a comfort letter ordinarily do not affect fair presentation in conformity with generally accepted accounting principles; however, if they do, the accountants will of course take cognizance of these departures in expressing their opinion and in consenting to the use of their report in the registration statement. If departures from published SEC requirements which require mention in a comfort letter either are not disclosed in the registration statement or have not been agreed to by representatives of the SEC, the accountants should consider carefully the issuance of a consent to the use of their report in the registration statement.

[3] See section 530.03–.08.

times request negative assurance as to the accountants' report. Because accountants have a statutory responsibility with respect to their opinion as of the effective date, and because the additional significance, if any, of a negative assurance is unclear and such assurance may therefore give rise to misunderstanding, it is inadvisable to give such negative assurance.

Unaudited Financial Statements and Subsequent Changes

In General

.16 Comments included in the letter will often concern (i) unaudited financial statements and schedules included in the registration statement, (ii) changes in capital stock and long-term debt, (iii) decreases in other specified financial-statement items (see paragraphs .21–.26), and (iv) pro forma financial statements. In commenting on these matters, the following guides are important:

a. Any statements by the accountants with respect to unaudited financial statements and schedules and subsequent changes or decreases should be limited to negative assurance. An appropriate manner of expressing the comments is shown in numbered paragraph 5 of Example A.

b. As explained in paragraph .07 above, the agreed-upon procedures performed by the accountants should be set forth in the letter. Such procedures are generally described along the lines of numbered paragraph 4 of Example A.

c. Terms of uncertain meaning such as "review," "general review," "limited review," "check," or "test" should not be used in describing the work, unless the procedures comprehended by the term are described in the comfort letter.

d. The letter should specifically identify any unaudited financial statements and schedules to which it refers. The letter should state that the accountants have not examined such financial statements and schedules in accordance with generally accepted auditing standards and do not express an opinion concerning them. An appropriate manner of making this clear is shown in numbered paragraph 3 of Example A. (See also paragraph .18.)

e. The accountants should not give negative assurance with respect to unaudited financial statements and schedules or changes or decreases unless they have made an examination of the client's financial statements for a period including or immediately prior to that to which the negative assurance relates or have completed an examination for a later period.

f. The accountants should not give negative assurance with respect to financial statements and schedules that have been examined and are reported on in the registration statement by other accountants.

g. The accountants should not give negative assurance on pro forma adjustments applied to historical financial statements unless they have made an examination of the historical financial statements of the client (or, in the case of business combinations, of a significant constituent part of the combined financial statements) (1) for the period presented, or (2) in the case of interim periods, for the latest fiscal period which includes or precedes the interim period.

h. The procedures followed with respect to interim periods may not disclose changes in capital stock or long-term debt or decreases in the specified financial-statement items, inconsistencies in the application of generally accepted accounting principles, instances of noncompliance as to form with accounting requirements of the SEC, or other matters as to which negative assurance is requested. An appropriate manner of making this clear is shown in the conclusion of numbered paragraph 4 of Example A.

i. The working papers relating to comfort letters should be prepared in a manner so as to constitute adequate evidence of what has been done.

Unaudited Financial Statements

.17 Comments in the comfort letter concerning the unaudited financial statements, summary of earnings, and schedules appearing in the registration statement should always be made in the form of negative assurance.[1] Frequently, such comments relate to (a) conformity with generally accepted accounting principles, (b) consistency with the audited financial statements, summary of earnings, and schedules included in the registration statement, and (c) compliance as to form with applicable accounting requirements. An appropriate manner of expressing the comments is shown in numbered paragraph 5a of Example A.

.18 When the most recent figures included in a summary of earnings (or statement of income) are for a period of less than one year, the SEC usually requires that comparative figures be shown for the corresponding short period of the preceding year. Frequently the financial statements for the latest interim period are unaudited, and financial statements for the interim period of the preceding year are ordinarily unaudited, even though that period is part of a year for which the financial statements have been audited. In these circumstances, the unaudited status of the financial statements of the earlier period should be made clear in the comfort letter. (See numbered paragraph 3 of Example A and paragraph .16(d).)

Capsule Information

.19 In many registration statements, the information shown in the summary of earnings (or statement of income) is supplemented by unaudited information as to subsequent sales and earnings (commonly called "capsule information"). This later information (either in narrative or in tabular form) is often shown in a paragraph following the summary, for a period within the current year and for the

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[1] Section 518.01–.02 restricts the use of negative assurance as follows:

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

However, negative assurances are permissible in letters required by security underwriters in which the independent auditor reports on limited procedures followed with respect to unaudited financial statements or other financial data pertinent to a registration statement filed with the Securities and Exchange Commission.

corresponding period of the prior year, and usually consists only of selected income-statement items. "Fair presentation," as used by independent certified public accountants, ordinarily relates to presentation in conformity with generally accepted accounting principles of financial statements as a whole, including the notes thereto; therefore accountants, in giving negative assurance regarding selected income-statement items, should not make reference to fair presentation but should only refer to whether the dollar amounts were determined on a basis substantially consistent with that of the corresponding amounts in the audited statement of income. An appropriate manner of expressing the comments is shown in Example E.

.20 In connection with capsule information, the underwriter occasionally asks the accountants (a) to give negative assurance with respect to the related unaudited financial statements and (b) to state that the capsule information agrees with amounts set forth in such statements. Although this is another means of accomplishing the same objective as the method described in paragraph .19, it is ordinarily not practicable. Even though trial balances, summary financial data, or financial statements normally prepared for management use may be available in final form so as to provide an appropriate basis for the company to present capsule information, they will seldom have been prepared in such form or detail, including relevant notes, as to permit the independent public accountant to give negative assurance on fair presentation in conformity with generally accepted accounting principles. If the underwriter requests it, however, and if it is practicable for the client to prepare financial statements on a timely basis in conformity with generally accepted accounting principles, it is appropriate for the accountants to agree to the underwriter's request described in the first sentence of this paragraph.

Subsequent Changes

.21 Comments as to subsequent changes also should be in the form of negative assurance. They should not relate to "adverse changes" since, despite long use, that term has not acquired any defined or clearly understood meaning in an accounting sense. In fact, upon reexamination, it appears that the term may, on some occasions, have been misinterpreted by underwriters as encompassing judgments and conclusions not contemplated by the accountants. For example, there has been no agreement among accountants, clients, and underwriters as to whether the term relates only to absolute changes or also includes trends in amounts or ratios. Further, there are differences of view as to whether an adverse change in results of operations is indicated solely by a decrease in net income or whether it also encompasses changes in sales, cost of sales, and other factors which separately or together might indicate the beginning or accentuation of an adverse trend. Also, the term has sometimes been construed as contemplating comments by accountants regarding matters to which their professional competence has little relevance, such as evaluating whether certain types of expenses that may decrease current income but are designed to increase future income (e.g., research and development costs, major advertising campaigns, and systems installations) are adverse or not. In order that comments on subsequent changes be unambiguous and their determination be within the professional competence of accountants, the comments should not relate to adverse changes, but should ordinarily relate to whether there has been any change in capital stock or long-term debt or "decreases" in other specified financial-statement items during a period known as the "change period" (see paragraph .23). Usually these items would include the amounts of net current assets, net assets (stockholders' equity), and net sales, and the total and/or per-share amounts of income before extraordinary items and of net income. An appropriate manner of expressing the comments is shown (a) in numbered paragraph 5b of Example A if there has been no decrease and (b) in Example F if there has been a decrease.

.22 The discussion concerning subsequent changes is not intended to suggest that accountants should avoid mentioning in their letter any changes other than defined decreases or any other matters known to them which in their opinion would be of interest to the underwriter. However, since matters to be covered by the letter should be made clear in the meetings with the underwriter and should be contemplated by the underwriting agreement and in the draft comfort letter, and since there is no way of anticipating other matters which would be of interest to an underwriter, accountants should not make a general statement in comfort letters that, as a result of carrying out the specified procedures, nothing else has come to their attention which would be of interest to the underwriter.

.23 In the context of a comfort letter, a decrease occurs when the amount of a financial-statement item at the cutoff date or for the change period (as if financial statements and their notes had been prepared at that date and for that period) is less than the amount of the same item at a specified earlier date or for a specified earlier period. With respect to the items mentioned in paragraph .21, the term "decrease" means (a) any combination of changes in amounts of current assets and current liabilities that results in decreased net current assets, (b) any combination of changes in amounts of assets and liabilities that results in decreased net assets, (c) decreased net sales, and (d) any combination of changes in amounts of sales and expenses and/or outstanding shares that results in decreased total and/or per-share amounts of income before extraordinary items and of net income (including, in each instance, a greater loss or other negative amount). The change period for which the accountants give negative assurance in the comfort letter ends on the cutoff date (see paragraph .08) and ordinarily begins (a) for balance-sheet items, immediately after the date of the latest balance sheet in the registration statement, and (b) for income-statement items, immediately after the latest period for which such items are presented in the registration statement. The comparison relates to the entire period and not to portions thereof. A decrease during one part of a period may be offset by an equal or larger increase in another part of the period; however, because there was no decrease for the period as a whole, the comfort letter would not report the decrease occurring during one part of the period. (See, however, paragraphs .22 and .43.)

.24 Underwriters occasionally request that the change period begin immediately after the date of the latest audited balance sheet (ordinarily also the closing date of the latest audited statement of income) in the registration statement, even though the registration statement includes a more recent unaudited balance sheet and statement of income. The use of the earlier date may defeat the underwriter's purpose since it is possible that an increase in one of the items referred to in paragraph .21 occurring between the dates of the latest audited and unaudited balance sheets included in the registration statement might more than offset a decrease occurring after the latter date. A similar situation might arise in the comparison of income-statement items. In these circumstances, the decrease occurring after the date of the latest financial statements included in the registration statement would not be reported in the comfort letter. It is desirable for the accountants to explain the foregoing considerations to the underwriter; however, if the underwriter nonetheless requests the use of a change period or periods other than those described in paragraph .23, the accountants may use the period or periods requested.

.25 The underwriting agreement usually specifies the dates and periods with which data at the cutoff date and for the change period are to be compared. For balance-sheet items the comparison date is normally that of the latest balance sheet included in the registration statement (i.e., immediately prior to the beginning of the change period); for income-statement items the comparison period or periods might be one or more of the following: (a) the corresponding period of the preceding year, (b) a period of corresponding length immediately preceding the change period, (c) a proportionate part of the preceding fiscal year, or (d) any other period of corresponding length chosen by the underwriter. Whether or not specified in the underwriting agreement, the date and period used in comparison should be identified in the comfort letter in both draft and final form so that there is no misunderstanding as to the matters being compared and so that the underwriter can determine whether the comparison period is suitable for his purposes.

.26 In addition to making the comparisons indicated above using the financial statements made available to them, the accountants will ordinarily be requested to read minutes and make inquiries of company officials relating to the whole of the change period.[1] For the period between the date of the latest financial statements made available and the cutoff date, the accountants must necessarily base their comments solely on the limited procedures actually performed with respect to that period (which in most cases will be limited to the reading of minutes and the inquiries of company officials referred to in the preceding sentence), and their comfort letter should make this clear. (See numbered paragraph 6 of Example A.)

Disclosure in Registration Statement

.27 Comments on the occurrence of changes in capital stock or long-term debt and decreases in other specified financial-statement

[1] The answers to these inquiries generally should be supported by appropriate written representations of the company officials.

items are limited to changes or decreases not disclosed in the registration statement. This limitation is referred to in the letter by the phrase, "except for changes or decreases which the Registration Statement discloses have occurred or may occur." Whenever it appears to the accountants that a change or decrease has occurred during the change period, they should refer to the registration statement to determine whether the change or decrease is disclosed therein.

Effect of Qualified Opinion

.28 The foregoing discussion contemplates that the accountants' opinion on the financial statements and schedules and the summary of earnings in the registration statement is unqualified. This usually is the case. Except in extraordinary circumstances, the requirements of the SEC do not permit a registration statement to become effective when the accountants' opinion is qualified as to the scope of their examination or as to the accounting principles reflected in the financial statements and schedules and the summary of earnings. However, such circumstances do occasionally arise and, although the SEC may permit the registration statement to become effective even though the opinion is qualified, the accountants may not be in a position to give an unqualified opinion that the financial statements in the registration statement comply as to form in all material respects with the published rules and regulations of the SEC under the Act. (See paragraph .13.)

.29 The SEC ordinarily will accept a "subject to" type of qualification in the accountants' opinion when there is uncertainty as to (a) the outcome of controversial matters such as litigation, renegotiation of contracts, or disputes concerning income taxes; (b) recovery of research and development costs or other deferred charges; or (c) other matters which are not susceptible of reasonable accounting determination, but which might have a material effect on financial position or results of operations.

.30 If the opinion is qualified, the qualification should be referred to in the opening paragraph of the comfort letter by saying, for example, ". . . our reports (which contain a qualification as set forth therein) with respect thereto are also included in such Registration Statement."

.31 If the letter includes negative assurance with respect to subsequent unaudited financial statements included in the registration statement or with respect to an absence of specified subsequent changes or decreases, the effect thereon of the subject matter of the qualification should also be considered. An illustration of how this type of situation may be dealt with is shown in Example G.

Other Accountants

.32 Comfort letters are occasionally requested from more than one accountant (for example, in connection with registration statements to be used in the subsequent sale of shares issued in recently effected mergers). In these circumstances, each accountant must, of course, be sure he is independent within the meaning of the Act and the applicable published rules and regulations thereunder. In connection with opinions expressed prior to the acquisitions, the accountants for previously nonaffiliated companies recently acquired by the registrant would not be required to have been independent with respect to the company whose shares are being registered. In such a case, the accountants should modify the wording suggested in paragraph .12 and make a statement regarding their independence along the following lines:

> As of [insert date of the accountants' most recent report on the financial statements of their client] and during the period covered by the financial statements on which we reported, we were independent certified public accountants with respect to [insert the name of their client] within the meaning of the Act and the applicable published rules and regulations thereunder and the answer to Item 24 of the Registration Statement is correct insofar as it relates to us.

.33 There may be situations in which more than one accountant is involved in the examination of the financial statements of a business and where the reports of more than one accountant appear in the registration statement. For example, certain significant divisions, branches, or subsidiaries may be examined by other accountants. The principal accountants (those who report on the consolidated financial statements and consequently are asked to give a comfort letter with regard to information expressed on a consolidated basis) should read the letter or letters of the other accountants reporting on significant units. Such letters should contain statements similar to those contained in the comfort letter prepared by the principal accountants, including statements as to their independence. The principal accountants should state in their comfort letter that (a) reading letters of other accountants was one of the procedures followed, and (b) the procedures performed by the principal accountants (other than reading the letters of the other accountants) relate solely to (1) companies examined by the principal accountants and (2) the consolidated financial statements. An appropriate manner of expressing these comments where the letters of the other accountants do not disclose matters which affect the negative assurance given is shown in Example H. If the letters of the other accountants disclose decreases in financial-statement items or any other matters that affect the negative assurance that is given, the principal accountants should make mention of these matters in their letter. Where appropriate, the principal accountants may comment that there were no decreases in the consolidated financial-statement items despite the decreases mentioned by the other auditors. In such a case, the principal accountants could give negative assurance that nothing had come to their attention regarding the consolidated financial statements as a result of the specified procedures (which, so far as the related company was concerned, consisted solely of reading the other accountants' letter) that caused them to believe that . . . .

.34 At the earliest practicable date, the client should advise any other accountants who may be involved as to any letter that may be required from them and should arrange for them to receive a draft of the underwriting agreement so that they may make arrangements at an early date for the preparation of a draft of their letter (a copy of which draft should be furnished to the principal accountants) and for the performance of their procedures. In addition, the underwriter may desire to meet with the other accountants for the purposes discussed in paragraph .05.

.35 When a comfort letter is furnished to other accountants, it should be addressed in accordance with paragraph .10, with copies furnished to the principal accountants and their client. The letter should contain a concluding paragraph along the lines suggested in paragraph .42.

Tables, Statistics, and Other Financial Information

.36 The underwriting agreement sometimes calls for a comfort letter which includes comments on tables, statistics, and other financial information appearing in the registration statement.

.37 The accountants should refrain from commenting on matters to which their competence as independent public accountants has little relevance. Accordingly, except as indicated in the next sentence, they should comment only with respect to information (a) which is expressed in dollars (or percentages derived from such dollar amounts) and has been obtained from accounting records which are subject to the internal controls of the company's accounting system or (b) which has been derived directly from such accounting records by analysis or computation. The accountants may also comment on quantitative information which has been obtained from an accounting record if the information is of a type that is subject to the same controls as the dollar amounts. Accountants should not comment on matters involving primarily the exercise of business judgment of management. For example, changes between periods in gross profit ratios or net income may be caused by factors that are not necessarily within the expertise of accountants. Similarly, even though the accountants might appropriately comment on amounts shown as profit contributions for each line of business as defined by management (see paragraph .40), it would seldom be appropriate for them to comment on the reasonableness of management's determination of the client's lines of business. The accountants should not comment on matters merely because they happen to be present and are capable of reading, counting, measuring, or performing other functions which might be applicable. Examples of matters that, unless subjected to the internal controls of the formal accounting system (which is not ordinarily the case), should not be commented on by the accountants include square footage of facilities, number of employees (except as related to a given payroll period), and backlog information. The accountants should not comment on tables, statistics, and other financial information relating to an unaudited period unless they have made an examination of the client's financial statements for a period including or immediately prior to the unaudited period or have completed an examination for a later period.

.38 As with comments relating to financial statement information, it is important that the procedures followed by the accountants with respect to other information be clearly set out in the comfort letter, in both draft and final form, so that there will be no misunderstanding as to the basis of comments thereon. Further, so that there will be no implication that the accountants are furnishing any assurance as to the sufficiency of the procedures for the underwriter's intended purpose, it is advisable for the comfort letter to contain a statement to this effect. An appropriate way of expressing this is shown in numbered paragraph 10 of Example I. (See paragraph .07.)

.39 In order to avoid ambiguity, the specific information commented on in the letter should be identified by reference to captions, tables, page numbers, or specific paragraphs or sentences. It should not refer, for example, to "all financial and statistical information" set forth (a) in the registration statement, (b) under specific captions, or (c) in response to specific item numbers in the registration statement.

.40 Comments in the comfort letter concerning tables, statistics, and other financial information appearing in the registration statement should be made in the form of a description of the procedures followed, the findings (ordinarily expressed in terms of agreement between items compared), and in some cases, as described below, statements with respect to the acceptability of methods of allocation used in deriving the figures commented upon. Whether comments upon the allocation of income or expense items between such categories as military and commercial sales, or lines of business, may appropriately be made will depend upon the extent to which such allocation is made in, or can be derived directly by analysis or computation from, the client's accounting records. In any event such comments, if made, should make clear that such allocations are to a substantial extent arbitrary, that the method of allocation used is not the only acceptable one, and that other acceptable methods of allocation might produce significantly different results. Appropriate ways of expressing such comments are shown in Example I.

.41 In comments concerning tables, statistics, and other financial information the expression, "presents fairly" (or a variation of it), should not be used. That expression, when used by independent certified public accountants, ordinarily relates to presentation of financial statements and should not be used in commenting on other types of information. Except with respect to requirements for financial statements, the question of what constitutes appropriate information for compliance with the requirements of a particular item of the registration statement form is a matter of legal interpretation outside the competence of the accountants. Consequently, the letter should state that the accountants make no representations as to any matter of legal interpretation. Since the accountants will not be in a position to make any representations as to the completeness or adequacy of disclosure or as to the adequacy of the procedures followed, the letter should so state. It should point out as well that such procedures would not necessarily disclose material misstatements or omissions in the information to which the comments relate. An appropriate manner of expressing the comments is shown in Example I.

Concluding Paragraph

.42 In order to avoid misunderstanding as to the purpose and intended use of the comfort letter, it is desirable that the letter conclude with a paragraph along the following lines:

> This letter is solely for the information of, and assistance to, the underwriters[1] in conducting and documenting their investigation of the affairs of the Company in connection with the offering of the securities covered by the Registration Statement, and is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the Registration Statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the Registration Statement.

[1] When the letter is furnished by the accountants for a subsidiary who are not accountants for the parent company, it should include at this point the following phrase: "and for the use of the accountants for [name of issuer] in furnishing their letter for the underwriters."

Miscellaneous

.43 Accountants who discover matters that may require mention in the final comfort letter but which are not mentioned in the draft letter that has been furnished to the underwriter, such as decreases or changes in specified items not disclosed in the registration statement (see paragraphs .21 and .27), will naturally want to discuss them with their client, so that consideration can be given to whether disclosure should be made in the registration statement. If such disclosure is not to be made, the accountants should inform the client that mention thereof will be made in the comfort letter and suggest that the underwriter be promptly so informed. It is recommended that the accountants be present when such matters are discussed between the client and the underwriter.

Examples

.44 The contents of letters for underwriters vary, depending on the extent of the information in the registration statement and the wishes of the underwriter. The following are examples of letters for underwriters, or portions of such letters.

Example A: *Typical Letter*

.45 The matters covered in a typical comfort letter are described below:

a. A statement as to the independence of the accountants (paragraph .12).

b. An opinion as to whether the audited financial statements and schedules included in the registration statement comply as to form in all material respects with the applicable accounting requirements of the Act and the published rules and regulations thereunder (paragraph .13).

c. Negative assurances as to whether the unaudited financial statements and schedules included in the registration statement (paragraphs .16–.18):

   (i) Comply as to form with the applicable accounting requirements of the Act and the published rules and regulations thereunder.

(ii) Are fairly presented in conformity with generally accepted accounting principles on a basis substantially consistent with that of the audited financial statements and schedules included therein.

d. Negative assurances as to whether, during a specified period following the date of the latest financial statements in the registration statement and prospectus, there has been any change in capital stock or long-term debt or any decrease in other specified financial-statement items (paragraphs .16 and .21–.26).

Example A is a letter covering all items described immediately above. Letters which cover some of the items may be developed by omitting inapplicable portions of Example A.

Example A assumes the following circumstances. The prospectus (Part I of the registration statement) includes consolidated balance sheets at December 31, 1970 (audited), and March 31, 1971 (unaudited); consolidated statements of income, retained earnings, and changes in financial position for the three years ended December 31, 1970 (audited), and the three months ended March 31, 1971 (unaudited); and a consolidated summary of earnings for the five years ended December 31, 1970 (audited), and the three-month periods ended March 31, 1970 and 1971 (both unaudited). Part II of the registration statement includes consolidated financial schedules for the three years ended December 31, 1970 (audited), and the three months ended March 31, 1971 (unaudited). The effective date is June 23, 1971. The cutoff date is June 25, 1971, and the letter is dated June 30, 1971.

Frequently, the income statement information is expanded to include all of the periods for which a summary of earnings is required and a separate summary of earnings is omitted. In this situation, Example A would be modified by expanding the references to the consolidated statements of income to cover the appropriate periods and omitting the references to the summary of earnings.

Each of the comments in the letter is in response to a requirement of the underwriting agreement. For purposes of Example A, the income-statement items of the current interim period are to be compared with those of the corresponding period of the preceding year.

June 30, 1971

[Addressee]

Dear Sirs:

We have examined the consolidated financial statements and schedules of The Blank Company, Inc. (the "Company") and subsidiaries as of December 31, 1970, and for the three years then ended, and the related summary of earnings for the five years then ended included in the Registration Statement (No. 2-00000) on Form S-1 filed by the Company under the Securities Act of 1933 (the "Act"); our reports with respect thereto are also included in such Registration Statement. Such Registration Statement, as amended as of June 23, 1971, is herein referred to as the "Registration Statement." In connection with the Registration Statement:

1. We are independent certified public accountants with respect to The Blank Company, Inc. within the meaning of the Act and the applicable published rules and regulations thereunder, and the answer to Item 24 of the Registration Statement is correct insofar as it relates to us.

2. In our opinion [include the phrase, "except as disclosed in the Registration Statement," if applicable], the financial statements and schedules and the summary of earnings examined by us and included or incorporated by reference in the Registration Statement comply as to form in all material respects with the applicable accounting requirements of the Act and the published rules and regulations thereunder.

3. We have not examined any financial statements of the Company as of any date or for any period subsequent to December 31, 1970; although we have made an examination for the year ended December 31, 1970, the purpose (and therefore the scope) of such examination was to enable us to express our opinion on the financial statements as of December 31, 1970, and for the year then ended, but not on the financial statements for any interim period within such year. Therefore, we are unable to and do not express any opinion on the unaudited consolidated balance sheet as of March 31, 1971; interim consolidated statements of income, retained earnings, and changes in financial position for the three months then ended; interim consolidated summary of earnings for the three-month periods ended March 31, 1971 and 1970; the related schedules included in the Registration Statement; or on the financial position, results of operations, or changes in financial position as of any date or for any period subsequent to December 31, 1970.

4. For purposes of this letter we have read the 1971 minutes of the stockholders, the Board of Directors, and [include other appropriate committees, if any] of the Company and its subsidiaries as set forth in the minute books at June 25, 1971, officials of the Company having advised us that the minutes of all such meetings through that date were set forth therein, and have carried out other procedures to June 25, 1971 (our work did not extend to the period from June 26, 1971, to June 30, 1971, inclusive), as follows:

a. With respect to the three-month periods ended March 31, 1970 and 1971, we have:

   (1) read the unaudited consolidated summary of earnings for these periods included in the Registration Statement;

   (2) read the unaudited consolidated balance sheet as of March 31, 1971, and unaudited consolidated statements of income, retained earnings, and changes in financial position for the three months then ended and the related unaudited schedules included in the Registration Statement; and

   (3) made inquiries of certain officials of the Company who have responsibility for financial and accounting matters as to (i) whether the unaudited financial statements, summary of earnings, and schedules referred to under a(1) and (2) above comply as to form in all material respects with the applicable accounting requirements of the Act and the published rules and regulations thereunder; (ii) whether said financial statements are fairly presented, and the information in said summary is fairly summarized, in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited financial statements and summary of earnings included in the Registration Statement; and (iii) whether said unaudited schedules, when considered in relation to the basic unaudited financial statements, present fairly in all material respects the information shown therein.

b. With respect to the period from April 1, 1971, to May 31, 1971, we have:

   (1) read the unaudited consolidated financial statements of the Company and subsidiaries for April and May of both 1970 and 1971 furnished us by the Company, officials of the Company having advised us that no such financial statements as of any date or for any period subsequent to May 31, 1971, were available; and

(2) made inquiries of certain officials of the Company who have responsibility for financial and accounting matters as to whether the unaudited financial statements referred to under b(1) above are stated on a basis substantially consistent with that of the audited financial statements included in the Registration Statement.

The foregoing procedures do not constitute an examination made in accordance with generally accepted auditing standards. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations as to the sufficiency of the foregoing procedures for your purposes.

5. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that:

a. (i) the unaudited financial statements, summary of earnings, and schedules described in 4a(1) and (2) above, included in the Registration Statement, do not comply as to form in all material respects with the applicable accounting requirements of the Act and the published rules and regulations thereunder; (ii) said financial statements are not fairly presented, or the information in said summary is not fairly summarized, in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited financial statements and summary of earnings; or (iii) said unaudited schedules, when considered in relation to the basic unaudited financial statements, do not present fairly in all material respects the information shown therein; or

b. (i) at May 31, 1971, there was any change in the capital stock or long-term debt of the Company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown in the March 31, 1971, balance sheet included in the Registration Statement or (ii) for the period from April 1, 1971, to May 31, 1971, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income, except in all instances for changes or decreases which the Registration Statement discloses have occurred or may occur.

6. As mentioned under 4b, Company officials have advised us that no consolidated statements as of any date or for any period subse-

quent to May 31, 1971, are available; accordingly, the procedures carried out by us with respect to changes in financial-statement items after May 31, 1971, have, of necessity, been even more limited than those with respect to the periods referred to in 4. We have made inquiries of certain officials of the Company who have responsibility for financial and accounting matters as to whether (i) there was any change at June 25, 1971, in the capital stock or long-term debt of the Company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown on the March 31, 1971, consolidated balance sheet included in the Registration Statement; or (ii) for the period from April 1, 1971, to June 25, 1971, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change or decrease, except in all instances for changes or decreases which the Registration Statement discloses have occurred or may occur.

7. This letter is solely for the information of, and assistance to, the underwriters in conducting and documenting their investigation of the affairs of the Company in connection with the offering of the securities covered by the Registration Statement, and is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the Registration Statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the Registration Statement.

Example B: *Alternate Wording for Companies That Are Permitted To Present Interim Earnings Data for Twelve-Month Period*

.46 Certain types of companies are permitted to include earnings data for a twelve-month period to the date of the latest balance sheet furnished in lieu of earnings data for both the interim period between the end of the latest fiscal year and the date of the latest balance sheet and the corresponding period of the preceding fiscal year. In addition to the foregoing, Example B assumes that the income statement is substituted for the summary of earnings. The following would be substituted for the applicable part of numbered paragraph 3 of Example A.

3. . . . was to enable us to express our opinion as to the financial statements as of December 31, 1970, and for the year then ended, but not as to the financial statements for any period included in part within such year. Therefore, we are unable to and do not express any opinion on the unaudited consolidated balance sheet as of March 31, 1971, the consolidated statement of income for the twelve months then ended, the statements of retained earnings and changes in financial position for the three months then ended, and the related schedules included in the Registration Statement. . . .

Example C: *Letter Reaffirming Comments in Example A As of a Later Date*

.47 If more than one comfort letter is requested, the later letter may, if appropriate, make reference to information appearing in the earlier letter without repeating such information (see paragraph .09). Example C reaffirms and updates the information in Example A.

July 25, 1971

[Addressee]
Dear Sirs:

We refer to our letter of [date of Example A] relating to the Registration Statement (No. 2-00000) of The Blank Company, Inc. We reaffirm as of the date hereof (and as though made on the date hereof) all statements made in that letter, except that, for the purposes of this letter:

1. The Registration Statement to which this letter relates is as amended as of July 13, 1971 [effective date].

2. The reading of minutes described in paragraph 4 of that letter has been carried out through July 20, 1971 [the new cutoff date].

3. The procedures and inquiries covered in paragraph 4 of that letter were carried out to July 20, 1971 [the new cutoff date] (our work did not extend to the period from July 21, 1971, to July 25, 1971 [date of letter], inclusive).

4. The period covered in paragraph 4b of that letter is changed to the period from April 1, 1971, to June 30, 1971; officials of the Company have advised us that the latest available financial statements are for the month of June 1971.

5. The references to May 31, 1971, in paragraph 5b of that letter are changed to June 30, 1971.

6. The references to May 31, 1971, and June 25, 1971, in paragraph 6 of that letter are changed to June 30, 1971, and July 20, 1971, respectively.

7. This letter is solely for the information of, and assistance to, the underwriters in conducting and documenting their investigation of the affairs of the Company in connection with the offering of the securities covered by the Registration Statement, and is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the Registration Statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the Registration Statement.

Example D: *Alternate Wording When SEC Has Agreed to a Departure From Its Published Accounting Requirements*

.48 Example D is applicable when (a) there is a departure from the applicable accounting requirements of the Act and the published rules and regulations thereunder and (b) representatives of the SEC have agreed to such departure. Numbered paragraph 2 of Example A would be revised to read as follows:

In our opinion [include the phrase "except as disclosed in the Registration Statement," if applicable], the financial statements and schedules and the summary of earnings examined by us and included or incorporated by reference in the Registration Statement comply as to form in all material respects with the applicable accounting requirements of the Act and the published rules and regulations thereunder; however, as agreed to by representatives of the SEC, separate parent-company financial statements and schedules as required by Instruction 1 as to Financial Statements for Form S-1 have been omitted.

Numbered paragraph 5a of Example A would be revised in part to read as follows:

(i) . . . do not comply as to form in all material respects with the applicable accounting requirements of the Act and of the published rules and regulations thereunder; however, as agreed to by representatives of the SEC, separate parent-company financial statements and schedules as required by Instruction 1 as to Financial Statements for Form S-1 have been omitted, (ii) . . .

Example E: *Alternate Wording When Recent Earnings Data Are Presented in Capsule Form*

.49 Example E is applicable when (a) the information shown in the summary of earnings (or statement of income) in the registration statement is supplemented (usually in a paragraph following the summary) by later information regarding sales and earnings (capsule information) and (b) the accountants are asked to comment on such information (paragraph .19). The same facts exist as in Example A except for the following:

1. Sales, net income (no extraordinary items), and earnings per share for the six-month periods ended June 30, 1970 and 1971 (both unaudited), are included in a paragraph following the summary of earnings.
2. No statements later than those for June 1971 are available.
3. The letter is dated July 25, 1971, and the cutoff date is July 20, 1971.

Numbered paragraphs 4, 5, and 6 of Example A should be revised to read as follows:

> 4. For purposes of this letter we have read the 1971 minutes . . . and have carried out other procedures to July 20, 1971 (our work did not extend to the period from July 21, 1971, to July 25, 1971, inclusive), with respect to the six-month periods ended June 30, 1970 and 1971, as follows:
>
> a. read the unaudited consolidated summary of earnings for the three-month periods ended March 31, 1970 and 1971, included in the Registration Statement;
>
> b. read the unaudited consolidated balance sheet as of March 31, 1971, and the unaudited consolidated statements of income, retained earnings, and changes in financial position for the three months then ended and the related unaudited schedules included in the Registration Statement;
>
> c. read the unaudited amounts for sales, net income, and earnings per share for the six-month periods ended June 30, 1970 and 1971, as set forth in the paragraph following the summary of earnings, and read the unaudited consolidated financial statements furnished us by the Company for those periods, from which said amounts were derived; and
>
> d. made inquiries of certain officials of the Company who have responsibility for financial and accounting matters as to (i)

whether the unaudited financial statements, summary of earnings, and schedules referred to under a and b above comply as to form in all material respects with the applicable accounting requirements of the Act and the published rules and regulations thereunder; (ii) whether said financial statements are fairly presented, and the information in said summary is fairly summarized, in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited financial statements and summary of earnings included in the Registration Statement; (iii) whether said unaudited schedules, when considered in relation to the basic unaudited financial statements, present fairly in all material respects the information shown therein; and (iv) whether the unaudited amounts referred to under c above are stated on a basis substantially consistent with that of the corresponding amounts in the audited statements of income.

The foregoing procedures do not constitute an examination made in accordance with generally accepted auditing standards. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations as to the sufficiency of the foregoing procedures for your purposes.

5. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that:

a. (i) the unaudited financial statements, summary of earnings, and schedules described in 4a and b above, included in the Registration Statement, do not comply as to form in all material respects with the applicable accounting requirements of the Act and the published rules and regulations thereunder; (ii) said financial statements are not fairly presented, or the information in said summary is not fairly summarized, in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited financial statements and summary of earnings; or (iii) said unaudited schedules, when considered in relation to the basic unaudited financial statements, do not present fairly in all material respects the information shown therein;

b. the unaudited sales and net income amounts referred to under 4c were not determined on a basis substantially consistent with that of the corresponding amounts in the audited statements of income; or

c. at June 30, 1971, there was any change in the capital stock or long-term debt of the Company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown in the March 31, 1971, consolidated balance sheet included in the Registration Statement, except for changes or decreases which the Registration Statement discloses have occurred or may occur.

6. Company officials have advised us that no consolidated statements as of any date or for any period subsequent to June 30, 1971, are available; accordingly, the procedures carried out by us with respect to changes in financial-statement items after June 30, 1971, have, of necessity, been even more limited than those with respect to the periods referred to in 4. We have made inquiries of certain officials of the Company who have responsibility for financial and accounting matters as to whether (i) at July 20, 1971, there was any change in the capital stock or long-term debt of the Company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown on the March 31, 1971, balance sheet included in the Registration Statement; or (ii) for the period from July 1, 1971, to July 20, 1971, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change or decrease, except in all instances for changes or decreases which the Registration Statement discloses have occurred or may occur.

Example F: *Alternate Wording When Accountants Are Aware of A Decrease in a Specified Financial-Statement Item*

.50 Example F covers a situation in which the accountants are aware of a decrease in a financial-statement item on which they are requested to comment (paragraphs .21–.26). The same facts exist as in Example A except for the decrease covered in the following change in numbered paragraph 5b.

5b. (i) at May 31, 1971, there was any change in the capital stock or long-term debt of the Company and subsidiaries consolidated or any decrease in consolidated net assets as compared with amounts shown in the March 31, 1971, consolidated balance sheet included in the Registration Statement; or (ii) for the period from April 1, 1971, to May 31, 1971, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or the total or per-share amounts of income before extraordinary items or net income, except in all instances for changes or decreases which the Registration Statement discloses have occurred or may occur; except that the unaudited consolidated balance sheet as of May 31, 1971, which we were furnished by the Company, showed a decrease from March 31, 1971, in consolidated net current assets as follows (in thousands of dollars):

	Current Assets	*Current Liabilities*	*Net Current Assets*
March 31, 1971	$4,251	$1,356	$2,895
May 31, 1971	3,986	1,732	2,254

6. As mentioned under 4b, Company officials have advised us that no consolidated statements as of any date or for any period subsequent to May 31, 1971, are available; accordingly, the procedures carried out by us with respect to changes in financial-statement items after May 31, 1971, have, of necessity, been even more limited than those with respect to the periods referred to in 4. We have made inquiries of certain officials of the Company who have responsibility for financial and accounting matters as to whether (i) there was any change at June 25, 1971, in the capital stock or long-term debt of the Company and subsidiaries consolidated or any decreases in consolidated net current assets or net assets as compared with amounts shown on the March 31, 1971, consolidated balance sheet included in the Registration Statement; or (ii) for the period from April 1, 1971, to June 25, 1971, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change or decrease except in all instances for changes or decreases which the Registration Statement discloses have occurred or may occur and except as described in the following sentence. We have been informed by officials of the Company that there continues to be a decrease in net current assets that is estimated to be approximately the same amount as set forth in 5b [or such other disclosure as fits the circumstances].

Example G: *Alternate Wording When Accountants' Opinion Contains a Qualification*

.51 Example G is applicable when the accountants' opinion on the audited financial statements included in the registration statement contains a qualification regarding a matter that may also affect the unaudited financial statements included in the registration statement. The introductory paragraph in Example A would be revised as indicated in paragraph .30. The following would be substituted for numbered paragraph 5a in Example A.

5a. subject to the effect of final settlement of the tax matters discussed in Note 3 to the financial statements (which resulted in the qualification of our opinion as referred to in the introductory paragraph of this letter), (i) the unaudited financial statements, summary of earnings, and schedules described in 4a(1) and (2) above . . .

The possible effect of the qualification should also be evaluated to determine whether it also requires mention in the comments on subsequent changes (numbered paragraph 5b of Example A). This might occur if the relative possible effect on net income of the matter to which the qualification relates is increasing.

Example H: *Alternate Wording When More Than One Accountant Is Involved*

.52 Example H applies when more than one accountant is involved in the examination of the financial statements of a business and the principal accountants have obtained a copy of the comfort letter of the other accountants (paragraph .33). Example H consists of an addition of a subparagraph c to numbered paragraph 4, a substitution for the applicable part of numbered paragraph 5, and an addition to numbered paragraph 6 of Example A.

4c. We have read the letter dated ________________ of [the other accountants] with regard to [the related company].

5. Nothing came to our attention as a result of the foregoing procedures (which, so far as [the related company] is concerned, consisted solely of reading the letter referred to in 4c above), however, that caused us to believe that. . . .

6. . . . On the basis of these inquiries and our reading of the minutes and the letter dated ______________________ of [the other accountants] with regard to [the related company] as described in

4, nothing came to our attention that caused us to believe that there was any such change or decrease except in all instances for changes or decreases which the Registration Statement discloses have occurred or may occur.

Example I: *Comments on Tables, Statistics, and Other Financial Information*

.53 Example I is applicable when the accountants are asked to comment on tables, statistics, or other compilations of information appearing in a registration statement (paragraphs .36–.41). Each of the comments is in response to a specific request. The paragraphs in Example I are intended to follow numbered paragraph 6 in Example A.

7. For purposes of this letter, we have also read the following, set forth in the Registration Statement on the indicated pages.[1]

Item	*Page*	*Description*
a.	4	"Capitalization." The amounts under the captions "Amount Outstanding as of June 15, 1971" and "As Adjusted." The related notes, except the following in Note 2: "See 'Transactions with Interested Persons.' From the proceeds of this offering the Company intends to prepay $90,000 on these notes, pro rata. See 'Use of Proceeds.'"
b.	13	"History and Business—Sales and Marketing." The table following the first paragraph.
c.	22	"Remuneration." The table at the bottom of the page, except as to estimated annual benefits upon retirement.
d.	33	"Revenue Sources." The amounts in the first paragraph and the table following that paragraph.

8. Our examination of the financial statements for the periods referred to in the introductory paragraph of this letter comprised

[1] In some cases it may be considered desirable to combine in one paragraph the substance of paragraphs 7 and 9. This may be done by expanding the identification of items in paragraph 9 to provide the identification information contained in paragraph 7. In such cases, the introductory sentences in paragraphs 7 and 9 and the text of paragraph 8 might be combined as follows:

For purposes of this letter, we have also read the following information and have performed the additional procedures stated below with respect to such information. Our examination of the financial statements. . . .

audit tests and procedures deemed necessary for the purpose of expressing an opinion on such financial statements taken as a whole. For neither the periods referred to therein nor any other period did we perform audit tests for the purpose of expressing an opinion on individual balances of accounts or summaries of selected transactions such as those enumerated above and, accordingly, we express no opinion thereon.

9. However, for purposes of this letter we have performed the following additional procedures, which were applied as indicated with respect to the items enumerated above:

Item in 7 above	*Procedures and Findings*
a.	We compared the amounts and numbers of shares listed under the caption, "Amount Outstanding as of June 15, 1971," with the balances in the appropriate accounts in the Company's general ledger at May 31, 1971 (the latest date for which postings had been made), and found them to be in agreement. We were informed by officials responsible for financial and accounting matters that there had been no changes in such amounts and numbers of shares between May 31, 1971, and June 15, 1971. We compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 1971" adjusted for the issuance of the Debentures to be offered by means of the Registration Statement and for the proposed use of a portion of the proceeds thereof to prepay portions of certain notes, as described under "Use of Proceeds," with the amounts and numbers of shares shown under the caption, "As Adjusted," and found such amounts and numbers of shares to be in agreement (however, we make no comments as to the reasonableness of the "Use of Proceeds" or whether such use will actually take place). We compared the description of the securities and the information (except certain information in Note 2 referred to in 7 above) included in the notes to the table with the corresponding descriptions and information in the Company's consolidated financial statements, including the notes thereto included in the Registration Statement, and found such descriptions and information to be in agreement.
b.	We compared the amounts of military sales, commercial sales, and total sales shown in the Registration Statement with the balances in the appropriate accounts in the Company's general ledger for the respective fiscal years and for the unaudited interim periods and found them to be in agreement (however, we make no comments as to the appropriateness of such classi-

Item in 7 above	*Procedures and Findings*

fication or the manner in which such classification has been made). We computed the approximate percentages of such amounts of military sales and commercial sales to total sales for the respective fiscal years and for the unaudited interim periods. We compared the computed percentages with the corresponding percentages appearing in the Registration Statement and found them to be in agreement.

c. We compared the amounts of direct remuneration listed in the Registration Statement with the corresponding amounts shown by the individual employee earnings records for the year 1970 and found them to be in agreement.

d. We compared the amounts of sales and contributions to profit for each line of business for the years 1968, 1969, and 1970 and the three months ended March 31, 1971, appearing in the Registration Statement with the corresponding amounts shown by an analysis prepared by the Company and found such amounts to be in agreement (however, we make no comments as to the appropriateness of the determination by the Company as to what constitutes its lines of business). We compared the amounts of total sales and total contributions to profit of the several lines of business for each of the periods mentioned in the preceding sentence with the corresponding amounts shown in the financial statements for such periods appearing in the Registration Statement and found such amounts to be in agreement. We computed the approximate percentages of the total amounts of sales and net income for each line of business for each of the periods mentioned in the preceding sentence. We compared the computed percentages with the corresponding percentages appearing in the Registration Statement and found them to be in agreement. We compared the sales and cost of sales shown in the analysis referred to above for each line of business with the balances in the appropriate accounts in the Company's general ledger for the respective fiscal years and for the unaudited interim periods and found them to be in agreement. Officials responsible for financial and accounting matters described to us the methods used in the analysis referred to above in allocating certain costs and expenses, including income tax expense, among the several lines of business, but we did not test the application of the procedures. Although nothing came to our attention as a result of the foregoing that caused us to believe that the method of allocation employed is not

Item in 7 above	*Procedures and Findings*

acceptable, it should be understood that the allocations are to a substantial extent necessarily arbitrary and that other acceptable methods of allocation might produce significantly different results.

10. It should be understood that we make no representations as to questions of legal interpretation or as to the sufficiency for your purposes of the procedures enumerated in the preceding paragraph; also, such procedures would not necessarily reveal any material misstatement of the amounts or percentages listed above. Further, we have addressed ourselves solely to the foregoing data as set forth in the Registration Statement and make no representations as to the adequacy of disclosure or as to whether any material facts have been omitted.

11. This letter is solely for the information of, and assistance to, the underwriters in conducting and documenting their investigation of the affairs of the Company in connection with the offering of the securities covered by the Registration Statement, and is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the Registration Statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the Registration Statement.

The next page is 1201.

AU Section 640

Reports on Internal Control

Issue date, unless otherwise indicated: November, 1972

.01 Independent auditors are sometimes requested to furnish reports on their evaluation of internal control for use by management, regulatory agencies, other independent auditors, or the general public. The purpose of this section is to improve the understanding of such reports with reference to the nature and effectiveness of internal control and the independent auditor's evaluation of it. For reports on internal control based on criteria established by governmental agencies, see section 641.

.02 As used herein, *management* includes directors, officers, and others who perform managerial functions; *regulatory agencies* include both governmental and other agencies, such as stock exchanges, that exercise regulatory, supervisory, or other public administrative functions; and the *general public* includes present and prospective investors, creditors, customers, and others who have an interest in particular organizations.

Usefulness of Reports on Internal Control

.03 Because of the technical nature and complexity of internal accounting control and the consequent problem of understanding reports thereon, questions have been raised as to whether such reports serve a useful purpose for all persons to whom they might be issued. The usefulness of such reports depends on the understanding of the reports and on the action that can be taken by those to whom the reports are issued. The expected usefulness to the principal classes or groups of such persons is discussed in paragraphs .04–.11.

Management, Regulatory Agencies, and Independent Auditors

.04 Management is responsible for establishing and maintaining internal accounting control. Regulatory agencies may be concerned with such control because it is relevant to their primary regulatory purpose or to the scope of their examination functions. Independent auditors of one entity or organization unit may be concerned with internal accounting control of another because it is relevant to the scope of their examination. It may be presumed that these groups include persons whose training and experience or intimate knowledge of the organization should provide a reasonable basis for understanding the nature and effectiveness of internal accounting control and the auditor's evaluation of it. Consequently, it is evident that reports on internal accounting control can serve a useful purpose for management, regulatory agencies, and other independent auditors.

General Public

.05 In contrast to the foregoing groups, the usefulness of reports on internal accounting control to the general public is questionable. The groups discussed in the preceding paragraph are directly concerned with internal accounting control and are in a position to take direct action as a result of reports thereon. On the other hand, any possible action that could be taken by the general public as a result of such reports would be indirect since it ordinarily would be limited to making decisions about either a company's financial statements or its management. The usefulness of reports on internal accounting control for these purposes is discussed in the next three paragraphs.

.06 Insofar as audited financial statements are concerned, the auditor's evaluation of internal accounting control is only an intermediate step in forming the opinion he expresses on such statements. Therefore, an auditor's report on his evaluation of internal accounting control would not provide any additional credibility to audited financial statements.

.07 Insofar as interim or other unaudited financial statements are concerned, a report on an auditor's evaluation of internal accounting control for an earlier period could only be used to project the evaluation into the future as a basis for reliance on the unaudited statements. Depending on the evaluation expressed in the report, such projections into the future could either increase or decrease the reliance that otherwise would be placed on the unaudited statements. Some believe that such projections would serve a useful purpose because the public is interested in unaudited statements and because the effectiveness of internal accounting control has a bearing on the probability that such statements will be reliable. Although conceding the relevance of internal accounting control in this respect, others believe that projections of auditors' evaluations thereof would result in either unwarranted reliance on, or unduly negative inferences concerning, unaudited financial statements. The latter group believes that unwarranted reliance would result from improper understanding of the inherent limitations on any system of internal accounting control, of the purpose and scope of the auditor's evaluation, and of the risks of projecting such evaluations into the future. Conversely, this same group believes unduly negative inferences would result from improper understanding that weaknesses in internal accounting control relate to conditions that could, but would not necessarily, cause unaudited financial statements to be misleading.

.08 There are also different views as to the usefulness of reports on internal accounting control for the purpose of making decisions about management's performance. Some believe such reports would be useful for that purpose because internal accounting control is an important area of management responsibility. Others believe the relative importance of this area of management responsibility, as compared to other areas for which reports are not presently available or feasible, is such that reports on internal accounting control alone would result in distorted appraisals of management performance.

.09 Although the general public has been defined broadly, it is recognized that within this group there may be considerable variation in the degree to which the conflicting expectations expressed in paragraphs .07 and .08 will materialize. This variation may arise from, and reflect differences in, circumstances such as the type and extent of investment or other interest in the organization and the related influence on management action, and the level of understanding of the nature and limitations of internal accounting control.

.10 Considering the conflicting views discussed above and the limited experience with such reports, the decision as to whether reports on an auditor's evaluation of internal accounting control would be useful for some portion or all of the general public in particular cases or classes of cases is the responsibility of management and/or any regulatory agencies having jurisdiction.

.11 In no event, however, should an auditor authorize a report on his evaluation of internal accounting control to be issued to the general public in a document that includes unaudited financial statements.

Form for Reports on Internal Control Based on Audits

.12 If reports on auditors' evaluations of internal accounting control are to be issued, the risk of misunderstanding can be reduced by adopting a form of report that describes in reasonable detail the objective and limitations of internal accounting control and the auditor's evaluation of it. Therefore, the following language should be used for such purpose except as discussed in the subsequent paragraphs in this section.

> We have examined the financial statements of ABC Company for the year ended December 31, 1970, and have issued our report thereon dated February 23, 1971.[1] As a part of our examination, we reviewed and tested the Company's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. Under these standards the purpose of such evaluation is to establish a basis for reliance thereon in determining the nature, timing, and extent of other auditing procedures that are necessary for expressing an opinion on the financial statements.
>
> The objective of internal accounting control is to provide reasonable, but not absolute, assurance as to the safeguarding of assets against loss from unauthorized use or disposition, and the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management.
>
> There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes

[1] If the report on an examination of the financial statements is qualified because of any restriction on the scope of the examination, the restriction and its effect on the evaluation of the system of internal accounting control should be indicated in the report thereon.

> of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends upon segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management with respect either to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with the procedures may deteriorate.
>
> Our study and evaluation of the Company's system of internal accounting control for the year ended December 31, 1970, which was made for the purpose set forth in the first paragraph above, would not necessarily disclose all weaknesses in the system. However, such study and evaluation disclosed the following conditions that we believe to be material weaknesses.

The above paragraphs should be followed by appropriate description of the material weaknesses. The descriptions should indicate whether the weaknesses relate to the prescribed procedures or to compliance with them. The report may also include recommendations for improvements, comments concerning corrective action taken or in process, or other comments appropriate in the circumstances. The basis for any comments concerning subsequent corrective action should be indicated, including the scope of any review and tests by the auditor. Although the first paragraph of the foregoing form of report clearly indicates that weaknesses in the system are considered in determining the nature, timing, and extent of auditing procedures necessary for expressing an opinion on financial statements, some auditors may want to include further comments in this respect.

.13 In some cases, the auditor may conclude that for certain weaknesses corrective action by management is not practicable in the circumstances, and he may decide to exclude such weaknesses from his report. If such weaknesses are excluded, the last sentence of the above form of report should be modified as follows:

> However, such study and evaluation disclosed the following conditions that we believe to be material weaknesses for which corrective action by management may be practicable in the circumstances.

Such a report should include appropriate description of material weaknesses for which the auditor has either (1) concluded that corrective action by management is practicable or (2) formed no conclusion in this respect.

.14 If there are no conditions to be reported in accordance with the two preceding paragraphs, the word "no" should be substituted for "the following" in the above form of report.

.15 The auditor may want to report other weaknesses, regardless of his judgment as to materiality or practicability of corrective action by management. The latter might include situations in which the organization is too small to permit adequate segregation of duties of employees. In any of these situations, the language in paragraph .12 should be modified as appropriate. If some weaknesses are reported to one group but not to another (for example, to management but not to regulatory agencies or to the general public), the more extensive report should distinguish the weaknesses that are excluded from the other report and the auditor should be prepared to support, if necessary, his judgment in making the distinction.

.16 In some cases reports on internal accounting control may include comments on additional matters. For example, a regulatory agency may require comments on certain aspects of administrative control or on compliance with certain provisions in contracts or regulations. In such cases the language in paragraph .12 should be modified to identify clearly the additional matters and distinguish them from internal accounting control, to describe in reasonable detail the scope of the review and tests concerning them, and to express conclusions in language comparable to that in paragraphs .12 through .15 as appropriate. The identification of the additional matters covered in the report should be as specific as the auditor considers necessary to prevent misunderstanding in this respect. Such identification can be made in some cases by reference to specific portions of other documents such as contracts or regulations.

.17 Since auditors are aware of the objectives and limitations of internal accounting control and of auditors' evaluations of it, use of the form of report in paragraph .12 is optional for reports issued solely for another independent auditor.

.18 Use of the form of report in paragraph .12 is optional also for reports issued solely for the internal information of management. Suggestions or other comments concerning specific aspects of internal accounting control and various other matters are often submitted to management by auditors as a result of observations made during their examinations of financial statements. These comments are often submitted by letters, memoranda, and other less formal means. This practice is encouraged, and this section is not intended to preclude the use of such means of communication.

Form for Reports on Internal Control Based on Special Studies

.19 Reports on internal accounting control sometimes are issued as a result of special studies. As used in this section *special studies* are those in which the scope of the study and evaluation being reported is substantially more extensive than that required for an examination of financial statements in accordance with generally accepted auditing standards. Special studies may relate either to an existing system or to a proposed system.

.20 If reports on special studies of internal accounting control are to be issued to regulatory agencies or to the general public, the form of report in paragraph .12 should be adapted by replacing the first paragraph and modifying the fourth paragraph therein. The first paragraph should describe the purpose and scope of the study. This description should be in reasonable detail and should indicate whether the scope included both a review of the system and tests of compliance with it. The fourth paragraph should be modified to refer to the purpose of the special study and any related limitations and to refer to the weaknesses disclosed or the absence thereof by using the language included in paragraphs .12 through .14 as appropriate in the circumstances.

.21 For reports issued solely for use by management or other independent auditors, the flexibility in reporting provided for in paragraphs .17 and .18 applies also to reports based on special studies.

The next page is 1221.

AU Section 641

Reports on Internal Control Based on Criteria Established by Governmental Agencies

Issue date, unless otherwise indicated: November, 1972

.01 Some governmental agencies[1] have commenced or completed audit guides, questionnaires, or other publications that set forth criteria for evaluation of the adequacy for their purposes of internal control procedures of organizations with which they are concerned; other agencies have been encouraged to do so.[2] The purpose of this section is to supplement section 640, "Reports on Internal Control," by dealing more specifically with reports on internal control based on criteria established by agencies in reasonable detail and in terms susceptible to objective application. This section does not apply if such criteria have not been established.

.02 Such criteria may encompass specified aspects of internal accounting control, and may also encompass specified aspects of administrative control or of compliance with grants, regulations, or statutes. For this reason, the auditor's report should identify clearly the matters covered by his study. This can be accomplished by reference to the publication in which the established criteria are set forth. The report should also indicate whether the auditor's study included tests of compliance with the procedures covered by his study.

.03 If criteria established by an agency are set forth in a questionnaire or other publication in reasonable detail and in terms susceptible to objective answers or application, the auditor's report may

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[1] The concepts expressed in this section also apply to reports for other organizations, such as stock exchanges, that exercise regulatory, supervisory, or other public administrative functions.

[2] See *Suggested Guidelines for the Structure and Content of Audit Guides Prepared by Federal Agencies for Use by CPAs,* which was issued in March 1972 by the Committee on Auditing for Federal Agencies of the American Institute of Certified Public Accountants.

express a conclusion, based on the agency's criteria, concerning the adequacy of the procedures studied, with an exception as to any condition he believes is not in conformity with such criteria and is a material weakness. Upon request of the agency or at the auditor's discretion, his report may also refer to any condition he believes is not in conformity with the agency's criteria but is not a material weakness. When the auditor issues this form of report, he does not assume any responsibility for the comprehensiveness of the criteria established by the agency; however, he should report any relevant condition that comes to his attention in the course of his study that he believes to be a material weakness even though not covered by such criteria.

.04 For the purpose of reports contemplated in paragraph .03, a material weakness means either (a) a condition in which the auditor believes the organization's prescribed procedures or the degree of compliance with them does not provide reasonable assurance that errors or irregularities in amounts that would be material in relation to the amount of the applicable grant or program would be prevented or detected within a timely period by employees in the normal course of performing their assigned functions or (b) a condition in which the auditor believes the lack of conformity with the agency's criteria is material in accordance with any guidelines for determining materiality that are included in such criteria.

.05 Reports that refer to weaknesses should describe such weaknesses in reasonable detail. The agencies ordinarily will require that such reports also include whatever comments are appropriate in the circumstances concerning any recommendations for corrective action.

.06 When the auditor issues this form of report, he should also include a statement that it is intended for use in connection with the grant to which the report refers and that it should not be used for any other purpose.

AU Section 700

SPECIAL TOPICS

. . . filings under federal securities statutes . . .
limited review of interim financial information . . .

TABLE OF CONTENTS

The next page is 1331.

AU Section 710

Filings Under Federal Securities Statutes

Issue date, unless otherwise indicated: November, 1972

.01 As in the case of financial statements used for other purposes, management has the responsibility for the financial representations contained in documents filed under the federal securities statutes. In this connection the Securities and Exchange 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 the accounting" (4 SEC 721[1939]).

.02 The responsibility of the independent auditor resulting from the inclusion of his report in registration statements, proxy statements, and periodic reports filed under the federal securities statutes is in substance generally no different from that involved in other types of reporting as previously described. However, the nature and extent of this responsibility are specified in some detail in these statutes and in the rules and regulations issued thereunder. For example, the Securities Act of 1933, as amended, in Section 11(a) imposes responsibility for false or misleading statements, or for omissions which render misleading the statements made, in an effective registration statement on

> . . . 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. . . .

.03 Section 11 also makes specific mention of the independent auditor's responsibility as an expert when his report is included in a registration statement filed under that Act. Section 11(b) states, in part, that no person shall be liable as provided therein if such person shall sustain the burden of proof that

> . . . 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 further provides that, in determining what constitutes reasonable investigation and reasonable ground to believe, "the standard of reasonableness shall be that required of a prudent man in the management of his own property."

.04 This discussion of the responsibilities of the independent auditor in connection with filings under the federal securities statutes is not intended to offer legal interpretations and is based on an understanding of the meaning of the statutes as they relate to accounting principles and auditing standards and procedures. The discussion is subject to any judicial interpretations which may be issued in the course of time.

.05 Because a registration statement under the Securities Act of 1933 speaks as of its effective date, the independent auditor whose report is included in such a registration statement has a statutory responsibility which is determined in the light of the circumstances on that date. This aspect of responsibility is peculiar to reports used for this purpose (see paragraphs .08–.11).

.06 The other federal securities statutes, while not containing so detailed an exposition, do impose responsibility, under certain conditions, on persons making false or misleading statements with respect to any material fact in applications, reports, or other documents filed pursuant to the statute.

.07 In filings under the Securities Act of 1933, frequently a statement is made in the prospectus that certain information is included in the registration statement in reliance upon the report of certain named experts. The independent auditor should make sure that his name is not being used in such a way as to indicate that his responsibility is greater than he intends. The "experts section" should be so worded that there is no implication that the financial statements have been prepared by the independent auditor or that they are not the direct representations of management. Another section of the typical prospectus which the independent auditor should review is the introduction to the summary of earnings or statement of income in the forepart of the prospectus.

Subsequent Events Procedures in 1933 Act Filings

.08 To sustain the burden of proof that he has made a "reasonable investigation" (see paragraph .03), as required under the Securities Act of 1933, the auditor should extend his procedures with respect to subsequent events from the date of his report up to the effective date or as close thereto as is reasonable and practicable in the circumstances. In this connection, he should arrange to be kept advised by his client of the progress of the registration proceedings so that his review of subsequent events can be completed by the effective date. The likelihood of the auditor discovering subsequent events must necessarily decrease following the completion of field work and, as a practical matter, subsequent to that time the independent auditor may rely, for the most part, on inquiries of responsible officials and employees. In addition to performing the procedures outlined in section 560.12 at or near the effective date, the auditor generally should:

a. Read the entire prospectus and other pertinent portions of the registration statement.
b. Inquire of and obtain written confirmation from officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to whether there have occurred any events other than those reflected or disclosed in the registration statement which, in the officer's opinion, have a material effect on the audited financial statements included therein or which should be disclosed in order to keep those statements from being misleading.

.09 Because the independent auditor has not examined the unaudited financial statements which may be included in the registration statement, he cannot be expected to have an opinion as to whether such statements have been prepared in conformity with generally accepted accounting principles. However, if he concludes on the basis of facts known to him that the unaudited financial statements are not in conformity with generally accepted accounting principles, he should insist upon appropriate revision; failing that, he should add a comment in his report calling attention to the departure; further, he should consider, probably with advice of legal counsel, withholding his consent to the use of his report on the audited financial statements in the registration statement. (See section 516.07.)

.10 A registration statement filed with the Securities and Exchange Commission may contain the reports of two or more independent auditors on their examinations of the financial statements for different periods. An auditor who has not examined the financial statements for the most recent audited period included in the registration statement has a responsibility relating to events subsequent to the date of, but bearing materially on, the financial statements on which he is reporting which continues to the effective date, and he generally should:

a. Read pertinent portions of the prospectus and of the registration statement.
b. Obtain a letter of representations from the successor independent auditor as to whether his examination (including his procedures with respect to subsequent events) revealed any matters which, in his opinion, might have a material effect on the financial statements reported on by the predecessor auditor or would require disclosure in the notes thereto.

.11 If the predecessor auditor becomes aware of any events or transactions which require adjustment or disclosure in the financial statements examined by him, the financial statements should be adjusted or the subsequent event should be disclosed in a note to the financial statements or the auditor should qualify his report.[1] The predecessor auditor should follow the procedures set forth in section 530.05 with respect to dating his report. He should satisfy himself

[1] In some cases, a disclaimer of opinion or an adverse opinion may be appropriate.

as to the propriety of any adjustment or disclosure affecting the financial statements covered by his report. This may be done by performing appropriate auditing procedures or by obtaining a letter of representations from the successor auditor. In the latter instance, he may decide to express reliance on the successor auditor.

→ *The next page is 1361.* ←

AU Section 720

Limited Review of Interim Financial Information

Effective with respect to interim and annual periods beginning after December 25, 1975, unless otherwise indicated *

.01 Independent certified public accountants may be involved with a client's interim financial information in a variety of ways. Involvement may be limited to informal consultation on matters that arise as interim financial information is being prepared, such as advice on accounting principles or disclosure. At the other extreme, involvement may include an examination of interim financial statements in accordance with generally accepted auditing standards. This section provides guidance concerning a limited type of formal involvement with interim financial information that is considerably different from an audit.

Purpose and Applicability

.02 This section describes the nature, timing and extent of procedures that the independent certified public accountant should apply to interim financial information when the accountant has been engaged to make a *limited review* of that information.

.03 This section applies to limited reviews of interim financial information, including interim financial statements and summarized

* See paragraph .25.

interim financial data, that purports to conform with the provisions of Accounting Principles Board Opinion No. 28,* as amended, and that is contained in reports issued to stockholders, and others, or filed with regulatory agencies. The provisions of this section and its appendix,[1] section 720A, do not apply to an accountant's involvement with interim financial information included in documents filed with the Securities and Exchange Commission pursuant to the Securities Act of 1933 unless the accountant has examined and reported on the financial statements in which the interim financial information is included.[2]

.04 Many entities that issue annual financial statements for purposes of reporting to stockholders, and others, or filing with regulatory agencies also issue interim financial information for these purposes. Accounting Principles Board Opinion No. 28,* "Interim Financial Reporting," states:

> Interim financial information may include current data during a fiscal year on financial position, results of operations and changes in financial position. This information may be issued on a monthly or quarterly basis or at other intervals and may take the form of either complete financial statements or summarized financial data. Interim financial information often is provided for each interim period or on a cumulative year-to-date basis, or both, and for the corresponding periods of the preceding year.

.05 Management of an entity is responsible for the preparation of interim financial information in conformity with generally accepted accounting principles and regulatory requirements for purposes of reporting to stockholders, and others, or filing with regulatory agencies. The board of directors of an entity is responsible for overseeing management's discharge of its responsibilities in these respects. Members of the board of directors, particularly those members who are not also members of management, may request assistance concerning

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[1] See section 720A concerning the application of this section to limited reviews made to comply with the provisions of Regulation S-X of the Securities and Exchange Commission and the instructions for its quarterly report on Form 10-Q.

[2] The accountant's procedures concerning such interim financial information for periods subsequent to the period reported on are discussed in section 630, "Letters for Underwriters," and section 710, "Filings Under Federal Securities Statutes."

* See AC section 2071.

accounting and financial reporting matters in carrying out their responsibilities.

Objective of Limited Review

.06 The objective of a limited review of interim financial information is to provide the accountant with a basis for reporting to the board of directors on those matters that he believes should be brought to its attention, based upon applying his objectivity and knowledge of financial reporting practices to significant accounting matters of which he becomes aware through inquiries and analytical procedures.

.07 The objective of a limited review differs significantly from the objective of an examination of financial statements in accordance with generally accepted auditing standards. The objective of an audit is to provide a reasonable basis for expressing an opinion regarding the financial statements under examination. A limited review does not provide a basis for the expression of such an opinion because a limited review does not contemplate a study and evaluation of internal accounting control; tests of accounting records and of responses to inquiries by obtaining corroborating evidential matter through inspection, observation, or confirmations; and certain other procedures ordinarily performed during an audit.

Procedures for Limited Review

.08 The characteristics of interim financial information necessarily affect the nature, timing and extent of procedures that the accountant may apply in making a limited review of that information prior to its issuance. Timeliness is an important element of interim financial reporting. Interim financial information customarily is made available to investors and others more promptly than is annual financial information. Timely reporting of interim financial information ordinarily precludes the development of information and documentation underlying interim financial information to the same extent as that underlying annual financial information. Therefore, a characteristic of interim financial information is that many costs and expenses are estimated to a greater extent than for annual financial reporting purposes. Another characteristic of interim financial information is its relationship to annual financial information. Each interim period is viewed primarily as an integral part of an annual period. Thus, deferrals, accruals and estimations at the end of each interim period are affected by judgments made at interim dates concerning anticipated results of operations for the remainder of the annual period.

.09 The procedures for a limited review are described in the following paragraphs concerning the (a) nature of procedures (paragraphs .10 and .11), (b) timing of procedures (paragraph .12), and (c) extent of procedures (paragraphs .13 through .18).

.10 *Nature of Procedures.* Procedures for making a limited review consist primarily of inquiries and analytical procedures concerning significant accounting matters relating to the financial information to be reported. The procedures that the accountant should apply ordinarily may be limited to the following:

a. Inquiry concerning (i) the accounting system, to obtain an understanding of the manner in which transactions are recorded, classified and summarized in the preparation of interim financial information, and (ii) any significant changes in the system of internal accounting control, to ascertain their potential effect on the preparation of interim financial information.
b. Analytical review of interim financial information by reference to internal financial statements, trial balances or other financial data, to identify and inquire about relationships and individual items that appear to be unusual. An analytical review consists of (i) a systematic comparison of current financial information with that anticipated for the current period, with that of the immediately preceding interim period, and with that of the corresponding interim period of the previous fiscal year; (ii) a study of the interrelationships of elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience; and (iii) a consideration of the types of matters that in the preceding year or quarters have required accounting adjustments.
c. Reading the minutes of meetings of stockholders, board of directors and committees of the board of directors to identify actions that may affect the interim financial information.

d. Reading the interim financial information to consider, on the basis of information coming to the accountant's attention, whether the information to be reported conforms with generally accepted accounting principles.

e. Obtaining letters from other accountants, if any, who have been engaged to make a limited review of the interim financial information of significant segments of the reporting entity, its subsidiaries or other investees.[3]

f. Inquiry of officers and other executives having responsibility for financial and accounting matters concerning (i) whether the interim financial information has been prepared in conformity with generally accepted accounting principles consistently applied, (ii) changes in the entity's business activities or accounting practices, (iii) matters as to which questions have arisen in the course of applying the foregoing procedures, and (iv) events subsequent to the date of the interim financial information that would have a material effect on the presentation of such information.

.11 In performing a limited review of interim financial information, considerations concerning locations to be visited for a client whose general accounting records are maintained at multiple locations ordinarily are similar to those involved in making an examination of the client's financial statements in accordance with generally accepted auditing standards. Usually this involves application of the foregoing procedures at both corporate headquarters and other locations selected by the accountant.

.12 *Timing of Procedures.* Adequate planning by the accountant is essential to the timely completion of a limited review. Performance of some of the work before the end of the interim period may permit the work to be carried out in a more efficient manner and to be completed at an earlier date. Performing some of the work earlier in the

[3] When an accountant acts as principal auditor (see section 543) and makes use of the work or reports of other auditors in the course of the annual examination of his client's financial statements, he ordinarily will be in a similar position in connection with a limited review of interim financial information. Therefore, he will require reports from other accountants as a basis, in part, for his report on his limited review of the consolidated interim financial information.

interim period also permits early consideration of significant accounting matters affecting the interim financial information.

.13 *Extent of Procedures.* The extent to which the procedures referred to in paragraph .10 are applied depends on the considerations described in paragraphs .14 through .18.

.14 *The accountant's knowledge of accounting and reporting practices*—Knowledge of a client's accounting and financial reporting practices is an important factor in the performance of a limited review. An understanding of a client's practices in preparing its most recent annual financial statements provides a practical basis for the inquiry and other procedures of a limited review designed to provide an understanding of a client's practices in preparing its interim financial information. An understanding of a client's practices in preparing annual financial statements can be expected to have been acquired by the accountant who has audited a client's financial statements for those periods. Nevertheless, when, for whatever reason, the accountant has not conducted such an audit, the need for an understanding of the client's accounting and financial reporting practices for its interim financial information is not diminished. Consequently, the accountant needs to consider whether, under the particular circumstances involved, he can acquire sufficient knowledge about the pertinent practices for the purposes contemplated in a limited review.

.15 *The accountant's knowledge of weaknesses in internal accounting control*—An accountant who has previously made an audit of his client's annual financial statements will have acquired knowledge concerning his client's system of internal accounting control relating to the preparation of financial statements, generally for an annual period. In these circumstances, the primary objective of the accountant's inquiries should be to identify and consider the effect of (a) changes in the system subsequent to his examination and (b) accounting control procedures used in the preparation of interim financial information that differ from those used in the preparation of annual financial statements. If the system of internal accounting control appears to contain weaknesses that do not permit preparation of interim financial information in conformity with generally accepted accounting principles, and, as a consequence, it is impracticable for the accountant to effectively apply his knowledge of financial reporting practices to the interim financial information, he should advise the board of directors of the circumstances. The accountant also may wish to submit suggestions for changes in the system to permit the preparation of appropriate interim financial information.

.16 *The accountant's knowledge of changes in the nature or volume of activity or accounting changes*—A limited review may bring to the accountant's attention changes in the nature or volume of the client's business activities or accounting changes. Examples of changes that could affect the interim financial information to be reported include business combinations; disposal of a segment of the business; extraordinary, unusual or infrequently occurring transactions; initiation of litigation or the development of other contingencies; trends in sales or costs that could affect accounting estimates relating to the valuations of receivables and inventories, realization of deferred charges, provisions for warranties and employee benefits, and unearned income; and changes in accounting principles or in the methods of applying them. If any such changes come to the accountant's attention, he should inquire about the manner in which the changes and their effects are to be reported in the interim financial information.

.17 *Issuance of accounting pronouncements*—The accountant's knowledge of financial reporting practices is expected to include an awareness of new pronouncements on financial accounting standards. In performing a limited review, he should consider the applicability of any such new pronouncements to his client's interim financial reporting practices. The accountant should also consider the applicability of existing pronouncements to new types of transactions or events that come to his attention.

.18 *Questions raised in performing other procedures*—If, in performing a limited review, information comes to the accountant's attention that leads him to question whether the interim financial information to be reported conforms with generally accepted accounting principles, he should make additional inquiries or employ other procedures he considers appropriate to permit him to report informatively to the board of directors. The procedures in a limited review may be modified, as appropriate, to take into consideration the results of auditing procedures applied in performing an examination in accordance with generally accepted auditing standards.

Report to Board of Directors[4]

.19 The board of directors of an entity has significant responsibilities with respect to the reporting of interim financial information. A limited review of interim financial information is intended to assist members of the board of directors in meeting their responsibilities. The board of directors should be in a position to understand the circumstances of the individual entity, its business and its industry, and should have an appreciation of the distinction between an audit and a limited review and an understanding of the inherent limitations of the review. A limited review may bring to the accountant's attention significant matters affecting the interim financial information, but it provides no assurance that the accountant will become aware of all significant matters. Also, the review might disclose conditions that affect the process by which interim financial information is prepared, but that do not necessarily affect the information presented. The board of directors is in a position to require any necessary corrective action for such conditions. Consequently, a report based on a limited review of interim financial information can serve a useful purpose for the board of directors.

.20 The report should be addressed to the entity's board of directors and should be dated as of the completion of the review.[5] It should include at least the following elements:

a. An identification of the interim financial information reviewed.

b. A description of the procedures performed, or a reference to procedures described in an engagement letter (see paragraph .24).

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[4] The Auditing Standards Executive Committee is continuing to study the appropriate action or report when an accountant is engaged to perform a limited review and reference is made to his limited review in a public document such as a Form 10-Q, a quarterly report required to be submitted to the Securities and Exchange Commission. In such a case, until the Committee's deliberations are completed, the existing guidance on reporting on unaudited financial statements is applicable. Also, the Committee is considering the effect of revisions to Regulation S-X on the nature and availability of an accountant's report on the application of the review procedures described in this section.

[5] A copy of a report based on a limited review that is to be used by another accountant in reporting on the results of a limited review may be furnished to him.

c. A statement that an examination in accordance with generally accepted auditing standards was not performed and a disclaimer of opinion.

d. A statement that a limited review would not necessarily disclose all matters of significance.

e. A description of the results of the review.

f. A statement that the report is designed for the use of an entity's board of directors, that it may also be furnished to management, but that it should not be otherwise used.

.21 If the accountant concludes that the interim financial information to be reported does not conform with generally accepted accounting principles, he should advise the board of directors of the respects in which he believes the information to be reported does not conform with generally accepted accounting principles. The accountant's description of the results of a limited review might include adjustments proposed, if any, to the interim financial information; matters not satisfactorily explained by management; deficiencies noted in the system of internal accounting control; recommendations for improvement of interim reporting practices; and any other matters of significance that come to the accountant's attention. The accountant's report may incorporate management's description of corrective action taken or explanations of matters not resolved to the accountant's satisfaction.

.22 A report that includes the elements required by paragraph .20 might be worded as follows:

> We have performed a limited review [describe the data or statements subjected to such review] of ABC Company and consolidated subsidiaries for the three-month and nine-month periods ended September 30, 19X1.
>
> Our limited review was performed in accordance with standards for such reviews promulgated by the American Institute of Certified Public Accountants and, accordingly, consisted principally of obtaining an understanding, by inquiries, of the accounting system for preparation of interim financial information; making an analytical review of pertinent financial data; and making inquiries of and evaluating responses from certain officials of the Company who have responsibility for financial and accounting matters. (In addition, at your request we have [describe any other procedures performed].) With regard to the CDE subsidiary whose total assets and revenue constitute 20 percent and 22 percent, respectively, of the related con-

solidated totals, we were furnished with the report of other accountants on their limited review of the interim financial information of such subsidiary.

Because our limited review did not constitute an examination made in accordance with generally accepted auditing standards, we express no opinion on [describe the data or statements subjected to the limited review].

In connection with our limited review and that of the other accountants referred to above, the following (no) matters came to our attention that we believe should be reported to you:

[Describe matters that should be brought to the attention of the board of directors.]

Had we performed additional procedures or had we made an examination of the [describe the data or statements subjected to the limited review or other procedures] in accordance with generally accepted auditing standards, (other) matters might have come to our attention that would have been reported to you.

This report is solely for the information of the board of directors and management and is not to be quoted in documents setting forth the unaudited interim financial information or in any other document available to the public.

[As amended, May 1976, by Statement on Auditing Standards No. 13.] (See section 519.)

Other Matters

.23 At the time of his report, the accountant may conclude that interim financial information to be issued is not in conformity with generally accepted accounting principles. Also, subsequent to the date of his report, the accountant may become aware that facts existed at the date of his report that might have affected his report had he then been aware of such facts. Because of the variety of conditions that might be encountered, the specific actions to be taken by the accountant in a particular case may vary in the light of the circumstances. In any event, the accountant would be well advised to refer to section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," because certain provisions of that section may be relevant to his consideration of the types of matters discussed in this paragraph.

.24 A clear understanding should be established with the client regarding the nature of the services to be performed in making a limited review and the responsibilities to be assumed. Accordingly, the accountant may wish to confirm the nature and scope of his engagement in a letter to his client. The letter usually would include (1) a general description of the procedures, (2) an explanation that such procedures do not constitute an examination made in accordance with generally accepted auditing standards, and (3) a description of the form of the report.

Effective Date

.25 Statements on Auditing Standards generally are effective at the time of their issuance. However, since this section provides for a new form of service that differs from services previously offered, it will be effective with respect to interim and annual periods beginning after December 25, 1975.

The next page is 1373.

AU Section 720A

Appendix—Interim Financial Information Filed with the Securities and Exchange Commission

.01 Certain companies are required by Regulation S-X of the Securities and Exchange Commission to include in audited annual financial statements a note containing selected interim financial information. Regulation S-X also provides that:

> If the financial statements covered by the accountant's report designate as "unaudited" the note required by Rule 3-16(t) (of Regulation S-X), it shall be presumed that appropriate professional standards and procedures with respect to the data in the note have been followed by the independent accountant who is associated with the unaudited footnote by virtue of reporting on the financial statements in which it is included.

.02 The instructions for the preparation of Form 10-Q, a quarterly report required to be submitted to the Securities and Exchange Commission pursuant to section 13 or 15 (d) of the Securities Exchange Act of 1934, provides that:

> The financial information included in this Form (10-Q) need not be reviewed prior to filing by an independent public accountant. If, however, a review of the data is made in accordance with established professional standards and procedures for such a review, the registrant may state that the independent accountant has performed such a review. If such a statement is made, the registrant shall indicate whether all adjustments or additional disclosures proposed by the independent accountant have been reflected in the data presented, and, if not, why not. In addition, a letter from the registrant's independent accountant confirming or otherwise commenting upon the registrant's representations and making such other comments as the independent accountant deems appropriate may be included as an exhibit to the Form (10-Q).

.03 This appendix provides guidance on the appropriate professional standards and procedures an independent accountant should follow in reviewing the interim financial information required to be included in Form 10-Q or in a note to the audited financial statements pursuant to Regulation S-X.[1]

.04 This appendix does not apply to those situations in which the interim financial information included in a note to audited financial statements is not designated as "unaudited." In such situations, the information should be examined in accordance with generally accepted auditing standards.

.05 *Regulation S-X.* The procedures for a limited review set forth in section 720.08 through 720.18, inclusive, constitute the appropriate professional standards and procedures for an independent accountant's review of the interim financial information designated as unaudited in a note to audited financial statements. The nature of these procedures may be modified, as appropriate, to take into consideration the results of auditing procedures applied in performing an examination in accordance with generally accepted auditing standards of the financial statements that include the interim financial information.

.06 There is no specific requirement for the accountant to perform these procedures other than at the time of an examination of the financial statements that include the interim financial information. However, performance of the procedures prior to the issuance of the quarterly data permits early consideration of significant accounting matters affecting the interim financial information and early modification of accounting procedures that the accountant believes might be improved. If review procedures are performed prior to the issuance of the respective quarterly data they need not be repeated at the time an examination is performed.

.07 *Form 10-Q.* When the accountant is requested to make a review of interim financial information required to permit the client to include a representation to that effect in Form 10-Q, the procedures for a limited review set forth in section 720.08 through 720.18, inclusive, constitute the appropriate professional standards and procedures that an accountant should follow in reviewing the interim financial information.

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[1] See footnote 4, section 720.19.

AU Section 900

SPECIAL REPORTS OF THE COMMITTEE ON AUDITING PROCEDURE

. . . public warehouses—controls and auditing procedures for goods held . . .

TABLE OF CONTENTS

The next page is 1451.

AU Section 901

Public Warehouses—Controls and Auditing Procedures for Goods Held

Issue date, unless otherwise indicated: November, 1972

Introduction

.01 In 1966, the Committee on Auditing Procedure completed a study of auditing procedures relating to the accountability of warehousemen for goods stored in public warehouses. The study was undertaken to determine whether recommendations should be made by the Committee with respect to auditing procedures applicable to goods so held in custody. Auditing procedures applicable to goods owned by the warehouseman were not specifically dealt with in the study or in this report as such procedures are similar to those applicable to owned inventories generally.

.02 In conjunction with its study, the Committee surveyed the control procedures of a sample number of public warehouses and the related auditing procedures followed by their independent auditors. Discussions were held with representatives of the warehouse industry and of institutions making loans secured by warehoused goods. The latter included representatives of the New York Clearing House Association, which issued a report dated July 1965 entitled "Warehouse Receipt Financing."

.03 Prior pronouncements of the Committee relating to inventories have dealt with the matter of goods stored in warehouses solely from the viewpoint of the auditor of the owner of the goods. These pronouncements were consolidated into and replaced by Statement on Auditing Procedure No. 33. As to inventories in general, the AICPA membership a number of years ago established a requirement that wherever practicable and reasonable, the independent auditor of the owner observe (including appropriate test counts) the taking of physical inventories. However, as to inventories in custody of a warehouseman, the prior pronouncement states:

> 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 the custodians is acceptable provided that where the amount involved represents a significant proportion of the current assets or the total assets, supplemental inquiries are made to satisfy the independent auditor as to the bona fides of the situation.[1]

With respect to the procedures of the independent auditor of the owner of goods in public warehouses, the Committee reaffirms, in principle, the general scope of the procedures prescribed in the prior pronouncement quoted above. In conjunction with its study, the Committee considered the internal controls and auditing procedures applicable to such goods and sets forth its suggestions and recommendations in paragraphs .28–.32 of this report.

.04 This report deals with the internal control of the warehouseman and the procedures of his independent auditor with respect to goods in the custody of the warehouseman. The auditing procedures recommended herein are, in many cases, extensions of practices found to have been in effect during the period covered by the Committee's study.

General Considerations

.05 Generally accepted auditing standards are broad criteria as to the quality of performance and the objectives to be attained by the independent auditor in his examination of financial statements and in reporting on them. Auditing procedures, on the other hand, relate to the steps to be taken by the auditor in complying with the standards in making his examination.

.06 The management of a business has the responsibility for the proper recording of transactions in its books of account, for the safeguarding of its assets, and for the substantial accuracy and adequacy of its financial statements. The independent auditor is not an insurer or guarantor; his responsibility is to express a professional opinion on the financial statements he has examined.[2]

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[1] Codification of Statements on Auditing Procedure, American Institute of Accountants (now the American Institute of Certified Public Accountants), 1951, p. 22.

[2] See section 110.

Summary of Recommendations

.07 The Committee recommends that the independent auditor of the warehouseman:

a. Make a study and evaluation of the effectiveness of both the accounting controls and the administrative controls, as defined in section 320.27–.28, relating to the accountability for and the custody of all goods placed in the warehouse.

b. Test the warehouseman's records relating to accountability for all goods placed in his custody.

c. Test the warehouseman's accountability under recorded outstanding warehouse receipts.

d. Observe physical counts of the goods in custody, wherever practicable and reasonable, and reconcile his tests of such counts with records of goods stored.

e. Confirm accountability (to the extent considered necessary) by direct communication with the holders of warehouse receipts.

The independent auditor should apply such other procedures as he considers necessary in the circumstances.

.08 Warehousing activities are diverse because the warehoused goods are diverse, the purposes of placing goods in custody are varied, and the scope of operations of warehouses is not uniform. The independent auditor has the responsibility to exercise his judgment in determining what procedures, including those recommended in this report, are necessary in the circumstances to afford a reasonable basis for his opinion on the financial statements.[1]

.09 The following sections of this report describe those aspects of warehousing operations of primary concern to independent auditors, suggest elements of systems of internal control for warehousemen, and offer the Committee's recommendations as to procedures of the independent auditor.

Public Warehouse Operations

Types of Warehouses

.10 A warehouse may be described as a facility operated by a warehouseman whose business is the maintaining of effective custody of goods for others.

[1] See section 330.

.11 Warehouses may be classified functionally as terminal warehouses or field warehouses:

> *Terminal Warehouse.* The principal economic function of a terminal warehouse is to furnish storage. It may, however, perform other functions, including packaging and billing. It may be used to store a wide variety of goods or only a particular type of commodity.
>
> *Field Warehouse.* A field warehouse is established in space leased by the warehouseman on the premises of the owner of the goods or the premises of a customer of the owner. In most circumstances all or most of the personnel at the warehouse location are employed by the warehouseman from among the employees of the owner (or customer), usually from among those who previously have been responsible for custody and handling of the goods. Field warehousing is essentially a financing arrangement, rather than a storage operation. The warehouse is established to permit the warehouseman to take and maintain custody of goods and issue warehouse receipts to be used as collateral for a loan or other form of credit.

Warehouses may be classified also by types of goods stored. Foods and other perishable products may be stored in refrigerated warehouses, constructed and equipped to meet controlled temperature and special handling requirements. Certain bulk commodities, such as various agricultural products and chemicals, are stored in commodity warehouses; these warehouses often are designed and equipped to store only one commodity, and fungible goods frequently are commingled without regard to ownership. A wide variety of goods, usually not requiring special storage facilities, is stored in general merchandise warehouses. Some warehouses confine their activities to storing furniture, other household goods, and personal effects.

Warehouse Receipts

.12 A basic document in warehousing is the warehouse receipt. The Uniform Warehouse Receipts Act and Article 7 of the Uniform Commercial Code regulate the issuance of warehouse receipts, prescribe certain terms that must be contained in such receipts, provide for their negotiation and transfer, and establish the rights of receipt holders. The Uniform Commercial Code has been adopted by a majority of the states, and the Uniform Warehouse Receipts Act is in force in all states where the Code has not been adopted.

.13 Warehouse receipts may be in negotiable form or non-negotiable form and may be used as evidence of collateral for loans or other forms of credit. Goods represented by a negotiable warehouse receipt may be released only upon surrender of the receipt to the warehouseman for cancellation or endorsement, whereas goods represented by a non-negotiable receipt may be released upon valid instructions without the need for surrender of the receipt. Other important ways in which the two kinds of receipts differ concern the manner in which the right of possession to the goods they represent may be transferred from one party to another and the rights acquired by bona fide purchasers of the receipts.

.14 Since goods covered by non-negotiable receipts may be released without surrender of the receipts, such outstanding receipts are not necessarily an indication of accountability on the part of the warehouseman or of evidence of ownership by the depositor. Since goods are frequently withdrawn piecemeal, the warehouseman's accountability at any given time is for the quantity of goods for which receipts have been issued minus the quantities released against properly authorized withdrawals.

.15 The Uniform Warehouse Receipts Act and Article 7 of the Uniform Commercial Code, in addition to their provisions with respect to the issuance and contents of warehouse receipts, contain provisions with respect to, among other things, the storage and release of warehoused goods, the standard of care to be exercised by the warehouseman, warehouseman's liability, and liens for the warehouseman's charges and expenses and the manner in which they may be enforced.

Government Regulation

.16 There are various other statutes and regulations, applicable in special situations, relating to the rights and duties of warehousemen and the operation of warehouses. Among the more important are (a) the United States Warehouse Act and the regulations adopted thereunder by the Department of Agriculture, providing for licensing and regulation of warehouses storing certain agricultural commodities, (b) the regulations adopted by commodity exchanges licensed under the United States Commodity Exchange Act, providing for issuance and registration of receipts and licensing and regulation of warehouses, and (c) the Internal Revenue Code and the Tariff Act of 1930, and regulations adopted thereunder, relating respectively to United States Revenue Bonded Warehouses and United States Customs Bonded Warehouses, providing for licensing, bonding, and regulation of such warehouses. In addition, there are statutes and regulations in various states relating to licensing, bonding, insurance, and other matters.

The Warehouseman

Internal Controls

.17 Goods held in custody for others are not owned by the warehouseman and, therefore, do not appear as assets in his financial statements. Similarly, the related custodial responsibility does not appear as a liability. However, as in other businesses, the warehouseman is exposed to the risk of loss or claims for damage stemming from faulty performance of his operating functions. Faulty performance may take the form of loss or improper release of goods, improper issuance of warehouse receipts, failure to maintain effective custody of goods so that lenders' preferential liens are lost, and other forms.

.18 In the broad sense, the internal controls of a business may be characterized as either accounting or administrative. Accounting controls generally bear directly and importantly on the reliability of the financial records and, therefore, require evaluation by the independent auditor. Administrative controls are concerned mainly with operational efficiency and adherence to managerial policies. Administrative controls ordinarily relate only indirectly to the financial records and, therefore, would not require evaluation by the auditor. However, if the auditor believes that certain administrative controls may have an important bearing on the reliability of the financial records, he should consider the need for evaluating such controls. The recommendation herein that the independent auditor of the warehouseman make a study and evaluation of administrative controls is based upon the important relationship of such controls to the custodial responsibilities of the warehouseman, which are not reflected in his financial statements.

Significant unrecorded liabilities may arise if these custodial responsibilities are not discharged properly.

.19 Whether and to what extent the suggested control procedures that follow may be applicable to a particular warehouse operation will depend on the nature of the operation, of the goods stored, and of the warehouseman's organization. Appropriate segregation of duties in the performance of the respective operating functions should be emphasized.

Receiving, Storing, and Delivering Goods

Receipts should be issued for all goods admitted into storage.

Receiving clerks should prepare reports as to all goods received. The receiving report should be compared with quantities shown on bills of lading or other documents received from the owner or other outside sources by an employee independent of receiving, storing, and shipping.

Goods received should be inspected, counted, weighed, measured, or graded in accordance with applicable requirements. There should be a periodic check of the accuracy of any mechanical facilities used for these purposes.

Unless commingling is unavoidable, such as with fungible goods, goods should be stored so that each lot is segregated and identified with the pertinent warehouse receipt. The warehouse office records should show the location of the goods represented by each outstanding receipt.

Instructions should be issued that goods may be released only on proper authorization which, in the case of negotiable receipts, includes surrender of the receipt.

Access to the storage area should be limited to those employees whose duties require it, and the custody of keys should be controlled.

Periodic statements to customers should identify the goods held and request that discrepancies be reported to a specified employee who is not connected with receiving, storing, and delivery of goods.

The stored goods should be physically counted or tested periodically, and quantities agreed to the records by an employee independent of the storage function; the extent to which this is done may depend on the nature of the goods, the rate of turnover, and the effectiveness of other control procedures.

Where the goods held are perishable, a regular schedule for inspection of condition should be established.

Protective devices such as burglar alarms, fire alarms, sprinkler systems, and temperature and humidity controls should be inspected regularly.

Goods should be released from the warehouse only on the basis of written instructions received from an authorized employee who does not have access to the goods.

Counts of goods released as made by stock clerks should be independently checked by shipping clerks or others and the two counts should be compared before the goods are released.

Warehouse Receipts

Prenumbered receipt forms should be used, and procedures established for accounting for all forms used and for cancellation of negotiable receipts when goods have been delivered.

Unused forms should be safeguarded against theft or misuse and their custody assigned to a responsible employee who is not authorized to prepare or sign receipts.

Receipt forms should be furnished only to authorized persons, and in a quantity limited to the number required for current use.

The signer of receipts should ascertain that the receipts are supported by receiving records or other underlying documents.

Receipts should be prepared and completed in a manner designed to prevent alteration.

Authorized signers should be a limited number of responsible employees.

Insurance

The adequacy, as to both type and amount, of insurance coverage carried by the warehouseman should be reviewed at appropriate intervals.

Additional Control Procedures for Field Warehouses

.20 As indicated earlier, the purpose of field warehousing differs from terminal warehousing. Operating requirements also may differ because a field warehouseman may operate at a large number of locations.

.21 In field warehousing, controls are applied at two points: the field location and the warehouseman's central office. At the field location, the control procedures as to receipt, storage, and delivery of goods and issuance of warehouse receipts generally will comprise the procedures suggested above, with such variations as may be appropriate in light of the requirements, and available personnel, at the respective locations. Only non-negotiable warehouse receipts should be issued from field locations, and the receipt forms should be furnished to the field locations by the central office in quantities limited to current requirements.

.22 The central office should investigate and approve the field warehousing arrangements, and exercise control as to custody and release of goods and issuance of receipts at the field locations. Control procedures suggested for the central office are the following:

Consideration of the business reputation and financial standing of the depositor.

Preparation of a field warehouse contract in accordance with the particular requirements of the depositor and the lender.

Determination that the leased warehouse premises meet the physical requirements for segregation and effective custody of goods.

Satisfaction as to legal matters relative to the lease of the warehouse premises.

Investigation and bonding of the employees at the field locations.

Providing employees at field locations with written instructions covering their duties and responsibilities.

Maintenance of inventory records at the central office showing the quantity (and stated value, where applicable) of goods represented by each outstanding warehouse receipt.

Examination of the field warehouse by representatives of the central office. These examinations would include inspection of the facilities, observation as to compliance with prescribed procedures, physical counts or tests of goods in custody and reconcilement of quantities to records at the central office and at field locations, accounting for all receipt forms furnished to the field locations, and confirmation (on a test basis, where appropriate) of outstanding warehouse receipts with the registered holders.

Procedures of the Independent Auditor

.23 The Committee recommends that the independent auditor of the warehouseman:

a. Make a study and evaluation of the effectiveness of both the accounting controls and the administrative controls, as defined in section 320.27–.28, relating to the accountability for and the custody of all goods placed in the warehouse.

b. Test the warehouseman's records relating to accountability for all goods placed in his custody.

c. Test the warehouseman's accountability under recorded outstanding warehouse receipts.

d. Observe physical counts of the goods in custody, wherever practicable and reasonable, and reconcile his tests of such counts with records of goods stored.

e. Confirm accountability (to the extent considered necessary) by direct communication with the holders of warehouse receipts.

The independent auditor should apply such other procedures as he considers necessary in the circumstances.

.24 The auditor's procedures relating to accountability might include, on a test basis, comparison of documentary evidence of goods received and delivered with warehouse receipts records, accounting for issued and unissued warehouse receipts by number, and comparison of the records of goods stored with billings for storage. In some circumstances, the auditor may consider it necessary to obtain confirmation from the printer as to the serial numbers of receipt forms supplied.

.25 In the case of a field warehouseman where goods are stored at many scattered locations, the independent auditor may satisfy himself that the warehouseman's physical count procedures are adequate by observing the procedures at certain selected locations. The amount of testing required will be dependent upon the uniformity and adequacy of the internal controls.

.26 The confirmation of negotiable receipts with holders may be impracticable, since the identity of the holders usually is not known to the warehouseman. Confirmation with the depositor to whom the outstanding receipt was originally issued, however, would be evidential of accountability for certain designated goods. It should be recognized, too, that as to both negotiable and non-negotiable receipts, confirmation may not be conclusive in the light of the possibility of issued but unrecorded receipts. In some circumstances, it may be desirable to request confirmations from former depositors who are not currently holders of record.

.27 The independent auditor should review the nature and extent of the warehouseman's insurance coverage and the adequacy of any reserves for losses under damage claims.

Controls and Auditing Procedures for Owner's Goods Stored in Public Warehouses

.28 The auditing procedures applicable to clients' inventories in the custody of public warehousemen, referred to in paragraph .03 of this report, relate principally to the scope of the "supplemental inquiries" which has not heretofore been defined. The Committee, therefore, makes the following suggestions as to the elements of internal control for the owner of the goods, and recommendations as to auditing procedures to be employed by his independent auditor.

Internal Controls

.29 The internal controls of the owner should be designed to provide reasonable safeguards over his goods in a warehouseman's custody. Ordinarily, the controls should include an investigation of the warehouseman before the goods are placed in custody, and a continuing evaluation of the warehouseman's performance in maintaining custody of the goods.

.30 Among the suggested control procedures that may be comprehended in an investigation of the warehouseman before the goods are placed in his custody are the following:

Consideration of the business reputation and financial standing of the warehouseman.

Inspection of the physical facilities.

Inquiries as to the warehouseman's control procedures and whether the warehouseman holds goods for his own account.

Inquiries as to type and adequacy of the warehouseman's insurance.

Inquiries as to government or other licensing and bonding requirements and the nature, extent, and results of any inspection by government or other agencies.

Review of the warehouseman's financial statements and related reports of independent auditors.

.31 After the goods are placed in the warehouse, suggested control procedures that may be applied periodically by the owner in evaluating the warehouseman's performance in maintaining custody of goods include the following:

Review and update the information developed from the investigation described above.

Physical counts (or test counts) of the goods, wherever practicable and reasonable (may not be practicable in the case of fungible goods).

Reconcilement of quantities shown on statements received from the warehouseman with the owner's records.

In addition, he should review his own insurance, if any, on goods in the custody of the warehouseman.

Procedures of the Independent Auditor

.32 The prior pronouncement (see paragraph .03) makes it clear that obtaining direct confirmation (on a test basis, where appropriate) from the custodian is the acceptable procedure to be followed, except that "supplemental inquiries" are to be made in cases where such inventories represent a significant proportion of the owner's current assets or total assets. The Committee recommends that supplemental inquiries include the following steps, to the extent the auditor considers necessary in the circumstances:

a. Discussion with the owner as to the owner's control procedures in investigating the warehouseman, and tests of related evidential matter.

b. Review of the owner's control procedures concerning performance of the warehouseman, and tests of related evidential matter.

c. Observation of physical counts of the goods, wherever practicable and reasonable.

d. Where warehouse receipts have been pledged as collateral, confirmation (on a test basis, where appropriate) from lenders as to pertinent details of the pledged receipts.

AU Section 1000

AUDITING COMMENTARIES

Occasionally, a condition arises in practice which indicates a need for timely communication of information on a profession-wide basis. Auditing Commentaries are not Statements on Auditing Standards nor Interpretations of Statements on Auditing Standards. Their purpose is to make practitioners aware of a problem currently being encountered in practice and to assist them in meeting the problem.

TABLE OF CONTENTS

AU Section 9000

AUDITING INTERPRETATIONS

The staff of the auditing standards division has been authorized to issue Interpretations to provide timely guidance on the application of pronouncements of the auditing standards executive committee. Interpretations are reviewed by members of that committee. An Interpretation is not as authoritative as a pronouncement of the auditing standards executive committee, but members should be aware that they may have to justify a departure from an Interpretation if the quality of their work is questioned.

TABLE OF CONTENTS

The next page is 1891.

AU Section 9330

Evidential Matter: Auditing Interpretations of AU Section 330

1. Evidence for Interim Information

.01 *Question*—APB Opinion No. 28 [AC section 2071] concluded that certain accounting principles and practices followed for annual reporting purposes may require modification at interim reporting dates. Paragraph 10 of Opinion No. 28 [AC section 2071.10] states that the modifications are needed "so that the reported results for the interim period may better relate to the results of operations for the annual period." The modifications introduce a need for estimates to a greater extent than is necessary for annual financial information. Does this imply a relaxation of the third standard of field work, which requires that sufficient competent evidential matter be obtained to afford a reasonable basis for an opinion regarding the financial statements under examination?

.02 *Response*—No. The third standard of field work applies to all engagements leading to an expression of opinion on financial statements or financial information.

.03 Section 330.09 indicates that in deciding the amount and kind of evidential matter required to support an informed opinion the auditor should consider "the nature of the item under examination; the materiality of possible errors and irregularities; the degree of risk involved, which is dependent on the adequacy of the internal control and susceptibility of the given item to conversion, manipulation or misstatement; and the kinds and competence of evidential matter available." If the auditor is unable to obtain sufficient competent evidential matter, he should not issue an unqualified opinion.

.04 Evidential matter obtained for an audit of annual financial statements may also be useful in an audit of interim financial statements, and evidential matter obtained for an audit of interim financial statements may also be useful in an audit of annual financial statements. Section 310.05-.06 indicates that "it is acceptable practice for the auditor to carry out substantial parts of the examination at interim dates," and that procedures as of the financial statement date may consist mainly of comparisons with "balances at prior dates and of review and investigation of unusual transactions and significant fluctuations."

.05 The introduction by Opinion No. 28 [AC section 2071] of a need for additional estimates in measuring certain items for interim financial information may lead to a need for evidence in examining those items that differs from the evidence required in an examination of annual financial information. For example, computing the provision for federal income taxes in interim information involves estimating the effective tax rate expected to be applicable for the full fiscal year, and the auditor should examine evidence as to the basis for estimating that rate. Since the effective tax rate for the full year ordinarily is known at yearend, similar evidence is not usually required in examining annual information.

[Issue Date: February, 1974.]

The next page is 1895.

AU Section 9331

Evidential Matter for Receivables and Inventories: Auditing Interpretations of AU Section 331

1. Evidence for Inventories at Interim Dates

.01 *Question*—Paragraph 14 of APB Opinion No. 28 [AC section 2071.14] states that "companies should generally use the same inventory pricing methods and make provisions for writedowns to market at interim dates on the same basis as used at annual inventory dates," and further states that there are four exceptions that are appropriate at interim reporting dates, including the use of estimated gross profit rates to determine the cost of goods sold for interim periods. What effect does the use of such estimates have on the auditor's examination of inventories for the interim period?

.02 *Response*—The auditor's objective in examining evidence as to the amounts shown for cost of goods sold and inventories in interim information should be to satisfy himself that the client's estimate produces results that are substantially the same as those that would be obtained by following yearend procedures. Examining such evidence may not provide the auditor with sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements under examination.

.03 Performing procedures with respect to the reasonableness of estimates used to determine cost of goods sold and inventories is not unlike performing procedures for an annual audit when inventory is not counted at the yearend date (see sections 310.05-.06 and 331.09, .10 and .13). The considerations that influence the auditor in deciding whether the procedures performed provide him with sufficient competent evidential matter for interim financial information are similar to those for annual financial information. Section 330.09 states that the auditor should exercise his professional judgment in deciding the amount and kinds of evidential matter necessary to support an informed opinion. The auditor should consider "the materiality of possible errors and irregularities; the degree of risk involved, which is dependent on the adequacy of the internal control and susceptibility of the given item to conversion, manipulation or misstatement; and the kinds and competence of evidential matter available."

.04 The auditor's decision as to the sufficiency and competence of the evidence available to support the amounts reported for cost of goods sold and for inventories will be influenced by many factors, among which are

1. The length of time that has elapsed since the most recent physical count.

2. The auditor's past experience with the client.

3. The auditor's knowledge of the nature of the client's business and the current business conditions.

4. The materiality of possible misstatement.

5. The nature and condition of the client's accounting records and system.

6. The existence of records that provide information as to inventory changes, such as shipments made, scrap, waste, obsolescence and shrinkage.

.05 The auditor ordinarily has more evidence available to evaluate the validity of estimates when the client's accounting system provides information as to changes in inventory. If the client's accounting records reflect the allocation and classification of transactions with persons outside the company but not inventory changes, the auditor is not likely to have the necessary evidence to support estimates of costs of goods sold and inventories. In either case the auditor must evaluate all relevant factors in deciding whether there is sufficient competent evidential matter.

[Issue Date: February, 1974.]

The next page is 1903.

AU Section 9335

Related Party Transactions: Auditing Interpretations of AU Section 335

1. Evaluating the Adequacy of Disclosure of Related Party Transactions

.01 *Question*—Section 335.16 states that the auditor "should . . . evaluate all the information available to him with respect to the [related party] transaction and satisfy himself on the basis of his professional judgment that the transaction is adequately disclosed. . . ." Section 335.17 lists the following matters that should be disclosed in the financial statements of a reporting entity that has participated in related party transactions that are material, individually or in the aggregate: the nature of the relationship, a description of the transactions, the dollar volume of transactions and the effects of any change in the method of establishing terms from that used in the preceding period, and amounts due to or from related parties. Some companies that prepare separate financial statements may have many transactions with a single related party, for example, a wholly owned subsidiary may have many transactions with the parent company. Other companies may have different types of transactions with similar types of related parties, such as affiliates. If the information required to be disclosed by section 335.17 concerning related party transactions is aggregated or summarized, how does that affect the auditor's evaluation of the adequacy of disclosure?

.02 *Interpretation*—In evaluating the adequacy of disclosure of related party transactions, the auditor should consider whether the disclosure provides users with information sufficient for an understanding of the nature and volume of the transactions with related parties.

.03 Disclosure need not involve detailing transactions within major classifications. For example, in the separate financial statements of a wholly owned subsidiary, disclosure of percentages or total dollar amounts of sales to, purchases from, or general and administrative charges by the parent company would be sufficient, without an itemization of each item bought or sold or each service rendered or received. However, aggregation or summarization of related party transactions would not be appropriate if it reduces the understanding of the financial statements.

.04 In some cases, the effect of the relationship between the parties may be so pervasive that disclosure of that relationship alone will be sufficient. For example, substantially all sales transactions may be with the controlling entity.

.05 A reporting entity that has similar transactions with different types of related parties might aggregate the transactions by type of related party. For example, all sales to affiliates might be aggregated by disclosing the dollar amount of such sales or the percentage of such sales in relation to total sales.

[Issue Date: March, 1976.]

2. Disclosure of Commonly Controlled Parties

.06 *Question*—Section 335.04 states: "Sometimes two or more entities are under common ownership or management control, but they do not transact business between or among themselves. Mere existence of common control, however, may result in operating results or financial position significantly different from those that would have been obtained if the entities were autonomous. . . . Consequently, the nature of the common control should be disclosed." Does that paragraph require disclosure of all common control relationships?

.07 *Interpretation*—No. Section 335.04 applies only to those entities that are under common control that could have operating results or financial position significantly different from that which would have been obtained if the entities were autonomous. Thus, if the nature of the commonly controlled entities is such that operating results or financial condition could not reasonably be affected by the common control, disclosure would not be necessary.

.08 Section 335.04 gives the following example of the type of common control that ordinarily requires disclosure: ". . . two or more entities in the same line of business may be commonly controlled by a party with the ability to increase or decrease the volume of business done by each." However, if the controlling party does not have such an ability, disclosure of the nature of common control is not contemplated by section 335.04. For example, the commonly controlled entities may be in unrelated businesses or they may be in the same line of business but other factors, such as geographic location, may preclude the controlling party from unilaterally influencing the volume of business done by each.

.09 However, when a party has the ability to affect the operating results or financial condition of a commonly controlled entity in a manner that could result in significant differences from that which would be obtained if the entities were autonomous, the nature of common control should be disclosed. For example, if two commonly controlled entities are in different geographic locations, but at the direction of the controlling entity use the same supplier, the controlling entity may have the ability to affect the operating results and financial condition of the controlled entities by influencing their respective costs and consequently the common control should be disclosed.

[Issue Date: March, 1976.]

3. Immediate Family

.10 *Question*—Section 335.02 states: ". . . the term *related parties* means the reporting entity; its affiliates; principal owners, management, and members of their immediate families. . . ." Which members of an individual's family should be considered to be "immediate family" for the purpose of applying section 335?

.11 *Interpretation*—Section 335 defined immediate family members of principal owners and management as related parties because the nature of the "immediate family" relationship is such that the actions of certain individuals ordinarily cannot be satisfactorily discerned from the actions of principal owners and management. Immediate family, therefore, includes those family members whom a principal owner or a member of management might control or influence or by whom they may be controlled or influenced because of the family relationship. Normally, the immediate family of an individual would include his (her) spouse as well as their parents, children, brothers and sisters and their spouses (consider adoptive and step relationships) and any other person who lives in the same household. In some circumstances, other relatives may also be related parties by reason of their ability to significantly influence members of management or management's ability to influence them and, in the case of significant transactions the auditor should inquire whether such persons are parties to such transactions.

[Issue Date: March, 1976.]

The next page is 1907.

AU Section 9410

Adherence to Generally Accepted Accounting Principles: Auditing Interpretations of AU Section 410

1. Accounting Principles Recommended by Trade Associations

.01 *Question*—Some trade associations, such as the one for real estate investment trusts, have proposed accounting principles for use in the financial statements of companies in the industries they serve. How, if at all, is an independent auditor's report affected by a trade association's recommendations on accounting principles?

.02 *Interpretation*—The first standard of reporting requires the independent auditor to state in his report whether the statements he has examined are presented in conformity with generally accepted accounting principles. Deciding whether an accounting principle established by a body other than the one designated by the Council of the AICPA to establish accounting principles (at present, the Financial Accounting Standards Board) is a generally accepted accounting principle requires the use of judgment. Section 411.04 states that the auditor should determine whether "the accounting principles selected and applied have general acceptance." Section 411.06 cautions the auditor to "be alert to changes [in principles] that become acceptable as a result of common usage in business, rather than as a result of pronouncements." The fact that an accounting principle has been adopted by a trade association may be an indication that it has found general acceptance. Other accounting principles might also be generally accepted. If the independent auditor decides that the principle adopted by a trade association is a generally accepted accounting principle, he may express an unqualified opinion on the financial statements. [References updated July, 1975 by SAS No. 5.]

.03 If a principle adopted by a trade association and used in preparing the financial statements has been disapproved by the body designated by the Council of the AICPA to establish accounting principles, and the effects are material, the independent auditor should ordinarily qualify his opinion or express an adverse opinion, notwithstanding the adoption by the trade association of the principle used.[1]

[Issue Date: November, 1974.]

[1] Rule 203 of the Rules of Conduct of the AICPA's *Code of Professional Ethics* deals with departures from principles promulgated by the body designated by the Council to establish GAAP. [ET section 203, Volume 2, *AICPA Professional Standards*.]

2. Effect on the Auditor's Opinion of FASB Statement on Research and Development Costs

.04 *Question*—Financial Accounting Standards Board (FASB) Statement No. 2, "Accounting for Research and Development Costs," [2] which is effective for fiscal years beginning on or after January 1, 1975, requires companies to expense research and development costs encompassed by that Statement in the period they are incurred. Companies that have deferred research and development costs are required to restate those accounts by prior period adjustment in financial statements for which FASB Statement No. 2 is effective. What is the impact on the auditor's report on financial statements issued before the Statement's effective date that present deferred research and development costs?

.05 *Interpretation*—In considering whether financial statements are presented fairly in conformity with generally accepted accounting principles (GAAP), section 411.08 states: "The auditor should be familiar with alternative accounting principles that may be applicable to the transaction or facts under consideration and realize that *an accounting principle may have only limited usage but still have general acceptance.*" [Italics added.] [Reference updated July, 1975 by SAS No. 5.]

.06 Thus, deferring research and development costs in financial statements prepared before the effective date of FASB Statement No. 2 is an acceptable alternative principle under GAAP, although FASB Statement No. 2 proscribes such a treatment for fiscal years beginning on or after January 1, 1975.

.07 Section 509.17 states: "Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements. If the client declines to disclose essential data in a financial statement, the auditor should provide it in his report if practicable and should express a qualified or adverse opinion because the information has been omitted from the financial statements."

.08 APB Statement No. 4, paragraph 106 [3] on adequate disclosure, states: "The headings, captions and amounts must be supplemented by enough additional data so that their meaning is clear. . . ." For financial statements that are prepared on the basis of accounting principles that are acceptable at the financial-statement date but that will not be acceptable in the future, the auditor should consider whether disclosure of the impending change in principle and the resulting restatement are essential data. If he decides that the matter should be disclosed and it is not, the auditor should qualify his opinion as to conformity with GAAP, as required by section 545.01.

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[2] See AC section 4211.
[3] See AC section 1024.34.

.09 The auditor should evaluate the adequacy of disclosure of the prospective change in principle and its potential effect on the financial statements. In some instances the effect of the anticipated prior period adjustment to write off previously deferred research and development costs may be so material that disclosure is essential for an understanding of the financial statements. In those cases that disclosure can best be made by supplementing the historical financial statements with pro forma financial data that give effect to the future adjustment as if it had occurred on the date of the balance sheet. (See section 560.05.) The pro forma data may be presented in columnar form alongside the historical statements, in the footnotes to the historical statements, or in separate pro forma statements presented with the historical statements.

.10 Even if the auditor decides that the disclosure of the forthcoming change and its effects are adequate and, consequently, he decides not to qualify his opinion, he nevertheless may decide to include an explanatory paragraph in his report if the effects of the change are expected to be unusually material. The explanatory paragraph should not be construed as a qualification of the auditor's opinion; it is intended to highlight circumstances of particular importance and to aid in interpreting the financial statements (see section 509.27).

.11 A company with significant deferred research and development costs might, as a result of the required adjustment, suffer a decline in its net worth that violates its debt covenants that may in turn accelerate the due date for repayment of debt. In such case, the auditor should consider the impact on his report of any uncertainties created by a violation of a debt covenant.

.12 When a company presents deferred research and development costs in financial statements issued before the effective date of FASB Statement No. 2[4] and the ultimate realization of those costs is uncertain, the auditor should consider the impact of the uncertainty on the financial statements. If he concludes an uncertainty exists and the amount of deferred costs is material, he should appropriately qualify his opinion (see section 509.21-.26).

[Issue Date: January, 1975.]

The next page is 1911.

[4] See AC section 4211.

AU Section 9420

Consistency of Application of Generally Accepted Accounting Principles: Auditing Interpretations of AU Section 420

1. Reporting on Consistency and Extraordinary Items

.01 *Question*—Opinion No. 30 [AC section 2012] of the Accounting Principles Board, "Reporting the Results of Operations," is effective for events and transactions occurring after September 30, 1973. Among other matters, the Opinion changes the criteria for determining the types of items that should be presented as extraordinary in a statement of income. Consequently, a company that presented an item as extraordinary in its 1972 statements may need to present differently those types of items in 1973; Paragraph 27 of Opinion No. 30 [AC section 2012.27] prohibits restating the prior-year presentation to conform with the current-year presentation. Under such circumstances, should the independent auditor's opinion on the company's 1973 financial statements be qualified as to consistency of application of generally accepted accounting principles?

.02 *Interpretation*—Yes, the auditor's opinion should be qualified as to consistency. An example of financial statement presentation and appropriate reporting for a change in the presentation of losses resulting from write-offs of goodwill follows (assuming the auditor is reporting only on 1973):

Excerpt from statement of income

	1973	*1972*
Other income (loss):		
Write-off of goodwill attributable to Division A (Note X)	(xx)	—
Income before income taxes and extraordinary items	xxx	xxx
Provision for income taxes	xxx	xxx
Income before extraordinary items	xxx	xxx
Extraordinary items:		
Write-off of goodwill attributable to Division B (Note X)	—	(xx)
Loss of New Jersey plant due to earthquake (Note Y)	(xx)	—
Net income	$ xxx	$ xxx

Auditors' report

(In the examples below, information about the accounting change is included for convenience in a middle paragraph. Alternatively, the auditor could refer in his qualification to a footnote which contains the information as to consistency and not include a middle paragraph in his report.)

.03 After a standard scope paragraph, the middle and opinion paragraphs of the auditor's report might read as follows:

> "As required by Opinion No. 30 [AC section 2012], adopted in 1973 by the Accounting Principles Board of the American Institute of Certified Public Accountants, the Company has changed the method of presenting losses arising from write-offs of goodwill (see Note X). Such losses were presented in 1972 as an extraordinary item, in conformity with the accounting principles then generally accepted, and in 1973 were included in determining income before extraordinary items, in conformity with the newly issued Opinion. The Opinion prohibits restating the 1972 financial statements. Had the Opinion been in effect for 1972, net income would have been the same, but income before extraordinary items would have been $xxx ($x.xx per share).
>
> "In our opinion . . . in conformity with generally accepted accounting principles which, except for the change, with which we concur, in the method of presenting losses arising from write-offs of goodwill discussed in the preceding paragraph have been applied on a basis consistent with that of the preceding year."

.04 Further, the independent auditor would qualify his opinion as to consistency if, in the preceding example, rather than a write-off of goodwill in 1973, a gain or loss resulted from any transaction that would be presented differently under the criteria of APB Opinion No. 30 [AC section 2012], such as a charge for relocation expense. An example of the independent auditor's middle and opinion paragraphs in those circumstances follows:

> "As required by Opinion No. 30 [AC section 2012], adopted in 1973 by the Accounting Principles Board of the American Institute of Certified Public Accountants, the company has changed its criteria for the types of items to be included in determining income before extraordinary items in the statement of income. In 1972 the company wrote off $xxx of goodwill (see Note X) and presented the loss as an extraordinary item in conformity with accounting principles then generally accepted. In 1973 transactions of that type were included in determining income before extraordinary items, in conformity

> with the newly issued Opinion, and a charge for relocation expenses of $xxx was included in the determination of income before extraordinary items. The Opinion prohibits restating the 1972 financial statements. Had the Opinion been in effect for 1972, net income would have been the same, but income before extraordinary items would have been $xxx ($x.xx per share).
>
> "In our opinion . . . in conformity with generally accepted accounting principles which, except for the change, with which we concur, in the method of determining income before extraordinary items discussed in the preceding paragraph, have been applied on a basis consistent with that of the preceding year."

[As modified, effective March 31, 1975, by FASB Statement No. 4.] (See AC section 2013.)

.05 If a transaction affected by the criteria of Opinion No. 30 [AC section 2012] occurs in only one of the years presented, the auditor should not qualify his opinion as to consistency.

.06 *Discussion*—Generally accepted accounting principles encompass classification.[1] Generally, however, auditors do not qualify their opinions as to consistency when there has been a change in classification. Section 420.14 states:

> "Classifications in the current financial statements may be different from classifications in the prior year's financial statements. . . . These changes . . . ordinarily would not affect the independent auditor's opinion as to consistency and need not be referred to in his report."

An example of the type of change contemplated by section 420.14 is combining "Cash on hand" with "Cash in bank" to create a new classification, "Cash." Section 420.14 does not contemplate a change in classification that affects significantly the *measurement* of financial position or results of operations. Such a change would call for a consistency qualification in the auditor's report.

.07 APB Opinion No. 30 [AC section 2012] changes significantly the types of items that are to be reported as extraordinary, and this in turn changes the measurement of "income before extraordinary items" and the related per-share amounts. Many accountants believe that the amount of income before extraordinary items is a very important aspect of an income statement. As evidence of its importance, APB Opinion No. 15 [AC section 2011] requires that earnings per share be presented for income before extraordinary items. By changing the determination of income before extraordinary items, Opinion

[1] APB Statement No. 4, "Basic Concepts and Accounting Principles Underlying Statements of Business Enterprises," pars. 176, 198 [AC sections 1027.02; 1027.25].

No. 30 [AC section 2012] changed the *measurement* of results of operations.

.08 Some accountants have also questioned whether the auditor's reporting decision should be influenced by the fact that the company's change in accounting principles does not result from an election, but instead was made necessary by the adoption of APB Opinion No. 30 [AC section 2012], and that Opinion prohibits restating the 1972 amounts. The answer is found in the objective of the consistency standard, as discussed in Section 420.02, which states, in part:

> "The objective of the consistency standard is (a) to give assurance that the comparability of financial statements between periods has not been materially affected by changes in accounting principles, which include not only accounting principles and practices but also the methods of applying them, or (b) if comparability has been materially affected by such changes, to require appropriate reporting by the independent auditor regarding such changes."

.09 The impact of a change in accounting principles on the comparability of financial statements is the same, whether the accounting change was elective or mandatory. In either case, if the change in principles has a material effect on comparability, the auditor should comment on the change in his report and should qualify his opinion as to consistency unless the financial statements for the prior year have been restated to apply the change retroactively (not permissible in the cases under discussion).

.10 As is true whenever audit judgments are to be made, all of the circumstances should be taken into consideration. The foregoing discussion contemplates that, absent the issuance of Opinion No. 30 [AC section 2012], the 1973 transaction would have been presented (under the provisions of Opinion No. 9 [AC section 2010]) as an extraordinary item. If, due to a change in the surrounding circumstances (for example, a change in the expected frequency of occurrence of transactions of the type at issue), the 1973 transaction would have been included in income before extraordinary items for that year even though the criteria had not been changed by Opinion No. 30 [AC section 2012], a consistency qualification would not be appropriate. Section 420.17 states, in part, that modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring does not involve the consistency standard; disclosure in the notes to the financial statements may, however, be required.

[Issue Date: January, 1974.]

2. Consistency of Interim and Annual Information

.11 *Question*—Independent auditors may be engaged to report on financial information for an annual period and a subsequent interim period. Should the auditor qualify his opinion as to consistency in those circumstances where accounting principles and practices used in preparing the annual financial information have been modified in accordance with APB Opinion No. 28 [AC section 2071] in preparing the interim financial statements?

.12 *Response*—No. The auditor should not qualify his opinion as to consistency. Although the modifications deemed appropriate under Opinion No. 28 [AC section 2071] may appear to be changes in the methods of applying accounting principles, they differ from changes in methods that require a consistency qualification since the modifications are made in order to recognize a difference in circumstances, that is, a difference between presenting financial information for a year and presenting financial information for only a part of a year.

.13 Section 420.02 states: "The objective of the consistency standard is (a) to give assurance that the comparability of financial statements between periods has not been materially affected by changes in accounting principles . . . or (b) if comparability has been materially affected by such changes, to require appropriate reporting by the independent auditor regarding such changes." Section 420.02 refers to changes in methods that lessen the usefulness of financial statements in comparing the financial information of one period with that of an earlier period. Thus, the purpose of an exception as to consistency in the auditor's report is to alert readers of the report not to make an unqualified comparison of the financial information for the two periods.

.14 The modifications introduced by Opinion No. 28 [AC section 2071], however, do not lessen the comparability of the financial information of an interim period with that of a preceding annual period. On the contrary, those modifications are intended to enhance comparability between the two sets of financial information. As paragraph 10 of Opinion No. 28 [AC section 2071.10] states, the modifications are needed "so that the reported results for the interim period may better relate to the results of operations for the annual period."

.15 Thus the modifications introduced by Opinion No. 28 [AC section 2071] are not of the type that would require a qualification of the auditor's opinion as to consistency. Independent auditors should, of course, qualify their opinions as to consistency if changes of the type that lessen comparability are introduced in the interim financial information.

[Issue Date: February, 1974.]

3. Impact on the Auditor's Report of FIFO to LIFO Change in the Earliest Year Reported On

.16 *Question*—Changing economic conditions have caused some companies to change their inventory pricing methods from the first in, first out (FIFO) method to the last in, first out (LIFO) method. When a company presents comparative financial statements and the year of the FIFO to LIFO change is the earliest year both presented and reported on, should the auditor refer to that change in accounting principle in his report?

.17 *Interpretation*—Ordinarily, the auditor need not refer in his report to a FIFO to LIFO change in the circumstances described above.

.18 A change in accounting principle usually results in including the cumulative effect of the change in net income of the period of the change. A change in inventory pricing method from FIFO to LIFO, however, is a change in accounting principle that ordinarily does not affect retained earnings at the beginning of the period in which the change was made. (See APB Opinion No. 20, paragraphs 14(d) and 26.) [2]

.19 An example of typical disclosure of a FIFO to LIFO change in the year of the change is as follows:

"In 1974, the company adopted the last in, first out (LIFO) method of costing inventory. Previously, the first in, first out (FIFO) method of costing inventory was used. Management believes that the LIFO method has the effect of minimizing the impact of price level changes on inventory valuations and generally matches current costs against current revenues in the income statement. The effect of the change was to reduce net income by $xxxx ($.xx per share) from that which would otherwise have been reported. There is no cumulative effect on prior years since the ending inventory as previously reported (1973) is the beginning inventory for LIFO purposes. Accordingly, pro forma results of operations for the prior year had LIFO been followed is not determinable."

.20 Section 420.20 discusses the periods to which the consistency standard relates: "When the independent auditor reports on two or more years, he should report on the consistency of the application of accounting principles between such years. . . ." If the change from FIFO to LIFO was made in the earliest year both presented and reported on, the principle has been applied consistently in the comparative financial statements.

.21 Section 546.03, discusses reporting on changes in accounting principle that should be accounted for by means other than by restat-

[2] See AC sections 1051.14(d) and 1051.26.

ing the financial statements of prior years. Thus, it applies to accounting changes accounted for in the current period, such as FIFO to LIFO. It states, in pertinent part: "If the year of change is the earliest year being reported upon, there is no inconsistency in the application of accounting principles during the period subsequent to the change, but the auditor should make reference to the change having been made in such year."

.22 Section 546.03 requires the auditor to refer to a change made in the earliest period reported on even though there is no inconsistency in the application of accounting principles because of a lack of comparability between the earliest year statements and those of subsequent years that results from presenting a material cumulative effect in the earliest year. Factors affecting comparability but not consistency ordinarily need not be commented on by the auditor (see section 420.05), but when comparability is affected by a change in accounting principle the auditor should refer to the change in his report.

.23 For a FIFO to LIFO change made in the earliest year presented and reported on, there is no inconsistency in the application of accounting principles, and comparability between the earliest year and subsequent years is not affected since no cumulative effect is reported in the year of the change. Consequently, the independent auditor need not refer to the change in inventory pricing methods.

[Issue Date: January, 1975.]

The next page is 1931.

AU Section 9509

Reports on Audited Financial Statements: Auditing Interpretations of AU Section 509

1. Alternative Procedures for Observation of Physical Inventories

.01 *Question*—Section 509.12 states that "common restrictions on the scope of the auditor's examination include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . ." A footnote to that paragraph states: "Circumstances such as the timing of his work may make it impracticable or impossible for the auditor to accomplish these procedures. In such case, if he is able to satisfy himself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of his work, and his report need not include reference to the omission of the procedures or to the use of alternative procedures." Outside firms of nonaccountants specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor's own observation of physical inventories?

.02 *Interpretation*—Sufficient competent evidential matter for inventories is discussed in section 331.09—.12. Section 331.09 states that ". . . it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests, and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client's representations about the quantities and physical condition of the inventories."

.03 Section 331.10—.11 discusses two variations of that procedure when the client has well-kept perpetual records that are checked periodically by comparisons with physical counts or when the client uses statistical sampling to determine inventories. In such instances, the auditor may vary the timing and extent of his observation of physical counts, but he "must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used."

.04 Section 331.12 deals with circumstances in which the auditor has not satisfied himself as to inventories in the possession of the client through procedures described in section *331.09—.11*. *In those* circumstances, the general requirement for satisfactory alternative procedures is that ". . . tests of the accounting records alone will not be sufficient for him to become satisfied as to quantities; it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions."

.05 The fact that the inventory is counted by an outside inventory firm of nonaccountants is not, by itself, a satisfactory substitute for the auditor's own observation or taking of some physical counts. The auditor's concern, in this respect, is to satisfy himself as to the effectiveness of the counting procedures used. If the client engages an outside inventory firm to take the physical inventory, the auditor's primary concern would be to evaluate the effectiveness of the procedures used by the outside firm and his auditing procedures would be applied accordingly.

.06 Thus, the auditor would examine the outside firm's program, observe its procedures and controls, make or observe some physical counts of the inventory, recompute calculations of the submitted inventory on a test basis and apply appropriate tests to the intervening transactions. The independent auditor ordinarily may reduce the extent of his work on the physical count of inventory because of the work of an outside inventory firm, but any restriction on the auditor's judgment concerning the extent of his contact with the inventory would be a scope restriction.

[Issue Date: July, 1975.]

2. Reporting on Comparative Financial Statements of Nonprofit Organizations

.07 *Question*—Section 509.49, "Reports on Audited Financial Statements," states: "When financial statements of the prior year are presented with those of the current year, the auditor should report on the financial statements of the prior year if he has examined them. (This requirement does not apply to summaries of financial information or other incomplete presentations.)" Is section 509.49 applicable to an auditor's report on a nonprofit organization covered by an AICPA industry audit guide (a hospital, college or university, voluntary health and welfare organization or state or local governmental unit)?

.08 *Interpretation*—No. An auditor's report on the financial statements of a nonprofit organization that are similar to the statements contained in the audit guides need cover only the financial statements of the current year.

.09 The financial statements of nonprofit organizations illustrated in the guides are intended to present only summarized comparative information for the prior year. For example, only total-all-funds information may be presented for the prior year rather than information by individual funds. Summarization of the prior year's information may be necessary because of space limitations or to avoid cumbersome or confusing formats. Consequently, the comparative information for the prior year contained in such financial statements should be considered to be incomplete presentations.

.10 In some circumstances, the auditor may wish to, or the client may request the auditor to, express an opinion on the prior year as well as the current year. In those circumstances, the auditor should consider whether the information included for the prior year contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, that will necessitate including additional columns or including separate detail by fund.

[Issue Date: January, 1976.]

3. Reporting on Loss Contingencies

.11 *Question*—Statement on Financial Accounting Standards No. 5,* "Accounting for Contingencies," of the Financial Accounting Standards Board specifies criteria for accruing and disclosing loss contingencies. What is the relationship between the criteria established in Statement No. 5 and the auditor's reporting obligations when the financial statements on which he is reporting are affected by such uncertainties?

.12 *Interpretation*—In discussing loss contingencies Statement No. 5 uses the terms *probable, reasonably possible* and *remote* to describe different degrees of likelihood that future events will confirm a loss or an impairment of an asset or incurrence of a liability and the accounting standards for accrual and disclosure are based on those terms. Paragraph 3 of that Statement defines those terms as follows:

Probable. The future event or events are likely to occur.

Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

Remote. The chance of the future event or events occurring is slight.

.13 Section 509.22 states: "In certain instances, the outcome of matters that may affect the financial statements or the disclosures required therein is not susceptible of reasonable estimation; such matters

* AC section 4311, Volume 3, *AICPA Professional Standards.*

are to be regarded as uncertainties. . . ." Section 509.24 states: "The auditor need not modify his opinion because of the existence of an uncertainty when he concludes that there is only a minimal likelihood that resolution of the uncertainty will have a material effect on the financial statements." The meaning of "minimal likelihood" as used in section 509 is equivalent to "remote" as used in FASB Statement No. 5.* Consequently, an independent auditor need not modify his opinion because of the existence of an uncertainty when he concludes that there is only a remote likelihood that resolution of the uncertainty will have a material effect on the financial statements on which he is reporting.

.14 When a future event or events that will resolve an existing contingency are reasonably possible (chance of occurrence is more than remote but less than likely) and the amount of the potential liability cannot be estimated, the auditor might modify his opinion if he concludes the potential effect of the resolution of the uncertainty is material. When the events that will resolve a contingency are probable (likely to occur), but the amount of the loss cannot be estimated, an uncertainty exists. In this case, the auditor should modify his opinion when he believes that the resolution of the uncertainty will have material effect on the financial statements he is examining.

[Issue Date: January, 1976.]

The next page is 1945.

* AC section 4311, Volume 3, *AICPA Professional Standards.*

AU Section 9516

Unaudited Financial Statements: Auditing Interpretations of AU Section 516

1. Disclosures in Internal Use Unaudited Statements

.01 *Question*—In what circumstances should the CPA's disclaimer of opinion on unaudited financial statements contain the reference to the absence of necessary disclosures and restriction of the statements to internal use as described in section 516.05?

.02 *Interpretation*—The notation of restriction to internal use and the possible lack of necessary disclosures should not be used when the CPA has knowledge that the client intends to distribute the report to third parties or in situations in which he believes distribution to third parties is likely. Paragraph .05 applies only to statements which a client in fact is going to use only internally. Thus, if the client intends showing the statements to an outsider, the CPA should comply with section 516.06 and insist upon including all necessary disclosures of which he has knowledge.

.03 In those circumstances when internal use statements are issued, the accountant should clearly indicate the restrictions placed upon the use of the financial statements. The report might be worded as follows:

> "The accompanying financial statements were not audited by us and, accordingly, we do not express an opinion on them. Because these financial statements are issued solely for the internal information of the company's management, they do not necessarily include all disclosures that might otherwise be required. Therefore, they should not be referred to or presented to anyone outside the company for any purpose."

[Issue Date: May, 1972.]

2. Annual Report Disclosure of Interim Data

.04 *Question*—APB Opinion No. 28, paragraph 31 [AC section 2071.31], which applies to publicly traded companies, states: "When interim financial data and disclosures are not separately reported for the fourth quarter, security holders often make inferences about that quarter by subtracting data based on the third quarter interim report from the annual results. In the absence of a separate fourth quarter report or disclosure of the results . . . for that quarter in the annual report, disposals of segments of a business and extraordinary, unusual or infrequently occurring items recognized in the fourth quarter, as well as the aggregate effect of year-end adjustments which are material to the results of that quarter . . . should be disclosed in the annual report in a note to the annual financial statements." Does the auditor have an obligation, arising from the disclosure requirements of paragraph 31 of Opinion No. 28 [AC section 2071.31], to audit interim data?

.05 *Response*—No. If the auditor has not been specifically engaged to audit interim information, he does not have an obligation to audit interim data as a result of his examination of the annual financial statements.

.06 Disclosures of fourth quarter adjustments and other disclosures required by paragraph 31 would appear in a note to the annual financial statements of a publicly traded company only if fourth quarter data were not separately distributed or did not appear elsewhere in the annual report. Consequently, such disclosures are not essential for a fair presentation of the annual financial statements in conformity with generally accepted accounting principles.

.07 If interim financial data and disclosures are not separately reported (as outlined in paragraph 30 of Opinion No. 2 [AC section 2071.30]) for the fourth quarter, the independent auditor during his examination of the annual financial statements should inquire as to whether there are fourth quarter items that need to be disclosed in a note to the annual financial statements.

.08 Information on fourth quarter adjustments and similar items that appear in notes to the annual financial statements to comply with paragraph 31 of Opinion No. 28 [AC section 2071.31] would ordinarily not be audited separately and, therefore, the information would be labeled "unaudited" or "not covered by auditor's report."

.09 If a publicly traded company fails to comply with the provisions of paragraph 31 of Opinion No. 28 [AC section 2071.31], the auditor should suggest appropriate revision; failing that, he should add a comment in his report calling attention to the omission of the information. The auditor need not qualify his opinion on the annual financial statements since the disclosure is not essential for a fair presentation of those statements in conformity with generally accepted accounting principles.

[Issue Date: February, 1974.]

3. Unaudited Financial Statements in Listing Applications—I

.10 *Question*—When a company whose securities are listed on a major stock exchange issues additional securities in connection with the acquisition of another company (in either a "purchase" or a "pooling of interests") it files an application to list the additional securities. The listing application includes the most recent audited financial statements of the company to be acquired (if its statements have been audited) and, in some instances, unaudited statements at and for a subsequent date and period. Is the independent auditor who reports, in the listing application, on the audited financial statements of the acquired company associated with the unaudited statements? If so, must he disclaim an opinion on them?

.11 *Interpretation*—The independent auditor of the acquired company is associated with the unaudited interim statements. Section 516.03 states: "A certified public accountant is associated with unaudited financial statements when he has consented to the use of his name in a report, document, or written communication setting forth or containing the statements."

.12 Section 516.11 discusses published annual reports that present unaudited statements of the prior period for comparative purposes, and Section 516.12 discusses documents, filed with the SEC, that present unaudited interim financial statements along with audited statements covering a number of years. Under the provisions of those sections, a disclaimer of opinion need not accompany the unaudited financial statements if the unaudited statements are appropriately marked as "unaudited." The reason for omitting the disclaimer is described in Section 516.11: "If the . . . statements are appropriately marked as unaudited, the disclaimer . . . is not necessary because the report of the independent auditor limits his opinion to the . . . [audited] financial statements."

.13 The same reasoning is applicable in the case of a listing application. That is, the independent auditor of the acquired company need not issue a disclaimer of opinion on the unaudited statements in a listing application if they are clearly marked as unaudited and if his report on the audited statements is included. However, if he has reservations about the unaudited statements, he should disclose them in his report on the audited statements, or he should issue a disclaimer of opinion on the unaudited statements and express his reservations in the disclaimer. (See Sections 516.07, 516.11 and 710.09.)

.14 The auditor is well advised to ask to see the final printer's proofs of the audited and unaudited statements that are to be included in the listing application to avoid the possibility of being associated improperly with financial statements.

[Issue Date: July, 1974.]

4. Unaudited Financial Statements in Listing Applications—II

.15 *Question*—In a listing application for securities to be issued in a business combination, the issuer (the acquiring company) may be required to describe the accounting treatment proposed for the transaction and to state whether the issuer's independent auditor (who is identified) has approved the proposed accounting treatment. (The auditor ordinarily expresses his approval in writing to the issuer.) In many instances, the only financial statements presented for the company to be acquired are unaudited ones. (In the latter situation, an officer "certifies" the unaudited statements.) Is the auditor of the issuer "associated" with the unaudited financial statements of the company to be acquired? If so, must he disclaim an opinion on them?

.16 *Interpretation*—Under a literal application of the first sentence of Section 516.03, quoted above, the auditor of the issuing company could technically be deemed to be associated with the unaudited financial statements, appearing in the listing application, of the company to be acquired. Section 516.03 was not intended, however, to be applied when the context in which the CPA's name appears clearly does not imply that he has audited the financial statements. In the circumstances under consideration here, the CPA's name appears solely to indicate approval of an accounting treatment proposed to be used by the acquiring company. If audited financial statements of the company to be acquired are included in the listing application, the auditor is identified. If only unaudited statements of the company to be acquired are included, they should be so marked. If they are so marked, the auditor of the acquiring company need not express a disclaimer of opinion concerning them.

[Issue Date: July, 1974.]

5. Auditor's Identification with Condensed Financial Data

.17 *Question*—Section 150.02 states in part: "In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking." Section 516.03 states that "A certified public accountant is associated with . . . financial statements when he has consented to the use of his name in a report, document, or written communication setting forth or containing the statements." Is the auditor "associated" with condensed financial data when he is identified by a financial reporting service as being a company's independent auditor or when his report is reproduced and presented with such data?

.18 *Interpretation*—No. The certified public accountant has not consented to the use of his name when it is published by a financial reporting service. Financial data released to the public by a company and the name of its auditor are public information. Accordingly, neither the auditor nor his client has the ability to require a financial reporting service to withhold publishing such information.

.19 Financial reporting services, such as Dun & Bradstreet and Moody's Investors Service, furnish to subscribers information and ratings concerning commercial enterprises as a basis for credit, insurance, marketing and other business purposes. Those reports frequently include condensed financial data and other data such as payments to trade creditors, loan experience with banks, a brief history of the enterprise and a description of its operations. Also, as part of its report, the financial service often discloses the names of the officers and directors or principals or owners of the company and the name of the company's auditor.

.20 In the context in which the certified public accountant's name appears, it is doubtful that readers will assume that he has audited the information presented. However, the AICPA has suggested to certain financial reporting services that they identify data as "unaudited" if the data has been compiled from unaudited financial statements. Also, the AICPA has suggested that when summarized financial data is presented together with an auditor's report on complete financial statements (including notes), the financial reporting services state that the auditor's report applies to financial statements not presented.

[Issue Date: March, 1976.]

The next page is 1955.

AU Section 9517

Reporting When a Certified Public Accountant Is Not Independent: Auditing Interpretations of AU Section 517

1. Applicability of Guidance on Reporting When Not Independent

.01 *Question*—Section 517 describes the reporting responsibilities of the certified public accountant who has determined that he is not independent with respect to financial statements with which he is associated. That section, however, does not indicate how he should determine whether he is independent. What should the certified public accountant consider in determining whether he is independent? Also, should his consideration be any different for an engagement to prepare unaudited financial statements?

.02 *Interpretation*—Section 517 explains the certified public accountant's reporting responsibilities when he is not independent; it does not attempt to explain how the certified public accountant determines whether he is independent because that is a question of professional ethics. Section 220.04 states: "The profession has established, through the Institute's Code of Professional Ethics, precepts to guard against the . . . loss of independence." The AICPA, state CPA societies and state boards of accountancy have issued pronouncements to provide the certified public accountant with guidance to aid him in determining whether he is independent.

.03 The certified public accountant should consider the AICPA's Code of Professional Ethics, its Rules of Conduct, Interpretations under the Rules and ethics rulings in determining whether he is independent and whether the reporting requirements of section 517 apply. He should also consider the ethical requirements of his state CPA society or state board of accountancy.

.04 Section 517.01 states that the section on reporting when not independent applies to all engagements in which the certified public accountant may be "associated" with financial statements. Association with financial statements includes engagements to prepare unaudited statements. Also, section 517.04 states that the recommended "type of disclaimer applies whenever the certified public accountant is not independent, *regardless of the extent of services performed.*" (Emphasis added.) Consequently, the certified public accountant's consideration of whether he is independent should be the same for all engagements in which he is associated with financial statements, no matter what the extent of his procedures.

[Issue Date: November, 1975.]

The next page is 1961.

AU Section 9544

Lack of Conformity with Generally Accepted Accounting Principles: Auditing Interpretations of AU Section 544

1. Auditors' Reports Solely for Purposes of Filing with Insurance Regulatory Agencies

.01 *Question*—Independent auditors are sometimes requested to report on insurance company financial statements prepared in accordance with statutory accounting practices solely for purposes of filing with insurance regulatory agencies. For example, an independent auditor might be engaged to examine statutory financial statements of an insurance company for purposes of fulfilling a regulatory agency examination requirement. What type of auditor's report is appropriate in such circumstances?

.02 *Interpretation*—Section 544.02 states:

"The basic postulates and broad principles of accounting comprehended in the term 'generally accepted accounting principles' which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (Such companies include public utilities, common carriers, insurance companies, financial institutions, and the like.) Accordingly, the first reporting standard is equally applicable to opinions on financial statements of such regulated companies *presented for purposes other than filings with their respective supervisory agencies;* and material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this will require either a qualified or an adverse opinion on such statements. An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles." (Emphasis added.)

.03 Statutory financial statements of an insurance company that are prepared for the purpose of filing with an insurance regulatory agency are special-purpose financial statements and, as indicated in section 544.02, the first standard of reporting is not applicable to an auditor's report on such financial statements. The auditor's report, therefore, need not include a qualified or adverse opinion on the financial statements because of variances from generally accepted accounting principles.

.04 State regulatory agencies are primarily concerned with the protection of policyholders and, therefore, statutory financial statements have been designed to facilitate consideration of whether insurance companies have made adequate provisions for their policyholders. Statutory accounting practices are primarily concerned with solvency and generally emphasize a very conservative presentation of balance sheet amounts. They are not designed to serve the needs and interests of others, such as present and potential investors. Consequently, generally accepted accounting principles differ in several important respects from statutory accounting practices. Different accounting standards are necessary, in this case, to meet the different needs and purposes of the regulators on the one hand, and the investing public and management on the other.

.05 The purpose of the auditor's engagement to examine statutory financial statements, in such circumstances, is solely to meet state regulatory examination requirements. The regulatory agencies understand the purpose of the engagement and are not concerned with the conformity of the financial statements with generally accepted accounting principles.

.06 Regulatory authorities, however, sometimes make statutory financial statements and the auditor's report thereon a matter of public record. Consequently, the auditor's report should clearly set forth the purpose of the financial statements and their lack of conformity with generally accepted accounting principles even though the financial statements are not circulated outside the regulatory authority.

.07 For example, the auditor's report on statutory financial statements might include a middle paragraph worded somewhat as follows:

"The accompanying financial statements have been prepared solely for filing with regulatory agencies and are not intended for any other purpose. The XYZ Insurance Company has prepared the financial statements in conformity with the accounting practices prescribed or permitted by the Insurance Department of ...., as described in Note X, and the financial statements are not intended to be presented in conformity with generally accepted accounting principles."

.08 The independent auditor's report would conclude with an opinion paragraph on the conformity of the financial statements with statutory accounting practices.

.09 If an insurance company prepares statutory financial statements for use as general-purpose financial statements, the first standard of reporting is applicable to auditors' reports on such statements and a qualified or adverse opinion would ordinarily be required.

[Issue Date: July, 1975.]

The next page is 2011.

AU Section 9640

Reports on Internal Control: Auditing Interpretations of AU Section 640

1. Scope of Special Study

.01 *Question*—Reports to grant agencies on internal control are sometimes based on special studies rather than on an audit. Special studies are defined in section 640.19, as "those in which the scope of the study and evaluation being reported is substantially more extensive than that required for an examination of financial statements in accordance with generally accepted auditing standards." Does this mean that the total amount of work performed as measured by man-hours or nature and extent of procedures will be greater?

.02 *Interpretation*—No, not necessarily. Section 640.20 indicates that the scope description of the report should specify whether the scope included "tests of compliance" with the system. Normally, some tests of compliance would be included in the scope of an examination in accordance with generally accepted auditing standards. However, a pre-award survey of a proposed system could not include tests of compliance and other procedures typically followed in a review and evaluation of internal control in an audit.

.03 The scope of a special study is "substantially more extensive" only in a particular area and not necessarily in total. The reference to a "substantially more extensive" scope in paragraph .19 means that either the types of controls reviewed in a special study will normally be greater in number than in audit, or, if only one phase or area of a system is included in a study, the procedures employed in that particular phase or area will be greater than in an audit. Thus, the total quantity of work for a special study may actually be less than for an audit.

[Issue Date: January, 1973.]

2. Explanatory Paragraphs

.04 *Question*—The two middle paragraphs of the report specified in section 640.12 contain explanations of the objectives and inherent limitations of internal accounting control. Is it permissible to delete one or both of these paragraphs in reports for governmental agencies?

.05 *Interpretation*—No. Internal control is a complex technical topic and a report on internal control may be subject to the risk of misunderstanding by report users. As stated in section 640.12, "the committee believes the risk of misunderstanding can be reduced by adopting a form of report that describes in reasonable detail the objective and limitations of internal accounting control and the auditor's evaluation of it." The two middle paragraphs are essential to reduce the risk of misunderstanding.

[Issue Date: January, 1973.]

The next page is 2021.

AU Section 9641

Reports on Internal Control Based on Criteria Established by Governmental Agencies: Auditing Interpretations of AU Section 641

1. Pre-Award Surveys

.01 *Question*—If an independent auditor is engaged to perform a pre-award survey in connection with a government grant program, how should he report on internal control, including incorporation of comments on the agency's criteria?

.02 *Interpretation*—The following report is illustrative of the type of report considered appropriate for a pre-award survey:

"We understand that (applicant) has applied for a grant of $...... from (agency) for the period from .... through .... for use in accordance with the (title or description of program). We have made a study of those internal accounting control and administrative control procedures of (applicant) that we considered relevant to the criteria established by (agency) as set forth in section .... of its Audit Guide issued (date). Since our study related to procedures (applicant) proposes to follow if the grant is awarded, it did not include tests of compliance with such procedures. Our study did not constitute an audit of any financial statements prepared by the (applicant).

"The objective of internal accounting control is to provide reasonable, but not absolute, assurance as to the safeguarding of assets against loss from unauthorized use or disposition, and the reliability of financial records for preparing financial statements and maintaining accountability for assets. We understand that the objective of those administrative control procedures comprehended in the (agency's) criteria is to provide similar assurance as to compliance with its related requirements. The concept of reasonable assurance recognizes that the cost of a system of internal control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management.

"There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal control. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness or other personal factors. Control procedures whose effectiveness depends upon segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management with respect either to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions, and that the degree of compliance with the procedures may deteriorate.

"We understand that procedures in conformity with the criteria referred to in the first paragraph of this report are considered by the (agency) to be adequate for its purposes in accordance with the (name of act) and related regulations, and that procedures not in conformity therewith indicate some inadequacy for such purposes. Based on this understanding and on our study, we believe the (applicant's) procedures would be adequate for the agency's purposes, assuming satisfactory compliance, except for the conditions described (reference to appropriate section of report) which we believe would be material weaknesses in relation to the grant to which this report refers. In addition to such weaknesses, other conditions which we believe would not be in conformity with the criteria referred to above are described (reference to appropriate section of report).

"This report is intended for use in connection with the grant to which it refers and should not be used for any other purpose."

.03 Since neither a pre-award nor post-award survey constitutes an audit of financial statements, the survey report should include a statement to that effect. In accordance with section 640.11 the auditor's report on internal control should not be issued in conjunction with unaudited financial statements with which the auditor's name is associated and, consequently, a disclaimer of opinion on any financial statements is not appropriate in the internal control report.

[Issue Date: January, 1973.]

2. Post-Award Surveys

.04 *Question*—How should the report for a post-award survey differ from that for a pre-award survey?

.05 *Interpretation*—The following report is illustrative of the type of report considered appropriate for a post-award survey:

Scope Paragraph

"We understand that (recipient) has been awarded a grant of $...... from (agency) for the period from .... through .... for use in accordance with the (title or description of program). We have made a study of those internal accounting control and administrative control procedures of (recipient) that we considered relevant to the criteria established by (agency) as set forth in section .... of its Audit Guide issued (date). Our study included tests of compliance with such procedures during the period from .... through .... Our study did not constitute an audit of any financial statements prepared by the (recipient)."

Explanatory Paragraphs

Same as for pre-award survey.

Concluding Paragraphs

"We understand that procedures in conformity with the criteria referred to in the first paragraph of this report are considered by the (agency) to be adequate for its purposes in accordance with (name of act) and related regulations, and that procedures not in conformity therewith indicate some inadequacy for such purposes. Based on this understanding and on our study, we believe the (recipient's) procedures were adequate for the agency's purposes, except for the conditions described (reference to appropriate section of report) which we believe are material weaknesses in relation to the grant to which this report refers. In addition to such weaknesses, other conditions which we believe are not in conformity with the criteria referred to above are described (reference to appropriate section of report).

"This report is intended for use in connection with the grant to which it refers and should not be used for any other purpose."

[Issue Date: January, 1973.]

3. Audit Engagements

.06 *Question*—What type of report is appropriate when the study is made in conjunction with an audit engagement?

.07 *Interpretation*—The following report is illustrative of the type of report considered appropriate for studies made in connection with an audit engagement:

Scope Paragraph

"We understand that (recipient) has been awarded a grant of $...... from (agency) for the period from .... through

.... for use in accordance with the (title or description of program). We have made a study of those internal accounting control and administrative control procedures of (recipient) that we considered relevant to the criteria established by (agency) as set forth in section .... of its Audit Guide issued (date). Our study included tests of compliance with such procedures during the period from .... through .... We have examined the financial statements of (recipient) for the year ended .... and have issued our report thereon dated ...."

Explanatory Paragraphs

Same as for pre-award survey.

Concluding Paragraphs

Same as for post-award survey.

[Issue Date: January, 1973.]

4. Knowledge of Other Weaknesses

.08 *Question*—The reports illustrated for pre-award and other surveys refer to the criteria set forth in an agency's audit guide. What should the auditor do if his study discloses material weaknesses in the system that relate to the grant, but the agency's criteria do not cover the areas in which the weaknesses exist?

.09 *Interpretation*—The auditor may find material weaknesses in areas not covered by an agency's audit guide. While the concluding paragraph in all the illustrated reports for grant agencies is expressed in terms of conformity with an agency's established criteria, as indicated in section 641.03, the auditor's report should disclose any other material weaknesses that come to his attention. The weaknesses cannot to be reported as exceptions to conformity with the agency's established criteria, but they should be disclosed in the report.

.10 On the other hand, since it is not possible to anticipate all matters which may be of interest to the governmental agency, the auditor should not make a general statement in his report that nothing else has come to his attention that would be of interest to the agency.

[Issue Date: January, 1973.]

5. Limited Scope

.11 *Question*—At times the terms of an engagement do not permit the examination of a delegate agency's (agencies') financial statements, internal controls and compliance with provisions of an act and related regulations or instructions. How should the auditor modify his report on internal control if he is not in a position to report on the delegate agency's (agencies') operations?

.12 *Interpretation*—If the operations of the delegate agency (agencies) are sufficiently material in the combined operations of the principal grant recipient and the delegate agency (agencies) and the latter is either unaudited or the work of other auditors is not acceptable to the primary auditor, the report on the financial statements covering the combined operations of the principal grant recipient and the delegate agency (agencies) should be a disclaimer in the usual form appropriate for reports on financial statements. The report on internal control, however, need not be an overall disclaimer if it clearly indicates in its scope and concluding paragraphs that it pertains only to the organization covered by the auditor's engagement. This distinction is appropriate because conditions with respect to internal control in several organizations cannot be combined in a meaningful way comparable to combined financial statements, and therefore there is no meaningful overall or combined system to which an overall disclaimer could relate.

[Issue Date: January, 1973.]

6. Statutory Reporting Requirements

.13 *Question*—The Economic Opportunity Act of 1964, as amended, sets forth specific requirements for accounting system surveys of organizations receiving grants under section 243 of the Act. Specific language is included in the Act concerning the adequacy of a grantee's accounting system and internal controls. How should this requirement be met?

.14 *Interpretation*—To comply with sections 640 and 641 and still meet the requirements of the Act, the auditor should state the assumption that the agency's criteria meet the requirement for adequacy and cite the Act. Accordingly, the last paragraphs of his report should be modified as follows:

Concluding Paragraphs

"We understand that procedures in conformity with the criteria referred to in the first paragraph of this report are considered by the Office of Economic Opportunity to be adequate for its purposes in accordance with section 243 of the Economic Opportunity Act and related regulations, and that procedures that are not in conformity therewith indicate some inadequacy for such purposes. Based on this understanding and on our study, we believe the (recipient's) procedures were adequate for the purposes of the Office of Economic Opportunity, except for the conditions described (reference to appropriate section of report) which we believe are material weaknesses in relation to the grant to which this report refers. In addition to such weaknesses, other conditions which we believe are not in conformity with the criteria referred to above are described (reference to appropriate section of report).

"This report is intended for use in connection with the grant to which it refers and should not be used for any other purpose."

[Issue Date: January, 1973.]

AU
APPENDIXES

. . . historical background . . . statements on auditing procedure/standards . . . sources of sections . . . cross-references for auditing interpretations . . . industry audit guides . . . changes in statements on auditing standards . . .

TABLE OF CONTENTS

The next page is 2061.

AU Appendix A

Historical Background

The "Bulletins" of 1917, 1918, 1929, and 1936

In 1917, the American Institute of Certified Public Accountants, then known as the American Institute of Accountants, at the request of the Federal Trade Commission, prepared "a memorandum on balance-sheet audits," which the Commission approved and transmitted to the Federal Reserve Board for the latter's consideration. The Federal Reserve Board, after giving the memorandum its provisional endorsement, published it in the *Federal Reserve Bulletin* of April 1917; reprints therefrom were widely disseminated for the consideration of "banks, bankers, banking associations; merchants, manufacturers, and associations of manufacturers; auditors, accountants, and associations of accountants" in pamphlet form with the title of "Uniform Accounting: a Tentative Proposal Submitted by the Federal Reserve Board." In 1918, this pamphlet was reissued under the same sponsorship, with its title changed to "Approved Methods for the Preparation of Balance-Sheet Statements," with practically no change from the 1917 issue except that, as indicated by the respective titles and corresponding change in the preface, instead of the earlier objective of "a uniform system of accounting to be adopted by manufacturing and merchandising concerns," the later objective was "the preparation of balance-sheet statements" for the same business entities.

In 1929, a special committee of the American Institute of Certified Public Accountants undertook the revision of the earlier pamphlet in the light of the experience of the decade that had elapsed; again under the auspices of the Federal Reserve Board, the revised pamphlet was promulgated in 1929 under the title of "Verification of Financial Statements."

The preface of the 1929 pamphlet spoke of its predecessors as having been criticized, on the one hand, by some accountants for being "more comprehensive than their conception of the so-called balance-sheet audit," and, on the other hand, by other accountants because "the procedure would not bring out all the desired information." This recognition of opposing views evidenced the growing realization of the impracticability of a uniform procedural pattern to fit the wide variety of situations encountered in actual practice. Of great significance is the appearance in the opening paragraph of "General Instructions" in the 1929 publication of the statement:

> The extent of the verification will be determined by the conditions in each concern. In some cases, the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others, where the system of internal check is good, tests only may suffice. The responsibility for the extent of the work required must be assumed by the auditor.

Between the years 1932 and 1934, there was an interchange of correspondence, dealing with both accounting and auditing matters, between the Institute's special committee on cooperation with stock exchanges and the committee on stock list of the New York Stock Exchange. The views expressed in the correspondence were an important development in the recognition of the position of accountancy in finance and business. The series of letters was published in 1934 under the title *Audits of Corporate Accounts.*

In 1936, a committee of the American Institute of Certified Public Accountants prepared and published a further revision of the earlier pamphlets under the title of "Examination of Financial Statements by Independent Public Accountants." It is interesting to observe, as a matter of historical development, that although in this 1936 revision the American Institute of Certified Public Accountants freely availed itself of the views of persons outside the ranks of the profession whose opinions would be helpful, the authority behind and responsibility for the publication of the pamphlet rested wholly with the American Institute of Certified Public Accountants as the authoritative representative of a profession that had by that time become well established in the business community. In the 1936 revision, aside from the very briefly noted "Modifications of Program for Larger or Smaller Companies," the detailed procedures set forth again were definitely and restrictively stated to be an "outline of examination of financial statements of a small or moderate size company." Moreover, the varying nature and extent of such examinations were predicated upon the purpose of the examination, the required detail to be reported upon, the types of business, and, most important of all, the system of internal check and control; the variations in the extent of the examination and of the test checks used were specifically related to "the size of the organization and the personnel employed" and were indicated to be "essentially a matter of judgment which must be exercised by the accountant."

It is possible from the foregoing narrative to trace the development of the profession's view of an audit based on the experience of three decades. The very succession of titles is illustrative. The earliest ambition for "uniform accounting" was quickly realized to be unattainable as an objective, and the same listed procedures were related instead to "balance-sheet statements." Then, with the gradually greater emphasis on periodic earnings, the earlier restrictive consideration of the balance sheet was superseded in the 1929 title, "Verification of Financial Statements," by according the income account at least equal status. When in turn the 1936 revision was undertaken, there had culminated a growing realization that, with the complexity of modern business and the consequent need of the independent auditor to rely on a system of carefully devised testing for his justification in accepting the representations of the examinee, such a word as "verification" was not an accurate portrayal of the independent auditor's function. Accordingly, the bulletin of that year was stated to cover an "examination" of financial statements.

Statements on Auditing Procedure

The Committee on Auditing Procedure had its beginning on January 30, 1939, when the executive committee of the Institute authorized the appointment of a small committee "to examine into auditing procedure and other related questions in the light of recent public discussion."

On May 9 of that year, the report "Extensions of Auditing Procedure" of this special committee was adopted by the Council of the Institute and authority given for its publication and distribution, and in the same year the bylaws were amended to create a standing Committee on Auditing Procedure.

In 1941, the executive committee authorized the issuance to Institute members, in pamphlet form, of the "Statements on Auditing Procedure," prepared by the Committee on Auditing Procedure, previously published only in *The Journal of Accountancy.*

The "Statements on Auditing Procedure" are designed to guide the independent auditor in the exercise of his judgment in the application of auditing procedures. In no sense are they intended to take the place of auditing textbooks; by their very nature textbooks must deal in a generalized manner with the description of procedures and refinement of detail rather than the wide variety of those differing situations encountered in actual practice which require the independent auditor to exercise his judgment.

It was largely to meet this need that the Institute inaugurated the series of Statements on Auditing Procedure. The first of these statements presented the report of the original special committee, as modified and approved, at the Institute's annual meeting on September 19, 1939, and promulgated under the title of "Extensions of Auditing Procedure." It was subsequently amended by Statement No. 12 issued in October 1942, and by Statement No. 23 (Revised) issued in December 1949. These statements likewise received formal approval at annual meetings on October 1, 1942, and November 1, 1949, respectively. The membership of the Institute has not acted on any of the other statements issued by the Committee.

Statement No. 1 presented certain conclusions drawn from the experience and tradition of the profession which largely furnished the foundation for the Committee's present structural outline of auditing standards; the other Statements on Auditing Procedure appropriately fit into the framework of that structural outline.

The "Codification of Statements on Auditing Procedure" was issued by the Committee on Auditing Procedure in 1951 to consolidate the features of the first 24 pronouncements which were of continuing usefulness. In the process of codification, certain changes took place:

a. Statements Nos. 1, 3, and 12 were clarified to eliminate ambiguities respecting the expression of an opinion in the rare situation where inventory observation or confirmation of receivables, though practicable and reasonable, is not carried out, but other procedures are employed which justify the expression of an opinion. Effect was also given to Accounting Series Releases Nos. 62 and 70 of the Securities and Exchange Commission, the former relating to the independent auditor's responsibility for summaries of earnings in registration statements and prospectuses and the latter to an amendment of Rule 2–02 of Regulation S-X.

b. The recommendations of Statements Nos. 7, 9, 10, 15, 17, 20, and 21 were omitted because they applied to special situations, such as those which arose in World War II.

When the Securities and Exchange Commission adopted the requirement that a representation as to compliance with generally accepted auditing standards be included in the independent auditor's report relating to financial statements filed with the Commission, it became apparent that a pronouncement was needed which would define these standards. Accordingly, the Committee undertook a special study of auditing standards (as distinguished from auditing procedures) and submitted a report that was published in October 1947 under the title "Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope." The recommendations of this brochure ceased to be tentative when, at the September 1948 meeting, the membership of the Institute approved the summarized statement of auditing standards appearing therein. In 1954 the "tentative" brochure was supplanted by the booklet *Generally Accepted Auditing Standards—Their Significance and Scope,* which was issued as a special report of the Committee on Auditing Procedure. This pronouncement also gave recognition to the approval of Statement on Auditing Procedure No. 23 (Revised), "Clarification of Accountant's Report When Opinion Is Omitted," and the issuance of the "Codification" (1951).

Statement on Auditing Procedure No. 33 was issued in 1963 as a consolidation of, and a replacement for, the following pronouncements of the Committee on Auditing Procedure: Internal Control (1949), Generally Accepted Auditing Standards (1954), Codification of Statements on Auditing Procedure (1951), and Statements on Auditing Procedure Nos. 25–32, which were issued between 1951 and 1963.

Statement No. 33 was essentially a codification of the substance of the earlier Committee pronouncements which the Committee believed to be of continuing interest to the independent auditor. However, in certain instances, for example, chapter 4, "Adequacy of Planning and the Timing of Field Work," chapter 6, "Evidential Matter," and chapter 11, "Reporting on Subsequent Events," the commentary was expanded and clarified; in chapter 12, "Long-Form Reports," the original Statement (No. 27, July 1957) was strengthened by providing that the independent auditor should clearly establish his position regarding data other than the basic financial statements included in long-form reports; and the paragraph dealing with opinions on prior year's statements in chapter 10 was also strengthened by a recommendation that where prior year financial statements are presented for comparative purposes, and the independent auditor has not made an examination of such financial statements, there should be appropriate disclosure in the financial statements or in this report.

Since the issuance of Statement on Auditing Procedure No. 33, 21 additional Statements on Auditing Procedure, Nos. 34 to 54, have been issued by the Committee on Auditing Procedure. Some of these Statements have superseded portions or all of SAP No. 33 and subsequent Statements on Auditing Procedure.

While it is not practicable, because of the wide variety 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 required to be observed by the independent auditor as he exercises his judgment in selecting the procedures to be used and in determining the extent to which he will apply such procedures. It is the intent of the American Institute of Certified Public Accountants, through its Auditing Standards Executive Committee, to continue to issue Statements on Auditing Standards (formerly known as Statements on Auditing Procedure). Such statements, covering recommended auditing procedures, represent the opinion of the Committee on the particular matters recited therein. While it is true that circumstances alter cases and that with any important variation in conditions there may also properly be changes in the procedures recommended or in the extent of their application, it is nevertheless the view of the Committee that such pronouncements point the general direction in which conclusions might be expected to lie under circumstances not radically different; while they do not preempt the independent auditor's judgment, they do guide his judgment. The independent auditor should recognize that the exercise of such professional judgment may lead him to perform additional procedures which go beyond those recommended in the Committee's pronouncements.

Appendix B begins on page 2071.

AU Appendix B

List of Statements on Auditing Procedure Nos. 1-54, and Statements on Auditing Standards Issued to Date

Statements on Auditing Procedure

No.	Date Issued	Title
1	Oct. 1939	Extensions of Auditing Procedure
2	Dec. 1939	The Auditor's Opinion on the Basis of a Restricted Examination
3	Feb. 1940	Inventories and Receivables of Department Stores, Instalment Houses, Chain Stores, and Other Retailers
4	March 1941	Clients' Written Representations Regarding Inventories, Liabilities, and Other Matters
5	Feb. 1941	The Revised SEC Rule on "Accountants' Certificates"
6	March 1941	The Revised SEC Rule on "Accountants' Certificates" (continued)
7	March 1941	Contingent Liability under Policies with Mutual Insurance Companies
8	Sept. 1941	Interim Financial Statements and the Auditor's Report Thereon
9	Dec. 1941	Accountants' Reports on Examinations of Securities and Similar Investments under the Investment Company Act
10	June 1942	Auditing under Wartime Conditions
11	Sept. 1942	The Auditor's Opinion on the Basis of a Restricted Examination (No. 2)

Statements on Auditing Procedure (continued)

No.	*Date Issued*	*Title*
12	Oct. 1942	Amendment to Extensions of Auditing Procedure
13	Dec. 1942	The Auditor's Opinion on the Basis of a Restricted Examination (No. 3)—Face-Amount Certificate Companies
14	Dec. 1942	Confirmation of Public Utility Accounts Receivable
15	Dec. 1942	Disclosure of the Effect of Wartime Uncertainties on Financial Statements
16	Dec. 1942	Case Studies on Inventories
17	Dec. 1942	Physical Inventories in Wartime
18	Jan. 1943	Confirmation of Receivables from the Government
19	Nov. 1943	Confirmation of Receivables (Positive and Negative Methods)
20	Dec. 1943	Termination of Fixed Price Supply Contracts
21	July 1944	Wartime Government Regulations
22	May 1945	References to the Independent Accountant in Securities Registrations
23	Dec. 1949	Clarification of Accountant's Report When Opinion is Omitted (Revised)
24	Oct. 1948	Revision in Short-Form Accountant's Report or Certificate
25	Oct. 1954	Events Subsequent to the Date of Financial Statements
26	April 1956	Reporting on Use of "Other Procedures"
27	July 1957	Long-Form Reports
28	Oct. 1957	Special Reports
29	Oct. 1958	Scope of the Independent Auditor's Review of Internal Control
30	Sept. 1960	Responsibilities and Functions of the Independent Auditor in the Examination of Financial Statements

Statements on Auditing Procedure (continued)

No.	Date Issued	Title
31	Oct. 1961	Consistency
32	Sept. 1962	Qualifications and Disclaimers
33	Dec. 1963	Auditing Standards and Procedures (a codification)
34	Sept. 1965	Long-Term Investments
35	Nov. 1965	Letters for Underwriters
36	Aug. 1966	Revision of "Extensions of Auditing Procedure" Relating to Inventories
37	Sept. 1966	Special Report: Public Warehouses—Controls and Auditing Procedures for Goods Held
38	Sept. 1967	Unaudited Financial Statements
39	Sept. 1967	Working Papers
40	Oct. 1968	Reports Following a Pooling of Interests
41	Oct. 1969	Subsequent Discovery of Facts Existing at the Date of Auditor's Report
42	Jan. 1970	Reporting When a Certified Public Accountant Is Not Independent
43	Sept. 1970	Confirmation of Receivables and Observation of Inventories
44	April 1971	Reports Following a Pooling of Interests
45	July 1971	Using the Work and Reports of Other Auditors
46	July 1971	Piecemeal Opinions
47	Sept. 1971	Subsequent Events
48	Oct. 1971	Letters for Underwriters
49	Nov. 1971	Reports on Internal Control
50	Nov. 1971	Reporting on the Statement of Changes in Financial Position
51	July 1972	Long-Term Investments

Statements on Auditing Procedure (continued)

No.	*Date Issued*	*Title*
52	Oct. 1972	Reports on Internal Control Based on Criteria Established by Governmental Agencies
53	Nov. 1972	Reporting on Consistency and Accounting Changes
54	Nov. 1972	The Auditor's Study and Evaluation of Internal Control

Statements on Auditing Standards

			Section
1	Nov. 1972	Codification of Auditing Standards and Procedures	See Appendix C
2	Oct. 1974	Reports on Audited Financial Statements	509
3	Dec. 1974	The Effects of EDP on the Auditor's Study and Evaluation of Internal Control......	321
4	Dec. 1974	Quality Control Considerations for a Firm of Independent Auditors	160
5	July 1975	The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report	411
6	July 1975	Related Party Transactions	335
7	Oct. 1975	Communications Between Predecessor and Successor Auditors	315
8	Dec. 1975	Other Information in Documents Containing Audited Financial Statements	550
9	Dec. 1975	The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination	322
10	Dec. 1975	Limited Review of Interim Financial Information	720
11	Dec. 1975	Using the Work of a Specialist	336
12	Jan. 1976	Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments	337

Statements on Auditing Standards (continued)

Appendix C begins on page 2081.

AU Appendix C

Sources of Sections in Current Text

Section	*Contents*	*Source*
100	**Introduction**	
110	Responsibilities and Functions of the Independent Auditor	33:1:1-9
150	Generally Accepted Auditing Standards	33:2:1-6
	Examination of Interim Financial Statements	33:4:12 (in part)
160	Quality Control Considerations for a Firm of Independent Auditors	SAS 4
200	**The General Standards**	
201	Nature of the General Standards	33:3:1 (in part)
210	Training and Proficiency of the Independent Auditor	33:3:1 (in part) 33:3:2-5
220	Independence	33:3:1 (in part) 33:3:6-11
230	Due Care in the Performance of Work	33:3:1 (in part) 33:3:12-14
300	**The Standards of Field Work**	
310	Adequacy of Planning and the Timing of Field Work	33:4:1-2
	Appointment of the Independent Auditor	33:4:3-4
	Appointment of Auditor Near or After the Year-End Date	33:4:11
	Timing of Audit Work	33:4:5-10
315	Communications Between Predecessor and Successor Auditors	SAS 7
320	The Auditor's Study and Evaluation of Internal Control	54:—:1-5
	Purpose of Auditor's Study and Evaluation	54:—:6-8
	Definitions and Basic Concepts	54:—:9-34 49:—:8 54:—:35-48
	Study of System	54:—:49-63
	Evaluation of System	54:—:64-68

Section	*Contents*	*Source*
420	Consistency of Application of Generally Accepted Accounting Principles	
	Changes Not Affecting Consistency	53:—:13-15 50:—:4-5 53:—:16-18
	Periods to Which the Consistency Standard Relates	53:—:19
	Consistency Expression	53:—:20
430	Adequacy of Informative Disclosure	33:9:1-6
500	**The Fourth Standard of Reporting**	
509	Reports on Audited Financial Statements	SAS 2
516	Unaudited Financial Statements	38:—:1-12 50:—:9
517	Reporting When a Certified Public Accountant Is Not Independent	42:—:1-6
518	Negative Assurance	33:10:19-21
519	Reports on a Limited Review of Interim Financial Information	SAS 13
530	Dating of the Independent Auditor's Report	47:—:13-14
	Events Occurring After Completion of Field Work but Before Issuance of Report	47:—:15-17
	Reissuance of the Independent Auditor's Report	47:—:18-20
542	Other Conditions Which Preclude the Application of Necessary Auditing Procedures	
	Receivables and Inventories	43:—:15-20
	Long-Term Investments	51:—:16
543	Part of Examination Made by Other Independent Auditors	45:—:1-13 51:—:5a(ii) 45:—:14-17
544	Lack of Conformity With Generally Accepted Accounting Principles	33:10:37-40
545	Inadequate Disclosure	33:10:41-43
	Omission of Statement of Changes in Financial Position	50:—:7-8
546	Reporting on Inconsistency	
	Change in Accounting Principle	53:—:24-26
	Reporting on Changes in Accounting Principle That Are Not in Conformity With Generally Accepted Accounting Principles	53:—:27-34

Section	Contents	Source
546	Reporting on Inconsistency	
	Reports Following a Pooling of Interests	44:—:1-2
	First Examinations	53:—:21-23
	Pro Forma Effects of Accounting Changes	53:—:35
550	Other Information in Documents Containing Audited Financial Statements	SAS 8
560	Subsequent Events	47:—:1-12
561	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report	41:—:2-11
600	**Other Types of Reports**	
610	Long-Form Reports	33:12:1-6
620	Special Reports	33:13:1-11
630	Letters for Underwriters	48:—:1-44
640	Reports on Internal Control	49:—:1-2 49:—:15-33
641	Reports on Internal Control Based on Criteria Established by Governmental Agencies	52:—:1-6
700	**Special Topics**	
710	Filings Under Federal Securities Statutes	33:1:10-16 47:—:21
	Subsequent Events Procedures in 1933 Act Filings	47:—:22-25
720	Limited Review of Interim Financial Information	SAS 10
900	**Special Reports of the Committee on Auditing Procedure**	
901	Public Warehouses—Controls and Auditing Procedures for Goods Held	37

Appendix D begins on page 2091.

AU Appendix D

Cross-Reference Table for Auditing Interpretations

(Sections of the text are cross-referenced to Auditing Interpretations)

Section	*Interpretation Subject (Interpretation No.)*	*Interpretation Section*
150.02	Auditor's Identification with Condensed Financial Data (No. 5)	9516.17-.20
220.04	Applicability of Guidance on Reporting When Not Independent (No. 1)	9517.01-.04
310.05	Evidence for Interim Information (No. 1)	9330.01-.05
310.05	Evidence for Inventories at Interim Dates (No. 1)	9331.01-.05
310.06	Evidence for Interim Information (No. 1)	9330.01-.05
310.06	Evidence for Inventories at Interim Dates (No. 1)	9331.01-.05
330.09	Evidence for Interim Information (No. 1)	9330.01-.05
330.09	Evidence for Inventories at Interim Dates (No. 1)	9331.01-.05
331.09	Evidence for Inventories at Interim Dates (No. 1)	9331.01-.05
331.09	Alternative Procedures for Observation of Physical Inventories (No. 1)	9509.01-.06
331.10	Evidence for Inventories at Interim Dates (No. 1)	9331.01-.05
331.10	Alternative Procedures for Observation of Physical Inventories (No. 1)	9509.01-.06
331.11	Alternative Procedures for Observation of Physical Inventories (No. 1)	9509.01-.06
331.12	Alternative Procedures for Observation of Physical Inventories (No. 1)	9509.01-.06
331.13	Evidence for Inventories at Interim Dates (No. 1)	9331.01-.05
335.02	Immediate Family (No. 3)	9335.10-.11
335.04	Disclosure of Commonly Controlled Parties (No. 2)	9335.06-.09
335.16	Evaluating the Adequacy of Disclosure of Related Party Transactions (No. 1)	9335.01-.05
335.17	Evaluating the Adequacy of Disclosure of Related Party Transactions (No. 1)	9335.01-.05
411.04	Accounting Principles Recommended by Trade Associations (No. 1)	9410.01-.03

Section	*Interpretation Subject (Interpretation No.)*	*Interpretation Section*
411.06	Accounting Principles Recommended by Trade Associations (No. 1)	9410.01-.03
411.08	Effect on the Auditor's Opinion of FASB Statement on Research and Development Costs (No. 2)	9410.04-.12
420.02	Reporting on Consistency and Extraordinary Items (No. 1)	9420.01-.10
420.02	Consistency of Interim and Annual Information (No. 2)	9420.11-.15
420.05	Impact on the Auditor's Report of FIFO to LIFO Change in the Earliest Year Reported on (No. 3)	9420.16-.23
420.14	Reporting on Consistency and Extraordinary Items (No. 1)	9420.01-.10
420.17	Reporting on Consistency and Extraordinary Items (No. 1)	9420.01-.10
420.20	Impact on the Auditor's Report of FIFO to LIFO Change in the Earliest Year Reported on (No. 3)	9420.16-.23
509.12	Alternative Procedures for Observation of Physical Inventories (No. 1)	9509.01-.06
509.17	Effect on the Auditor's Opinion of FASB Statement on Research and Development Costs (No. 2)	9410.04-.12
509.21	Effect on the Auditor's Opinion of FASB Statement on Research and Development Costs (No. 2)	9410.04-.12
509.22	Reporting on Loss Contingencies (No. 3)	9509.11-.14
509.24	Reporting on Loss Contingencies (No. 3)	9509.11-.14
509.27	Effect on the Auditor's Opinion of FASB Statement on Research and Development Costs (No. 2)	9410.04-.12
509.49	Reporting on Comparative Financial Statements of Nonprofit Organizations (No. 2)	9509.07-.10
516.03	Unaudited Financial Statements in Listing Applications-I (No. 3)	9516.10-.14
516.03	Unaudited Financial Statements in Listing Applications-II (No. 4)	9516.15-.16
516.03	Auditor's Identification with Condensed Financial Data (No. 5)	9516.17-.20
516.05	Disclosures in Internal Use Unaudited Statements (No. 1)	9516.01-.03
516.06	Disclosures in Internal Use Unaudited Statements (No. 1)	9516.01-.03

Section	*Interpretation Subject (Interpretation No.)*	*Interpretation Section*
516.07	Unaudited Financial Statements in Listing Applications-I (No.3)	9516.10-.14
516.11	Unaudited Financial Statements in Listing Applications-I (No. 3)	9516.10-.14
516.12	Unaudited Financial Statements in Listing Applications-I (No. 3)	9516.10-.14
517.01	Applicability of Guidance on Reporting When Not Independent (No. 1)	9517.01-.04
517.04	Applicability of Guidance on Reporting When Not Independent (No. 1)	9517.01-.04
544.02	Auditors' Reports Solely for Purposes of Filing with Insurance Regulatory Agencies (No. 1)	9544.01-.09
545.01	Effect on the Auditor's Opinion of FASB Statement on Research and Development Costs (No. 2)	9410.04-.12
546.03	Impact on the Auditor's Report of FIFO to LIFO Change in the Earliest Year Reported on (No. 3)	9420.16-.23
560.05	Effect on the Auditor's Opinion of FASB Statement on Research and Development Costs (No. 2)	9410.04-.12
640.11	Pre-Award Surveys (No. 1)	9641.01-.03
640.12	Explanatory Paragraphs (No. 2)	9640.04-.05
640.19	Scope of Special Study (No. 1)	9640.01-.03
640.20	Scope of Special Study (No. 1)	9640.01-.03
641.03	Knowledge of Other Weaknesses (No. 4)	9641.08-.10
710.09	Unaudited Financial Statements in Listing Applications-I (No. 3)	9516.10-.14

Appendix E begins on page 2101.

AU Appendix E

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Appendix F begins on page 2111.

AU Appendix F

Schedule of Changes in Statements on Auditing Standards

Section	*Par.*	*Changes*	*Date of Change*
210	.05	Amended by SAS 5	July, 1975
320	.33	Amended by SAS 3	December, 1974
320	.74	Superseded by SAS 9	December, 1975
331	.16	Amended by SAS 2	December, 1974
332	.16	Amended by SAS 2	December, 1974
410	.03–.04	Superseded by SAS 5	July, 1975
509	.18	Amended by SAS 5	July, 1975
510		Superseded by SAS 2	December, 1974
511		Superseded by SAS 2	December, 1974
512		Superseded by SAS 2	December, 1974
513		Superseded by SAS 2	December, 1974
514		Superseded by SAS 2	December, 1974
515		Superseded by SAS 2	December, 1974
516	.02	Amended by SAS 2	December, 1974
516	.09	Amended by SAS 13	May, 1976
516	.11	Amended by SAS 2	December, 1974
535		Superseded by SAS 2	December, 1974
540		Superseded by SAS 2	December, 1974
541		Superseded by SAS 2	December, 1974
542	.01–.04	Superseded by SAS 2	December, 1974
543	.18	Superseded by SAS 7	November, 1975
544	.01	Superseded by SAS 2	December, 1974
544	.02	Amended by SAS 2	December, 1974
546	.17	Amended by SAS 2	December, 1974
547		Superseded by SAS 2	December, 1974
560	.12d	Amended by SAS 12	January, 1976
720	.22	Amended by SAS 13	May, 1976

AU TOPICAL INDEX

References are to AU section and paragraph numbers.