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Statements on Auditing Procedure

No. 25

October 1954

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Committee on Auditing Procedure,
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Events Subsequent to the Date of Financial Statements

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

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

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

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

T H E P R O B L E M

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

C O N C L U S I O N

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

- (a) certain steps which ordinarily are carried out after the balance-sheet date (such as cash cut-offs, review of subsequent collections, confirmation follow-ups, etc.), and
- (b) certain general procedures which are designed to support an informed opinion on the financial statements (such as reading available minutes and interim reports, discussions with management, etc.) which normally are continued throughout the auditor's examination.

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

TYPES OF 'SUBSEQUENT' EVENTS OR TRANSACTIONS

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

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

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

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

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

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

CLIENT'S PRIMARY RESPONSIBILITY FOR FINANCIAL STATEMENTS

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

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

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

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

THE AUDITOR'S RESPONSIBILITY FOR REPORTING

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

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

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

- (a) To see that they are properly considered and, when deemed appropriate, given effect by adjustment or annotation of the statements; or
- (b) If, in his opinion, there is, in the financial statements, significant lack of compliance with any of the points covered in (a) above, to qualify his report or present therein appropriate information, depending upon the circumstances.

**AUDITING PROCEDURES WHICH EXTEND
INTO THE SUBSEQUENT PERIOD**

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

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

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

DETERMINATION OF THE 'SUBSEQUENT PERIOD'

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

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

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

SPECIAL SITUATIONS

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

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

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

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

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

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

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

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

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

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

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

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

**SPECIAL REQUIREMENTS UNDER
SECURITIES ACT OF 1933**

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

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

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

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

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

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

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

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

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

- 1) The reading of available minutes of meetings of stockholders, directors, and finance or executive committees, as applicable.
- 2) Reading of such available interim financial statements as are regularly prepared by the client.
- 3) The reading of the full text of the prospectus and review of pertinent portions of the rest of the registration statement.
- 4) Inquiry of one or more officers or key employees and of legal

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

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

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

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

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

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

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

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