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Qualifications and disclaimers (clarification of reporting standards); Statements on auditing procedure, No. 32

American Institute of Accountants. Committee on Auditing Procedure

Statements on Auditing Procedure

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Qualifications and Disclaimers

(Clarification of Reporting Standards)

When an independent auditor's name is associated with financial statements which purport to present financial position and results of operations, generally accepted auditing standards (the fourth standard of reporting) require him to express an opinion on the financial statements taken as a whole or, if an opinion is not being expressed, to state that he is unable to express an opinion and to give his reasons.

Rule 2.03 of the Institute's Code of Professional Ethics requires compliance with the fourth standard of reporting when it states:

> A member or associate shall not permit his name to be associated with statements purporting to show financial position or results of operations in such a manner as to imply that he is acting as an independent public accountant unless he shall: (a) express an unqualified opinion, or (b) express a qualified opinion, or (c) disclaim an opinion on the statements taken as a whole and indicate clearly his reasons therefor, or (d) when unaudited financial statements are presented on his stationery without his comments, disclose prominently on each page of the financial statements that they were not audited.

The committee considers it desirable to clarify the application of this standard and rule and to provide suggestions whereby the independent auditor, in the exercise of his judgment, may assure himself that his opinions on financial statements will be clearly and unequivocally expressed or, in the absence of an opinion, that the degree of responsibility being taken will be clearly indicated.[1]

[1] This statement is not intended to supersede Statements on Auditing Procedure No. 28, "Special Reports."

Objective of the Fourth Reporting Standard

1. The objective of the fourth reporting standard is to prevent misinterpretation of the degree of responsibility the independent auditor is assuming whenever his name is associated with financial statements. The standard requires the independent auditor to include in his report, in all cases, a clear indication of the character of his examination, if any, and the degree of responsibility that he is assuming in the light of the scope of examination described. This requires him:

(1) to express an opinion regarding the financial statements taken as a whole; or
(2) to state that an opinion is not being expressed, and to give the reasons why an opinion cannot be expressed; or
(3) when unaudited financial statements are presented on his stationery, without his comments, to disclose prominently on each page of the financial statements that they are unaudited.

2. In considering the degree of responsibility he is assuming, the independent auditor must bear in mind that justification for the expression of his opinion, whether qualified or unqualified, rests on the degree to which the scope of his examination conforms with generally accepted auditing standards.

3. Although the fourth reporting standard states that "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," the committee believes that this standard does not preclude the expression of separate opinions on financial position and results of operations. The independent auditor may also express an unqualified opinion on one of the financial statements and disclaim an opinion or express a qualified or an adverse opinion on the others (see paragraph 28).

Unqualified Opinion

4. An unqualified opinion that financial statements present fairly financial position and results of operations may be expressed only when the independent auditor has formed the opinion, on the basis of an examination made in accordance with generally accepted auditing standards, that the presentation conforms with generally accepted accounting principles applied on a consistent basis and includes all informative disclosures necessary to make the statements not misleading.

Qualified Opinion

5. Qualified opinions were given recognition in the publication *Generally Accepted Auditing Standards,* 1954, on page 47, as follows:

> . . . Thus, when an unqualified opinion cannot be expressed, the accountant must weigh the qualifications or exceptions to determine their significance. If they are not such as to negative the opinion, a properly qualified opinion would be satisfactory.

6. When a qualified opinion is intended, the opinion paragraph of the standard short-form report should be modified in a way that makes clear the nature of the qualification. It should refer specifically to the subject of the qualification and should give a clear explanation of the reasons for the qualification and of the effect on financial position and results of operations, if reasonably determinable. Reference in the opinion paragraph to a note to the financial statements or to a preceding paragraph in the report that describes the circumstances is an acceptable method of clarifying the nature of a qualification. However, a qualification based upon the scope of the examination ordinarily should be covered entirely in the independent auditor's report. When a qualification is so material as to negative an expression of opinion as to the fairness of the financial statements as a whole, either a disclaimer of opinion or an adverse opinion is required.

7. The committee recommends the use of phrases that include either "except" or "exception" in qualified opinions on financial statements. However, in certain cases where the outcome of a matter is uncertain the phrase "subject to" may be appropriate (see paragraphs 29, 44 and 45). The committee believes that phrases such as "with the foregoing explanation" are generally not clear or forceful enough for a qualification and should not be used to qualify an opinion.

8. Any modifying phrases in the standard short-form opinion paragraph (or sentence) should be considered as qualifying the opinion in some manner; however, reference to the report of other independent auditors as the basis, in part, of the opinion, whether made in the scope paragraph or the opinion paragraph, is not to be construed as a qualification of the opinion on the fairness of presentation of the consolidated financial statements or consistency, but rather as an indication of the divided responsibility for the performance of the work (see paragraphs 31-35).

Adverse Opinion

9. An adverse opinion is an opinion that the financial statements do not present fairly the financial position or results of operations in conformity with generally accepted accounting principles.

10. *Generally Accepted Auditing Standards*, 1954, on page 48, gives recognition to adverse opinions as follows:

> . . . It is possible that cases may occur where the accountant's exceptions as to practices followed by the client are of such significance that he may have reached a definite conclusion that the financial statements do not fairly present the financial position or results of operations. In such cases, he should be satisfied that his report clearly indicates his disagreement with the statements presented.

In addition, the Code of Professional Ethics, Rule 2.02 (a) and (b) states:

> In expressing an opinion on representations in financial statements which he has examined, a member or associate may be held guilty of an act discreditable to the profession if . . . he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading, or . . . he fails to report any material misstatement known to him to appear in the financial statements. . . .

11. An adverse opinion is required in any report where the exceptions as to fairness of presentation are so material that in the independent auditor's judgment a qualified opinion is not justified. In such circumstances a disclaimer of opinion *is not* considered appropriate since the independent auditor has sufficient information to form an opinion that the financial statements are not fairly presented.

12. Whenever the independent auditor issues an adverse opinion, he should disclose *all* the substantive reasons therefor, usually by referring to a middle paragraph of his report describing the circumstances (see paragraph 37).

Disclaimer of Opinion

13. When he has not examined sufficient competent evidential matter to form an opinion on the fairness of presentation of the financial statements as a whole, the independent auditor should state in his report that

he is unable to express an opinion on such statements. The necessity of disclaiming an opinion may arise either from a serious limitation on the scope of examination or from the existence of unusual uncertainties concerning the amount of an item or the outcome of a matter materially affecting financial position or results of operations, causing the independent auditor not to be able to form an opinion on the financial statements as a whole.

14. With respect to significant scope limitations, he may recite the procedures followed (in which case the standard short-form scope paragraph should not be used) or the procedures omitted. In either case, he should state clearly that the scope of examination was not adequate to warrant the expression of an opinion on the financial statements taken as a whole.

15. Whenever the independent auditor disclaims an opinion, he should give *all* substantive reasons for doing so. For example, when he disclaims an opinion because the scope of examination was inadequate, he should also disclose any reservations or exceptions he may have regarding fairness of presentation.

Unaudited Statements

16. When no audit has been performed, or the auditing procedures performed are insignificant in the circumstances, any financial statements with which the independent auditor is in any way associated should be clearly and conspicuously marked on each page as unaudited, whether accompanied by his comments or not. The committee believes it preferable that a disclaimer of opinion accompany all such statements; when they are accompanied by comments, the independent auditor *must* issue a disclaimer of opinion. Such a disclaimer of opinion may read as follows:

> The accompanying balance sheet as of November 30, 19.... and the related statements of income and retained earnings for the year then ended were not audited by us and we express no opinion on them.

Phrases which may cause the reader to believe an examination or review of any type was made should be avoided in any such disclaimer.

17. The independent auditor should refuse to be associated in any way with unaudited financial statements which he believes are false or misleading.[2]

[2] See Opinion No. 8 of the committee on professional ethics.

Negative Assurance

18. 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)."

19. 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. These letters usually state specifically that no audit has been made of such statements and data, and distribution of the letters is restricted to parties to the underwriting agreement.

20. In situations involving special reports covering data which do not purport to present financial position or results of operations, negative assurances may be given provided the auditing procedures followed are appropriate and reasonable in the circumstances and the scope of the examination is described in the report.[3]

Piecemeal Opinions

21. *Generally Accepted Auditing Standards,* 1954, pages 47 and 48, refers to limited or piecemeal opinions as follows:

> . . . To the extent the scope of his examination and the findings thereof justify, he may also comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an opinion on the over-all fairness of the financial statements. . . .
>
> In some cases of extensive exceptions, where an over-all opinion has been disclaimed, it may be possible to express an opinion limited to the items in the financial statements with which the accountant is satisfied. When that is done, however, the report must make clear that no over-all opinion as to position or operating results is intended and the accountant should be careful to indicate clearly the limitation of such comments to the individual items in the financial statements.

22. Thus, it seems clear that the independent auditor may issue a piecemeal opinion only when, in his judgment, the scope of his examination and his findings justify it, and then only if it is accompanied by a

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[3] *See paragraphs 6 and 15 of Statements on Auditing Procedure No. 28, "Special Reports."*

disclaimer of opinion or adverse opinion with respect to the financial statement(s) taken as a whole. Moreover, the piecemeal opinion should not overshadow or appear to contradict the disclaimer of opinion or adverse opinion; otherwise it may result in a misleading inference regarding the financial statements taken as a whole.

23. A piecemeal opinion may name the accounts covered by the opinion, or may name those accounts which are excluded and designate the accounts which are covered with an expression such as "all the other accounts." The interrelationship of the accounts affected should be carefully considered by the independent auditor if the latter approach is used. For example, when an opinion is disclaimed because the taking of the closing inventory has not been observed, it would ordinarily be improper for the independent auditor to use the expression "all the other accounts," thereby covering in his piecemeal opinion cost of sales, gross profit, profit before taxes, taxes, net profit, accrued income taxes, retained earnings, and, perhaps, accounts payable. In such cases, a listing of the accounts that are covered by the piecemeal opinion would be preferable.

24. The independent auditor should realize that the expression of a piecemeal opinion with respect to individual items included in a financial statement may require a more extensive examination of such items than would be required if he were expressing an opinion on the financial statements as a whole.

Circumstances Which Require a Departure From the Standard Short-Form Report

25. The usual circumstances which may require the independent auditor to deviate from the standard short-form report on financial statements are as follows:

A. The scope of his examination is limited or affected:
   (1) By conditions which preclude the application of auditing procedures considered necessary in the circumstances.
   (2) By restrictions imposed by clients.
   (3) Because part of the examination has been made by other independent auditors.

B. The financial statements do not present fairly financial position or results of operations because of:
   (1) Lack of conformity with generally accepted accounting principles.
   (2) Inadequate disclosure.

C. Accounting principles are not consistently applied.

D. Unusual uncertainties exist concerning future developments, the effects of which cannot be reasonably estimated or otherwise resolved satisfactorily.

These circumstances are discussed below.

SCOPE OF EXAMINATION

Conditions Which Preclude the Application of Necessary Auditing Procedures

26. Circumstances may at times make it impracticable or impossible for the independent auditor to follow certain customary auditing procedures. When this occurs, the independent auditor may be able to satisfy himself by the application of other auditing procedures. If he is able to do so there is, in effect, no limitation on the scope of the examination and reference to alternative procedures is not required, except in those cases where confirmation of receivables or observation of the taking of inventories has been omitted with respect to the latest balance sheet.[4] In these two cases the independent auditor should refer in the scope paragraph to the omission of customary procedures even when he is able to satisfy himself by the application of other auditing procedures. In any event, where he has been able to satisfy himself by other procedures he should not refer to them in the opinion paragraph of his report.

27. Where he is unable to satisfy himself by the application of other auditing procedures, the independent auditor should indicate clearly in the scope (or middle) paragraph the limitations on his work and, depending on the materiality of the amounts involved, he should either qualify his opinion or disclaim an opinion on the financial statements taken as a whole.

28. An illustration follows:

(Scope paragraph)
We have examined the balance sheet of XYZ Company as of September 30, 1962, 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 ac-

[4] It should be noted that the omission of observation of the taking of opening inventories is not required to be disclosed in situations where the independent auditor has satisfied himself with respect to such inventories by other auditing procedures. (See Codification of Statements on Auditing Procedures, page 21). However, he may wish to disclose the circumstances of the engagement and briefly describe the other procedures.

cordingly 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, 1961, we were not present to observe the physical inventory taken at that date and we have not been able to satisfy ourselves concerning inventory quantities by other procedures. The beginning inventory has a significant effect on the results of operations for the year. Therefore, we do not express an opinion on the accompanying statements of income and retained earnings for the year ended September 30, 1962.

(Opinion paragraph)
In our opinion, the accompanying balance sheet presents fairly the financial position of the Company at September 30, 1962, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(*Note*: It is assumed that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles.)

Restrictions Imposed by Clients

29. When a qualified opinion is expressed because the scope of the examination was restricted, the qualification should relate to the items in the statements on which an opinion cannot be expressed, rather than to the restriction, as such. For example, the report may read:

(Scope paragraph)
. . .and such other auditing procedures as we considered necessary in the circumstances, except as noted in the following paragraph.

(Middle paragraph)
In accordance with your instructions, we did not request any owners to confirm their balances of accumulated storage charges. Accordingly, we do not express an opinion as to accumulated storage charges, stated as $......, which amount enters into the determination of financial position and results of operations.

(Opinion paragraph)
In our opinion, with the exception stated in the preceding paragraph, the accompanying . . .

Such wording would appear to be preferable to "Except for the abovementioned limitation on the scope of our examination, in our opinion . . ." which bases the exception not on a possible material effect but on the restriction. The committee recognizes that uncertainties are present when limitations on the scope of the examination have been imposed, but it believes such uncertainties are not of the nature and type which permit the use of "subject to" in qualifying the opinion (see paragraph 7).

30. Restrictions imposed by clients on the scope of the examination most commonly concern the omission of the observation of inventory taking or the confirmation of receivables by direct communication. Generally, in such cases when inventories or receivables are material the independent auditor should disclaim an opinion on the financial statements taken as a whole (see paragraphs 14 and 15). An illustration follows:

> (Scope paragraph)
> . . . and such other auditing procedures as we considered necessary in the circumstances, except as noted in the following paragraph.
>
> (Middle paragraph)
> In accordance with your instructions we were not in attendance at the taking of the physical inventory as of November 30, 19. . . . Accordingly, we do not express any opinion concerning such inventory stated at $. . . . .
>
> (Opinion paragraph)
> Because the inventory at November 30, 19. . . . enters materially into the determination of financial position and results of operations, we do not express an opinion on the accompanying financial statements taken as a whole.

Part of the Examination Made by Other Independent Auditors

31. In reporting on financial statements, the independent auditor may not have examined the financial statements of one or more subsidiaries, divisions, or branches included therein, but he may have received the reports of other independent auditors with respect to such statements. Similar situations are often present in the case of business combinations. In these situations, questions arise as to the extent of the responsibility of the independent auditor reporting on the consolidated or combined statements with regard to such reports of other auditors and the financial statements covered thereby. In such cases, the principal auditor is usually willing (after following certain procedures described later) to utilize the report of the other independent auditor for the purpose of expressing his opinion on the consolidated or combined statements, but

he is unwilling (unless he otherwise states[5]) to assume responsibility for the performance of the work (to the same extent as though he had performed that work himself) which served as a basis for the opinion of the other auditor. The committee considers such utilization reasonable in these circumstances (and in accordance with generally accepted auditing standards) and believes that the principal auditor may appropriately express an unqualified opinion on the fairness of the consolidated or combined statements without assuming responsibility for the report or work of the other independent auditor, provided the basis for his opinion is adequately described. This description should include a statement in the scope paragraph or in the opinion paragraph to the effect that in the formation of his opinion, amounts applicable to the entities examined by the other independent auditor were included solely upon the basis of the report of such other auditor (see paragraph 8).

32. Before he utilizes the report of another independent auditor for this purpose, the principal auditor should make such inquiries or adopt such measures as, in his judgment, are appropriate to satisfy himself as to the independence and professional reputation of the other auditor. If the other independent auditor's primary place of practice is outside of the United States, the principal auditor should also satisfy himself that the other auditor is familiar with, and will report in accordance with, auditing standards and accounting principles generally accepted in the United States. He should also take whatever action he deems essential to assure the necessary coordination of his activities with those of the other independent auditor to achieve a proper review of the matters affecting consolidation of the financial statements, such as arrangements for evaluating the company's elimination of intercompany transactions, uniformity of accounting practices, etc. In some cases he may need to issue instructions to, or make periodic visits with, the other independent auditor. Despite the foregoing, the other independent auditor remains responsible for the performance of his own work and for his opinion, and the principal auditor assumes no responsibility in this connection except for the matters heretofore discussed in this paragraph.

33. The following language is considered appropriate where the principal auditor is utilizing the reports of other independent auditors:

We have examined the consolidated balance sheet of X Com-

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[5] However, as to filings with the Securities and Exchange Commission, Rule 2-05 of Regulations S-X states: "If, with respect to the certification of the financial statements of any person, the principal accountant relies on an examination made by another independent public accountant of certain of the accounts of such person or its subsidiaries, the certificates of such other accountant shall be filed . . . ; however, the certificate of such other accountant need not be filed (a) if no reference is made directly or indirectly to such other accountant's examination in the principal accountant's certificate, or (b) if, having referred to such other accountant's examination, the principal accountant states in his certificate that he assumes responsibility for such other accountant's examination in the same manner as if it had been made by him."

> pany and subsidiaries as of November 30, 19.... and the consolidated statements of income and retained earnings for the year then ended.[6] Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of B Company, a consolidated subsidiary, which statements were examined by other certified public accountants whose report thereon has been furnished to us. Our opinion expressed herein, insofar as it relates to the amounts included for B Company, is based solely upon such report.
>
> In our opinion, the accompanying consolidated financial statements present fairly . . .

As an alternative, reference to the report of the other independent auditor as the basis, in part, for the opinion expressed may be placed in the opinion paragraph rather than in the last sentence of the scope paragraph. An illustration follows:

> (Opinion paragraph)
>
> In our opinion, based upon our examination and the aforementioned report of other certified public accountants, the accompanying consolidated financial statements present fairly . . .

34. If the principal auditor is unwilling to utilize the report of the other independent auditor in these cases, he should appropriately qualify or disclaim his opinion on the fair presentation of the consolidated financial statements (disclosing the percentages of consolidated assets and revenues which are qualified[7]) and give his reasons. The use of "except for" is recommended when the intention is to qualify the opinion.

35. In some instances the principal auditor may be willing to assume responsibility for the work of another auditor to the same extent as though he had performed the work himself. This would usually be the case when:

(a) The principal auditor has engaged the other auditor as his agent; or
(b) The other independent auditor is an affiliated or correspondent firm whose work is usually accepted by the principal auditor; or
(c) The principal auditor has made sufficient review of the other auditor's work to justify accepting full responsibility; or
(d) The amounts are immaterial.

When the principal auditor assumes responsibility for such work, he need make no reference to the other independent auditor in either the scope or opinion paragraph of his report. If reference is made, he should state that he is assuming responsibility for such work.

[6] The auditor may prefer to modify the introductory sentence to the effect that he has not examined the financial statements of B Company.

[7] The committee sees no need to make this disclosure if a qualification is not intended. Some independent auditors may, however, prefer to make this disclosure in all cases.

FAIRNESS OF PRESENTATION

Lack of Conformity with Generally Accepted Accounting Principles

36. Whenever financial statements deviate materially from generally accepted accounting principles, the issuance of a qualified opinion or an adverse opinion is required by the first reporting standard.

37. When the independent auditor believes the presentation of a material item to be at variance with generally accepted accounting principles, he should qualify his opinion or, if he regards the effect of such variance as sufficiently material, express an adverse opinion. The basis for the qualified or adverse opinion should be clearly stated. Illustrations follow:

> Although the proceeds of sales are collectible on the installment basis over a five-year period, revenue from such sales is recorded in full by the Company at time of sale. However, for income tax purposes, income is reported only as collections are received and no provision has been made for income taxes on installments to be collected in the future, as required by generally accepted accounting principles. If such provisions had been made, net income for 1961 and retained earnings as of December 31, 1961 would have been reduced by approximately \$........ and \$........, respectively, and the balance sheet would have included a liability for deferred income taxes of approximately \$........
>
> *Qualified Opinion*
>
> In our opinion, except that provision has not been made for additional income taxes as described in the foregoing paragraph, the accompanying financial statements present fairly . . .
>
> *Adverse Opinion*
>
> Because of the materiality of the amounts of omitted income taxes as described in the preceding paragraph, we are of the opinion that the financial statements do not present fairly the financial position of X Company at December 31, 1961 or the results of its operations for the year then ended in conformity with generally accepted accounting principles.

Regulated Companies

38. In the past, in the absence of a clear statement on the subject by this committee, there has been a question concerning the applicability of the first reporting standard to an independent auditor's opinion on published financial statements of companies whose accounting practices are prescribed by governmental regulatory authorities or commissions.[8] Such companies include public utilities, common carriers,

[8] See paragraph 4, Statements on Auditing Procedure No. 28, "Special Reports."

insurance companies, financial institutions, and the like. 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 such regulated companies.[9] 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 adverse opinion on such statements. However, an adverse opinion may be accompanied by a piecemeal opinion on the unaffected items in the statements or on any supplementary data furnished which are fairly presented in conformity with generally accepted accounting principles.

39. 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. The committee sees 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.

Inadequate Disclosure

40. Information essential for a fair presentation 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 data considered essential to a fair presentation 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.

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[9] It should be recognized, however, that appropriate differences exist with respect to the application of generally accepted accounting principles as between regulated and non-regulated businesses because of the effect in regulated businesses of the rate-making process, a phenomenon not present in non-regulated 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.

41. An illustration of appropriate wording in such instances follows:

(Middle paragraph)
On January 15, 1962, 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, 1961.

(Opinion paragraph)
In our opinion, the accompanying financial statements, except for the omission of the information in the preceding paragraph, present fairly . . .

42. 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.

Lack of Consistency

43. Statements on Auditing Procedure No. 31, *Consistency,* should be referred to in considering the question of qualifications based on lack of consistency in the application of generally accepted accounting principles.

Unusual Uncertainties as to the Effect of Future Developments on Certain Items

44. The management of a company ordinarily is expected to evaluate matters affecting financial position and results of operations. In cases where the probable effects of a matter are not reasonably determinable at the time of the opinion, such as in the case of certain lawsuits, tax matters, and other contingencies which may have a material effect upon the financial statements, and the final outcome is dependent upon the decision of parties other than management, the independent auditor should appropriately qualify his opinion. In such instances use of the phrase "subject to" is appropriate. An example follows:

(Opinion paragraph)
In our opinion, subject to any adjustments to the balance sheet and statement of retained earnings which may result from the final determination of the company's income tax liability for prior years as indicated in Note A to the financial statements, the accompanying financial statements present fairly . . .

NOTE A: The Company is presently contesting deficiencies in consolidated federal income taxes proposed by the Internal Revenue Service for the years 1958 to 1960, inclusive, in the aggregate amount of $........, exclusive of interest. The point in question is one on which there are conflicting federal court decisions and on which further litigation may be required; consequently it is impossible to determine the extent of the Company's liability, if any, at this time. No provision has been made for this contingent liability.

45. Occasionally, uncertainties arising from questions of valuation or realizability of assets dependent upon management's judgment may require a qualification of opinion. In such cases, use of the phrase "subject to" is also considered appropriate. For example:

(Opinion paragraph)
In our opinion, subject to the successful conclusion of X project and the ultimate recovery thereby of the related deferred research and development costs in the amount of $........ described in Note .., the accompanying financial statements . . .

46. In some instances where the outcome of a matter is uncertain, the amount concerned may be so material that a qualified opinion is inappropriate. An example of such a situation would be a case in which the company is a defendant in a suit claiming damages of a very large amount in relation to the company's net assets and there is considerable uncertainty as to the outcome of the suit. In such cases, the facts may be disclosed in a middle paragraph of the independent auditor's report and the disclaimer of opinion may read as follows:

(Opinion paragraph)
Because of the possible material effect on the financial statements of the above-mentioned lawsuit, the outcome of which is uncertain, we do not express any opinion on the company's financial statements taken as a whole.

The statement entitled "Qualifications and Disclaimers (Clarification of Reporting Standards)" was adopted unanimously by the twenty-one members of the committee, of whom seven, Messrs. Armstrong, Comer, Gellein, Halvorson, Luther, Malone and Steres, assented with qualification.

Messrs. Armstrong, Comer, Luther, Malone and Steres qualify their assent to the Statement with respect to paragraph 8 and related portions of paragraphs 31 and 33. Paragraph 8 clearly indicates that reference to the report of other independent auditors as the basis, in part, of the principal auditor's opinion, whether made in the scope paragraph or the opinion paragraph, is not to be construed as a qualification of the opinion on fairness of presentation or consistency of the consolidated financial statements, but rather as an indication of the divided responsibility for the performance of the work. They believe reference to other independent auditors in such situations should be shown only in the scope paragraph or a middle paragraph of the principal auditor's report in order to clearly and unequivocally express an unqualified opinion on the fairness of presentation of the consolidated or combined financial statements. Otherwise, the use of the alternative placement of such reference in the opinion paragraph, permitted by paragraphs 8, 31 and 33, would confuse readers of the auditor's report, who would be inclined to believe that any modifying phrase in the opinion paragraph constituted a qualification of fairness of presentation or consistency.

Mr. Halvorson disagrees with the implied preference in paragraphs 31 and 33 for disclosing reliance on the reports of other auditors in the scope paragraph of the principal auditor's report without mention of such reliance in the opinion paragraph. He believes that such disclosure should always be made in the opinion paragraph, since he believes it to be a qualification, and that to permit its omission will defeat one of the principal objectives of the Statement, which is to "assure . . . that . . . opinions on financial statements will be clearly and unequivocally expressed. . . ."

Messrs. Gellein and Halvorson do not agree with those parts of paragraphs 7, 8 and 42 which proscribe (with one stated exception) the inclusion of explanatory phrases in the opinion paragraph of the standard short-form report. They believe this deprives the independent auditor of an effective means of giving emphasis to important matters not calling for qualification of an opinion. They object further to that part of paragraph 18 which proscribes the use of negative assurance in reports on financial statements. They believe this deprives the independent auditor of an effective means of making it clear that he does not have knowledge of additional pertinent information—that he is not holding anything back. In their view these practices should be circumscribed by definition, explanation, and illustration, but should not be prohibited.

NOTES

Unless otherwise indicated, Statements on Auditing Procedure present the considered opinion of the twenty-one members of the committee on auditing procedure, 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 committee on auditing procedure is the senior technical committee of the Institute designated to express opinions on auditing matters. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the committee's recommendations must be assumed by those who adopt other practices.

COMMITTEE ON AUDITING PROCEDURE (1961-62)