

1970

**Confirmation of receivables and observation of inventories :  
(supersedes paragraphs 16-20 of chapter 6 and paragraphs 27-29  
of chapter 10 of Statement on auditing procedure no. 33, and  
Statement on auditing procedure no. 36); Statement on auditing  
procedure, No. 43**

American Institute of Accountants. Committee on Auditing Procedure

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# STATEMENT ON AUDITING PROCEDURE

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## *Confirmation of Receivables and Observation of Inventories*

(Supersedes paragraphs 16-20 of Chapter 6 and paragraphs 27-29 of Chapter 10 of Statement on Auditing Procedure No. 33, and Statement on Auditing Procedure No. 36)

### **Purposes of This Statement**

1. By vote of the Institute's membership in 1939 confirmation of receivables and observation of inventories were adopted as "generally accepted auditing procedures."<sup>1</sup> The Committee reaffirms the importance of these well-established auditing procedures and emphasizes that 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.

2. The purposes of this Statement are to provide additional guidelines for the independent auditor in confirming receivables and observing inventories and to modify existing reporting requirements.<sup>2</sup> This Statement relates only to confirmation of receivables and observation of inventories and does not deal with

<sup>1</sup> Confirmation of receivables and observation of inventories had been the subject of a report entitled "Extensions of Auditing Procedure" issued by a special committee.

<sup>2</sup> The Executive Committee of the Institute by resolution on April 29-30, 1966 approved "the issuance of statements on auditing procedure which may modify or revise pronouncements on matters of auditing, previously approved by members at annual meetings as consistent with the authority granted to the Committee on Auditing Procedure by the Council."

*Issued by the Committee on Auditing Procedure  
American Institute of Certified Public Accountants*

other important auditing procedures which generally are required for the independent auditor to satisfy himself as to the fair presentation of these assets.

### Receivables

3. 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.

4. 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.

5. 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<sup>3</sup> 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,

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<sup>3</sup> 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.

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.

6. 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.

7. 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.

8. 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 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<sup>4</sup> 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**

9. 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

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<sup>4</sup> See definition of "significant" in footnote 3, p. 80.

measure of reliance which may be placed upon the client's representations about the quantities and physical condition of the inventories.

10. When 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,<sup>5</sup> are reasonable in the circumstances.

12. When the independent auditor has not satisfied himself as to inventories in the possession of the client through the procedures described in paragraphs 9-11, 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 ex-

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<sup>5</sup> See "Relationship of Statistical Sampling to Generally Accepted Auditing Standards, a Special Report by the Committee on Statistical Sampling of the American Institute of Certified Public Accountants," *The Journal of Accountancy*, July 1964.

amination 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.

### **Reporting Requirements**

14. The report entitled "Extensions of Auditing Procedure" and subsequent statements of the Committee on Auditing Procedure have required disclosure in the independent auditor's report of omission of confirmation of receivables or observation of inventories included in the latest balance sheet, even though the auditor satisfied himself by the application of other auditing procedures and issues an unqualified opinion. The Committee has reconsidered the desirability of that reporting requirement, which singles out two customary auditing procedures for special reporting treatment to the exclusion of other customary procedures.

15. The Committee believes that if the independent auditor has been unable to apply the customary auditing procedures of confirming receivables or observing inventories because it was impracticable<sup>6</sup> or impossible to do so but nevertheless has satisfied himself by means of other auditing procedures,<sup>7</sup> it is unlikely that disclosure of that fact in the auditor's report has any significance to the reader. Further, there is a possibility that the disclosure may be misinterpreted by the reader to be a qualification of the auditor's opinion.

16. The Committee, therefore, has concluded that if the independent auditor has been unable to confirm receivables or observe the client's taking of physical inventories solely because

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<sup>6</sup> In auditing, impracticable means "not capable of being done with the available means or with reason or prudence."

<sup>7</sup> As used in paragraphs 15 and 16, "other auditing procedures" with respect to inventories requires observation or some physical counts as specified in paragraph 12 herein.

it was impracticable or impossible to do so but has satisfied himself as to receivables or inventories by means of other auditing procedures,<sup>8</sup> no comment need be made in his report, although he may wish to disclose the circumstances of the engagement and describe the other procedures. The auditor should consider carefully his decision that confirmation of receivables or observation of inventories is impracticable or impossible.

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

18. If either confirmation of receivables or observation of inventories is omitted because of a restriction imposed by the client, and such inventories or receivables are material, the auditor should indicate clearly in the scope paragraph (or in a middle paragraph) the limitations on his work and, generally, should disclaim an opinion on the financial statements taken as a whole.

19. The omission of these procedures at the beginning of the year is not required to be disclosed in situations where the independent auditor has satisfied himself by means of other auditing procedures. Nevertheless, he may wish to disclose the circumstances of the engagement and briefly describe the other procedures.

20. 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, 1970, and the related statements of

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<sup>8</sup> See "other auditing procedures" in footnote 7, p. 83.

income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except as stated in the following paragraph.

(Middle Paragraph)

Because we were not engaged as auditors until after September 30, 1969, we were not present to observe the physical inventory taken at that date and we have not satisfied ourselves by means of other procedures concerning inventory quantities. The amount of the inventory at September 30, 1969 enters materially into the determination of the results of operations for the year ended September 30, 1970. Therefore, we do not express an opinion on the accompanying statements of income and retained earnings for the year ended September 30, 1970.

(Opinion Paragraph)

In our opinion, the accompanying balance sheet presents fairly the financial position of X Company at September 30, 1970, 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.)

*The Statement entitled "Confirmation of Receivables and Observation of Inventories" was adopted unanimously by the twenty-one members of the Committee on Auditing Procedure.*

#### NOTE

*Statements on Auditing Procedure present the considered opinion of the Committee on Auditing Procedure, which is the senior technical committee of the Institute designated to issue pronouncements on auditing matters. Departures from the Committee's recommendations must be justified by those who do not follow them.*

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