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EXTENSIONS
OF
AUDITING PROCEDURE

A Report of
The Special Committee on Auditing Procedure
American Institute of Accountants



*Adopted by the Council of the
American Institute of Accountants
May 9, 1939*

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Extensions of Auditing Procedure

REPORT OF THE SPECIAL COMMITTEE ON AUDITING PROCEDURE AMERICAN INSTITUTE OF ACCOUNTANTS

RESOLVED: That the council of the American Institute of Accountants hereby adopts the report of the special committee on auditing procedure dated May 9, 1939, as a statement of the best practice for the future in regard to the matters dealt with in the report. Be it

FURTHER RESOLVED: That the report be printed and distributed to members of the Institute and others interested.

Adopted May 9, 1939

TO THE COUNCIL OF THE AMERICAN
INSTITUTE OF ACCOUNTANTS:

Gentlemen:

Pursuant to its appointment the special committee on auditing procedure has reviewed certain phases of auditing procedures and related matters. It has taken cognizance of recent discussions regarding such procedures, both within and without the profession, and now submits its report and recommendations relating to the following:

Examination of inventories
Examination of receivables
Appointment of independent certified public accountants
Form of independent certified public accountant's report

Your committee has limited its consideration of auditing procedures and related matters to those cases in which financial statements are accompanied by a report and opinion of an independent certified public accountant. Accordingly, the report which follows should be read in the light of this limitation.

At the outset it is pertinent to state that, since the recent disclosure of conditions existing in exceptional cases, certified public accountants have been considering possible implications which

may arise therefrom in relation to their practice. The committee desires to state its opinion that auditing procedure has kept, and continues to keep, pace with the growth and development of industry and that the well established custom of making test-checks of accounting records and related data and, beyond that, reliance upon the system of internal check and control after investigation of its adequacy and effectiveness, has with very few exceptions proved sufficient for its purpose. Because of public interest and discussion in the press, there is a question now before the profession as to whether its procedures shall be extended. In order to consider the question intelligently there must first be some general understanding of certain fundamentals.

In the performance of his duties as auditor the independent certified public accountant holds himself out as one who is proficient in accounting practice and auditing procedure. The function of the independent certified public accountant is to examine a concern's accounting records and supporting data, in certain matters to obtain outside confirmations, and to require and consider supplementary explanations and information from the management and employees, to the extent necessary to

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enable him to form an opinion as to whether or not the financial statements as submitted present fairly the position and results of periodic operations. Generally speaking, his function is limited to reporting upon situations arising out of business transactions that have taken place in the past. In no sense is he an insurer or guarantor. In offering his opinion, the independent certified public accountant assumes heavy responsibilities. He must be skilled in his professional work and must have made a reasonable examination of the accounts in order to warrant his expression of an opinion. He must state his opinion clearly and unequivocally.

Management itself has the direct responsibility for the maintenance of an adequate and effective system of accounts, for the proper recording of transactions in the books of account and for the safeguarding of the assets of a concern. 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.

In order to qualify himself to carry out his function the independent certified public accountant has completed a rigorous course of professional study and training as a background to the essential practical experience he must obtain, for it is only by study, training, and practical experience that the independent auditor acquires skill in accounting and related matters. In the ordinary course of his day-to-day practice he 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 affairs of a concern because, through his training and experience, he has become not only skilled in accounting and auditing but has acquired the ability and habit of considering dispassionately and independently the facts recorded in books

of account or otherwise disclosed by his examination and because, as a result, his opinion provides reasonable assurance that a fair and adequate presentation of pertinent information has been made in the financial statements.

The independent auditor must also exercise his best judgment in determining the scope of his examination and in deciding whether the interests of stockholders and creditors justify the time and expense involved in the extension of any particular line of inquiry. Experience shows that, with few exceptions, the personnel of business organizations is honest. The discovery of defalcations has not been a primary objective of an examination incident to the issuance of financial statements accompanied by a report and opinion of an independent certified public accountant, although such discovery has frequently resulted. In a well organized concern the principal reliance for the detection of such irregularities is placed upon the maintenance of an adequate system of accounting records with appropriate internal check and control. It is the duty of the independent auditor to satisfy himself that the system of internal check and control is adequate and sufficiently effective to justify reliance thereon. To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises—a cost which would pass all bounds of reasonable expectation of benefit or safeguard therefrom, and place an undue burden on industry.

In carrying out his work the independent certified public accountant must always be on his guard against collusive fraud and be alert in detecting any sign of such collusion. However, on the basis of his examination by tests and checks, he relies upon the integrity of the client's organization unless cir-

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cumstances are such as to arouse suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified.

In the judgment of this committee the independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, and that they conform to generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and if appropriate his reasons for omitting an expression of opinion.

Turning now to consideration of the specific matters referred to at the beginning of this report, it may be noted in passing that, although it has not generally been considered normal procedure, in some cases independent certified public accountants have made physical test-checks of inventory quantities and have confirmed receivables by direct communication with debtors. Such physical tests of inventory, however, have usually been undertaken as an additional procedure under arrangement with the client, while confirmation of receivables by direct communication with debtors has been undertaken where the accountant thought it an essential or desirable step in a particular case or at the request of the client.

Your committee is of the opinion that recognition should be given to the widespread demand for an extension of auditing procedures with regard to inventories and receivables. However, it should be noted that additional expense to business will be involved in the added procedures, and business concerns which do not have them undertaken must recognize the necessity of disclosure of their omission.

INVENTORIES

The added steps that may well be taken to give greater assurance with regard to inventory quantities will vary in different circumstances but, however extensive these may be, the training and experience of an independent certified public accountant do not qualify him as a general appraiser, valuer, or expert in materials. The public should understand that, while he can take steps to warrant the expression of his opinion as an accountant that stated quantities of merchandise are actually on hand, such procedure does not invest his opinion with a degree of authority which he does not claim for it, or impose upon him a measure of responsibility which the nature of his work does not justify.

Your committee believes that corroboration of inventory quantities by physical tests should be accepted as normal audit procedure. The manner and extent thereof will necessarily vary with the circumstances, because the independent auditor is justified in giving consideration to the effectiveness of the internal check and control as applied to book records and to the procedure of taking physical inventories.

In cases where the inventory is determined solely by means of a physical count at the end of the accounting period it will be necessary for the test-checks of quantities to be made at that time. In some cases it may be practicable and satisfactory for the independent auditor to be present at the time of taking the inventory to see that a method, carefully thought out and established, and providing adequate internal check and control, is in fact being followed. Another plan which would be satisfactory where the circumstances permitted would be for the auditor to encourage throughout the year the continuous taking and checking of parts of the inventories against stock records, or other book records, by employees independent of the stock-

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keeping departments, and for the auditor to examine in whole or in part the reports on these partial checks and to participate in some of them.

The general adoption of such added procedures regarding physical quantities of inventories may also necessitate procedural changes on the part of clients. So many corporations close their books upon a calendar year basis that your committee doubts whether the profession as at present organized can undertake to make physical tests adequately and satisfactorily on the last day of each year. Many corporations do not have adequate perpetual inventory records and greater use of them should be encouraged.

The extension of procedures regarding inventories would be greatly facilitated if each concern adopted its natural business year instead of the calendar year as its fiscal year, and introduced continuous well kept perpetual inventory records.

The proposed changes will take time to bring about, and your committee is of the opinion that in the meantime the profession may well be faced with the necessity of submitting qualified reports in those cases in which it has been impracticable to carry out the added procedures.

Taken in consideration with the foregoing discussion of audit procedures relating to inventories, your committee makes the following recommendations in respect thereof:

(a) That hereafter it should be generally recognized as normal procedure in the examination of a concern where inventories are a material factor, where the independent certified public accountant intends to report on the financial statements of the concern over his signature, and where

- (1) such inventories are physically taken at the balance-sheet date or
- (2) such inventories are physically taken at a date prior or subsequent to the balance-sheet date

but within a reasonable time thereof, with adequate records supporting the interim changes in inventories,

he shall make such auditing tests and checks of the inventory accounts and records as may be feasible in corroboration of the representations of the concern relative to the inventories; also, he shall wherever practicable and reasonable make, or where the inventory taking is adequately planned and controlled observe the making of, physical tests by count, weight, or measurement, for the purpose of satisfying himself that the methods of inventory taking have been carried out effectively and for the purpose of testing the accuracy of the recording of quantities in the inventory records;

(b) That hereafter where inventories are a material factor, and a concern does not customarily take a physical inventory at the balance-sheet date but maintains well kept and controlled perpetual inventory records supported by: (1) a complete physical inventory at a date not coincident with the balance-sheet date, or (2) physical inventories of individual items from time to time so that the quantity on hand of each item is compared with the inventory record for that item at least once in each year, the independent certified public accountant shall wherever practicable and reasonable make, or, where the inventory taking is adequately planned and controlled observe the making of, physical tests by count, weight, or measurement, at any interim date or dates selected by him for the purpose of satisfying himself as to the substantial accuracy of the perpetual inventory records so that they may be relied upon to support the inventory totals as shown on the balance sheet; and that such an examination be recognized as normal audit procedure;

(c) That hereafter, where the independent certified public accountant has not made, or observed the making of, physical tests by count, weight, or meas-

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urement, either because such tests in his opinion are not practicable or reasonable, or because he has departed from normal auditing procedure, he shall make suitable explanation or exception in reporting on the financial statements of a concern over his signature;

(d) That hereafter, 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 such custodians is acceptable as a procedure in lieu of physical tests; except that where the amount involved represents a significant proportion of the current assets or of the total assets of a concern the independent certified public accountant shall make supplementary inquiries.

In making, or observing the making of, physical tests by count, weight, or measurement, the independent certified public accountant does not hold himself out as, or assume the responsibilities of, a general appraiser, valuer, or expert in materials.

RECEIVABLES

In regard to the question of confirming receivables by direct communication with the debtor, your committee makes the following recommendations:

(a) That hereafter, in cases where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as normal audit procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of obtaining such confirmations in each engagement, and whether of all receivables or a part

thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment; and

(b) That hereafter, where the independent certified public accountant, for any reason, has not made such confirmation, he shall make suitable explanation or exception in his report.

APPOINTMENT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Apart from the specific phases of auditing procedure which have been the subject of consideration, your committee is of the opinion that the method of appointment of the independent auditor and his status in relation to the client are subjects of great importance to stockholders and creditors.

Your committee suggests that the independent auditor should be engaged or nominated by the board of directors.

Some prominent corporations have adopted the practice of having the independent auditor elected annually by the stockholders. Other corporations have provided that the stockholders be given an opportunity to ratify the selection made by the directors.

Your committee believes that the auditor should be appointed early in each fiscal year so that he may carry out part of his work during the year.

FORM OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT'S REPORT

The services which independent auditors render usually culminate in a report, which may take varying forms. In some cases a detailed report is rendered accompanied by statements and supporting schedules; in other cases the report is limited to a concise statement of the scope of the examination and the related opinion of the independent auditor concerning the accompanying financial statements of the client. For present purposes the discussion is confined to the short form

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of auditor's report, which is sometimes described as a certificate. The terms "report," "report and opinion," and "certificate" have been used interchangeably. As uniformity is desirable the word "report" is recommended for general use and has been adopted in the following comments.

In January, 1934, the Institute issued a pamphlet entitled "Audits of Corporate Accounts," dealing with a standard form of auditor's report. The short form of report then recommended, and since widely adopted by the profession, met a long-felt need.

Developments during the five years in which the standard form of report has been used indicate the need of revision in the interest of clarity. If the revised short form recommended herein be adopted, the independent certified public accountant should recognize that in some cases it may not be altogether appropriate. For instance, there may be cases where the auditor may prefer to alter the first sentence of the standard short form, substituting some words to the effect that the accounting records (instead of the financial statements) have been examined. Obviously, also, it would be erroneous to mention internal control if none existed. Accordingly, while the proposed form is submitted as a standard, it is not prescribed or recommended for invariable use but should be adapted to the needs of the particular case. For example, the report may be used in connection with an examination covering a period of years, in which case a modification of language would be necessary. Also, in new engagements appropriate investigation relating to prior years will have to be made to justify the use of the short-form report. However, in the interest of reasonable uniformity it is recommended that the substance of appropriate phrases in the standard form be used unless inappropriate.

The major changes recommended pertain to the description of the scope

of the examination, specifically to include reference to the system of internal control. The phrase "obtained information and explanations from officers and employees of the company" has been omitted because it is inherent in all auditing procedure to obtain information and explanations from officers and employees concerning the accounts, either as supplementing information obtained from other sources or as constituting the only available information on the subject. In the latter case, the auditor must decide, in view of all the circumstances, whether he should rely upon such information without disclosure of the source. The phrase in question has led to serious misconception as to the degree of reliance on such information and explanations. The statement "but we did not make a detailed audit of the transactions" has been omitted from the revised form. It will be recalled that this clause was included in the standard form of 1934, in order to make clear that the auditor's usual procedure consisted of testing and sampling rather than a detailed audit. It is believed that the business and financial public now fully understand that, in a well organized concern, the detection of irregularities is primarily a matter of internal procedure, and that testing and sampling, to determine whether such procedure is adequate in scope and effective in operation, is the usual practice of the independent auditor. The negative statement disclaiming a detailed audit may, therefore, well be omitted. There has also been excluded the phrase "based upon such examination," as it is obvious that the independent certified public accountant can express an opinion only after he has completed the work set forth in the first paragraph of the report.

The revised short form of report consists of two paragraphs. The first contains a brief statement of the scope of the examination, and the second deals

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with the auditor's opinion on the financial statements of the client as a result of his examination.

In considering the independent certified public accountant's opinion the reader should bear in mind one of the most important underlying concepts of financial statements, viz., that normally many of the assets of a concern are not realizable in cash but are commonly stated at their historical cost or going-concern basis as figures which are usually greater than the realizable value in forced liquidation. Again, the true profit or loss of a concern can be determined with accuracy only over its entire existence. Therefore, in any attempt to allocate to specific periods profit or loss applicable thereto, it must be recognized among other considerations that, as many transactions are not fully completed within such periods, the result as shown must contain many estimates and approximations in the endeavor to present fairly the operating results of a period.

Assuming that normal procedures have been carried out it is considered to be neither necessary nor generally desirable to describe the details of the examination in this form of report. Any such details as are given should be included in separate paragraphs of the report. For example, reference may be made to procedures which the accountant has adopted regarding the examination of inventory quantities, and confirmation of receivables by direct communication with debtors; also, it may be pertinent to mention the fact that certain portions of the auditor's work have been carried out at different times during the course of the year. This may be indicated by inserting the words "at times" in the first paragraph of the short form of report immediately after the words "by methods."

It should be borne in mind that the financial statements, with all supplemental descriptive and explanatory data, including footnotes, are regarded

as representations of the client. It is upon all these representations that the independent certified public accountant renders his opinion. If he considers explanations essential or desirable, and they have not been made in the financial statements, it will be necessary for him to make such explanations in a separate paragraph of his report.

It is desirable as a general rule that exceptions by the independent certified public accountant be included in a paragraph separate from all others in the report, and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally, as to whether it affects the scope of the work, any particular item of the financial statements, the soundness of the company's procedures (as regards either the books or the financial statements), or the consistency of accounting practices where lack of consistency calls for exception.

It is worthy of repetition that the extent of sampling and testing should be based upon the independent auditor's judgment as to the effectiveness of internal control, arrived at as the result of investigations, tests, and inquiries. Depending upon his conclusions in this respect, the independent certified public accountant should extend or may restrict the degree of detailed examination. Consequently, in some cases it may be necessary to modify or omit reference to reliance upon the system of internal control. It follows also that where a detailed examination is made no reference to internal control is necessary.

It is contemplated that, before signing a report of the short-form type suggested, the independent certified public accountant will be satisfied that his examination is in conformity with the procedures and practices outlined in "Examination of Financial Statements," a bulletin published by the American Institute of Accountants in

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January, 1936, or in any subsequent revision thereof.

The report should be addressed to the board of directors or the stockholders if the appointment is made by them.

The description of the financial statements in both paragraphs should, of course, conform to the titles of the accompanying statements.

In consideration of the foregoing remarks your committee recommends the following short form of report:

Short Form of Independent Certified Public Accountant's Report

TO THE BOARD OF DIRECTORS (OR STOCKHOLDERS) OF THE XYZ COMPANY:

We have examined the balance-sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company, and have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate.

In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at April 30, 1939, and the results of its operations for the fiscal year, and conform to generally accepted accounting principles applied on a basis consistent with the preceding year.

In conclusion, your committee desires to state that it has dealt only with the more important phases of auditing

procedures and related matters which are the subject of current public interest. A more extensive review of auditing procedures is in process. In the course of its deliberations your committee has conferred with representatives of the following bodies whose interest might be affected by the committee's recommendations and has endeavored to keep them informed of progress in the work:

Advisory Council of State Society Presidents
Controllers Institute of America
National Association of Cost Accountants
National Association of Credit Men
National Association of Manufacturers
New York Stock Exchange
Robert Morris Associates
Securities and Exchange Commission

Samuel J. Broad, chairman of the special committee to revise the bulletin "Examination of Financial Statements by Independent Public Accountants," and Edward A. Kracke, chairman of the special committee on inventories, have participated in all meetings of the committee.

Respectfully submitted,
SPECIAL COMMITTEE ON
AUDITING PROCEDURE

P. W. R. GLOVER, *Chairman*
GEORGE COCHRANE
GEORGE P. ELLIS
STANLEY G. H. FITCH
J. K. MATHIESON
NORMAN L. McLAREN
MAURICE E. PELOUBET
WALTER A. STAUB
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