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Extensions of auditing procedure: report of May 9, 1939, as modified and approved at the annual meeting, September 19, 1939

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EXTENSIONS
OF
AUDITING PROCEDURE

Report of May 9, 1939, as Modified and Approved
at the Annual Meeting, September 19, 1939

October 18, 1939
American Institute of Accountants
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by

The American Institute of Accountants
Extensions of Auditing Procedure

To the Members of the American Institute of Accountants:

Gentlemen:

Under date of May 9, 1939, the council of the American Institute of Accountants adopted a report submitted by the special committee on auditing procedure entitled “Extensions of Auditing Procedure,” and at the same time it was anticipated that the committee would make a supplemental report at the September meeting. The report of May 9th emphasized that it was the ultimate responsibility of the independent certified public accountant to adopt such procedures as in his professional judgment he deemed appropriate, but recommended that certain additional procedures regarding inventories and accounts receivable should be considered as generally accepted practice. It further recommended that, where these additional procedures regarding inventories and accounts receivable had not been undertaken, that fact should be disclosed in the auditors’ report or opinion.

The action of the council received widespread support of state organizations of certified public accountants, and the recommendations evoked the hearty approval of investors, credit grantors, the press, and the public.

During the four months which elapsed between the issuance of the report and the September meeting, the committee had considerable discussion and correspondence with informed people, both within and without the profession, and held a number of meetings. While the recommended additional procedures had the united support of independent accountants, it was evident that there was some misconception as to the meaning intended to be conveyed by the term “physical tests” as applied to inventory quantities, that considerable misunderstanding had arisen as to the responsibility which the auditor might be assuming, and that the recommended reference in the auditors’ report of opinion to the omission of such procedures had been misconstrued.

In its supplemental report presented to council under date of September 18th, the committee explained the term “physical tests” and indicated that in his capacity as auditor the independent certified public accountant could properly attend at the inventory-taking and observe the methods of taking the inventory, making in conjunction therewith such suitable inquiries or requiring such test checks under his observation as he deemed advisable, and that such a program was within the meaning of the term “physical tests.”

The auditor’s duty was increased in that the additional procedures were adopted as generally accepted practice wherever they are practicable and reasonable, but beyond this the auditor’s responsibility remained unchanged. The responsibility of the management for taking proper inventories was again emphasized.

The committee reiterated its recommendation of May 9th that, where exceptions were required, such exceptions should be expressed clearly and unequivocally. However, where exception was not called for under the terms of the report, it was felt that no good purpose would be served by requiring negative explanations, because discussion and experience in the meantime had demonstrated that negative references in the auditors’ report gave rise to misconception in that they tended to convey implications of reservations or exceptions where none existed or was intended.
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In other words, they had the effect of casting an unwarranted cloud on the statements.

The council at its meeting on September 18, 1939, adopted the supplemental report of the committee which, after discussion at the meeting of the Institute on September 19th, was approved. The executive committee was authorized and instructed by council to coordinate the two reports into one document and to distribute it to the membership. This document is submitted herewith; it supersedes the report of May 9, 1939.

Respectfully submitted,

EXECUTIVE COMMITTEE

By: John L. Carey,

Secretary.

October 18, 1939.
Extensions of Auditing Procedure

Report of May 9, 1939, as Modified and Approved at the Annual Meeting, September 19, 1939

Following the adoption by council on May 9, 1939, of the report of the special committee on auditing procedure entitled "Extensions of Auditing Procedure" and the approval at the annual meeting of the supplementing and interpreting report of the same committee dated September 18, 1939, the executive committee was instructed by council to coordinate the two reports into one document and to distribute it. There is presented herewith the modified report which deals with the following matters:

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

Auditing procedures and related matters dealt with herein relate to those cases in which financial statements are accompanied by a report and opinion of an independent certified public accountant. Accordingly, that which follows should be read in the light of this limitation.

At the outset it is pertinent to state that, since the late 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 enable him to form an opinion as to whether or not the financial statements as submitted present fairly the position and the 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
Extensions of Auditing Procedure

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 ordinary examination incident to the issuance of financial statements accompanied by a report and opinion of an independent certified public accountant is not designed to discover all defalcations, because that is not its primary objective, although discovery of defalcation frequently results. 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 review the system of internal check and accounting control so as to determine the extent to which he considers that he is entitled to rely upon it. 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 circumstances are such as to arouse suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified.

The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company
A Report of the Special Committee on Auditing Procedure

and the results of its operations, in conformity with 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 in some cases independent certified public accountants have attended at the inventory taking or observed physical test checks of inventories and have confirmed receivables by direct communication with debtors. Such steps, however, have usually been undertaken as additional procedures under arrangement with the client, or where the accountant thought them essential or desirable in a particular case.

It is believed 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.

INVENTORIES

Added steps may well be taken to give greater assurance with regard to inventories. The extent of such additional procedures 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 not only to book records, but also to the procedure of taking physical inventories. 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 in his capacity as an auditor undertake additional procedures as to inventories, such procedures do 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. Such procedures are only for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition.

Taken in consideration with the foregoing discussion of auditing procedures, the following recommendations are made concerning inventories:

(A) That hereafter, where the independent certified public accountant intends to report over his signature on the financial statements of a concern in which inventories are a material factor, it should be generally accepted auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified public accountant may require physical tests of inventories to be made under his observation.

In cases where the inventory is determined solely by means of a physical inventory at the end of the accounting period (or at a date prior or subsequent thereto but within a reasonable time thereof, with adequate records supporting the interim changes), it will ordinarily be necessary for the foregoing procedures to be followed at that time.

In cases where the concern 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 taken from time to time so that the quantity of each item on hand is compared with the inventory record for that item at least once in each year, it will be satisfactory to undertake the procedure outlined at any interim date or dates selected by the auditor, his purpose being to satisfy himself as to the credibility of the perpetual inventory records and whether they may be relied upon to support the inventory totals as shown on the balance-sheet.

(B) 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 procedure; 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.

It should be clearly understood that in undertaking these auditing procedures regarding inventories, the independent certified public accountant does so for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition and does not hold himself out as a general appraiser, valuer, or expert in materials.

The general adoption of such added procedures regarding inventories may necessitate procedural changes on the part of clients. So many corporations close their books upon a calendar-year basis that it is doubtful whether the profession as at present organized can undertake the additional work 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 regard-

ing 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 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.

**Receivables**

In regard to the question of confirming receivables by direct communication with the debtor, the following recommendation is made:

That hereafter, wherever practicable and reasonable, and 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 generally accepted auditing 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 confirming receivables 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.

**Appointment of Independent Certified Public Accountants**

Apart from the specific phases of auditing procedure which have been the subject of consideration, the method of appointment of the independent auditor and his status in relation to the client are believed to be subjects of great importance to stockholders and creditors.
A Report of the Special Committee on Auditing Procedure

To emphasize the auditor’s independence of the management, some corporations affected by public interest have adopted the practice of having the independent auditor engaged or nominated by the board of directors or elected annually by the stockholders. Other corporations have provided that the stockholders be given an opportunity to ratify the selection made by the directors.

It is suggested 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 or Opinion

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 of auditor’s report, which is sometimes described as a certificate. The terms “report,” “opinion,” “report and opinion,” and “certificate” have been used interchangeably. As uniformity is desirable, either of the words “report” or “opinion” is recommended for general use. The word “report” 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. 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 with the auditor’s opinion on the financial statements of the client as a result of his examination.

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 sense of the statement “but we did not make a detailed audit of the transactions” has been retained in a 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. Nevertheless, it is considered advisable for the purpose of emphasis to include the phrase, “without making
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a detailed audit of the transactions." There has 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 independent certified public accountant should recognize that in some cases the revised short form recommended 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 investigations 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 phrases in the standard form be used unless inappropriate.

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 at amounts 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 in conformity with generally accepted accounting principles.

Assuming that normal procedures have been carried out, it is not considered necessary 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 inventories and receivables; 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.

In explanation of the general principles governing the auditor's opinion, with particular regard to explanations and exceptions, it is pertinent to state that the auditor satisfies himself as to
the fairness of the statements "by methods and to the extent he deems appropriate," in general conformity with the auditing procedures recommended in the Institute's bulletin Examination of Financial Statements. Ordinarily, if he has so satisfied himself, he is in a position to express an unqualified opinion. However, if he considers it in the interest of clear disclosure of material fact to include explanations of procedures followed, he is free to do so. If, on the other hand, such disclosures are made by reason of any reservation or desire to qualify the opinion, they become exceptions and should be expressly stated as such in the opinion paragraph of the auditor's report. As previously stated, if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole.

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 the responsibility of the accountant—and one which he cannot escape—to determine the scope of the examination which he should make before giving his opinion on the statements under review. If in his judgment it is not practicable and reasonable in the circumstances of a given engagement to undertake the auditing procedures regarding inventories and/or receivables set forth in this report as generally accepted procedure and he has satisfied himself by other methods regarding such inventories and/or receivables, no useful purpose will be served by requiring an explanation in his report. If physical tests of inventories and/or confirmation of receivables are practicable and reasonable and the auditor has omitted such generally accepted auditing procedure, he should make a clear-cut exception in his report.

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. Clearly also where a detailed examination is made, the phrase "without making a detailed audit of the transactions" would be inappropriate.

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 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 state-
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It is worthy of repetition and emphasis that, 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.

In consideration of the foregoing remarks the following short form of report is recommended:

**SHORT FORM OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT'S REPORT OR OPINION**

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, without making a detailed audit of the transactions, 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, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

It is worthy of repetition and emphasis that, 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.