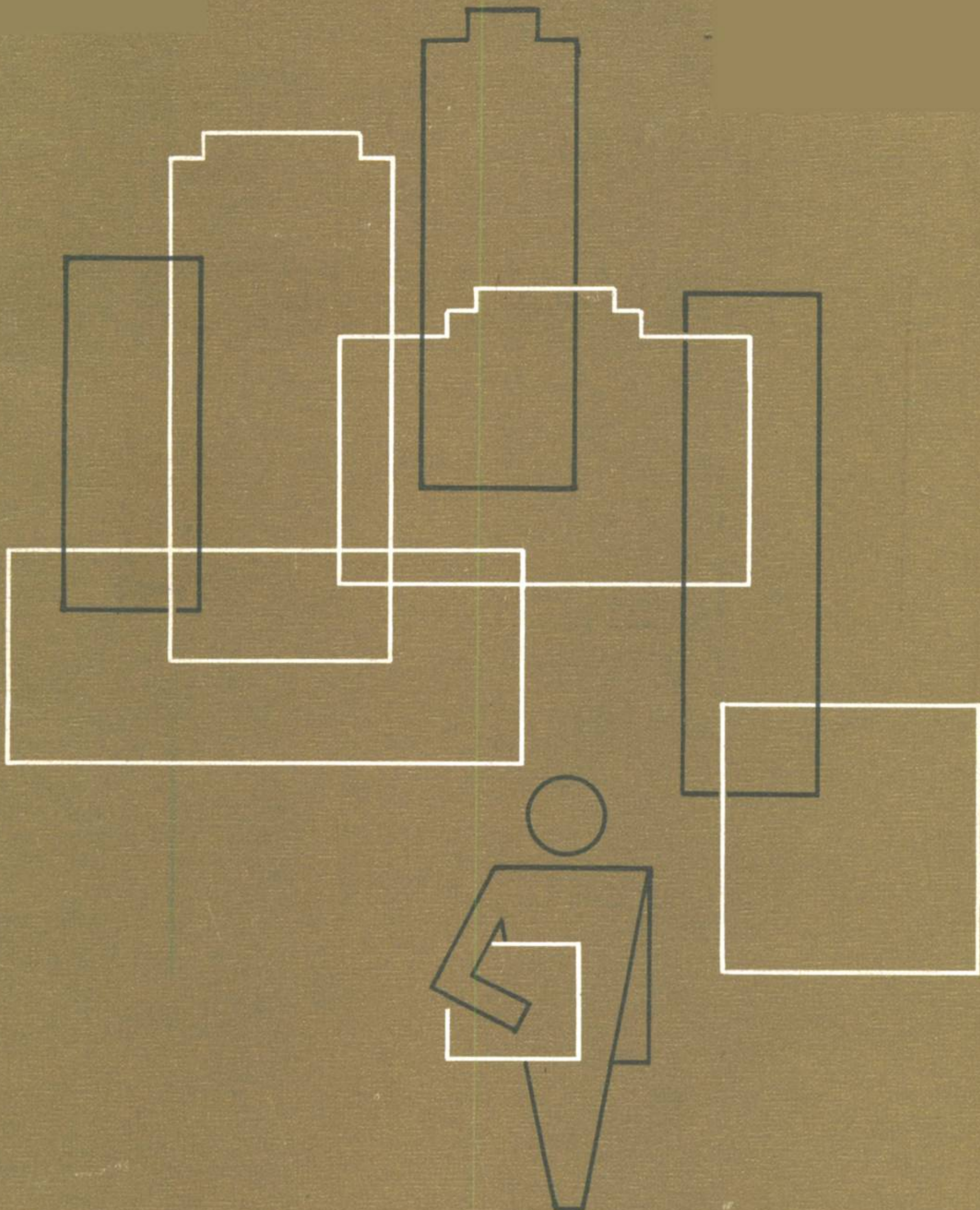
1967

Auditor's report ... its meaning and significance

National Conference of Bankers and Certified Public Accountants

American Institute of Certified Public Accountants. Committee on Relations with Bankers and Other Credit Executives



the Auditor's Report

...its meaning and significance

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A Statement Prepared
by the Certified Public Accountant Members of
National Conference of Bankers and Certified Public Accountants
Distributed by
Credit Policy Committee, The American Bankers Association
and
Committee on Relations with Bankers and Other Credit Executives, American Institute of Certified Public Accountants

July 1967

PREFACE

In 1966, The American Bankers Association and the American Institute of Certified Public Accountants, ever conscious of their mutuality of interests and concerns in modern business and finance, designated six representatives from each of their respective memberships to meet and to conduct continuing dialogues as a section (Section II on Financial Reporting of Borrowers) of the National Conference of Bankers and Certified Public Accountants.

By mutual consent, these two groups invited three representatives of the Robert Morris Associates, the national association of bank loan officers and credit men, to participate in the discussions.

One of the preliminary purposes of this section of the conference is to achieve among bankers a better understanding of the responsibilities and functions of the independent auditor and of the meaning and significance of an audit report.

To that end, the material that follows has been prepared by the CPA members of Section II of the conference. It is, in essence, a statement by accountants of the accounting profession's concept of its responsibilities and functions in rendering audit reports on the financial statements of business managements.

By means of this preface, all the banker members of the group recommend strongly to bankers everywhere a thorough study and understanding of this clear, authoritative exposition of just what an audit report means. It is factual and instructive. It provides in a few pages an invaluable short course in much of the philosophy and functioning of the public accounting profession as viewed by the profession itself today.

No bank officer anywhere is qualified to make loan judgments on the strength of audit reports unless he is fully conversant with the concepts and viewpoints that are set out in the paper that follows.

This is public accounting as it is, not necessarily as bankers might hope it to be. This is public accounting as it must be understood by all who look to audit reports for assurance and guidance in the making of credit judgments on the strength of financial statements.

An ultimate objective of the conference dialogues is to provide a means whereby bankers and CPAs can, through a better understanding of each other's problems and needs, bring about those changes in their respective responsibilities and methods of operation that will best serve the business community and which will produce more meaningful financial statements and more responsive reporting thereon by independent auditors. This booklet — an exposition of the *status quo* as it relates to the auditor's report — is an essential first step in that direction. The dialogues to follow can now proceed toward the examination of those changes which may be desirable and feasible in order to achieve the goal set.

Credit Policy Committee
The American Bankers Association

July 1967

NATIONAL CONFERENCE OF BANKERS AND CERTIFIED PUBLIC ACCOUNTANTS

Section II on Financial Reporting of Borrowers

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Northwestern National Bank
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The Northern Trust Company
Chicago, Illinois

John P. Wright, President
American National Bank & Trust Company
Chattanooga, Tennessee

TABLE OF CONTENTS

THE AUDITOR'S REPORT

ITS MEANING AND SIGNIFICANCE

INTRODUCTION

The independent auditor's primary function is to express an informed professional opinion on the financial statements of business enterprises. On the basis of questions which are sometimes raised, there seems to be a need for a greater understanding of the meaning and significance of the auditor's report and of the responsibilities which the auditor assumes in expressing an opinion on financial statements. This paper, written in nontechnical language, is an attempt to explain the function of the independent auditor as understood and practiced by the accounting profession in the United States for many years.

The preparation of financial statements involves consideration of many factors requiring the exercise of judgment; such judgment frequently involves consideration of complex factors that are not susceptible to a precise determination. Likewise, the audit of financial statements requires the application of professional judgment in a tremendously wide variety of situations and circumstances. Thus, the auditor's opinion is based on his examination of the financial statements and reflects his judgment of the fairness of the financial statement presentation in accordance with generally accepted accounting principles.

The auditor is responsible for his work, and, accordingly, the issuance of an opinion imposes serious obligations on him. While the auditor has the sole responsibility for his opinion as expressed in his report, the primary responsibility for a company's financial statements, including any accompanying footnotes, rests with the management, and this responsibility cannot be relieved by the engagement of an independent auditor. The financial statements constitute a representation by management as to its stewardship of the business enterprise. At the same time, the auditor recognizes that the significance of the opinion expressed in his report enables him to exert considerable influence on the financial statements and to make recommendations that will assure a fair presentation of the information contained therein.

There are a number of ways in which the independent auditor may report upon a company's financial statements. The auditor's report on financial statements generally takes one of two forms: (1) an opinion, commonly referred to as the short-form report, or (2) an opinion plus additional comments and data, commonly referred to as the long-form report. This paper will discuss primarily the conventional short-form report and touch only briefly on the long-form report.

SHORT-FORM REPORT

The conventional short-form report is most frequently used in business practice today. This form of report is illustrated in Exhibit 1, page 3.

In the exhibits that are included in this paper, the plural "we" has been used in the auditors' report, since many auditors practice as firms in the form of partnerships.

This type of report form originated in the mid-1930s as a result of the combined efforts of what is now known as the American Institute of Certified Public Accountants (AICPA) and the New York Stock Exchange. The language of the report was modified slightly in 1948 and has remained basically unchanged since that time. The report consists of two basic parts — a scope section (the first paragraph) and an opinion section (the second paragraph).

There are eight key elements in the short-form report that have special significance:

1. The date
2. The salutation
3. An identification of the statements examined
4. A statement of the scope of the examination
5. The opinion introduction
6. A reference to fair presentation in conformity with generally accepted accounting principles
7. A reference to consistency
8. The signature

In order to better understand the significance of the short-form report, each of the eight elements referred to above will be reviewed.

AUDITORS' REPORT

To the Stockholders of
X Company:

We have examined the balance sheet of X Company as of December 31, 1966, and the related statements of income, retained earnings and source and application of funds 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.

In our opinion, the accompanying balance sheet and statements of income, retained earnings and source and application of funds present fairly the financial position of X Company as of December 31, 1966, and the results of its operations and source and application of funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

JOHN DOE & CO.

NEW YORK, N.Y.
FEBRUARY 15, 1967

Exhibit 1

The Date

In expressing his opinion on the fairness of presentation, the auditor considers the effect of any significant event or transaction which he finds has occurred after the date of the financial statements but before the completion of his examination. Normally the auditor's report carries the date of the completion of his field work, and this date indicates the end of the period subsequent to the balance sheet date during which the auditor has continued certain limited auditing procedures. During this period there may be events or transactions which have a material effect on the financial statements or which may be an important consideration in connection with these statements.

For example, if subsequent information is acquired which would have been reflected in the financial statements had it been available at the balance sheet date, appropriate adjustments may be required. Examples of this type of event would be the collection of receivables or settlement or determination of liabilities on a substantially different basis from that previously anticipated. In addition, there may be events subsequent to the date of the balance sheet which have no direct effect on the financial statements being presented, but their significance may be such that disclosure is necessary or advisable. Examples of this type of event or transaction are the sale or issuance of significant amounts of additional capital stock or new borrowings, or purchase of a significant new business.

The Salutation

Generally, the report is addressed to the stockholders of the company, the board of directors, or both. The salutation reflects the auditor's awareness that his prime obligation is to that group, namely, the owners and their elected representatives. There is a growing trend in American business today to submit the appointment of auditors to the shareholders of publicly owned corporations for ratification at the annual meeting.

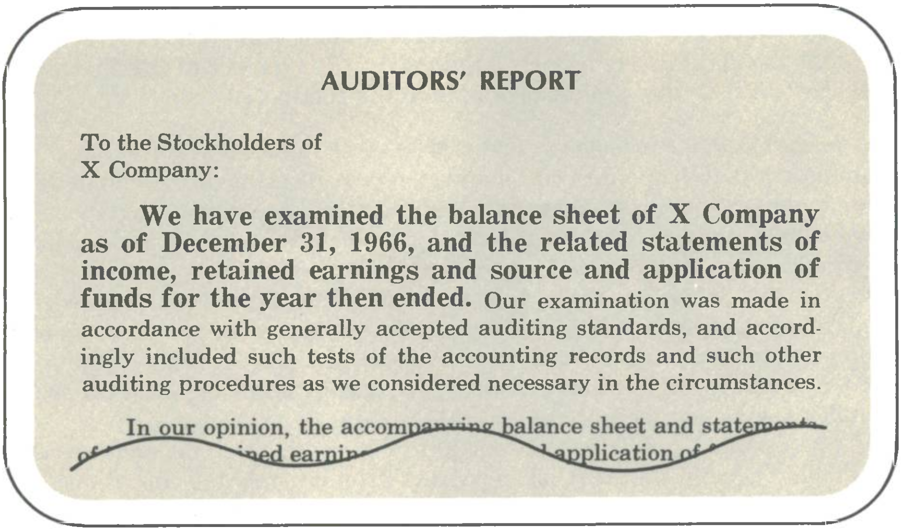
Identification of the Statements Examined

As we examine the opening sentence in the scope paragraph (Exhibit 2, page 5), it will be noted that the auditor affirmatively states that he has examined specified statements of a certain company or business entity.

The use of the possessive should be noted—"We have examined the balance sheet *of* . . ." This emphasizes the fact that the financial statements are representations of the company.

Scope of the Examination

The second sentence in the scope section indicates the character of the auditor's examination. Occasionally, the question is raised as to the necessity of a recital of scope, since the opinion paragraph is the key matter in the report. The basis for its inclusion can be traced to the historical development of the auditor's report and particularly to the influence of the Securities and Exchange Commission. In the formulation of the audit report, it has been generally agreed that without any representation by an auditor as to the scope



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ned earnin application of

Exhibit 2

of his examination it would be more difficult to hold him responsible for a poorly or inadequately performed examination.

The first part of the second sentence of the scope paragraph begins, "Our examination was made in accordance with generally accepted auditing standards. . . ." What are generally accepted *auditing standards*? Generally accepted auditing standards have evolved over the years and have been approved and adopted by the membership of the AICPA. The standards are broad in scope and are basically classified into three groups: the *general standards,* the *standards of field work,* and the *reporting standards.*

The standards are outlined specifically in the Statements on Auditing Procedure No. 33 issued in 1963 by the Committee on Auditing Procedure of the AICPA. This publication is a consolidation and codification of a number of auditing pronouncements issued over a period of years and represents the cumulative efforts of many CPAs through their professional organizations to raise the level of professional performance of independent auditors. Each of the three groups of standards is discussed in the following paragraphs.

The General Standards

The general standards define the personal qualities required by the independent certified public accountant. They require that the examination be made by auditors having adequate technical training and proficiency in auditing, that the auditors be, in fact, independent with respect to the client, and that they exercise due professional care in the conduct of their work.

Training and Proficiency. The first general standard requires that "the examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor." It recognizes that however capable an individual may be in other fields, including finance and business, he cannot meet the requirements of the auditing standards without proper education and experience in the field of auditing. The attainment of proficiency in accounting practice and auditing procedure begins with the auditor's education and extends into his subsequent experience. The training of the independent auditor, in addition to being adequate in terms of technical scope, includes a sufficient measure of general education.

The certified public accountant is presumed to meet the requirements for the first general standard, since he must meet not only the educational but also the experience standards set by the various CPA boards before he may sit for portions of the CPA examination or be licensed to practice. This provides assurance that he has had practical audit and accounting experience with proper supervision and review of his work by an experienced practitioner.

Independence. The second general standard requires that "in all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors." Thus, stated simply, the auditor must be independent. To be independent, the auditor must be without bias with respect to his clients. As pointed out in Statement No. 33, "independence does not imply the attitude of a prosecutor, but rather a judicial impartiality that recognizes an obligation for fairness not only to the management and owners (shareholders) of a business, but also to creditors and those who may otherwise rely (in part, at least) upon the auditor's report, as in the case of prospective owners or creditors."

To be independent, the auditor should not only be independent in fact—intellectually honest—but must be recognized as such by others. For example, an auditor with a financial interest in a company might be unbiased in expressing his opinion on the financial statements of that company, but the public would be reluctant to believe that he was unbiased. The profession, through the AICPA's Code of Professional Ethics, has established definite guidelines to guard against the presumption of loss of independence. Rule 1.01 of the AICPA code reads, in part, as follows:

> Neither a member or associate, nor a firm of which he is a partner, shall express an opinion on financial statements of any enterprise unless he and his firm are in fact independent with respect to such enterprise.
>
> Independence is not susceptible of precise definition, but is an expression of the professional integrity of the individual. A member or associate, before expressing his opinion on financial statements, has the responsibility of assessing his relationships with an enterprise to determine whether, in

the circumstances, he might expect his opinion to be considered independent, objective and unbiased by one who had knowledge of all the facts.

> A member or associate will be considered not independent, for example, with respect to any enterprise if he, or one of his partners, (a) during the period of his professional engagement or at the time of expressing his opinion, had, or was committed to acquire, any direct financial interest or material indirect financial interest in the enterprise, or (b) during the period of his professional engagement, at the time of expressing his opinion or during the period covered by the financial statements, was connected with the enterprise as a promoter, underwriter, voting trustee, director, officer or key employee. . . .

While it is true that the client engages the independent auditor and pays his professional fee for undertaking to perform an audit, the independent auditor is not an employee of the client but is engaged as an independent contractor. Obviously, his usefulness as an outside auditor would be at an end if he did not maintain his independence.

Due Professional Care. The third general standard requires that "due professional care is to be exercised in the performance of the examination and the preparation of the report." The exercise of due care requires a critical review of supervision of the work done at every level and of the judgment exercised by those assisting in the examination – in other words, what the independent auditor does and how well he does it.

The Standards of Field Work

The standards of field work cover the actual execution of the examination and are as follows:

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Planning the Audit. The first standard of field work concerns the timeliness of the auditing procedures and the orderliness of their application. Many audit tests can be conducted at almost any time during the year. During the course of this interim work, the auditor makes tests of the client's records and procedures to determine the extent to which he may rely on them and to assist him in determining the audit procedures to be undertaken to complete the examination.

Consideration of the first standard of field work recognizes that early appointment of the auditor has advantages to both the auditor and his client. The performance of some of the audit work during the year permits the examination to be completed in a more efficient manner and at an earlier date after the year end. It also permits early consideration of accounting problems affecting the financial statements and early modification of accounting procedures that the auditor thinks might be improved.

An assistant just entering an auditing career must obtain his professional experience with the proper supervision and review of his work by a more experienced superior. The auditor charged with the final responsibility for the engagement must exercise a seasoned judgment in the degree of his supervision and review of the work done and in the judgment exercised by his subordinates.

Evaluation of Internal Control. The subject of internal control has filled many volumes. In paragraph 2, Chapter 5, in Statement No. 33, internal control is defined as follows:

> Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

It is perhaps significant to point out the all-encompassing extent of this definition. Internal control is concerned not only with those matters which relate solely to the function of the accounting or financial departments (with which the auditor is mainly concerned) but, in the broadest sense, to all aspects of a company's operations, including such matters as budgetary control and production scheduling.

Since the internal control procedures will vary from company to company, the auditing procedures will likewise vary from company to company. Audit procedures for the same company may change from year to year — especially if the recommendations of the independent auditor for improvement of internal control are adopted by management. While it is customary for auditors to notify management when weaknesses in internal control are noted, the responsibility for the establishment and enforcement of good internal control rests with the management. Although such weaknesses may cause the auditor to adapt certain procedures to fit the circumstances, they do not affect his opinion on the fairness of the statements (assuming he has satisfied himself by examining sufficient evidence) and they would not be noted in the auditor's report.

At this point it might be helpful to explain what the auditor means by "tests" of the accounting records. There are a number of auditing procedures which bear no specific relationship to tests of the records themselves (such as the evaluation of internal control, for example) but insofar as tests are made of the records themselves, the extent of such tests depends upon the effectiveness of the internal control.

Since the auditor is often faced with accounting records summarizing thousands of transactions, testing techniques are used in auditing procedures. Even a relatively small business in modern times has a large volume of transactions. Thus, the concept of an auditor as one who examines every transaction is old-fashioned and obsolete. In determining the extent of a particular audit test and the method of selecting the items to be examined, the auditor may use statistical sampling techniques which have been found to be advantageous in certain instances. The use of statistical sampling does not reduce the use of judgment by the auditor, but provides certain statistical measurement as to the results of the audit tests, which measurement may not be otherwise available.

In making his usual examination, the auditor is aware of the possibility that fraud may exist. The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the usual examination directed to the expression of an opinion on financial statements is not primarily or specifically designed and cannot be relied upon to disclose defalcations or similar irregularities although their discovery may result. If an objective of an independent auditor's examination were the discovery of all fraud, even assuming that all fraud could be detected, the auditor would have to extend his work to a point where its cost would be prohibitive. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examinations cannot be relied upon to assure its discovery. Reliance for the prevention and detection of fraud should be placed principally upon an adequate accounting system with appropriate internal control. The responsibility of the auditor for failure to detect fraud arises only when such failure clearly results from his noncompliance with generally accepted auditing standards.

Evidential Matter. The third standard of field work requires that sufficient evidence is to be obtained through inspection, inquiries, and confirmation to support the basis for a conclusion. In addition to outlining in broad general terms the manner of obtaining sufficient evidence to form an opinion, this standard establishes that the confirmation of receivables and the observations of inventories are generally accepted auditing procedures when they are practicable and reasonable and the amounts with respect to such items are material to financial position or results of operations. *Practicable* has been defined, as it relates to auditing, as "capable of being done with the available means," and *reasonable* has been defined as "sensible in the light of the surrounding circumstances." In connection with physical inventory observations, it should be pointed out that it is management's responsibility to take and value the inventory.

Thus the third standard of field work outlines that in order to have an informed opinion the auditor must make an examination and generally must observe the physical taking of inventories and confirm receivables if material.

The Reporting Standards

The reporting standards govern the preparation of the auditor's report. There are four standards of reporting, and they are as follows:

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

In summary, these standards require the auditor to state in his opinion (1) whether generally accepted accounting principles have been followed and (2) whether they have been consistently applied. He must make such additional informative disclosure in his report as may be necessary to make the financial statements not misleading. Finally, the reporting standards require that the auditor's report contain a clear-cut indication of the degree of responsibility he is taking. Thus, in all cases where an auditor's name is associated with financial statements, he must either express an opinion on the financial statement or disclaim an opinion, stating the reason for doing so.

Auditing Procedures and Objectives

The reference in the scope paragraph to such other auditing procedures as were "considered necessary in the circumstances" (Exhibit 2) reflects the fact that the auditor has considerable latitude in the conduct of the examination and exercises his professional judgment in the selection of auditing procedures. The auditor should design his program for the examination of the financial statements to take into consideration the materiality of the various accounts and the specific problems associated with the engagement.

In the case of the two mandatory audit procedures previously mentioned, namely, the confirmation of receivables and the observation of physical inventories (when the amounts involved are material and the procedures are reasonable and practicable in the circumstances), the auditor must comment in his scope paragraph if he has not performed either of these audit procedures, even though he may have satisfied himself of the amounts involved by alternate means.

Some examples of subjects upon which the auditor should satisfy himself before issuing his report are the following:

Internal control

Adequacy
Basis for reliance

Cash

Existence and ownership

Accounts receivable

Bona fide
Collectibility
Encumbrances, pledging, if any

Inventories

Existence and ownership
Pricing
Realization
Encumbrances, if any

Liabilities

Fully recorded
Classification in the balance sheet
Collateral
Subordination of liabilities
Contingencies and commitments

Income and expense

Proper recognition by periods
Matching of revenue and expense
Classification

Opinion

We have considered the scope section, and have summarized the reporting standards which govern the preparation of the auditor's report. Now let us review the so-called opinion section and consider how the auditor must comply with these reporting standards.

The introductory phrase in the opinion section of the auditor's unqualified report normally begins "In our opinion. . . ." It is perhaps appropriate here to reemphasize the point made at the outset—an auditor can only express his informed professional opinion on the financial statements of a business after having carefully planned and executed the examination. An unqualified opinion (Exhibit 3, page 12) means that the independent auditor has, on the basis of an examination made in accordance with generally accepted auditing standards, formed a professional opinion that the presentation conforms with generally accepted accounting principles applied on a consistent basis and includes all informative disclosures considered necessary for a fair presentation. Thus, the independent auditor is neutral with regard to any interpretation of the

AUDITORS' REPORT

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JOHN DOE & CO.

NEW YORK, N. Y.
FEBRUARY 15, 1967

Exhibit 3

financial statements. The unqualified opinion is not a stamp of approval from a credit or investment viewpoint and should never be mistaken for one. A company may or may not be a good investment or a good credit risk, but it is not for the independent auditor to make such a determination; his function is to express an opinion of the fairness of the financial information presented.

Conformity with Generally Accepted Accounting Principles

The auditor expresses an opinion on whether there is a fair presentation of financial position and results of operations in conformity with generally accepted accounting principles. Accounting for business transactions requires approximations and estimates. Unlike certain fields of science where a specific result can be achieved by the combination of certain elements, the amounts of many items in the financial statements cannot be measured with exactness but are subject to the application of professional judgment on an informed basis. Therefore, when the auditor refers to fairness of presentation, no claim is being made as to precise exactness. Rather, the auditor is saying that within a reasonable range of materiality, the financial statements have been presented on a basis which is fair to all segments of the financial community.

When we mention generally accepted accounting principles, we are referring to that group of concepts and related practices for dealing with accounting matters. They have been developed over the years as a result of study and experience and have come to be recognized as guides in making accounting decisions. Accounting Research Study No. 7, published by the AICPA in 1965, contains an inventory of generally accepted accounting principles for business enterprises. Each one of the principles discussed in that research study lists the sources of authoritative support, which may include, among others, AICPA pronouncements—for example, accounting research bulletins or Opinions of the Accounting Principles Board—or positions of the Securities and Exchange Commission as set forth in its regulations or releases. Examples of such principles, which comprise quite an extensive list, include such matters as carrying productive facilities at cost and depreciating them over their useful service lives and stating inventories at the lower of cost or market.

In recent years there has been extensive discussion, inside and outside the accounting profession, about the broad range of alternative methods which can presently be categorized as being in accordance with generally accepted accounting principles. Because of the wide divergence of "acceptable practices," the resulting financial statement presentations can vary significantly, depending on what practices are adopted. In some cases the practices followed represent those which best reflect the circumstances in a particular situation; in other cases the practices followed are merely selected from among the available alternatives.

The AICPA has taken steps to reduce the number of alternative accounting principles and methods. This has been done in the following ways:

1. In 1959 a research group was formed under a new director of accounting research for the purpose of issuing accounting research studies to provide professional accountants and others interested in the development of accounting with an informative discussion of accounting problems under review. The studies also furnish a vehicle for the exposure of matters for consideration and experimentation prior to the issuance of pronouncements by the Accounting Principles Board (also formed at the same time). To date, nine research studies and ten opinions have been issued through this process, and many more are in preparation.
2. While recognizing that Opinions of the Accounting Principles Board could not bind the business community, because other authoritative support may exist for principles not accepted by the board, the AICPA declared in 1964 that when financial statements employ accounting principles that depart from those prescribed by an official APB Opinion, Institute members issuing reports thereon would be required either to take exception to the practices followed, or if in their opinion substantial authoritative support

exists therefore, to see, if practicable, that the effects of the departure from the APB Opinion is disclosed in the footnotes to the financial statements or in the auditor's report.

These efforts, which are continuing, will narrow the range of alternatives permitted within the concept of "generally accepted accounting principles" and provide means whereby financial statements will be more comparable and capable of better and more useful interpretation. It has been said that one objective is "to make like things look alike, and to make unlike things look unlike."

Consistency

In addition to commenting upon adherence to generally accepted accounting principles, the auditor, in the last phrase of the standard short-form report, states that the accounting principles were applied on a basis consistent with that of the preceding year. A change in accounting principles can distort the earnings between periods and therefore limit the meaningfulness of the financial statements as a basis for evaluating trends. It is the responsibility of the auditor to indicate whether there has been a material change in accounting principles followed or in their application. A significant change in principles would require the auditor to identify it in his opinion. The effect of the change on the financial statements should be indicated either in the footnotes to the financial statement or in the auditor's opinion.

It is perhaps pertinent at this point to indicate that certain changes affecting the comparability of financial statements between years do not normally require disclosure in the auditor's report. For example, there may be a change in conditions unrelated to accounting, such as the acquisition of a new subsidiary or business or the sale of a division or plant or a product line. Another example would be altered conditions which necessitate accounting changes but which do not involve changes in the accounting principles employed. An illustration of this type of occurrence would be a revision in the estimated useful life of a plant because of a technological change. Changes of these types having a material effect on the financial statements should be disclosed in the footnotes and ordinarily would not be commented upon in the auditor's report where there is footnote disclosure.

Qualified Opinions, Adverse Opinions and Disclaimers of Opinion

The auditor's report considered up to this point has been the so-called unqualified or "clean" opinion. Ideally, every audit examination should be started with the objective of issuing such an opinion, but occasionally this objective cannot be achieved. In such cases the auditor is required to (1) express a qualified opinion, (2) express an adverse opinion, or (3) disclaim an opinion.

If uncertainties exist about the future which cannot be resolved or the effect of which cannot be estimated, the words "subject to" will usually be used to introduce the auditor's opinion. However, depending upon the significance of the matter, the auditor may also "disclaim" an opinion on the financial statements taken as a whole.

If the scope of the auditor's examination has been limited, he may express an opinion introduced with the words "except for" or he may disclaim an opinion on the financial statements taken as a whole, depending upon the nature and significance of the limitation.

If the auditor believes that the statements do not present fairly the financial position or results of operations in conformity with generally accepted accounting principles, he may also express an "except for" opinion or he may issue an "adverse" opinion, again depending upon the nature and significance of the problem to which his reservation relates. Each of these types of reports is discussed in the following paragraphs.

"Subject to" Opinion

An example of a "subject to" opinion is presented in Exhibit 4, page 16.

As mentioned earlier, this type of opinion is used where the outcome of some material unresolved matter is dependent upon future developments or decisions outside the control of the client's management. In Exhibit 4, we have an example of such an unresolved matter—a pending lawsuit concerning the collection of a disputed receivable. Another example would be a pending examination of Federal income tax returns by the Internal Revenue Service where significant deficiencies have been proposed by the agent and are being contested. One characteristic of situations resulting in "subject to" opinions is that they are not susceptible to audit verification in the normal sense of the term. When the auditor makes his opinion "subject to," he will normally describe the nature of the unresolved matter and, whenever possible, will disclose the aggregate amount involved.

"Except for" Opinion

Another type of qualification in the auditor's opinion is introduced by the phrase "except for" (Exhibit 5, page 17).

Such a qualification may indicate that the auditor is not in agreement with one or more of the accounting principles used by the company in preparing its financial statements. In Exhibit 5 we have an example of a company which has

AUDITORS' REPORT
QUALIFIED FOR AN UNRESOLVED MATTER

To the Stockholders of
X Company:

We have examined the balance sheet . . . , etc.

As set forth in Note 1 to the financial statements, trade receivables at December 31, 1966, include $1,250,000, which the Company is seeking to collect through legal action. Pending the outcome of such action, it is not possible to form an opinion as to the adequacy of the reserve of $50,000 for loss on this receivable.

In our opinion, subject to the effect of any additional losses that may be sustained in collection of the receivable referred to above, the accompanying financial statements present fairly the financial position of X Company as of December 31, 1966, and the results of its operations and source and application of funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

NEW YORK, N. Y.
FEBRUARY 15, 1967

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Exhibit 4

not provided a warranty liability on products sold. The auditor considers the omission a deviation from generally accepted accounting principles. In this type of qualification, the auditor will normally explain in his report the reasons for his qualification, setting forth the approximate amount involved and the effect of the matters on financial position and results of operations. Thus, the reader of the financial statements has available the information necessary to adjust the financial statements.

The "except for" introduction should also be used when a qualification is in order because of scope limitations; for example, when the auditor is unable in a first-time audit to satisfy himself adequately as to inventory quantities at the beginning of the year which were not observed.

AUDITORS' REPORT
WITH AN EXCEPTION TO ACCOUNTING PRACTICE

To the Stockholders of
X Company:

We have examined the balance sheet. . . , etc.

No provision has been made in the accounts for the company's warranty liability on products sold. This liability was estimated to be approximately $1,750,000 at December 31, 1966, and $1,200,000 at the end of the preceding year, after considering the related Federal income taxes. Had such provisions been made, net income for 1966 and retained earnings as of December 31, 1966, would have been reduced by approximately $550,000 and $1,750,000, respectively.

In our opinion, except for the effect of the omission of a provision for the warranty liability discussed in the preceding paragraph, the accompanying financial statements present fairly the financial position of X Company as of December 31, 1966, and the results of its operations and source and application of funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

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FEBRUARY 15, 1967

Exhibit 5

Disclaimer of Opinion

There may be instances when the auditor's uncertainties about the financial statements are so great, or the limitations on the scope of his audit procedures are so extensive, or the records are so inadequate that it is not possible for the auditor to form an opinion on the fairness of the financial statements taken as a whole. In such cases the auditor will disclaim an overall opinion on the financial statements, indicating his reasons for doing so.

Exhibit 6, page 18, illustrates a disclaimer where an uncertainty exists. It will be noted that the second paragraph in Exhibit 6 is identical to the one in Exhibit 4 for a "subject to" opinion. The facts and amounts are the same in both cases; but in one case the company is smaller and the effect of the uncertainty, therefore, is so material as to negate any overall opinion on the financial statements.

AUDITORS' REPORT
DISCLAIMER OF OPINION

To the Stockholders of
X Company:

We have examined the balance sheet . . . , etc.

As set forth in Note 1 to the financial statements, trade receivables at December 31, 1966, include $1,250,000, which the company is seeking to collect through legal action. Pending the outcome of such action, it is not possible to form an opinion as to the adequacy of the reserve of $50,000 for loss on this receivable.

Because of the significance of the matter referred to in the preceding paragraph, we are unable to express an opinion on the accompanying financial statements of X Company taken as a whole. [An opinion on individual items in the financial statements will often be added in these situations.]

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NEW YORK, N. Y.
FEBRUARY 15, 1967

Exhibit 6

Circumstances sometimes make it impossible or impracticable for the auditor to follow certain customary auditing procedures. In such cases, the auditor may be able to satisfy himself by the application of other auditing procedures, but if he is unable to do so, he may issue an "except for" opinion or may disclaim an opinion, depending upon the nature and significance of the scope limitation. Exhibit 7, page 19, illustrates a disclaimer where the auditor was unable to satisfy himself concerning inventories, the amounts of which could significantly affect the reported financial position and results of operation.

Had the amounts of the inventories been less significant and had the auditor been able to satisfy himself with respect to the ending balances, the auditor's opinion might have begun with "except for."

In both of the situations just discussed, the auditor may go on to give an opinion on specific items in the financial statements if he has been able to satisfy himself with respect to those items—a presentation commonly referred to as a "piecemeal" opinion. From the similarity of the situations presented in the examples of the "subject to" and "disclaimer" opinions, it is apparent that the

AUDITORS' REPORT
DISCLAIMER OF OPINION
BECAUSE OF SCOPE LIMITATION

To the Stockholders of
X Company:

We have examined the balance sheet . . ., etc.

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 explained in the following paragraph.

We did not observe the taking of the physical inventories as of December 31, 1965 ($657,000) and December 31, 1966 ($728,000), since these dates were prior to our initial engagement as auditors for the company. The company's records do not permit adequate retroactive tests of inventory quantities.

Since we could not make adequate retroactive tests of the inventory quantities as of December 31, 1965, and 1966 and because of the significance of these amounts, we are unable to express an opinion on the accompanying financial statements taken as a whole. [An opinion on individual items in the financial statements not affected by the inventories will often be added in these situations.]

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NEW YORK, N. Y.
FEBRUARY 15, 1967

Exhibit 7

decision by the auditor as to the type of opinion to be rendered is largely judgmental—depending on the materiality of the amounts involved or the degree of uncertainty.

Adverse Opinion

An adverse opinion is one that states that the financial statements *do not* present fairly the financial position or results of operations in conformity with generally accepted accounting principles. In Exhibit 8, page 20, the facts disclosed in the second paragraph are the same as in Exhibit 5 where an "except for" opinion was given. The difference in opinion, as in the distinction discussed above between a "subject to" opinion and a disclaimer, results from the relative impact of the qualified matter on the financial statements as a whole.

From a practical point of view, an adverse opinion is a rare occurrence, for the auditor is usually able to persuade his client to adopt more appropriate accounting principles prior to the issuance of the auditor's report. The adverse opinion is used where the exception as to fairness of presentation is so material that, in the independent auditor's judgment, a qualified opinion is not warranted. The auditor, when issuing an adverse opinion, will disclose, usually in an explanatory middle paragraph, the reasons for doing so.

AUDITORS' REPORT
ADVERSE OPINION

To the Stockholders of
X Company:

We have examined the balance sheet . . . , etc.

No provision has been made in the accounts for the company's warranty liability on products sold. This liability was estimated to be approximately $1,750,000 at December 31, 1966, and $1,200,000 at the end of the preceding year, after considering the related Federal income taxes. Had such provisions been made, net income for 1966 and retained earnings as of December 31, 1966, would have been reduced by approximately $150,000 and $1,750,000, respectively.

Because of the significance of the matter referred to in the preceding paragraph, in our opinion the financial statements do not present fairly the financial position of X Company as of December 31, 1966, or the results of its operations and source and application of funds for the year then ended, in conformity with generally accepted accounting principles. [An opinion on individual items in the financial statements will often be added in these situations.]

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NEW YORK, N.Y.
FEBRUARY 15, 1967

Exhibit 8

In every case where the auditor considers it necessary to qualify his opinion, the opinion should be written so that the reader clearly understands precisely what the auditor is not satisfied with, the portions of the financial statements affected by the matter, and the approximate dollar range (if determinable) of the misstatement.

Signature

As was previously mentioned, many auditors practice as firms in the form of partnerships. The opinion on the financial statements is a responsibility of the partnership and thus of all the partners. Accordingly, the auditor's report is generally signed with the partnership name rather than with the name of an individual.

LONG-FORM REPORT

While the short-form report is used almost universally in connection with the auditor's examination of financial statements intended for publication, the auditor is sometimes asked to prepare a so-called long-form report. In addition to the basic financial statements, these reports ordinarily include details of items in the statements, statistical data, explanatory comments, and other informative material, some of which may be of a nonaccounting nature. These reports also may contain a more detailed description of the scope of the auditor's examination than is contained in the short-form report. As in the case of all auditor's reports, an auditor's opinion covering a long-form report must contain a clear-cut indication of the character of his examination and the degree of responsibility he is taking for the data contained in the report.

In many cases, much of the data which would normally be presented in an auditor's long-form report is prepared on a recurring basis by the business entity and included in its financial statements prepared for management. The managements of many companies prefer to have the auditor furnish the usual short-form opinion on the financial statements and to forego the added cost of the long-form reports where most of the information which would be included in them is available in summary form.

STATEMENTS PREPARED FROM THE BOOKS WITHOUT AUDIT

A certified public accountant may be engaged to prepare, or to assist his client in preparing, unaudited financial statements. Some companies need assistance in the preparation of their financial statements, and the certified public accountant performs a useful professional service in providing such assistance. It should be understood that this type of work is an accounting service—it is not auditing.

While the auditor may make suggestions to improve obvious deficiencies, the financial statements are said to be unaudited if the certified public accountant has applied no auditing procedures or only auditing procedures which are not significant in the circumstances. Under these conditions the financial statements should be clearly and conspicuously marked "unaudited" on each page and accompanied by a disclaimer of opinion. Such a disclaimer would normally be worded along the following lines:

> The accompanying balance sheet of X Company as of December 31, 1966, and the related statements of income and retained earnings for the year then ended were not audited by us and accordingly we express no opinion on them.

CONCLUSION

Accounting and auditing are not exact sciences, and the preparation of financial statements requires the exercise of judgment involving considerations that are often not susceptible to a single precise determination. Although the auditor may influence the way in which the financial statements are presented, the statements constitute management's representation as to its stewardship of the business enterprise. The auditor, in issuing a report on financial statements, provides a professional opinion as to whether the representations of management, as contained in those statements, present fairly to all users of those statements the company's financial position and the results of its operations.