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Rough Draft of the Supplemental Report by the Special Committee on Auditing Procedure to the Council of the American Institute of Accountants, August 25, 1939

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AUG 25 1939

ROUGH DRAFT OF SUPPLEMENTAL REPORT BY THE SPECIAL COMMITTEE ON
AUDITING PROCEDURE TO THE COUNCIL OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

TO THE COUNCIL OF THE AMERICAN
INSTITUTE OF ACCOUNTANTS:

Gentlemen:

Following the adoption by the Council on May 9, 1939 of the report entitled "Extensions of Auditing Procedure", the Special Committee on Auditing Procedure has had an opportunity to weigh the reactions and criticisms of the profession and others throughout the country consequent upon its publication.

The Committee has held several meetings as a result of which it was unanimously resolved to take cognizance of these reactions and to submit a supplemental and interpretive report to the Council at its next meeting September 18, 1939, with the object of clarifying the nature of the services the independent certified public accountant is able to perform and the measure of reliance that may be placed on his opinion regarding the financial statements of a concern.

EXAMINATION OF INVENTORIES:

A good deal of misunderstanding seems to exist regarding the extension of auditing procedure relating to inventories and as to just what is meant by "physical tests by count, weight, or measurement". In some cases the inferences drawn have been entirely erroneous and despite the continued assertion by the profession that the certified public accountant is not qualified to act as a general appraiser, valuer, or expert in materials, it has come to the attention of the Committee that many individuals have assumed that hereafter the independent accountant will assume full responsibility for quantities and

condition of inventories. The plain fact of the matter is, of course, that the direct responsibility lies with the management of a concern. What the independent accountant does is to use every reasonable auditing procedure to satisfy himself concerning the credibility of the representations of management in respect to quantities and condition. Apparently, too much stress has been placed inadvertently in the report of May 9th on physical test checks of inventory quantities. It has been stated by some that the Committee under-emphasized the importance of attendance at and observation of the inventory taking by the independent certified public accountant. The Committee agrees with this viewpoint and is satisfied that attendance and observation in carrying out the added procedures will be almost the universal rule. To state that the independent auditor will make physical test checks of inventories may imply to the uninitiated reader that he has assumed a far greater degree of responsibility in connection with quantities and qualities of inventories than the nature and extent of his work warrant. It is probably a true statement that in comparatively few cases will actual physical test checks be made by the independent auditor. He can observe intelligently as an experienced accountant the work of other people in counting and compiling an inventory but he is much less able in a personal sense to make physical tests of quantities on his own initiative.

The report of May 9, 1939, in suggesting extensions of procedure to give greater assurance concerning inventories intended to emphasize the fact that 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. It is worthy of repetition 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, and accordingly do not constitute a basis for his assuming full responsibility for quantity and condition.

The report of May 9, 1939, proposed 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 recognized auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records, he should, wherever practicable and reasonable in some manner establish physical contact with inventories. It was the clear intent of the committee that this purpose would be served if the auditor were present either in person or by his representatives, at the inventory-taking and by suitable observation and inquiry satisfied himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which might 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 inventories are physically taken at the balance sheet date (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; and

In cases where the 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 taken 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, 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.

The report of May 9, 1939, in providing that hereafter, where the independent certified public accountant has neither been present at the inventory-taking nor required physical tests of the

inventories to be made under his observation, he should make suitable explanation or exception in his opinion, clearly intended that explanation would be appropriate only if he had satisfied himself by other methods, and that otherwise exception is required.

As stated in the report of May 9, 1939, 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, hereafter, 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.

The committee emphasizes again that in undertaking these auditing procedures regarding inventories the independent certified public accountant does so for the purpose of satisfying himself as to the fairness and credibility of the representations made by the Company, but that he is not responsible for determining the quantities or passing upon the condition and does not hold himself out as a general appraiser, valuer, or expert in materials.

EXAMINATION OF RECEIVABLES:

Several questions have likewise been raised concerning the committee's recommendations regarding receivables.

The report of May 9, 1939, in providing that hereafter 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 recognized auditing procedure, clearly intended that such procedure should be undertaken wherever practicable and reasonable, and should be based upon sampling and testing. Obviously, the method, extent, and time of obtaining such confirmations in each engagement, and whether of all receivables or a part thereof, should be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment.

As in the case of inventories, hereafter, where the independent certified public accountant, for any reason, has not made such test confirmation, he shall make suitable explanation if he has satisfied himself by other methods or, if he considers it necessary, take exception, in expressing his opinion over his signature regarding the financial statements of a concern.

DISCLAIMERS REGARDING INVENTORIES AND RECEIVABLES:

Disclaimers regarding inventories and receivables, requiring the independent auditor to make suitable explanation or exception when he has not carried out the extensions of auditing procedure recommended in the report of May 9, 1939 relate to the terms of the independent auditor's report arising out of the auditing procedures followed. There has been some criticism of the requirements relating to these disclaimers, and the committee realizes that it is somewhat unusual to require negative explanations by the auditor when he has carried out his work "by methods and to the extent he has deemed appropriate".

Upon careful reconsideration the committee believes the disclaimers to be necessary and desirable during the transitional period in which these extensions of procedure will become effective, because of general public interest in the auditor's practice relating to these important assets.

In further explanation of the general principles governing the form of the auditor's opinion, with particular regard to explanations and exceptions, it is pertinent to repeat that the auditor satisfies himself as to the fairness of the representations made by the client "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. Furthermore, as stated in the report of May 9th, 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 should probably state 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.

SHORT FORM OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT'S REPORT:

The committee expressed the belief in its report of May 9, 1939 that the business and financial public now fully understand that testing and sampling is the usual practice of the independent auditor. As a result of the many suggestions received, the committee is now persuaded that the sense of the phrase "but we did not make a detailed audit of the transactions" should be restored in the short form of independent certified public accountant's report or opinion. For purposes of emphasis, it is accordingly considered advisable to include the phrase "without making a detailed audit of the transactions". It is important to leave no doubt that an opinion regarding financial statements must necessarily be based upon their conformity with generally accepted accounting principles rather than upon the basis of liquidating values or otherwise. This fact is more clearly expressed by substituting "in conformity with" in lieu of the words "and conform to".

The short form of auditor's report or opinion thus revised reads as follows:

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.

* * * * *

The committee requests the adoption of this supplemental report by the council, as an official interpretation of the report of May 9, 1939; and requests approval of the foregoing revision of the short form of auditor's report (or opinion).

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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