

## APPENDIX A

### Action Taken Since the McKesson & Robbins Disclosures With Respect to Auditing Procedures by Professional Accounting and Other Interested Organizations

There is presented herein a brief summary of the activities of the public accounting profession and of certain other organizations relative to questions of auditing procedure and practice that arose as a result of the disclosures made in the McKesson & Robbins case.

The summary includes the activities of the American Institute of Accountants, the national organization of certified public accountants, as well as the activities of state organizations or societies of public accountants to the extent of information available. Included also is a brief reference to the activities of a group of organizations outside the public accounting field. These organizations, although not directly concerned with the formulation of auditing procedures and practices for the guidance of public accountants, are nevertheless interested in the results which such procedures are intended to accomplish. This group is composed of the Controllers Institute of America, National Association of Cost Accountants, National Association of Credit Men, National Association of Manufacturers, New York Stock Exchange, and the Robert Morris Associates. The summary is based upon information reported in official organs or bulletins issued by the foregoing organizations or obtained directly from such organizations through correspondence.

The sensational disclosures in the McKesson & Robbins case received immediate widespread publicity through newspapers and other publications. The magnitude of the sums involved, the prominence of the Company in its field of industry, and the extraordinary and unusual circumstances attending the conception and long continuation of the inflations disclosed were features that heightened public interest in the case. It was a matter of general information that the books and records of the Company had been audited and the financial statements certified for many years by a well-known firm of public accountants, Price, Waterhouse & Co. Under such circumstances, it was to be expected that the accounting profession would be subjected to critical comment in regard to auditing procedures.

A short time after the overstatements in the financial statements of the Company were disclosed in early December 1938, the Attorney

General of the State of New York invited, among others, the American Institute of Accountants and the New York State Society of Certified Public Accountants to send representatives to an open meeting to be held, January 6, 1939, for the purpose of discussing "certain fundamental weaknesses in the preparation of financial statements of large corporations" which the Attorney General stated had been revealed by recent investigations conducted by his office into certain matters.<sup>1</sup>

The American Institute of Accountants and the New York State Society of Certified Public Accountants each appointed a special committee of three members, who prepared a joint statement which was presented at the Attorney General's meeting. This statement gave a brief description of the two organizations, including number of members, requirements for admission, and character of activities; it reviewed the development of present standards of auditing and accounting procedure; discussed the responsibility of auditors and possible improvements in auditing and in auditing procedures relating to inventories and accounts receivable; and commented on methods of appointment of auditors, the natural business year, and internal check and control.<sup>2</sup>

A report making certain observations and recommendations regarding auditing practices was submitted to the Attorney General by members of his staff in charge of the meeting.<sup>3</sup> The principal recommendations were that physical testing of inventory quantities and verification of accounts receivable by direct communication with the debtors should be adopted as general auditing procedures and if omitted on any audit the balance sheet should state that the assets in question were not verified by these methods.

The position of the American Institute of Accountants<sup>4</sup> on questions raised by the disclosures in the McKesson & Robbins case was stated in an editorial appearing in the *Journal of Accountancy* (official organ of the Institute), February 1939, in the following language:

"In the light of circumstances so unusual, one might predict that such a case could never occur again. Yet the fact remains that auditors had been misled and that a published balance sheet had contained substantial overstatements of assets. The need for a critical review of audit procedure was evident. Members of the Institute from all parts of the country were demanding some public statement by the executive committee to clarify the position of the profession as a whole. After extensive deliberation, the executive committee issued a short statement to the press on December 28,<sup>5</sup> simply saying that in the interest of the

<sup>1</sup> For complete text of Attorney General's letter, see *The Certified Public Accountant*, January 1939.

<sup>2</sup> For complete text of this statement see *Statement to Attorney General Bennett*, *New York Certified Public Accountant*, January 1939. See also editorial in *Journal of Accountancy*, February 1939, for comment on the statement.

<sup>3</sup> For the text of the report, see *The Certified Public Accountant*, February 1939.

<sup>4</sup> The American Institute of Accountants reported that it had 5118 members at May 1, 1939. *The Certified Public Accountant*, June 1939, p. 5.

<sup>5</sup> For the text of this statement see *The Certified Public Accountant*, January 1939, p. 2.

public and the accounting profession the Institute would review customary auditing procedure in the light of the McKesson & Robbins case to determine what, if any, changes should be adopted; that a standard of accounting procedure had been in existence for many years in written form in the bulletin, Examination of Financial Statements by Independent Public Accountants (a copy of which was sent to every newspaper which received the release); that the McKesson & Robbins case was an extraordinary one in which there was testimony indicating collusive fraud on the part of high officers and the forging of accounting records, and therefore should not be emphasized unduly in consideration of proper auditing procedure in the great majority of cases; that the problem of auditing was to find means of affording adequate protection at a cost which would not constitute an undue burden on honestly administered companies.

“The principal purposes of this statement were to inform the public that certified public accountants are members of a well organized profession which recognizes its responsibilities in this case, and that the profession had not neglected its duty to set up standards of procedure and to publish them for the information of the financial community. At the same time it was made clear that the profession was ready and willing to reexamine those procedures and to change them if they could be strengthened.”

A special committee on auditing procedure was appointed by the American Institute of Accountants and in due course it reported to the Council of the Institute that,

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

Examination of inventories.

Examination of receivables.

Appointment of independent certified public accountants.

Form of independent certified public accountant's report.”

This report was submitted under the title, “Extensions of Auditing Procedure” and was formally adopted by the Council of the American Institute of Accountants on May 9, 1939. Publication and widespread distribution of this report<sup>6</sup> led to extensive discussion of its proposals culminating in the drafting of a modified report which was approved on September 19, 1939 at the annual meeting of the Institute. Both of these reports prescribe as normal audit procedure attendance of the independent accountant at the inventory taking or the observing of or making of physical test checks of inventory quantities and the confirmation of receivables by direct communication with debtors. The principal modifications in the September report were changes in the language of the proposed short-form report (or certificate) and the elimination of the requirement for an explanation in the auditor's report, when he has not confirmed accounts receivable or made a physical verification of inventories in those cases where doing so was

<sup>6</sup> The Institute reported that at June 30, 1939, 23,319 copies of this report had been distributed. The Certified Public Accountant, July 1939, p. 6.

not reasonable or practicable. The modified report is reproduced at the end of this appendix.

An editorial in the *Journal of Accountancy*, June 1939, referring to the report of May 9, 1939 read in part as follows:

"The adoption of this report fulfills the promise made publicly by the executive committee of the Institute last December that auditing procedure would be carefully reviewed by the Institute in the light of current public discussion. The fact that recommendations on important aspects of auditing procedure have been suggested, considered, and adopted in so short a space of time has led observers to ask whether the proposals were 'hasty and ill considered'. This question could not arise in the mind of anyone who had had the privilege of observing the intensive study which the proposals received before adoption. It is estimated that 1500 man-days of time were spent by the committees of the Institute and the New York State Society of Certified Public Accountants which collaborated in drafting the report. More than 300 persons outside the committees, including representatives of business organizations and regulatory bodies, as well as state societies of certified public accountants, controllers and others were provided with successive drafts, and their numerous and frank criticisms were studied in the greatest detail \* \* \*."

In respect to the modified report *The Journal of Accountancy* stated editorially <sup>7</sup> (in part):

"Another point of immediate interest and importance is the elimination by the council at its September meeting of the recommendation in the May 9th report that an explanation be included in the auditor's report where the additional procedures with regard to inventories and receivables have not been undertaken because it was not practicable and reasonable to do so, even though the auditor had satisfied himself by other means. Discussion and criticism of this feature of the original report convinced the council that it was unwise and that no useful purpose would be served by requiring a negative explanation in the auditor's report, but rather that it would tend to convey unwarranted implications of reservations or exceptions when none was intended. The revised report will place the responsibility squarely upon the accountant to determine the scope of the examination which he should make before giving his opinion on the statements under review. The council reiterated, however, that if the additional procedures recommended in the May 9th report are practicable and reasonable and the auditor has omitted them he should make a clear-cut exception in his opinion."

In the early part of July 1939, a letter was addressed by the Chief Accountant of the Securities and Exchange Commission to all state societies or organizations of public accountants inquiring whether any rules, resolutions, or other materials relating to auditing theory or practice had been promulgated or approved during 1939, whether any such matters were pending, and whether any accounting forums, conferences, or other similar meetings which included a discussion of auditing theory and practice had been sponsored or participated in during 1939. The purpose of this inquiry was to secure information as to activities these organizations had undertaken with respect to the foregoing matters.

<sup>7</sup> November 1939, p. 290.

The replies <sup>8</sup> to this inquiry indicate that generally the state societies expected the American Institute of Accountants to take the initiative in dealing with questions of auditing procedure and that they should await the final action of that body before taking decisive action themselves on such questions.

The New York State Society of Certified Public Accountants was an exception in that respect. A special committee of this Society cooperated with the Committee of the American Institute of Accountants and prepared a report on auditing practice and procedure which was adopted by the Society at a special meeting, May 22, 1939. This report is identical in all essential respects to that submitted in the same month by the special committee on auditing procedure of the American Institute of Accountants.<sup>9</sup> This report was reconsidered at a special meeting of the Society held on December 5, 1939 and modifications similar to those of the American Institute of Accountants' modified report were adopted.

A number of state societies of public accountants formally adopted by resolution the May report of the special committee of the American Institute of Accountants and others delayed action and adopted the revised report. Falling in one category or the other are the societies of the states of Connecticut, Florida, Idaho, Illinois, Iowa, Kansas, Massachusetts, Missouri, Nebraska, North Carolina, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas, Utah, Washington, and of the District of Columbia.<sup>10</sup>

Soon after the May 1939 report was published, each of three separate groups of state societies held joint conferences at which resolutions were adopted, recommending to the several state societies represented at the conference that they support the report of the American Institute of Accountants by giving it their approval. The three conferences referred to and the societies represented are as follows:

East Four States Conference, embracing the Societies of Connecticut, New York, New Jersey, and Pennsylvania.

Central States Conference, embracing the Societies of Illinois, Iowa, Kansas, Minnesota, Missouri, Nebraska, South Dakota, and Wisconsin.

Middle Atlantic States Conference,<sup>11</sup> embracing the District of Columbia Institute of Certified Public Accountants, Kanawha Valley (W. Va.) Accountants Association, Maryland Association of Certified Public Accountants, North Carolina Association of Certified Public Accountants, South Carolina Association

<sup>8</sup> As of July 1, 1940 all but five state societies had responded.

<sup>9</sup> Printed report available from New York State Society of Certified Public Accountants.

<sup>10</sup> Missouri approved "in substance" and Rhode Island "in principle," the latter society taking exception to the form of the certificate which they felt could not be used in all cases. The District of Columbia Society approved the revised report as minimum requirements. The Illinois Society favors a positive statement in the certificate as to the nature and extent of the auditor's tests of quantities "in all cases where inventories are a material factor." Washington refers to the Seattle chapter which includes about seventy-five percent of that State's members.

<sup>11</sup> Papers presented at this conference have been published in a volume which includes some of the papers presented at the Central States conference.

of Certified Public Accountants, Virginia Society of Public Accountants, West Virginia Society of Certified Public Accountants.

As to matters pending relative to auditing procedure and practice, many of the state societies indicated that the report of the American Institute of Accountants was under consideration. In a number of instances it was stated that the report was not completed in time to be considered and acted upon at meetings of Societies held early in the year, 1939, but that action on the report would probably be taken at meetings to be held in the latter part of the year. In a few instances the probability of approval of the report was indicated.<sup>12</sup>

Thirty-five state societies were reported to have devoted considerable time and attention during the year 1939 to consideration of auditing procedures and practices. Numerous open forum or round-table discussions were held at which these matters were discussed. In addition, many papers dealing with various aspects of auditing procedure and practice were presented and discussed at state conventions and interstate group conferences. Procedures relating to the verification of inventories and accounts receivable, including the report of the American Institute of Accountants on these matters, were the subject of extended discussion at these conventions and conferences. In addition, a substantial part of the program of the 1939 annual meeting of the American Institute of Accountants was devoted to these questions.<sup>13</sup>

In addition to the "Extensions of Auditing Procedure" two additional formal statements of the American Institute of Accountants Special Committee on Auditing Procedure should be mentioned. The first, "The Auditor's Opinion on the Basis of a Restricted Examination" was published in the Journal of Accountancy for December 1939. The statement constitutes an opinion of the Committee in respect to an audit in which a large proportion of the assets were receivables and inventories in branch offices of the client and the audit had been restricted to head office records and omitted confirmation of receivables and generally accepted auditing procedures with regard to physical quantities of inventories. The opinion given was that under the circumstances the exceptions with regard to the scope of the examination would have been so material as to negative the expression of an opinion and that, consequently, the auditors should refrain from expressing one. The second, "Inventories and Receivables of Department Stores, Instalment Houses, Chain Stores, and Other Retailers"<sup>14</sup> takes the position that the extensions of auditing proce-

<sup>12</sup> As of July 1, 1940 the following societies had not advised us of final action but had stated previously that such action was pending: Alabama, California, Colorado, Georgia, Indiana, Michigan, Minnesota, Montana, New Jersey, Ohio, Virginia, West Virginia, and Wyoming.

<sup>13</sup> Papers on Auditing Procedure and other Accounting Subjects, American Institute of Accountants, New York, 1939, 295 pages.

<sup>14</sup> 69 Journal of Accountancy 88 (1940).

dures in respect to receivables and inventories are reasonable and practicable in these lines of business in which some accountants had expressed some doubt as to their applicability. The prompt publication of these statements and of the "Extensions of Auditing Procedures" may be considered an emergency measure pending the incorporation of these ideas in a thorough revision of the bulletin, "Examination of Financial Statements by Independent Public Accountants", a project with which the Committee on Auditing Procedure plans to proceed.<sup>15</sup>

Those organizations, referred to hereinabove as being outside the public accounting field but interested in its objectives, reported that their activities during 1939 relating to auditing procedures and practices consisted principally in cooperating and consulting with organizations of public accountants directly concerned with these matters. Relations of this character were cited by the National Association of Credit Men, National Association of Cost Accountants, National Association of Manufacturers, New York Stock Exchange, and Robert Morris Associates. It is quite possible that organizations other than these had similar relationships with the public accounting profession. Other activities in the field of auditing procedures and practice which were mentioned specifically by certain organizations in this group follow.

The National Association of Manufacturers reported that its Committee on Industrial Practices made a study during 1939 of the auditing practices of business. The Committee made a report<sup>16</sup> which was subsequently approved by the Association's Board of Directors recommending, among other things, selection of the auditors by a committee of the board of directors with approval by the full board and if feasible by the stockholders, spot checking of inventories on interim dates as a test of perpetual inventories, clarification of the auditors' report and "that business should attempt to adopt its natural business year as its fiscal year."

The National Association of Cost Accountants carried out a survey during 1939 on "The Place of Internal Auditing in Industrial Companies."<sup>17</sup> The report is based on questionnaire replies from 285 N. A. C. A. members and is an illuminating document on the function of the controller and the purpose of internal auditing. It also covers important points in the internal control procedures intended to safeguard the company from losses in connection with cash, receivables, inventories, and capital expenditures.

The New York Stock Exchange on August 23, 1939, adopted a report of the Sub-Committee on Independent Audits and Audit Procedure of Committee on Stock List in which the McKesson &

<sup>15</sup> The Certified Public Accountant, June 1940, p. 4.

<sup>16</sup> See N. A. M. News Letter, June 23, 1939.

<sup>17</sup> For text of report see N. A. C. A. Bulletin, June 1, 1939, Section III.

Robbins case was considered and the scope of independent audits was discussed. The report endorses the extensions of audit procedure adopted by the American Institute of Accountants and states that the Sub-Committee "believes that the primary responsibility for establishing standards of the scope of the independent auditor's examination must rest with the accounting profession." A section of the report dealing with the manner and time of appointment of auditors; increasing the responsibility, authority, and facilities of the controller or internal auditor; and the adoption of the natural business year in lieu of the calendar year is reproduced at the end of this appendix.

The Sub-Committee favored a short certificate but recognized the need for further education of the public in a concise summary of efforts in this direction:

"It is generally conceded that a program of general education of the public in the significance and necessary limitations of financial statements and audits is highly desirable. In recent accountants' speeches and reports, widely quoted in newspapers and periodicals, very explicit statements are made of the meaning, value and inevitable limitation of independent audits. Your Sub-Committee urges more widespread familiarity with the Institute's Bulletin, 'Examination of Financial Statements'; the 'Report on Independent Audits', made to the Board of Governors of the Exchange in 1933; 'Extensions of Auditing Procedure', the most recent report of the Institute; and the April, May, and June, 1939, issues of 'The Journal of Accountancy', which include enlightening summaries of parts of the recent S. E. C. hearings following the McKesson & Robbins case, at which the views of twelve leading members of the accounting profession were given on numerous questions of auditing procedure. These summaries are not long, and the views expressed are worded so that even those with little technical knowledge may get a broad view of present day auditing problems and experience."

This brief survey of the activity of organizations interested in the work of professional accountants indicates that they have confidence in the accountants' ability to cope with the problems presented to the profession as a result of the McKesson & Robbins case. The American Institute of Accountants' "Extensions of Auditing Procedure" and an extract from the Report of the New York Stock Exchange's Sub-Committee on Independent Audits and Audit Procedure of Committee on Stock List are reproduced in the following pages.



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

## 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 has 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. 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 coördinate 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 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 and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negate 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.<sup>18</sup>

<sup>18</sup> See page 436 *supra* for paragraphs of the May 9, 1939 version omitted in this revision.

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

The proposed changes will take time to bring about, and 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.<sup>18</sup>

<sup>18</sup> See page 436 *supra* for paragraphs of the May 9, 1939 version omitted in this revision.



## 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.

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

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.



## RECOMMENDATIONS AS TO CORPORATE PROCEDURES

### An Extract from New York Stock Exchange—Report of Sub-Committee on Independent Audits and Audit Procedure of Committee on Stock List

“Your Sub-Committee regards the responsibilities of corporations in auditing matters as two-fold: to institute such corporate procedures as will make its system of bookkeeping, and of internal control and audit, as efficient as possible; and to facilitate in every reasonable way the work of the independent auditor. Of a large number of proposals considered in these connections, your Sub-Committee has selected four as sufficiently important and practicable to warrant endorsement by the New York Stock Exchange. These recommendations are made subject to consideration of applicability in the particular case, and in the knowledge that their usefulness in connection with audits might have to be weighed against other disadvantages.

#### 1. *Strengthening the Position of the Independent Public Accountant.*

This might best be accomplished through the general assumption by Boards of Directors of direct responsibility for either the appointment of the auditors or for their selection and recommendation to the stockholders for approval. Where practicable, the selection of the auditors by a Special Committee of the Board composed of Directors who are not officers of the Company appears desirable.

The results of the auditor's examination should always be available to the Board of Directors, his report should be addressed to the stockholders, and he should be afforded the opportunity to appear at any stockholders meeting.

#### 2. *Increasing the Responsibility, Authority, and Facilities of the Controller or Internal Auditor.*

More emphasis should be placed on the responsibility of the Controller and the assurance to him of adequate authority and facilities. The scope of his responsibilities should be fixed by the Board of Directors, and he should report periodically to them, in addition to making his customary reports to the operating management.

The Controller or chief financial officer should sign the published financial statements of his company, even in those cases where the statements are accompanied by the report of the independent public accountant.

Independent and efficient accounting and internal auditing departments are a vital factor in assuring the accuracy of the books and published reports. The importance of the Controller or internal auditor in these connections is paramount and the Board of Directors should take an active interest in his selection.

#### 3. *Adoption of Natural Business Year in Lieu of Calendar Year.*

The Natural Business Year of the industry in which a company is engaged is recommended, unless impracticable for special reasons, as the fiscal year of the company instead of the Calendar Year. The more

general adoption of the natural business year by companies in each industry would to a large extent smooth out the huge peaks of audit work which now occur in the early part of each calendar year. By adopting a Natural Business Year which conforms to the true business cycle of the particular industry, corporations may simplify their problems of year end adjustment and reduce the cost of stock-taking, besides permitting a more efficient and more economical audit. The income account of a company based on a completed cycle of a normal year's operations would give the investor a fairer picture of the operations of his company. Reports of companies in the same field of business would be directly comparable, as almost all industries have their own clearly defined natural business years.

*4. Appointment of the Independent Public Accountants Early in the Fiscal Year.*

The appointment of the independent auditor early in the fiscal year appears eminently desirable, so that part of his work may be done during the year and he may be free to make an examination of any phase of the company's operations at any time."