Outline Of Statements On Auditing Standards And Procedures

UNITED STATES GENERAL ACCOUNTING OFFICE

OUTLINE OF STATEMENTS ON AUDITING STANDARDS AND PROCEDURES

PREPARED FOR ADVANCED ACCOUNTING
AND AUDITING STUDY PROGRAM

UNITED STATES GENERAL ACCOUNTING OFFICE
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INTRODUCTION

The following outlines were taken from Statements on Auditing Procedure issued by the Committee on Auditing Procedure of the AICPA. These outlines are not intended to replace the full discussion contained in the statements.

The outlines were prepared by staff members of the General Accounting Office for use in their Advanced Accounting and Auditing Study Program, which includes an annual CPA Review Course.

Leo Herbert, Director
Office of Personnel
Management

STATEMENT NO. 33

STATEMENTS ON AUDITING PROCEDURE

SECTION I - GENERAL

CHAPTER 1

RESPONSIBILITIES AND FUNCTIONS OF THE INDEPENDENT AUDITOR

The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position and results of operations. In his report the auditor states whether his examination has been made in accordance with generally accepted auditing standards. These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted principles of accounting and whether such principles have been consistently applied in the preparation of the financial statements of the current period in relation to those of the preceding period.

Management has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, and for devising an effective system of internal control. The fairness of the representations made through financial statements is an implicit and integral part of managements responsibility. The independent auditor may make suggestions as to the form or content of financial statements he has examined; however, his responsibility is confined to the expression of his opinion on them.

The independent auditor must possess the professional qualifications of adequate education and experience and have the ability to exercise professional informed judgment. His qualifications do not include those of a person trained to engage in another profession or occupation, such as an appraiser or an attorney.

The independent auditor's ordinary 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 and similar irregularities, although their discovery may result. The responsibility of the independent auditor for failure to detect fraud arises only when such failure clearly results from his noncompliance with generally accepted auditing standards. Reliance for the prevention of fraud should be placed upon an adequate accounting system with good internal control.

The independent auditor has a responsibility to his profession to comply with the standards accepted by his fellow practitioners. The Institute has adopted, as part of its Code of Professional Ethics, rules which support the standards and provide a basis for enforcement of them.

The Securities and Exchange Commission has said that the fundamental responsibility for the accuracy of financial information filed with the Commission and disseminated among the investors rests upon management. For example, section 11 of the Securities Act of 1933 imposes responsibility for false or misleading statements, or for omissions which render misleading the statements made, in an effective registration statement on accountants who have certified any part of the registration statement.

CHAPTER 2

GENERALLY ACCEPTED AUDITING STANDARDS

Auditing "standards" differ from auditing "procedures" in that procedures relate to acts to be performed, whereas standards deal with measures of the quality of the performance of those acts and the objectives to be attained by the use of the procedures undertaken. The generally accepted auditing standards, as approved and adopted by the membership of the American Institute of Certified Public Accountants, are as follows:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

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.

Standards of Reporting

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 either contain 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.

The elements of "materiality" and "relative risk" underlie the application of all the standards, particularly the standards of field work and reporting.

NOTE: Statements on Auditing Procedure No. 33 is essentially a codification of the substantive matters contained in earlier pronouncements of the AICPA Committee on Auditing Procedure.

Although the substance of the committee's 1954 special report, Generally Accepted Auditing Standards--Their Significance and Scope, was consolidated in Statement No. 33, there is much in the 54-page booklet of continuing usefulness to those interested in a more comprehensive study of generally accepted auditing standards.

SECTION II - GENERALLY ACCEPTED AUDITING

STANDARDS AND PROCEDURES - GENERAL STANDARDS

CHAPTER 3

THE GENERAL STANDARDS

The general standards are personal in nature and are concerned with the qualifications of the auditor and the quality of his work.

The first general standard reads:

> The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

In the performance of the examination which leads up to an opinion, the independent auditor holds himself out as one who is proficient in accounting practice and auditing procedure. The attainment of that proficiency begins with the auditor's formal education and extends into his subsequent experience. The independent auditor must undergo training adequate to meet the requirements of a professional man. This training must be adequate in technical scope and should include a commensurate measure of general education.

The second general standard reads:

> In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners.

The third general standard reads:

> Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Due care imposes a responsibility upon each person within an independent auditor's organization to observe the standards of field work and reporting. Exercise of due care requires critical review at every level of supervision of the work performed and the judgment exercised by those assisting in the examination.

SECTION III - GENERALLY ACCEPTED

AUDITING STANDARDS AND PROCEDURES

FIELD WORK STANDARDS

CHAPTER 4

ADEQUACY OF PLANNING AND THE TIMING OF FIELD WORK

The first standard of field work reads:

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

Adequately planning by an auditor is facilitated by an early appointment by the client. Early appointment enables the auditor to plan his work so that it may be done expeditiously and to determine the extent to which it can be done before the balance-sheet date. An early appointment is particularly helpful with respect to planning for the observation of the taking of physical inventory. The spreading of work throughout the year also permits more efficient scheduling of staff assignments.

The first standard of field work concerns particularly the timeliness of the auditing procedures and the orderliness of their application. The timeliness with which auditing procedures are undertaken involves the proper timing and synchronizing of their application in the examination of related accounts. The need for orderliness in carrying out audit procedures is apparent, for example, in the application of procedures for inventory observation.

Although early appointment is preferable, an independent auditor may accept an engagement near or after the close of the fiscal year. In such instances, before accepting the engagement, he should ascertain whether circumstances are likely to permit an adequate examination and expression of an unqualified opinion; and, if they will not, he should discuss with the client the possible necessity for a qualified opinion or disclaimer of opinion.

CHAPTER 5

EVALUATION OF INTERNAL CONTROL

The second standard of field work reads:

> 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.

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. This definition recognizes that a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments.

In the broad sense, internal control includes controls which may be characterized as either accounting or administrative. Accounting controls encompass the methods of safeguarding assets and maintaining reliable financial records. They include authorization controls governing the acquisition and disposition of assets, physical control of assets, internal auditing, and the separation of duties concerned with recordkeeping from those concerned with asset custody. Administrative controls are concerned with operational efficiency and adherence to managerial policies, and they usually relate only indirectly to the financial records. These controls include time and motion studies, performance reports, employee training programs, quality controls, and statistical analyses.

The characteristics of a satisfactory system of internal control would include:

1. A plan of organization that provides appropriate segregation of functional responsibilities.

2. A system of authorization and record procedures adequate to provide reasonable accounting control over assets, liabilities, revenues, and expenses.

3. Sound practices to be followed in performance of duties and functions of each of the organizational departments.

4. Personnel of a quality commensurate with responsibilities.

These elements, as important as each is in its own right, are all so basic to adequate internal control that serious deficiencies in any one normally would preclude successful operation of the system.

While the responsibility for the establishment and enforcement of internal control rests with management, the degree to which such controls exist and are carried out is of great concern to the independent auditor. The independent auditor should make a proper study and evaluation of the existing internal control to ascertain the degree of reliance that may be placed on the internal control in determining the extent of the tests to which auditing procedures are to be restricted.

Where feasible, the independent auditor's review of internal control may be conducted as a separate phase of the examination, preferably at an interim date, by applying appropriate auditing procedures directed particularly to appraising the effectiveness of the client's system. As a by-product of this study and evaluation, the independent auditor is frequently able to offer constructive suggestions to his client on ways in which internal control may be improved.

NOTE: Statements on Auditing Procedure No. 33 is essentially a codification of the substantive matters contained in earlier pronouncements of the AICPA Committee on Auditing Procedure.

The substance of the committee's 1949 special report on Internal Control was consolidated in Statement No. 33. However, there is much in the 34-page booklet of continuing usefulness to those interested in a more comprehensive study of internal control. (See Journal of Accountancy, August 1964, p. 63.)

CHAPTER 6

EVIDENTIAL MATTER

The third standard of field work reads:

> 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.

The auditor obtains and examines evidential matter in order to formulate an opinion on financial statements. The value of evidential matter varies; therefore, the auditor must use judgment to determine what evidential matter is to influence him most in developing his opinion on the financial statements.

Evidential matter consists of underlying accounting data and corroborating information. Books of original entry. the general and subsidiary ledgers, related accounting manuals, and such informal and memorandum records as work sheets supporting cost allocations, computations, and reconciliations, all constitute evidence in support of the financial statement. Corroborating information includes documentary material such as checks, invoices, and confirmations; information obtained through observation and physical examination; and all other pertinent available evidence.

To be competent, evidence must be both valid and relevant. Although circumstances lead to exceptions to rules, the following presumptions about the validity of evidential matter in auditing have some usefulness:

1. Evidence from independent outside souces provides greater assurance of reliability than internal evidence.

2. Accounting data developed under satisfactory conditions of internal control is more reliable than accounting data developed under unsatisfactory conditions of internal control.

3. Direct personal knowledge obtained through physical examination, observation, computation, and inspection is more persuasive than information obtained indirectly.

Sufficiency of evidential matter is dependent upon the circumstances in each particular case. The circumstances relate to the nature; materiality; degree of risk; internal control; and susceptibility to conversion, manipulation, or misstatement of each particular case.

Generally, the auditor finds it necessary to rely on evidence that is persuasive rather than convincing. If substantial doubt exists as to the fairness of the financial statements, the auditor must not formulate an opinion on the statements until more evidence is gathered, or the auditor must express a qualified opinion or a disclaimer of opinion.

The auditor must consider the economic limits on obtaining information. As a guiding rule, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. Statistical sampling techniques may be considered, but these techniques should not reduce the use of judgment by the auditor.

The auditor must consider the fact that the financial statements may not be presented fairly. All relevant evidential matter must be considered whether it supports or contradicts the financial statements. It is not sufficient to offer an opinion only on the grounds that nothing came to the auditor's attention to cause him to question the assertions in the financial statements under examination.

Confirmation of receivables and observation of inventories were established in 1939 as generally accepted auditing procedures where they are practical (capable of being done with available means) and reasonable (sensible in the light of the surrounding circumstances) and the assets concerned are material to financial position or results of operation. When these procedures cannot be used, the auditor bears the burden of justifying the opinion expressed.

The number of confirmations and the method and time of the confirmations are determined by the auditor's judgment in light of the circumstances which surround the receivable (i.e., internal control, materiality, and other factors).

Where inventory quantities are determined solely by physical count, the auditor should observe the count and satisfy himself respecting the effectiveness of the method of inventory-taking. The independent auditor may observe inventory counts at interim dates if perpetual inventory records are checked periodically by physical count and comparisons.

In all the discussion in this section pertaining to the accumulation of competent evidential matter, it is implied that the evidence gathered by the auditor during the examination is included in the working papers.

NOTE: In October 1964, the President of the AICPA issued a special bulletin to the members of the American Institute of Certified Public Accountants stating that "The Council of the Institute, at its meeting October 2, 1964, unanimously adopted recommendations that members should see to it that departures from Opinions of the Accounting Principles Board (as well as effective Accounting Research Bulletins issued by the former Committee on Accounting Procedure) are disclosed, either in footnotes to financial statements or in the audit reports of members in their capacity as independent auditors."

SECTION IV - GENERALLY ACCEPTED

AUDITED STANDARDS AND PROCEDURES - REPORTING

CHAPTER 7

ADHERENCE TO GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

The first standard of reporting reads:

> The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

The term "principles of accounting" includes not only accounting principles and practices but also the methods of applying them. The first reporting standard requires the auditor to form an opinion as to whether the financial statements are presented in conformity with such principles.

It is the responsibility of the auditor to become familiar with all generally accepted accounting principles, including those of limited usage which still have general acceptance. He must keep abreast of pronouncements issued by the American Institute of Certified Public Accountants which give recognition to changes in generally accepted accounting principles. He should also be alert to changes which become acceptable through common usage by business although not a subject of an Institute pronouncement.

CHAPTER 8

CONSISTENCY OF APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

The second standard of reporting reads:

> The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

It is implicit in the standard that such principles have been consistently observed within each period. The objective of the consistency standard is (1) to give assurance that the comparability of financial statements as between periods has not been materially affected by changes in the accounting principles employed or in the method of their application or (2) if comparability has been materially affected by such changes, to require a statement of the nature of the changes and their effects on the financial statements.

The consistency standard involves the consistent application of accounting principles. Generally, lack of consistency produces lack of comparability; but lack of comparability may not be caused by lack of consistency.

In general, comparability of financial statements as between years is affected by changes from (1) a change in accounting principles employed, (2) changed conditions which necessitate accounting changes but which do not involve changes in the accounting principles employed, and (3) changed conditions unrelated to accounting. Distinguishing characteristics of the types of changes included in each of these three classes are briefly commented upon in the following paragraphs.

ANALYSIS OF CAUSES OF LACK OF COMPARABILITY

Comparability affected by	Example	Disclosure required in auditor's report
A. Change in accounting principles employed	Change in method of depreciation	Yes
B. Changed conditions which necessitate accounting changes but which do not involve changes in the accounting principles employed	Change in estimated useful life of an asset	No, but if amount is material it should be disclosed by a note to the financial statements
C. Changed conditions unrelated to accounting	Acquisition or disposition of a subsidiary	No, but may be disclosed by a note to the financial statements

Reclassifications of items in the financial statements usually need not be disclosed unless they are material, in which case they may be disclosed by a note to the financial statements.

The consistency standard is aimed at the comparability of the financial statements of the current year with those of the preceding year. If the auditor's opinion is to pertain to a longer period, a change in the wording of the short-form report is appropriate.

A type "A" inconsistency (change in accounting principles employed) which has a material effect on the financial statements requires disclosure in the opinion section of the auditor's report.

The following chart suggests guides to be followed in writing the auditor's opinion paragraph for various type "A" inconsistencies.

Change	Disclosure in short-form audit report
A. Change to alternative generally accepted accounting principle	1. Refer to change 2. No need to qualify conformity statement 3. May express approval
B. Change from principle which lacks general acceptance to a generally accepted accounting principle	1. Refer to change 2. Express approval
C. Change to principle or practice which lacks general acceptance	1. Qualification or adverse opinion is necessary
D. Change expected to have material future effect	1. No need to disclose if there is a note to the financial statements
E. Change makes it desirable to restate financial information for prior years and the auditor reports on:	
1. The current year	1. Refer to change 2. May express approval
2. Years restated and change made in current year	1. Refer to change 2. May express approval
3. Years restated but change not made in current year	1. No need to disclose if there is a note to the financial statements
F. Change of accounting principles employed but prior year's financial information not restated and:	
1. Change took place in the current year	1. Reference to consistency may be omitted 2. Insert a middle explanatory paragraph
2. Change took place in other than the current year and auditor is reporting on	
a. All the years	1. Refer to change
b. Only the current year	1. No need to disclose if there is a note to the financial statements

Special Conditions

A. Independent auditor's first report on:	
1. A newly organized company	1. No reference to consistency needed
2. An established company and:	
a. Where records are adequate and it is practical to extend auditing procedures	1. Report on consistency
b. Same as "a" but limitations on procedures are imposed by the client	1. Appropriate qualification required
c. There are inadequate records and the auditor cannot form an opinion on consistency or accuracy of the statements of income and retained earnings	1. No reference to consistency 2. No reference to statement of income and retained earnings 3. Insert explanatory paragraph describing situation and inability to express opinion on the statements of income and retained earnings and omit statement on consistency
d. Prior years' accounting records, kept on a basis which did not result in a fair presentation of financial position and results of operations for those years, not comparable with current year's statements	1. Insert a middle explanatory paragraph 2. Omit reference to consistency
B. Pooling of interests and:	
1. Comparative financial statements are not in accordance with Accounting Research Bulletins Nos. 48 and 49	1. Refrain from use of standard consistency expression 2. Refer to inconsistency in report
2. Single-year statements only are presented	1. Consistency standard may be used if appropriate note is made to financial statements

CHAPTER 9

ADEQUACY OF INFORMATIVE DISCLOSURE

The third standard of reporting reads:

> Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report

The fairness of presentation of financial statements, apart from the relationship to generally accepted accounting principles, is dependent upon the adequacy of disclosures of material matters. What constitutes a matter requiring disclosure is for the independent auditor to decide in the exercise of his judgment in light of the circumstances and facts of which he is aware at that time. Certain kinds of information that would be detrimental to the company and the stockholders should not be disclosed. Information that has been omitted from the financial statements, which the auditor believes is significant, should be disclosed in his report together with an accompanying qualification of his opinion.

Somewhat related to the matter of disclosure is the matter of information which the auditor receives in confidence akin to the status of privileged communication. If the information received does not, in his judgment, require disclosure for the financial statements not to be misleading, this standard does not require disclosure of such information.

CHAPTER 10

EXPRESSION OF OPINION, OR REASONS FOR NO OPINION, IN THE INDEPENDENT AUDITOR'S REPORT

The fourth standard of reporting reads:

> The report shall either contain 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.

The objective of the fourth reporting standard is to prevent misinterpretation of the degree of responsibility the independent auditor is assuming whenever his name is associated with the financial statements. The auditor must bear in mind that justification for the expression of his opinion, whether qualified or unqualified, rests on the degree to which the scope of his examination conforms with generally accepted auditing standards. This standard of reporting does not preclude the expression of separate opinions on financial position and results of operations. By utilizing a "piecemeal opinion" the independent auditor may express an unqualified opinion on one of the financial statements and disclaim an opinion or express a qualified or an adverse opinion on the others.

The short-form report of the auditor is customarily used in connection with the basic financial statements. It is also often included as part of a long-form report. The usual short-form report consists of a "scope" paragraph which represents the work performed and an "opinion" paragraph that reveals the independent auditor's conclusions.

An unqualified opinion that the financial statements present fairly the financial position and results of operations may be expressed only when the independent auditor has formed the opinion based on an examination made in accordance with generally accepted auditing standards. The presentation of the financial statements must also conform with generally accepted accounting principles applied on a consistent basis and include all necessary and material informative disclosures necessary to make the statements not misleading.

When a qualified opinion is rendered because of a specific deviation from the essentials needed for an unqualified opinion, the auditor should refer specifically to the subject of the qualification and reveal in his report the reasons for his qualification and the effect on the financial position and results of operations, if reasonably determinable. When a qualification is so material as to negative an expression of opinion as to the financial statements as a whole, an adverse opinion is required. An adverse opinion is an opinion that the financial statements do not present fairly the financial position or results of operations in conformity with generally accepted accounting principles. A disclaimer of opinion should be rendered if the auditor has not obtained sufficient competent evidential matter to form an opinion as to the fairness of the statements. The necessity of disclaiming an opinion may arise either from a serious limitation on the scope of examination or from the existence of unusual uncertainties concerning the amount of an item or the outcome of a matter materially affecting financial position or results of operations, causing the independent auditor not to be able to form an opinion on the financial statements as a whole. When an adverse opinion or a disclaimer of opinion has been rendered on the financial statements as a whole, the auditor may express a "piecemeal opinion" as to the individual financial statements or accounts that comply with generally accepted accounting principles.

Upon completion, the report should be appropriately addressed to the client, the board of directors, or the stockholders, depending upon the circumstances, and it should be signed by the independent auditor.

If the auditor has prepared financial statements without an audit, each page of the statements should be conspicuously marked "without audit" or "unaudited," whether accompanied by his comments or not. The independent auditor should refuse to be associated in any way with unaudited financial statements which he believes are false or misleading.

Where the scope of the examination is limited by the omission of necessary auditing procedures, reports should not be issued which temper the qualification or disclaimer of opinion by the inclusion of misleading favorable expressions. However, negative assurances are permissible in letters required by security underwriters in which the independent auditor reports on limited procedures. These letters usually state specifically that no audit has been made, and distribution of the letter is restricted to parties to the underwriting agreement.

The usual circumstances which may require the independent auditor to deviate from the standard short-form report and a guide to the applicable deviation follow:

Circumstance	Guide to deviation
A. The scope of his examination is limited or affected:	
1. By conditions which preclude the application of necessary auditing procedures and the auditor is:	
a. Able to satisfy himself by other auditing procedures	1. None required
(1) Exception: omission of confirmation of receivable and observation of inventories at end of year	2. Refer in scope paragraph to omission of customary procedures and use of other procedures
b. Unable to satisfy himself by other auditing procedures	3. Indicate in scope paragraph and qualify or disclaim opinion
2. By restrictions imposed by clients	1. Indicate in scope paragraph and qualify (relate to item) or disclaim opinion
3. Because part of examination has been made by other independent auditors and principal auditor is:	
a. Unwilling to assume responsibility for other auditor's work	1. Include statement to the effect that amounts examined by other auditors have been included on the basis of that auditor's report
b. Unwilling to utilize report of other auditor	2. Qualify or disclaim opinion
c. Willing to assume responsibility	3. No reference to other auditor necessary
B. The financial statements do not present fairly financial position or results of operations because of:	
1. Lack of conformity with generally accepted accounting principles	1. Qualify or express adverse opinion
a. Regulated companies	1. Qualify or express adverse opinion if applicable
2. Inadequate disclosure	1. Supply supplemental information and qualify opinion
C. Lack of consistency	1. See chapter 8, page 10
D. Unusual uncertainties as to the effect of future developments on certain items which include:	
1. Those having a material effect on financial statements, and outcome is dependent on decision of parties other than management	1. Qualify opinion
2. Questions of valuation or realizability of assets is dependent on management's judgment	1. May require qualification of opinion
3. Amounts so material that qualification is inappropriate	1. Disclaim an opinion

Prior year's statements presented for comparative purposes do not require extension of auditor's opinion to cover them unless no examination of prior year's statements has been made or the auditor has significant exceptions or reservations regarding them.

CHAPTER 11

REPORTING ON SUBSEQUENT EVENTS

The independent auditor's examination relating to the fairness of financial statements is essentially historical in character. However, events or transactions sometimes occur subsequent to the balance-sheet date which may have a material effect on the financial statements or which may be important in connection with consideration of the statements and, therefore, require adjustment or annotation of the statements.

Although the independent auditor has no duty to extend the usual audit procedures to cover transactions of the subsequent period, his audit program ordinarily includes (1) certain procedures which are ordinarily carried out after the balance-sheet date, such as cash cut-offs, review of subsequent collections, confirmation follow-ups, etc., and (2) certain general procedures which normally are continued throughout his examination, such as reading available minutes of meetings and interim reports, having discussions with management, etc.

The independent auditor's responsibility for reporting on subsequent events is directly related to the third reporting standard, which states that informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

In general, there are three types of subsequent events or transactions:

1. Subsequent events that affect the financial statements directly and should be recognized therein. Examples are subsequent information acquired which would have been utilized had it been available at the balance-sheet date, such as the collection of receivables, or the settlement of liabilities on a substantially different basis from that previously anticipated.

2. Subsequent events which have no direct effect on the financial statements of the prior year but whose effects may be such that disclosure is advisable. Examples are the sale of a capital stock issue, purchases of businesses, or serious damage from fire, flood, or other casualty.

3. Subsequent events which are not likely to require disclosure in the financial statements; for example, nonaccounting matters such as war, legislation, management changes, product changes, strikes, etc.

There is no predetermined period, after the balance-sheet date, with which the auditor must be concerned in completing various phases of his examination. The duration of this period will depend upon the practical requirements of each examination and may vary from a relatively short period to one of several months.

When the report of an independent auditor is included in a filing with the Securities and Exchange Commission under one of the Federal securities statutes, his responsibility with respect to subsequent events is basically the same as that outlined above. However, section 11 of the Securities Act of 1933, which deals with the possible liability of an independent auditor acting as an expert in support of a registration statement, extends the period of time for which the auditor has a responsibility for subsequent events to the effective date of the registration statement. In view of the above circumstances, the independent auditor should increase and extend his examination of subsequent events when preparing financial statements for registration with the Securities and Exchange Commission.

In general, the date of completion of all important audit procedures should be used as the date of the independent auditor's report. In most cases this date will coincide with the completion of his work in the client's office.

For various reasons, it is not unusual that an independent auditor is requested by his client to furnish additional copies of a previously issued report. Generally, an effort will be made by the independent auditor to have these reports identical in appearance and date and, therefore, in the same condition as if the additional copies had been initially requested and furnished at the same time as the first copies were delivered. Under such circumstances, additional report copies may be delivered without further investigation or inquiry as to events which may have occurred between the date of issuance of the initial report and the request for additional copies.

CHAPTER 12

LONG-FORM REPORTS

Long-form reports include greater details of the customary basic financial statements, statistical data, explanatory comments, and sometimes a more detailed description of the scope of the auditor's examination than the description in the usual short-form reports.

The language of the short-form report is generally used in long-form reports. Accordingly, because the usual short-form report covers only the basic financial statements, the auditor should clearly establish his position regarding the other data in the long-form report. The auditor may wish to clarify his position by a brief statement in his comments explaining that:

1. His examination has been made for the purpose of formulating his opinion on the basic financial statements, taken as a whole.

2. The other data contained in the report for purposes of supplementary analysis either have been subjected to the audit procedures applied in the examination of the basic financial statements or have not been subjected to the audit procedures applied in the examination of the basic financial statements. He should state the source of this information and the extent of his examination and responsibility assumed, if any.

Where a long-form report is coexisting with a conventional short-form report, the auditor should make sure that:

1. The long-form report does not contain data which, if omitted from the short-form report, might support a contention that the short-form report was misleading because of

inadequate disclosure of material facts known to the independent auditor.

2. None of the comments or other data contained in the long-form report lend themselves to a contention that they constitute exceptions or reservations, as distinguished from mere explanations.

In addition, the auditor must consider whether the long-form report contains other financial data in such form as to support a contention that he has made factual representations with respect to the financial statements or books of account rather than that he has expressed an opinion on financial data consisting of management representations.

CHAPTER 13

SPECIAL REPORTS

The term "special reports" has reference to reports for which the wording of the usual short-form report may be inappropriate. Special reports may include:

1. Reports on financial statements of organizations which maintain their accounts and prepare their statements on a basis other than the accrual basis.

2. Reports on financial statements of some nonprofit organizations which follow accounting practices differing from practices followed by profitmaking organizations.

3. Reports prepared for limited purposes, such as:

   a. Reports relating only to certain aspects of financial statements.

   b. Reports that are filed with various agencies on prescribed forms.

The "general standards" and "standards of field work," to the extent appropriate in view of the character of the engagement, are applicable to engagements involving special reports. Also applicable are the third and fourth "reporting standards." When the special report relates to statements which purport to present the financial position and results of operations, the second standard of reporting as to consistency in the application of generally accepted accounting principles is applicable.

The first standard of reporting does not apply to statements which do not purport to present the financial position and results of operations. Under these circumstances, the independent auditor should express his opinion as to whether or not the statements fairly present the data on the basis indicated.

In reporting on statements prepared on a cash basis which do not present the financial position and operations, disclosure should be made in the statements or their footnotes or, less preferably, in the independent auditor's report (1) of the fact that the statements have been prepared on the cash basis and (2) of the general nature of any material items omitted, such as accounts receivable and accounts payable, and of the net effect of such omissions on the statements.

Statements prepared on a modified accrual basis of accounting may be judged by the independent auditor as materially incomplete. In such cases the nature and the amounts of the major variances should be disclosed and the independent auditor should render a qualified or adverse opinion.

In reporting on nonprofit organization financial statements, which have been prepared in accordance with clearly defined generally accepted accounting principles applicable to nonprofit organizations, the independent auditor may state his opinion as to the conformity of the statements either with generally accepted accounting principles or with accounting practices for that particular field.

Special reports in which incomplete financial presentations or no financial presentations are made should be drafted with a view to their special purpose and, accordingly, should state what information is presented, the basis on which it was prepared, and whether, in the auditor's opinion, it is presented fairly on that basis. Where the situation is such that an independent auditor considers it appropriate to express an opinion on an incomplete financial presentation, he should be cognizant of the added responsibility he may be assuming and the possible necessity of extending the scope of his examination.

Statements prepared on printed forms designed by the authorities with which they are to be filed may require classifications or procedures that, in the independent auditor's opinion, do not fairly present the financial position or results of operations of the company filing the statements, even though they purport to do so. Also, such forms may involve the additional problem of conforming the prescribed auditor's opinion or certificate to professional standards. Whenever the printed forms call upon the independent auditor to make an assertion which he believes he is not justified in making, he has no alternative but to reword them or to submit his separate report.

STATEMENT NO. 34

LONG TERM INVESTMENTS

I. Purpose of the Statement: Long term investments make up a significant portion of the assets of many firms. This statement furnishes guidelines for conducting examinations of the financial statements of firms with such investments.

II. Objective of the Examination: The auditor seeks to ascertain whether long term investments are stated in accordance with generally accepted accounting principles and whether the disclosures are adequate.

III. Types of Evidence

A. Evidence pertinent to existence and ownership includes accounting records and supporting documents.

1. In the case of securities (stocks, bonds and notes), inspection by the auditor or confirmation in writing by the cognizant custodian is appropriate.

2. In the case of loans, advances and similar debt obligations, written confirmation from the debtor or trustee should be obtained.

B. Additional evidence may be in the following forms:

1. Audited financial statements of the company whose securities are held as long term investments, when the report is satisfactory to the principal auditor. If using reports of other auditors is a major element of the competent evidence, the auditor should be guided by reporting standards in chapter 10 of Statements on Auditing Procedure #33.

2. Market quotations, if the market is reasonably broad and active.

3. Other evidence:

   a. Auditing procedures applied to the financial statements of the company in which there is a long term investment.

   b. When the cost of the investment reflects factors not in the financial statements of the company invested in, (such as mineral rights, patents, etc.) evidence may be in the form of current evaluations of these factors. Evaluations made by persons within the invested-in company as well as by independents constitute evidence. The latter is usually more reliable.

   c. Often the long term investment is secured by collateral. The auditor should satisfy himself as to such collateral's existence and, if the collateral is important in assuring collection, he should obtain additional evidence.

IV. Effect of Evidence matter on Opinion.

A. If the auditor has not obtained sufficient evidence as described above he is not in a position to express an unqualified opinion on financial statements.

B. In such circumstances the auditor should qualify or disclaim an opinion, or give a piecemeal opinion. Examples follow:

<u>Qualified Opinion</u>

We have examined the balance sheet of XYZ Investment Company, as of December 31, 19 , and 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.

Investments described in Note 1 are in companies whose financial statements indicate they are in the promotional and development stage (or other wording descriptive of the facts). Accordingly, the ultimate realization of these investments depends on circumstances which cannot be evaluated currently.

In our opinion, subject to the realization of the carrying values of investments referred to in the preceding paragraphs, . . .

Disclaimer of Opinion

Because the investments referred to in the preceding paragraph enter materially into the determination of financial position and results of operations, we do not express an opinion on the accompanying financial statements taken as a whole.

Piecemeal Opinion

Because the investments referred to in the preceding paragraph enter materially into the determination of financial position and results of operations, we do not express an opinion on the accompanying financial statements taken as a whole. However, in our opinion, current assets, current and long-term liabilities, capital stock, revenues, and interest expense are presented fairly in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

STATEMENT NO. 35

LETTERS FOR UNDERWRITERS

I. Introduction

A. Independent accountants are often involved in the examination of statements and schedules in registration statements, applications, and annual reports required by the Securities and Exchange Commission.

B. In connection with A., independent accountants sometimes issue letters for underwriters concerning the distribution of securities.

C. This statement contains guides which should be carefully considered when preparing letters for underwriters, commonly called "comfort letters."

D. Comfort letters are not required by SEC administered law but are a usual condition of an underwriting agreement. The letter is one means by which underwriters learn of events subsequent to the latest financial statements.

E. If the accountants discover an event requiring disclosure, they should notify the registrant (i.e. the client) promptly so the matter can be called to the underwriter's attention. Because of the possible results of such a discovery, which may have to be disclosed in the comfort letter, the accountants should plan to avoid delays.

F. Comfort letters typically refer to one or more of the following subjects.

1. The independence of the accountants.

2. Compliance of the financial statements and schedules with accounting requirements of the SEC.

3. Unaudited financial statements and schedules in the registration statement.

4. Changes in capital stock and long term debt.

5. Material adverse changes in financial position or operations results subsequent to the latest financial statements or data in the registration statement.

6. Tables and other financial information in the registration statement.

G. Matters dealt with in the letter should be limited to those specified in the underwriting agreement. The accountants should advise the registrant on wording of the agreement so that impossible demands will not be placed on the accountants.

II. Dating

A. The letter is dated on or shortly before the "closing date" (the date the securities are delivered to the underwriter in exchange for net sale proceeds).

B. The underwriting agreement will normally specify the date. The accountants should see that the date specified does not place an unreasonable burden on them.

III. Address. The letter may be addressed to the registrant, to the underwriters, or to both jointly.

IV. An introductory paragraph should be included stating the scope of the examination and explaining the abbreviated terms to be used in the body of the letter. An example follows:

We have made an examination of the consolidated financial statements and schedules of the Blank Company, Inc., and its subsidiaries as of December 31, 1964 and for the three years then ended, and of the related summary of earnings for the five years ended December 31, 1964, and our opinions with respect to the foregoing are included in the registration statement (No. 2-00000) filed by the Company under the Securities Act of 1933 (the "Act"). Such registration statement and the related prospectus, as amended at the time such registration statement became effective, are herein referred to respectively as the "Registration Statement" and the "Prospectus."

Sometimes the foregoing paragraph is preceded by a paragraph somewhat as follows:

This letter is written at your request (or at the request of The Blank Company, Inc., if the letter is not addressed to the registrant) pursuant to Section 8 of an agreement of April 18, 1965 between the Company and The Blank Underwriters.

V. The letter should contain a statement concerning the accountants' independence. For example:

We are independent public accountants as required by the Act and the applicable published rules and regulations thereunder.

VI. A statement concerning the compliance of the financial statements as to form with SEC regulations may be requested in the agreement. For example:

In our opinion, the financial statements and schedules and the summary of earnings examined by us and included or incorporated by reference in the Prospectus or elsewhere in the Registration Statement comply (as to form) in all material respects with the applicable accounting requirements of the Act and of the published rules and regulations thereunder with respect to registration statements on Form ______.

VII. Unaudited financial statements and subsequent changes.

A. Comments required in the letter may concern:

1. Unaudited financial statements included in the registration statement.

2. Changes in capital stock and long term debt.

3. Material adverse changes in financial position or operations' results subsequent to the latest financial statements in the registration statement.

B. The following guides are important when commenting on the matters in A.

1. Procedures followed should be specified. Do not use terms such as "review," "limited review," etc., unless the procedures comprehended by such terms are clearly specified.

2. Avoid statements that the accounting records were tested unless they specifically were.

3. State that interim financial statements were not examined, and that the work done was not an examination made in accordance with generally accepted auditing standards.

4. Disclaim opinion on the interim statements.

5. If the underwriting agreement calls for comments on adverse changes, application of generally accepted accounting principles or instances of non-compliance with SEC regulations, state in the letter that the

procedures followed would not necessarily reveal such matters.

6. Working papers related to the letter should be so prepared as to constitute adequate evidence of what was done, comparisons made, and discussions with corporate officials and others.

C. Unaudited Financial Statements.

1. Comments concerning unaudited statements should always be in the form of negative assurance ordinarily with respect to:

    a. Conformity with consistently applied, generally accepted accounting principles.

    b. Material adjustments required for fair presentation.

    c. Compliance as to form with applicable accounting requirements.

2. When data for the latest interim period per unaudited statements are compared with the corresponding period of the previous year, the data are usually presented as though the previous year's interim statements are unaudited, even though the financial statements covering the entire previous year were audited. In such circumstances, the accountant should indicate that the data for the previous year was audited with respect to the whole year, not an interim period.

D. Subsequent Changes.

1. Give only negative assurance as to subsequent changes relating to absence of change in

capital stock or long term debt and material adverse changes in financial position or operations' results.

2. Comments as to material adverse changes relate to the "comfort" period. The "comfort" period ends on the cut-off date and begins:

   a. Immediately after the date of the latest balance sheet in the registration statement, (in the case of changes in financial position) or,

   b. Immediately after the latest period represented in the earnings summary (in the case of changes in operations' results).

3. The underwriting agreement may specify the period(s) with which the "comfort" period is to be compared. In addition to making comparisons based on the latest financial statements, the accountants should read minutes and make inquiries to corporate officials.

4. The type of changes the accountants should refer to is limited to what would be shown in financial statements at the cut-off date for the "comfort" period then ended (if statements could be prepared). This limitation should be classified in the letter as follows:

The terms "financial position" and "results of operations" are used in this letter in their conventional accounting sense; accordingly, they relate to the financial statements of the business as a whole and have the same meaning when used in this letter as in our opinion contained in the Registration Statement and Prospectus.

5. What constitutes an adverse change in a matter of disagreement and is subject to the accountants' judgment.

6. Any indications of material adverse changes should be discussed with the client. The accountant should tell the client of his intentions as to what will be disclosed in the letter, making sure that the client understands the significance of any exceptions.

E. Disclosure in Prospectus

1. The negative assurances given do not require specific references to changes which are disclosed in the registration statement. This is effected by stating "except as set forth in or contemplated by the registration statement and prospectus."

2. If it appears that a change occurred during the comfort period, the accountants should scrutinize the registration statement and prospectus to see if such change is set forth or contemplated therein.

3. Examples of changes set forth or contemplated may be:

   a. Payment of long term debt.

   b. Issue of stock under option plan.

   c. Payment of dividends.

   d. Adverse earning trend due to seasonal factors.

   e. Changes in application of accounting principles.

VIII. Effect of qualified opinion.

A. Usually the SEC will not permit a registration statement to become effective if the accountants' opinion on the financial statements is qualified as to scope of the examination or accounting principles. When the SEC permits the registration to become effective even though the opinion is qualified, the accountant may not be in a position to give an opinion that the financial statements in the registration statement comply as to form with SEC Regulations.

B. The SEC will usually accept a "subject to" qualification when the outcome of negotiations or litigation concerning taxes, renegotiation, recovery of research and development costs, etc. is ensure.

C. If the opinion is qualified it should be so stated in the opening paragraph.

IX. The comfort letter should be concluded as follows:

This letter is solely for the information of the Company and the underwriters and is not to be referred to in whole or in part in the registration statement, prospectus, or any other similar document, or quoted by excerpt or reference outside the underwriting group in connection with the registration under the Act or the sale of securities, except for any reference to it in the underwriting agreement or in any list of closing documents.

X. Other Accountants

A. Comfort letters are sometimes requested from more than one accountant in connection with subsequent sales of shares after a recent merger. Each accountant must be independent with respect to his client. Accountants for the absorbed company would not be required to have been independent with respect to the company whose shares are being registered.

B. Such accountants should make clear the extent of their independence as follows:

> We are independent public accountants <u>with respect to Company B</u> within the meaning of the Securities Act of 1933 and the rules and regulations thereunder.

C. If different accountants are examining various units of one registrant, then the one reporting on the consolidated statements should obtain letters from the others. These others should state their independence with respect to the parent company. The accountant reporting on the parent should let the other accountants know that he expects a letter so they can be prepared.

XI. Tables and other Compilations of Financial Information.

A. Sometimes the underwriting agreement calls for the accountant to make comments on tables, statistics, etc.

B. The following guides should be followed when commenting on such data:

1. Give no more than negative assurance.

2. State the basis for negative assurance.

Examples of appropriate phrases are:

a. For the period covered by the examination- "during the course of our examination."

b. For the comfort period - "as a result of the limited procedures described in this letter."

c. When additional procedures are appropriate - " - - - - Made inquiries of officials responsible for financial and accounting matters as to whether the accounting information set forth in the Registration Statement and Prospectus under the captions ' - - - - - - - ' and ' - - - - - - - ' requires any material adjustment for a fair presentation."

3. Avoid terms used in the standard short form opinion.

4. Don't use terms such as "correctly stated," "adequately presented," "adequately disclosed," etc.

5. Identify information covered by specific references to captions, tables, page numbers, etc. Don't use broad designations.

6. Avoid implying responsibility for legal interpretations by an appropriate disclaimer of opinion.

C. Examples of negative assurance.

1. For financial information of the type referred to above

During the course of our aforementioned examination of the financial statements for the year ended December 31, 1964, nothing came to our attention which caused us to believe that the accounting information set forth in the Registration Statement and Prospectus under the caption "Remuneration of Directors and Officers" required any material adjustment for a fair presentation.

2. For financial information concerning an unaudited period.

The limited procedures described in this letter did not bring anything to our attention which caused us to believe that the accounting information set forth in the Registration Statement and Prospectus under the caption "Capitalization" requires any material adjustment for a fair presentation.

3. For financial information involving legal interpretations.

During the course of our examination . . . (see above, but expand period to three years, if appropriate) . . . and as a result of the limited procedures described in this letter, nothing came to our attention which caused us to believe that the accounting information set forth in the Registration Statement and Prospectus under the caption "Recent Sales of Unregistered Securities" requires any material adjustment for a fair presentation, to the extent such accounting information is reflected in the accounting records, and excluding any questions of legal interpretation.

XII. Example of a letter for underwriters.

EXAMPLE

This letter is based on a situation in which the registration statement includes an audited consolidated balance sheet as of December 31, 1964, statements of consolidated income and surplus for the three years then ended, and a summary of consolidated earnings for the five years then ended. No unaudited financial statements are included in the registration statement but the capitalization table is as of a date later than the balance sheet. The underwriting agreement mades no reference to schedules but requires an opinion as to compliance, a representation as to independence, and negative assurance relating to the absence of material adverse changes in financial position or results of operations and changes in capitalization; the underwriters have agreed, in advance, that the corresponding period of the previous year might be used for pusposes of comparison with the results of operations for the current interim period.

Dear Sirs:

This letter is written at your request to enable Blank Company to comply with Section 10 of its agreement of April 17, 1965, with the Underwriters, Inc.

We have made an examination of the consolidated financial statements of Blank Company (the "Company") and its subsidiaries as of December 31, 1964, and for the three years then ended, and of the related summary of consolidated earnings for the five years ended December 31, 1964, and our opinion with respect to the foregoing is included in the registration statement (No. 2-00000) filed by the Company under the Securities Act of 1933 (the "Act"). Such registration statement and the related prospectus, as amended at the time such registration statement became effective, are herein referred to respectively as the "Registration Statement" and the "Prospectus."

We are independent public accountants as required by the Act and the applicable published rules and regulations thereunder.

In our opinion, the financial statements and summary of earnings examined by us and included in the Prospectus comply as to form in all material respects with the applicable accounting requirements of the Act and of the published rules and regulations thereunder with respect to Registration Statements on Form S-1.

We have not made an examination of any financial statements of the Company or any of its subsidiaries as of any date or for any period subsequent to December 31, 1964, and, therefore, we are unable to and do not express any opinion on any such financial statements. However, we have, at the Company's request, carried out procedures and made inquiries with respect to the period from December 31, 1964 to May 25, 1965 as follows:

1. read the interim unaudited consolidated financial statements of the Company and its subsidiaries covering the period from January 1, 1965, to April 30, 1965, officials of the Company having advised us that no such financial statements as of any date or for any period subsequent to April 30, 1965 were available;

2. read the 1965 minutes of the meetings of the stockholders, the Board of Directors, and the executive and finance committees of the Company and its subsidiaries as set forth in the minute books at May 25, 1965, officials of the Company having advised us that the minutes of all such meetings through that date were set forth therein; and

3. made inquiries of certain officials of the Company and its subsidiaries who have responsibility for financial and accounting matters as to whether since March 31, 1965 there had been any change in the consolidated capital stock or long-term debt of the companies from that shown as of March 31, 1965 under the caption "Capitalization" in the Prospectus, and as to whether since December 31, 1964 there has been any material adverse change in the consolidated financial position or consolidated results of operations.

The foregoing procedures and inquiries do not constitute an examination made in accordance with generally accepted auditing standards; also they would not necessarily reveal material adverse changes in the financial position or results of operations or inconsistencies in the application of generally accepted accounting principles.

We may state, however, that the foregoing procedures and inquiries did not cause us to believe that during the period from March 31, 1965 to May 25, 1965, there was any change in the capital stock or funded debt of the Company on a consolidated basis from that shown or contemplated under the caption "Capitalization" in the Prospectus or that during the period from January 1, 1965 to May 25, 1965 there was any material adverse change in the consolidated financial position of the Company and its subsidiaries from that set forth by the consolidated balance sheet as of December 31, 1964 included in the Prospectus or any material adverse change in the consolidated results of their operations as compared with the corresponding period in the preceding year, except in all instances as set forth in or comtemplated by the Registration Statement and Prospectus or as occasioned by the declaration or payment of dividends.

The terms "financial position" and "results of operations" are used in this letter in their conventional accounting sense; accordingly, they relate to the financial statements of the business as a whole and have the same meaning when used in this letter as in our opinion contained in the Registration Statement and Prospectus.

This letter is solely for the information of the Company and the Underwriters and is not to be referred to in whole or in part in the Registration Statement of Prospectus or quoted by excerpt or reference outside the underwriting group in connection with the registration under the Act or the sale of securities except for any reference to it in an underwriting agreement or in any list of closing documents.

STATEMENT NO. 36

INVENTORY

I. Prior Pronouncements:

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.

The above has generally been understood as requiring the client to make a complete physical count of all items each year in order for the independent auditor to satisfy himself by his tests as to inventory quantities within the meaning of generally accepted auditing standards.

II. Revision:

In recent years, some companies have developed inventory controls or methods of determining inventories, including statistical sampling, of sufficient reliability to make an annual physical count of each item of inventory unnecessary. The purpose of this statement is to recognize this development.

Where a client's inventory control procedures or methods of determining inventories are highly effective, an accurate determination of inventory quantities may be made without a count of all items each year. In such circumstances, the independent auditor must satisfy himself that client's procedures or methods are sufficiently reliable to produce results comparable to those which would be obtained by a complete physical inventory each year. If statistical sampling methods are used by the client in the taking of the physical inventory, the independent auditor must be satisfied that the sampling plan has statistical validity, that it has been properly applied and that the resulting precision and reliability, as defined statistically, are reasonable in the circumstances.

If the independent auditor is able to satisfy himself as set forth in the preceding paragraph and has carried out adequate inventory observation procedures (see paragraphs 16, 17 and 19 of Chap. 6 of Statements on Auditing Procedure No. 33), he has complied with generally accepted auditing standards and the disclosure requirement referred to in paragraph 27 of Chap. 10 of Statements on Auditing Procedure No. 33 does not apply.

STATEMENT NO. 37

PUBLIC WAREHOUSES

I Types of Warehouses:

A. Terminal Warehouse. The principal economic function of a terminal warehouse is to furnish storage. It may, however, perform other functions, including packaging and billing. It may be used to store a wide variety of goods or only a particular type of commodity.

B. Field Warehouse. A field warehouse is established in space leased by the warehouseman on the premises of the owner of the goods or the premises of a customer of the owner. In most circumstances, all or most of the personnel at the warehouse location are employed by the warehouseman from among employees of the owner (or customer) usually from among those who previously have been responsible for custody and handling of the goods. Field warehousing is essentially a financing arrangement rather than a storage operation. The warehouse is established to permit the warehouseman to take and maintain custody of goods and issue warehouse receipts to be used as collateral for a loan or other form of credit.

Warehouses may be classified also by types of goods stored. Foods and other perishable products may be stored in refrigerated warehouses, constructed and equipped to meet controlled temperature and special handling requirements. Certain bulk commodities, such as agricultural products and chemicals, are stored in commodity warehouses; these warehouses often are designed and equipped to store only one commodity, and fungible goods are frequently commingled without regard to ownership. A wide variety of goods, usually not requiring special storage, are stored in general merchandise warehouses. Some warehouses confine their activities to storing furniture, other household goods, and personal effects.

II. Warehouse Receipts:

A. Warehouse receipts may be in negotiable or non-negotiable form and may be used as evidence of collateral for loans or other forms of credit. Goods represented by a negotiable warehouse receipt may be released only upon surrender of the receipt to the warehouseman for cancellation or endorsement, whereas goods represented by a non-negotiable receipt may be released upon valid instructions without need for surrender of receipt. Other important ways in which the two kinds of receipts differ concern the manner in which right of possession to the goods they represent may be transferred from one party to another and rights acquired by bona fide purchasers of the receipts.

B. Since goods covered by non-negotiable receipts may be released without surrender of the receipt, such outstanding receipts are not necessarily an indication of accountability on the part of warehouseman or of evidence of ownership by the depositor. Since goods are frequently withdrawn piecemeal, the warehouseman's accountability at any given time is for the quantity of goods for which receipts have been issued minus the quantities released against properly authorized withdrawal instructions.

C. Prenumbered receipt forms should be used, and procedures established for accounting for all forms used and for cancellation of negotiable receipts when goods have been delivered. Unused forms should be safeguarded against theft or misuse and their custody assigned to a responsible employee who is not authorized to prepare or sign receipts. Receipt forms should be furnished only to authorized persons, and in a quantity limited to the number required for current use. The signer of receipts should ascertain that the receipts are supported by receiving records or other underlying documents. Receipts should be prepared and completed in a manner designed to prevent alteration. Authorized signers should be a limited number of responsible employees.

III. Insurance:

The adequacy as to type and amount of insurance coverage carried by the warehouseman should be reviewed at appropriate intervals.

IV. Warehouseman:

A. Internal Controls:

1. Goods held in custody for others are not owned by the warehouseman and, therefore, do not appear as assets in his financial statements. Similarly, the related custodial responsibility does not appear as a liability. However, as in other businesses, the warehouseman is exposed to the risk of loss or claims for damage stemming from faulty performance of his operating functions. Faulty performance may take the form of loss or improper release of goods, improper issuance of warehouse receipts, failure to maintain effective custody of goods so that lenders' preferential liens are lost, and other forms.

2. In the broad sense, internal controls of a business may be characterized as either accounting or administrative. Accounting controls generally bear directly and importantly on reliability of financial records, and therefore require evaluation by the independent auditor. Administrative controls are concerned mainly with operational efficiency and adherence to managerial policies. Administrative controls ordinarily relate only indirectly to financial records and, therefore, would not require evaluation by

the auditor. However, if the auditor believes that certain administrative controls may have an important bearing on the reliability of the financial records, he should consider the need for evaluating such controls. The recommendation herein that the independent auditor of the warehouseman make a study and evaluation of administrative controls is based upon the important relationship of such controls to the custodial responsibilities of the warehouseman, which are not reflected in his financial statements. Significant unrecorded liabilities may arise if these custodial responsibilities are not discharged properly.

3. Whether and to what extent the suggested control procedures that follow may be applicable to a particular warehouse operation will depend on nature of the operation, of the goods stored, and of the warehouseman's organization. Appropriate segregation of duties in the performance of the respective operating functions should be emphasized.

B. Receiving, Storing, and Delivering Goods:

Receipts should be issued for all goods admitted into storage. Receiving clerks should prepare reports as to all goods received. The receiving report should be compared with quantities shown on bills of lading or other documents received from owner or other outside sources by an employee independent of receiving, storing and shipping. Goods received should be inspected, counted, weighed, measured, or graded in accordance with applicable requirements. There should be a periodic check of the accuracy of any mechanical facilities used for these purposes.

Unless commingling is unavoidable, such as with fungible goods, goods should be stored so that each lot is segregated and identified with the pertinent warehouse receipt. Warehouse office records should show the location of the goods represented by each outstanding receipt. Instructions should be issued that goods may be released only on proper authorization which, in the case of negotiable receipts, includes surrender of the receipt. Access to the storage area should be limited to those employees whose duties require it, and custody of keys should be controlled.

Periodic statements to customers should identify the goods held and request that discrepancies be reported to a specified employee who is not connected with receiving, storing and delivery of goods. The stored goods should be physically counted or tested periodically, and the quantities should be reconciled with the records by an employee independent of the storage function; the extent to which this is done may depend on the nature of the goods, the rate of turnover, and the effectiveness of other control procedures. Where the goods are perishable, a regular schedule for inspection of condition should be established.

Protective devices such as burglar alarms, fire alarms, sprinkler systems, and temperature and humidity controls should be inspected regularly.

Goods should be released from the warehouse only on basis of written instructions received from an authorized employee who does not have access to the goods. Counts of goods released as made by stock clerks should be independently checked by shipping clerks or others and the two counts should be compared before the goods are released.

V. Prior Pronouncements:

A. 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 the custodians is acceptable provided that where the amount involved represents a significant proportion of the current assets or total assets, supplemental inquiries are made to satisfy the independent auditor as to the bona fides of the situation.

B. Generally accepted auditing standards are broad criteria as to the quality of performance and objectives to be attained by an independent auditor in his examination of financial statements and in reporting on them. Auditing procedures, on the other hand, relate to steps to be taken by auditor in complying with the standards in making his examination.

C. The management of a business has the responsibility for proper recording of transactions in its books of account, for safeguarding its assets, and for the substantial accuracy and adequacy of its financial statements. The independent auditor is not an insurer or guarantor; his responsibility is to express a professional opinion on the financial statements he has examined.

VI. Summary of Recommendations:

A. Make a study and evaluation of the effectiveness of both accounting controls and administrative controls, as defined in paragraph five of Chap. 5 of Statements on Auditing Procedure No. 33, relating to the accountability for and the custody of all goods placed in the warehouse.

B. Test the warehouseman's records relating to accountability for all goods placed in his custody.

C. Test the warehouseman's accountability under recorded outstanding warehouse receipts.

D. Observe physical counts of the goods in custody, wherever practicable and reasonable, and reconcile tests of such counts with records of goods stored.

E. Confirm accountability (to the extent considered necessary) by direct communication with holders of warehouse receipts.

The independent auditor should apply such other procedures he considers necessary in the circumstances.

Warehousing activities are diverse because the warehoused goods are diverse, the purposes of placing goods in custody are varied, and the scope of operations of warehouses is not uniform. The independent auditor has responsibility to exercise his judgment in determining what procedures, including those recommended in this report, are necessary in the circumstances to afford a reasonable basis for his opinion on the financial statements.

VII. <u>Investigation of Warehouseman by Owner</u>:

A. Before goods are placed in a warehouseman's custody the owner should:

1. Consider the business reputation and financial standing of the warehouseman.

2. Inspect the physical facilities.

3. Inquire as to the type and adequacy of the warehouseman's

    a. Insurance

    b. Control procedures

    c. Licensing and bonding

    d. Results of inspection by governmental agencies

4. Review the warehouseman's financial statements and the related reports of independent auditors.

B. After goods are placed in a warehouseman's custody the owner should:

1. Physically count the goods wherever practicable and reasonable.

2. Reconcile quantities shown on statements received from the warehouseman with the owner owner's records.

C. Auditor's responsibility:

Review owner's control procedures; observe physical counts of goods wherever practicable and reasonable; discuss with owner his procedures in investigating the warehouseman; obtain from lenders pertinent details of any warehouse receipts that have been pledged as collateral by direct confirmation.

STATEMENT NO. 38

UNAUDITED FINANCIAL STATEMENTS

(Supersedes par. 17 & 18 of Chap. 10 of Statements on Auditing Procedure No. 33)

I. A CPA may be engaged to prepare, or to assist his client in preparing, unaudited financial statements. This type of engagement is an accounting service as distinguished from an examination of financial statements in accordance with generally accepted auditing standards. This accounting service, which may include assistance in adjusting and closing the general books, frequently is rendered as an adjunct to the preparation of tax returns. Although a CPA may have prepared, or assisted in preparing, unaudited financial statements, the statements are representations of management, and the fairness of their representation is management's responsibility.

II. For purposes of this Statement, financial statements are unaudited if the CPA (a) has not applied any auditing procedures to them, or (b) has not applied auditing procedures which are sufficient to permit him to express an opinion concerning them. <u>The CPA has no responsibility to apply any auditing procedures to unaudited financial statements</u>.

III. A CPA is associated with unaudited financial statements when he has consented to use of his name in a report, document or written communication setting forth or containing the statements. Further, when a CPA submits to his client or others, with or without a covering letter, unaudited financial statements which he has prepared or assisted in preparing, he is deemed to be associated with such statements. This association is deemed to exist even though the CPA does not append his name to the financial statements or uses "plain paper" rather than his own stationery. However, association does not arise if the CPA, as an accommodation to his client, merely types on "plain paper" or reproduces unaudited financial statements so long as he has not prepared or otherwise assisted in preparing the statements and so long as he submits them only to his client.

IV. The committee believes that a disclaimer of opinion should accompany unaudited financial statements with which a CPA is associated. Disclaimer of opinion is the means by which a CPA clearly indicates the fact that he has not audited the financial statements and accordingly does not express an opinion on them. An example of such a disclaimer of opinion is as follows:

> "The accompanying balance sheet of X Co. as of Dec. 31, 19xx and the related statement(s) of income and retained earnings for the year then ended were not audited by us and accordingly we do not express an opinion on them."

The disclaimer of opinion may accompany the audited financial statements, or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

V. A CPA may be retained by his client to perform routine bookkeeping services or to prepare financial statements for the client's internal use only, possibly on a monthly or quarterly basis. For such statements, it may not be necessary to include all footnotes or other disclosures that might otherwise be desirable. <u>Under these circumstances, the accountant should add to the disclaimer of opinion a sentence to the effect that</u>

financial statements are restricted to internal use by the client and therefore do not necessarily include all disclosures that might be required for a fair presentation.

VI. Because unaudited financial statements, by definition, have not been audited by the CPA, he cannot be expected to have an opinion as to whether such statements have been prepared in conformity with generally accepted accounting principles. However, if the CPA concludes on the basis of facts known to him that unaudited financial statements with which he may become associated are not in conformity with generally accepted accounting principles, which includes adequate disclosure, he should insist (except under the conditions described in paragraph V) upon appropriate revision; failing that, he should set forth clearly his reservations in his disclaimer of opinion. His disclaimer should refer specifically to the nature of his reservations and to the effect, if known to him, on the financial statements.

VII. If, under circumstances such as those described in paragraph VI, the client will not agree to appropriate revision or will not accept the accountant's disclaimer of opinion with the reservations clearly set forth, the accountant should refuse to be associated with the financial statements and, if necessary, withdraw from the engagement. Further, the CPA should refuse to provide typing or reproduction services or to be associated in any way with unaudited financial statements which, on the basis of facts known to him, he concludes are false or intended to mislead.

VIII. Any auditing procedures that may have been performed in connection with unaudited financial statements ordinarily should not be described in the accountant's report; to do so might cause the reader to believe that the financial statements have been audited. However, in connection with letters for underwriters (see Statements on Auditing Procedure #35) or letters pursuant to agreements between a prospective buyer and seller of a business, or in similar circumstances, it may be appropriate for an <u>accountant to describe the limited procedures applied with respect to unaudited financial statements. The accountant should specify in such letters or reports that their distribution is to be restricted solely to the parties involved</u>.

IX. Normally, a CPA's name would not appear in client-prepared reports setting forth unaudited financial statements. If an accountant is aware that his name is to be included, he should request (a) that his name not be included in the report, or (b) that the financial statements be marked as unaudited and that there be a notation that he does not express an opinion on them. If the client does not comply, the accountant should advise him that he has not consented to the use of his name.

X. Published annual reports of companies customarily include financial statements for the prior year for comparative purposes. Paragraph 48 of Chp. 10 of Statements on Auditing Procedure No. 33 states that where an independent auditor "has not made an examination of prior year's statements, there should be appropriate disclosure in the statement or in auditor's report." If the prior year's statements have not been audited by anyone, they should be clearly and conspicuously marked on each page as unaudited, or the <u>auditor should insert in his report a disclaimer such as</u>:

> "We did not examine the financial statements for the year , and, accordingly, do not express an opinion on them."

If the prior year's statements are appropriately marked as unaudited, the disclaimer above is not necessary because the report of the independent auditor limits his opinion to the current year's financial statements. It should be noted that paragraph 48 of Chapter 10 of Statements on Auditing Procedure No. 33 also states that the auditor should make appropriate disclosure in his report where he has significant exceptions or reservations as to the prior year's statements.

XI. A similar situation exists for documents filed with the SEC, wherein financial statements covering a number of years and possibly interim periods may be required. Under rules and regulations of the Commission, certain of these financial statements must be audited by independent public accountants, whereas others may be included in the filings without audit. In such cases, it is not necessary that a disclaimer of opinion accompany the unaudited financial statements. For a discussion of certain responsibilities of accountants resulting from inclusion of their reports in documents filed with the SEC, see Paragraph 10 through 16 of Chapter 1 of Statements on Auditing Procedure No. 33.

XII. This Statement does not apply to tax returns and other data prepared solely for submission to taxing authorities.

STATEMENT NO. 39

WORKING PAPERS

I. Purpose of This Statement:

The purpose of this statement is to provide guidance for the independent auditor regarding working papers for examination of financial statements or other engagements to which any of the generally accepted auditing standards apply. There is no intention to specify the form or details of content of working papers since they should be designed to meet the circumstances and the auditor's needs on the individual engagement; nor is there any intention to imply that the auditor would be precluded from supporting his opinion and his representation as to compliance with auditing standards by other means in addition to working papers. Since this is the first statement the Committee has issued dealing with the subject of working papers, it recognizes that some of the guidelines set forth herein may go beyond current general practice.

II. Functions and Nature of Working Papers:

A. Working papers serve mainly to:

1. Aid the auditor in the conduct of his work; and

2. Provide important support for the auditor's opinion, including his representation as to compliance with auditing standards.

B. Working papers are the records kept by the independent auditor of procedures he followed, tests he performed, information he obtained, and conclusions he reached pertinent to his examination. Working papers, accordingly, may include work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules of commentaries prepared or obtained by the auditor.

C. Working papers should fit the circumstances and the auditor's needs on the engagement to which they apply. Factors affecting the independent auditor's judgment as to quantity, type and content of working papers desirable for a particular engagement include: (a) the nature of the auditor's report; (b) the nature of financial statements, schedules or other information upon which the auditor is reporting; (c) the nature and condition of the client's records and internal controls; (d) the needs in the particular circumstances for supervision and review of the work performed by any assistants.

III. Guidelines:

A. Although the quantity, type and content of working papers will vary with circumstances, they generally would include or show:

1. Data sufficient to demonstrate that the financial statements or other information upon which the auditor is reporting were in agreement with (or reconciled with) the client's records.

2. That the engagement had been planned, such as by use of work programs, and that the work of any assistants had been supervised and reviewed, indicating observance of the first standard of field work.

3. That the client's system of internal control had been reviewed and evaluated in determining the extent of the tests to which auditing procedures were restricted, indicating observance of the second standard of field work.

4. The auditing procedures followed and testing performed in obtaining evidential matter, indicating observance of the third standard of field work. The record in these respects may take various forms, including memoranda,

check lists, work programs and schedules and would generally permit reasonable identification of the work done by the auditor.

5. How exceptions and unusual matters, if any, disclosed by the independent auditor's procedures were resolved or treated.

6. Appropriate commentaries prepared by the auditor indicating his conclusions concerning significant aspects of the engagement.

IV. <u>Ownership and Custody of Working Papers</u>:

A. Working papers are the property of the independent auditor, and in a number of states, there are statutes which designate the auditor as the owner of working papers. The auditor's rights of ownership of the working papers, however, are subject to those ethical limitations designed to prevent improper disclosures by the auditor of confidential matters relating to his clients' affairs.

B. While the independent auditor's working papers may serve as a useful reference source from time to time for his client, the papers should not be regarded as constituting a part of, or as a substitute for, the client's accounting records.

C. An independent auditor should adopt reasonable procedures for safe custody of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and to satisfy any pertinent legal requirements of records retention.

STATEMENT NO. 40

REPORTS FOLLOWING A POOLING OF INTERESTS

(Supersedes paragraphs 35 and 36 of Chapter 8 of Statements on Auditing Procedure No. 33)

I. When companies have merged or combined in accordance with the accounting concept known as a "pooling of interests," appropriate effect of the pooling should be given in the presentation of balance sheets, results of operations and other historical financial data of the continuing business for years prior to the year of pooling, as described in paragraph 5 of Opinion No. 10 of the Accounting Principles Board. If prior year financial statements, presented in comparison with current year financial statements, are not restated to give appropriate recognition to a pooling of interests, the comparative financial statements are not presented on a consistent basis. In this case, the inconsistency arises not from a change in the application of an accounting principle in the current year, but from the lack of such application to prior years. Such inconsistency would require a qualification in the independent auditor's report. In addition, failure to give appropriate recognition to the pooling in comparative financial statements is a departure from an Opinion of the Accounting Principles Board. Therefore, the auditor must also give appropriate consideration to provisions of the Special Bulletin of the AICPA issued in October 1964 relating to disclosures of departures from Opinions of the APB.

II. When single-year statements are presented, a note to the financial statements should adequately disclose the pooling transaction and state the revenues and net earnings of the constituent companies for the preceding year on a combined basis. In such instances, disclosure and consistency standards are met. Omission of disclosure of the pooling transaction and its effect on the preceding year would require a qualification as to the lack of disclosure and consistency in the independent auditor's report.

STATEMENT NO. 41

SUBSEQUENT DISCOVERY OF FACTS EXISTING

AT THE DATE OF THE AUDITORS REPORT

I. The purpose of this statement is to establish procedures to be followed when the auditor learns facts subsequent to his report which might have affected the report had he known them at the report date.

II. These procedures are often generalized. The auditor is advised to consult his attorney when circumstances to which this statement may apply arise.

III. It is not suggested that the auditor has any obligation to make inquiry or perform audit procedures after the report date, unless new information comes to his attention. Also, this statement does not apply to events occurring after the report date. This statement is not intended to be retroactive.

IV. When the auditor learns of facts which may have caused him to investigate if he had known them, he should discuss the matter with the client and request cooperation.

V. If the subsequently discovered facts are reliable and if they existed at the date of the auditor's report, and if

A. the report would have been affected and,

B. he believes that persons are relying on or attaching importance to the report (giving consideration to the time elapsed since the report was issued) then he should advise the client to make appropriate disclosure of the facts.

If the effects can be promptly determined, revised financial statements and auditor's reports should be issued. Reasons for the revision should be disclosed in a note to the statements and referred to in the report. Generally only the most recent statements will need to be revised.

If the issue of new statements and the accompanying auditor's report is imminent the revision can be disclosed therein.

If a prolonged investigation is required, the client should notify persons who rely on the statements and report. If the SEC, stock exchanges, or regulatory agencies are involved, the client should be advised to discuss the matter with them.

VI. The auditor should satisfy himself that the client has made the disclosures.

VII. If the client refuses to make such disclosures, the auditor should notify all members of the board of directors of the refusal and proceed to take the following steps: (if the attorney does not advise differently and if applicable)

A. Notify the client that the auditor's report must no longer be associated with the financial statements.

B. Notify any regulatory agencies having jurisdiction over the client not to rely on the report.

C. Notify each person known to rely on the report that it is no longer reliable. (This step is often impracticable and b, above is often the only way disclosure can be made.)

VIII. The contents of the auditors' disclosure to persons other then the client should be governed by the following guides:

A. If the investigation is satisfactory and the information reliable:

1. describe the effect the information would have had had the auditor known it. Include a description of the subsequently acquired information and of its effect on the financial statements.

2. present the information as precisely and factually as possible. Avoid comments concerning the conduct or motives of any person.

B. If the auditor was unable to conduct a satisfactory examination due to the client's noncooperation, the auditor should merely indicate that information has come to his attention which the client has not cooperated in substantiating, and that if the information is true then the report must not be relied upon or associated with the financial statements.

IX. The concepts set forth above apply to all cases where auditors have examined and reported on financial statements.

STATEMENT NO. 42

Reporting When a Certified Public Accountant is Not Independent

I. The purpose of this Statement is to clarify the position of the certified public accountant when he is considered not independent with respect to a client with whose financial statements he is associated (See Rule 1.01 of Article I of the Code of Professional Ethics) and to specify the type of disclaimer of opinion which the accountant should express in such circumstances. This type of disclaimer applies whenever the certified public accountant is not independent, regardless of the extent of services performed. Thus it is applicable when the type of disclaimer illustrated in Statement on Auditing Procedure No. 38 would otherwise apply.

II. The second general standard of generally accepted auditing standards, as approved and adopted by the membership of the American Institute of Certified Public Accountants, requires that "In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors." The independent auditor "must be without bias with respect to the client under audit, since otherwise he would lack that impartiality necessary for the dependability of his findings . . . ." When a certified public accountant who is not independent is associated with financial statements, any procedures he might perform would not be in accordance with generally accepted auditing standards, and accordingly he would be precluded from expressing an opinion on such statements.

III. Under these circumstances the accountant should disclaim an opinion with respect to the financial statements and should state specifically that he is not independent. However, the reason for lack of independence should not be described; including the reason might confuse the reader concerning the importance of the impairment of independence. Whether or not the accountant is independent is something he must decide as a matter of professional judgment.

IV. The recommended disclaimer of opinion, regardless of the extent of services performed, is as follows:

> We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19 __ and the related statement(s) of income and retained earnings for the year then ended were not audited by us; accordingly, we do not express an opinion on them.
>
> (Signature and Date)

Each page of the financial statements should clearly and conspicuously be marked "Unaudited--see accompanying disclaimer of opinion," unless the disclaimer of opinion appears thereon.

V. Any procedures that may have been performed by the accountant in connection with such financial statements should not be described in his report; to do so might cause the reader to believe that the financial statements have been audited.

VI. If the accountant concludes on the basis of facts known to him that financial statements with which he is associated are not in conformity with generally accepted accounting principles, which include adequate disclosure, he should insist upon appropriate revision; failing that, he should set forth clearly his reservations in his disclaimer of opinion. The disclaimer should refer specifically to the nature of his reservations and to the effect, if known to him, on the financial statements. If the client will not agree to the appropriate revision or will not accept the accountant's disclaimer of opinion with the reservations clearly set forth, the accountant should refuse to be associated with the financial statements and, if necessary, withdraw from the engagement.