

***Outline Of
Statements
On Auditing
Standards
And
Procedures***

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OUTLINE OF STATEMENTS ON AUDITING STANDARDS AND PROCEDURES

PREPARED FOR ADVANCED ACCOUNTING
AND AUDITING STUDY PROGRAM

UNITED STATES GENERAL ACCOUNTING OFFICE
// OFFICE OF PERSONNEL MANAGEMENT
WASHINGTON, D.C. 20548

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1971

127
132
133

TABLE OF CONTENTS

<u>Statement number</u>	<u>Subject</u>	<u>Page</u>
33	Statements on Auditing Procedure	2
34	Long Term Investments	32
35	Letters for Underwriters	35
36	Inventory	36
37	Public Warehouses	37
38	Unaudited Financial Statements	45
39	Working Papers	50
✓ 40	Reports Following a Pooling of Interest	53
✓ 41	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report	54
✓ 42	Reporting When a CPA is Not Independent	57
✓ 43	Confirmation of Receivables and Observation of Inventories	60
✓ 44	Reports Following a Pooling of Interest	66
✓ 45	Using the work of another Auditor	68
✓ 46	Piecemeal Opinions	79
✓ 47	Subsequent events	84

<u>Statement number</u>	<u>Subject</u>	<u>Page</u>
48	Letters For Underwriters	97
✓ 49	Reports On Internal Control	122
✓ 50	Reporting On The Statement Of Changes In Financial Position	136

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 sources 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

<u>Comparability affected by</u>	<u>Example</u>	<u>Disclosure required in auditor's report</u>
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.

<u>Change</u>	<u>Disclosure in short-form audit report</u>
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:

<u>Circumstance</u>	<u>Guide to deviation</u>
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

Superseded by SAP No. 47.

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 non-profit 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 piece-meal opinion. Examples follow:

Qualified Opinion

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.

STATEMENT NO. 35

LETTERS FOR UNDERWRITERS

Superseded by SAP No. 48.

STATEMENT NO. 36

INVENTORY

Superseded by SAP No. 43.

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. Investigation of Warehouseman by Owner:

- 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. The CPA has no responsibility to apply any auditing procedures to unaudited financial statements.
- 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. Under these circumstances, the accountant should add to the disclaimer of opinion a sentence to the effect that

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 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.

- 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 auditor should insert in his report a disclaimer such as:

"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. Ownership and Custody of Working Papers:

- 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

Superseded by SAP No. 44.

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 than 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 non-cooperation, 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.

STATEMENT NO. 43

CONFIRMATION OF RECEIVABLES AND

OBSERVATION OF INVENTORIES

(Supersedes paragraphs 16-20 of Chapter 6 and paragraphs 27-29 of Chapter 10 of Statement No. 33, and Statement No. 36)

- I. The purposes of this statement are to provide additional guidelines for the independent auditor in confirming receivables and observing inventories and to modify existing reporting requirements. This statement relates only to confirmation of receivables and observation of inventories and does not deal with other important auditing procedures which generally are required for the independent auditor to satisfy himself as to the fair presentation of these assets.

II. Receivables

- A. Confirmation of receivables requires direct communication with debtors either during or after the period under audit; the confirmation date, the method of requesting confirmations and the number to be requested are determined by the independent auditor. Such matters as the effectiveness of internal control, the apparent possibility of disputes, inaccuracies, or irregularities in the accounts, the probability that requests will receive consideration or that the debtor will be able to confirm the information requested, and the materiality of the amounts involved are factors to be considered by the auditor in selecting the information to be requested and the form of confirmation, as well as the extent and timing of his confirmation procedures.
- B. Two forms of confirmation requested are (a) the "positive form of request, wherein the debtor is asked to respond whether or not he is in agreement with the information given, and (b) the "negative" form of request, wherein the debtor is asked to respond only if he disagrees with the information given.

- C. Because the use of the positive form results in either (a) the receipt of a response from the debtor constituting evidence regarding the debt or (b) the use of other procedures to provide evidence as to the validity and accuracy of significant nonresponding accounts, the use of the positive form is preferable when individual account balances are relatively large or when there is reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. The negative form is useful particularly when internal control surrounding accounts receivable is considered to be effective, when a large number of small balances are involved, and when the auditor has no reason to believe the persons receiving the requests are unlikely to give them consideration. If the negative rather than the positive form of confirmation is used, the number of requests sent or the extent of the other auditing procedures applied to the receivable balance should normally be greater in order for the independent auditor to obtain the same degree of satisfaction with respect to the accounts receivable balance.
- D. In many situations a combination of the two forms may be appropriate, with the positive form used for large balances and negative form for small balances.
- E. Confirmation procedures may be directed toward account balances with debtors or toward individual items included in such balances. The latter procedure may be particularly useful when the nature of the accounts or the debtor's records are not likely to permit successful confirmation of account balances.
- F. When the independent auditor sets out to confirm receivables by means of positive requests, he should generally follow up with a second and sometimes an additional request to those debtors from whom he receives no reply. The auditor should employ such alternative procedures as are practicable to obtain adequate evidence necessary to satisfy himself as to those significant requests for which he receives no replies. These procedures may include examination of

evidence of subsequent cash receipts, cash remittance advices, sales and shipping documents, and other records.

III. Inventories

- A. When inventory quantities are determined solely by means of a physical count, and all counts are made as of the balance sheet date or as of a single date within a reasonable time before or after the balance sheet date or as of a single date within a reasonable time before or after the balance sheet date, it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client's representations about the quantities and physical condition of the inventories.
- B. When well-kept perpetual inventory records are checked by the client periodically by comparisons with physical counts, the auditor's observation procedures usually can be performed either during or after the end of the period under audit.
- C. In recent years, some companies have developed inventory controls or methods of determining inventories including statistical sampling, which are highly effective in determining inventory quantities and which are sufficiently reliable to make unnecessary an annual physical count of each item of inventory. In such circumstances, the independent auditor must satisfy himself that the client's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year. The auditor must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used.

If statistical sampling methods are used by the client in the taking of the physical inventory, the 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.

- D. When the independent auditor has not satisfied himself as to inventories in the possession of the client through the procedures described in paragraphs A-C, tests of the accounting records alone will not be sufficient for him to become satisfied as to quantities; it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions. This should be coupled with a review of the records of any client's counts and procedures relating to the physical inventory on which the balance sheet inventory is based.
- E. The independent auditor may be asked to make an examination of financial statements covering the current period and one or more periods for which he had not observed or made some physical counts of prior inventories. He may nevertheless, be able to become satisfied as to such prior inventories through appropriate procedures, such as tests of prior transactions, reviews of the records of prior counts, and the application of gross profit tests, provided that he has been able to become satisfied as to the current inventory.

IV. Reporting Requirements

- A. If the independent auditor has been unable to confirm receivables or observe the client's taking of physical inventories solely because it was impossible to do so but has satisfied himself as to receivables or inventories by means of other auditing procedures, no comment need be made in his report, although he may wish to disclose the circumstances of the engagement and describe the other procedures.

- B. When the independent auditor is unable to satisfy himself by the application of other auditing procedures, depending on the degree of materiality of the amounts involved, he should indicate clearly in the scope paragraph (or in a middle paragraph) the limitations on his work and either qualify his opinion on the financial statements taken as a whole or disclaim an opinion on them.
- C. If either confirmation of receivables or observation of inventories is omitted because of a restriction imposed by the client, and such inventories or receivables are material, the auditor should indicate clearly in the scope paragraph (or in a middle paragraph) the limitations on his work and, generally, should disclaim an opinion on the financial statements taken as a whole.
- D. The omission of these procedures at the beginning of the year is not required to be disclosed in situations where the independent auditor has satisfied himself by means of auditing procedures. Nevertheless, he may wish to disclose the circumstances of the engagement and briefly describe the other procedures.
- E. If the independent auditor has not satisfied himself by means of other auditing procedures with respect to opening inventories, he should either disclaim an opinion on the statement of income or qualify his opinion thereon, depending on the degree of materiality of the amounts involved. An illustration of such a disclaimer follows:

Scope paragraph

We have examined the balance sheet of X company as of September 30, 1970, and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, excepted as stated in the following paragraph.

Middle paragraph

Because we were not engaged as auditors until after September 30, 1969, we were not present to observe the physical inventory taken at that date and we have not satisfied ourselves by means of other procedures concerning inventory quantities. The amount of the inventory at September 30, 1969, enters materially into the determination of the results of operations for the year ended September 30, 1970. Therefore, we do not express an opinion on the accompanying statements of income and retained earnings for the year ended September 30, 1970.

Opinion paragraph

In our opinion, the accompanying balance sheet presents fairly the financial position of X company at September 30, 1970, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

STATEMENT NO. 44

REPORTS FOLLOWING A POOLING OF INTERESTS

(Supersedes Statement No. 40)

- 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 financial position, results of operations and other historical financial data of the continuing business for the year in which the combination is consummated and, in comparative financial statements, for years prior to the year of pooling, as described in Accounting Principles Board Opinion No. 16, "Business Combinations." 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 the provisions of the Special Bulletin of the AICPA issued in October 1964 relating to disclosures of departures from Opinions of the Accounting Principle Board.

- II. When single-year statements only are presented for the year in which a combination is consummated, a note to the financial statements should adequately disclose the pooling transaction and state the

revenues, extraordinary items and net earning of the constituent companies for the preceding year on a combined basis. In such instances, the 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. 45

USING THE WORK AND REPORTS OF OTHER AUDITORS

(Supersedes paragraphs 32 to 36 of Chapter 10 of Statement No. 33)

I. The purpose of this Statement is to establish guidelines for reporting on financial statements when the independent auditor (referred to herein as the principal auditor) utilizes the work and reports of other independent auditors who have examined the financial statements of one or more subsidiaries, divisions, branches, or other components included in the financial statements presented.

II. Principal Auditor's Course of Action

- A. The auditor in this situation may have performed all but a relatively minor portion of the work, or significant parts of the examination may have been performed by other auditors. In the latter case he must decide whether his own participation is sufficient to enable him to serve as the principal auditor and to report as such on the financial statements. In deciding this question, the auditor should consider, among other things, the materiality of the portion of the financial statements he has examined in comparison with the portion examined by other auditors, the extent of his knowledge of the overall financial statements and the importance of the components he examined in relation to the enterprise as a whole.
- B. If the auditor decides that it is appropriate for him to serve as the principal auditor, he must then decide whether to make reference in his report to the examination made by another auditor. If the principal auditor decides to assume responsibility for the work of the other auditor insofar as that work relates to

the principal auditor's expression of an opinion on the financial statements taken as a whole, no reference should be made to the other auditor's examination. On the other hand, if the principal auditor decides not to assume that responsibility, his report should make reference to the examination of the other auditor and should indicate clearly the division of responsibility between himself and the other auditor in expressing his opinion on the financial statements. Regardless of the principal auditor's decision, the other auditor remains responsible for the performance of his own work and for his own report.

III. Decision Not to Make Reference

- A. If the principal auditor is able to satisfy himself as to the independence and professional reputation of the other auditor, and takes steps he considers appropriate to satisfy himself as to the other auditor's examination, he may be able to express an opinion on the financial statements taken as a whole without making reference in his report to the examination of the other auditor. If the principal auditor decides to take this position, he should not state in his report that part of the examination was made by another auditor because to do so may cause a reader to misinterpret the degree of responsibility being assumed.
- B. Ordinarily, the principal auditor would be able to adopt this position when:
 1. Part of the examination is made by another independent auditor which is an associated or correspondent firm and whose work is acceptable to the principal auditor based on his knowledge of the professional standards and competence of that firm; or

2. The other auditor was retained by the principal auditor and the work was performed under the principal auditor's guidance and control; or
3. The principal auditor, whether or not he selected the other auditor, nevertheless takes steps he considers necessary to satisfy himself as to the other auditor's examination and accordingly is satisfied as to the reasonableness of the accounts for the purpose of inclusion in the financial statements on which he is expressing his opinion; or
4. The portion of the financial statements examined by the other auditor is not material to the financial statements covered by the principal auditor's opinion.

IV. Decision to Make Reference

- A. On the other hand, the principal auditor may decide to make reference to the examination of the other auditor when he expresses his opinion on the financial statements. In some situations, it may be impracticable for the principal auditor to review the other auditor's work or to use other procedures which in the judgment of the principal auditor would be necessary for him to satisfy himself as to the other auditor's examination. Also, if the financial statements of a component examined by another auditor are material in relation to the total, the principal auditor may decide, regardless of any other considerations, to make reference in his report to the examination of the other auditor.
- B. When the principal auditor decides that he will make reference to the examination of the other auditor, his report should indicate clearly, in both the scope and opinion paragraphs, the division of responsibility as

between that portion of the financial statements covered by his own examination and that covered by the examination of the other auditor. The report should disclose the magnitude of the portion of the financial statements examined by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues or other appropriate criteria, whichever most clearly reveals the portion of the financial statements examined by the other auditor. The other auditor may be named, but only with his express permission and provided his report is presented together with that of the principal auditor.

- C. Reference in the report of the principal auditor to the fact that part of the examination was made by another auditor is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors who conducted the examinations of various components of the overall financial statements.
- D. An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the examination of the other auditor follows:

We have examined the consolidated balance sheet of X Company and subsidiaries as of December 31, 197_ and the related consolidated statements of income and retained earnings and of changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of B Company, a consolidated subsidiary, which statements

reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. These statements were examined by other auditors whose report thereon has been furnished to us and our opinion expressed herein, insofar as it relates to the amounts included for B Company, is based solely upon the report of the other auditors.

In our opinion, based upon our examination and the report of other auditors, the accompanying consolidated balance sheet and consolidated statements of income and retained earnings and of changes in financial position present fairly...

When two or more auditors in addition to the principal auditor participate in the examination, the percentages covered by the other auditors may be stated in the aggregate.

V. Procedures Applicable to
Both Methods of Reporting

- A. Whether or not the principal auditor decides to make reference to the examination of the other auditor, he should make inquiries concerning the professional reputation and independence of the other auditor. He also should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements. These inquiries and other measures may include procedures such as the following:
1. Make inquiries as to the professional reputation and standing of the other auditor to one or more of the following:

- a. The American Institute of Certified Public Accountants, the applicable state society of Certified Public Accountants and/or the local chapter, or in the case of a foreign auditor, his corresponding professional organization.
 - b. Other practitioners.
 - c. Bankers and other credit grantors.
 - d. Other appropriate sources.
2. Obtain a representation from the other auditor that he is independent under the requirements of the American Institute of Certified Public Accountants and, if appropriate, the requirements of the Securities and Exchange Commission.
 3. Ascertain through communication with the other auditor:
 - a. That he is aware that the financial statements of the component which he is to examine are to be included in the financial statements on which the principal auditor will report and that the other auditor's report thereon will be relied upon (and, where applicable, referred to) by the principal auditor.
 - b. That he is familiar with accounting principles generally accepted in the United States and with the generally accepted auditing standards promulgated by the American Institute of Certified Public Accountants and will conduct his examination and will report in accordance therewith.
 - c. That he has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with regulatory agencies such as the Securities and Exchange Commission, if appropriate.

d. That a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.

B. If the results of inquiries and procedures by the principal auditor with respect to matters described in paragraph V-A lead him to the conclusion that he can neither assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, nor report in the manner set forth in paragraph IV-D, he should appropriately qualify his opinion or disclaim an opinion on the financial statements taken as a whole. His reasons therefor should be stated, and the magnitude of the portion of the financial statements to which his qualification extends should be disclosed.

VI. Additional Procedures Under Decision Not to Make Reference

- A. When the principal auditor decides not to make reference to the examination of the other auditor, in addition to satisfying himself as to the matters described in paragraph V-A, he should also consider whether to perform one or more of the following procedures:
1. Visit the other auditor and discuss the audit procedures followed and results thereof.
 2. Review the audit programs of the other auditor. In some cases, it may be appropriate to issue instructions to the other auditor as to the scope of his audit work.

3. Review the working papers of the other auditor, including his evaluation of internal control and his conclusions as to other significant aspects of the engagement.
- B. In some circumstances the principal auditor may consider it appropriate to participate in discussions regarding the accounts with management personnel of the component whose financial statements are being examined by other auditors and/or to make supplemental tests of such accounts. The determination of the extent of additional procedures, if any, to be applied rests with the principal auditor alone in the exercise of his professional judgment and in no way constitutes a reflection on the adequacy of the other auditor's work. Because the principal auditor in this case assumes responsibility for his opinion on the financial statements on which he is reporting without making reference to the other auditor's examination, his judgment must govern as to the extent of procedures to be undertaken.

VII. Qualifications in Other Auditor's Report

- A. If the opinion of the other auditor is qualified, the principal auditor should decide whether the subject of the qualification is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require qualification of his own report. If the subject of the qualification is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to the qualification; if the other auditor's report is presented, the principal auditor may wish to make reference to such qualification and its disposition.

VIII. Restated Financial Statements of Prior Years Following a Pooling of Interests

- A. Following a pooling of interests transaction, an auditor may be asked to report on restated financial statements for one or more prior years when other auditors have examined one or more of the entities included in such financial statements. In some of these situations the auditor may decide that he has not examined a sufficient portion of the financial statements for such prior year or years to enable him to serve as principal auditor. Also, in such cases, it often is not possible or it may not be appropriate or necessary for the auditor to satisfy himself with respect to the restated financial statements. In these circumstances, it may be appropriate for him to express his opinion solely with respect to the compilation of such statements; however, no opinion should be expressed unless the auditor has examined the statements of at least one of the entities included in the restatement for at least the latest period presented. The following is an illustration of appropriate reporting on compilation which can be presented in an additional paragraph of the auditor's report following the standard scope and opinion paragraphs covering the consolidated financial statements for the current year:

We previously examined and reported upon the consolidated statements of income and of changes in financial position of XYZ Company for the year ended December 31, 19__ prior to its restatement for 19__ poolings of interests. The contribution of XYZ Company to revenues and net income represented ___ percent and ___ percent of the respective restated totals. Separate financial statements of the pooled companies included

in the 19__ restated consolidated statement of income were examined and reported upon separately by other auditors. We also have reviewed, as to compilation only, the accompanying consolidated statements of income and of changes in financial position for the year ended December 31, 19__ after restatement for 19__ poolings of interests; in our opinion, such consolidated statements have been properly compiled on the basis described in Note X of notes to consolidated financial statements.

B. In reporting on the compilation of restated financial statements as described in the preceding paragraph, the auditor does not assume responsibility for the work of other auditors nor the responsibility for expressing an opinion on the restated financial statements taken as a whole. His review is directed toward procedures which will enable him to express an opinion as to proper compilation only. These procedures include checking the compilation for mathematical accuracy and for conformity of the compilation methods with generally accepted accounting principles. For example, the auditor should review and make inquiries regarding such matters as the following:

1. Elimination of intercompany transactions and accounts.
2. Combining adjustments and reclassifications.
3. Adjustments to treat like items in a comparable manner, if appropriate.
4. The manner and extent of presentation of disclosure matters in the restated financial statements and notes thereto.

The auditor should also consider the application of procedures contained in paragraph V-A.

IX. Predecessor Auditor

- A. When one auditor succeeds another, the successor auditor must establish the basis for expressing his opinion on the financial statements for the first year he examines and on the consistency of the application of accounting principles in that year as compared with the preceding year. This may be done by applying appropriate auditing procedures to the account balances at the beginning of the period under examination. The scope of this work may be reduced by consultation with the predecessor auditor and review of the predecessor auditor's working papers. In such cases, it is customary for the predecessor auditor, as a matter of professional courtesy, to make himself available to the successor auditor for consultation and to make his working papers available for review. However, in reporting on his examination, the successor auditor should not make reference to the report or work of the predecessor auditor as the basis in part for his own opinion. If the successor auditor is unable to obtain satisfaction as to the opening balances insofar as they affect the financial statements for the period on which he is reporting, he should appropriately qualify his opinion or disclaim an opinion and state his reasons for doing so.

STATEMENT NO. 46

PIECEMEAL OPINIONS

(Supersedes paragraphs 22-25 of chapter 10 of Statement No. 33 and pertinent portions of paragraph 9 of Statement No. 34)

I. The purposes of this Statement are to identify the circumstances in which the auditor's expression of a piecemeal opinion may be appropriate, to clarify the scope of an examination necessary to support a piecemeal opinion, and to set forth the precautions which should be taken when a piecemeal opinion is expressed.

II. Scope of Examination

A. The auditor should recognize that the expression of a piecemeal opinion with respect to specific items included in financial statements usually requires a more extensive examination of such items than would ordinarily be required if he were expressing an opinion on the financial statements taken as a whole. Three basic factors influence the sufficiency and competence of evidence necessary to support a piecemeal opinion as to specific items in financial statements:

1. Client-imposed restrictions on scope limit the auditor's freedom to select procedures and examine evidence.
2. Many items within financial statements are interrelated.
3. The materiality threshold for financial statement items considered individually is ordinarily lower than for such items considered as components of financial statements taken as a whole.

B. A piecemeal opinion should not be expressed, if, as a result of restrictions imposed by the client (such as not being permitted to examine a sufficient number of subsidiaries of a holding company, not being permitted to observe physical inventories, etc.), the auditor is unable to examine evidence supporting financial statement items or is prevented from applying auditing procedures he believes would be necessary to support an unqualified or qualified opinion on the financial statements taken as a whole. Exceptions to this general prohibition can be made only in the following special circumstances:

1. The report on the client's financial statements is intended solely for the internal information of the client's management; the auditor specifies in his report that its distribution is to be so restricted; and the nature and source of the limitations on his work are clearly described.
2. The report is issued pursuant to an agreement between a prospective buyer and seller of a business; the parties involved agree to the limitations imposed on the auditor's work; the auditor describes in the report the nature and source of such limitations; and the auditor specifies in his report that its distribution is to be restricted to the parties involved.

In these special circumstances, the readers normally would be fully aware of the nature and significance of the scope limitation and would be unlikely to misinterpret the disclaimer of opinion and the piecemeal opinion.

C. Many financial statement items are interrelated, for example, sales and receivables, inventory and payables, and fixed assets and depreciation. A piecemeal opinion on specific

items can be expressed only after the auditor is satisfied that the reservations, limitations or insufficiency of evidence which prevent the expression of an opinion with respect to items to be excluded from the piecemeal opinion do not materially affect, directly or indirectly, the items on which the opinion is issued.

- D. For purposes of reporting on individual financial statement items, the threshold of materiality is ordinarily lower since, rather than being measured in relation to the statements as a whole, the individual items stand alone, thus affording a smaller base. Therefore the auditor ordinarily should extend his auditing procedures because of such materiality considerations.

III. Expression of Piecemeal Opinion

- A. A piecemeal opinion should be carefully worded so as not to contradict or overshadow the disclaimer of opinion or adverse opinion with regard to the financial statements taken as a whole. A piecemeal opinion should clearly indicate that no opinion on financial position or results of operations is intended. The report should identify the specific accounts covered by the piecemeal opinion, such as "cash, accounts receivable and securities." In some cases, when there are only a few accounts not covered by the piecemeal opinion, clear identification may be accomplished by reference to the excluded accounts, such as "assets other than accounts receivable." Use of broad phrases in identifying the items on which an opinion is being given, such as "in all other respects," could lead users of the report to believe that the opinion applies to items other than those intended, and, consequently, use of such phrases should be avoided.

- B. When the auditor expresses a piecemeal opinion, the interrelationship of the accounts affected should be carefully considered. For example, when an opinion on financial statements is disclaimed because the auditor has been unable to satisfy himself as to the valuation of inventories, it would ordinarily be improper for the auditor to express his piecemeal opinion upon "accounts other than inventories." To do so would extend his opinion to related items as to which audit satisfaction has not been obtained, such as cost of sales, gross profit, earnings before income taxes, income taxes, net earnings, accrued income taxes and retained earnings.
- C. The piecemeal opinion should also avoid any implication that the accounts upon which an opinion is expressed present financial position or results of operations. Reference should not be made to "financial position" and "results of operations" within the piecemeal opinion portion of the report.
- D. If a piecemeal opinion is considered appropriate, it should follow immediately after the disclaimer of opinion or adverse opinion covering the financial statements. The piecemeal opinion should be expressed either in the paragraph in which the disclaimer of opinion or adverse opinion appears or in an additional paragraph. The following report is an example of wording that might be used in a piecemeal opinion. This example is not intended to imply that in cases where there are uncertainties of the kinds indicated that a disclaimer of opinion is necessarily required; rather it is assumed that in this case the auditor has concluded that a qualified opinion is not justified in the circumstances.

(Scope paragraph--standard wording)

(Middle paragraph)

Deferred development costs of \$___ relate to the development of computer programs and educational films and books. The recovery of such costs is dependent on successful development of these projects and the company's ability to sell the related products profitably in the future. (See note X to the financial statements.) Also, as indicated in note Y, the company is defendant in a legal action wherein the plaintiffs are claiming damages of \$___ and the company is counterclaiming \$___ against the plaintiffs. The ultimate outcome of this litigation is uncertain.

(Opinion paragraph)

Because of the possible material effect of the uncertainties described in the preceding paragraph on financial position and results of operations, we do not express an opinion on the financial statements taken as a whole. In our opinion, however, the following items in the accompanying financial statements are presented fairly at December 31, 197_ and for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year: cash; trade accounts receivable; inventories; property and equipment; notes payable to banks; accounts payable; long-term debt; capital stock; sales; selling, general and administrative expenses; and interest expense.

STATEMENT NO. 47

SUBSEQUENT EVENTS

(Supersedes chapter II of Statement No. 33)

- I. There are two types of subsequent events that require consideration by management and evaluation by the independent auditor.
 - A. The first type consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.
 - B. Identifying events that require adjustment of the financial statements under the criteria stated above calls for the exercise of judgment and knowledge of the facts and circumstances. For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy subsequent to the balance sheet date would be indicative of conditions existing at the balance sheet date, thereby calling for adjustment of the financial statements before their issuance. On the other hand, a similar loss resulting from a customer's major casualty such as a fire or flood subsequent to the balance sheet date would not be indicative of conditions existing at the balance sheet date and adjustment of the financial statements would not be appropriate. The settlement of litigation

for an amount different from the liability recorded in the accounts would require adjustment of the financial statements if the events, such as personal injury or patent infringement, that gave rise to the litigation had taken place prior to the balance sheet date.

- C. The second type consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements. Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading. Occasionally such an event may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements.
- D. Examples of events of the second type that require disclosure in the financial statements (but should not result in adjustment) are:
1. Sale of a bond or capital stock issue.
 2. Purchase of a business.
 3. Settlement of litigation when the event giving rise to the claim took place subsequent to the balance sheet date.
 4. Loss of plant or inventories as a result of fire or flood.

5. Losses on receivables resulting from conditions (such as a customer's major casualty) arising subsequent to the balance sheet date.
- E. Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities ordinarily will require adjustment of the financial statements because such events typically represent the culmination of conditions that existed over a relatively long period of time. Subsequent events such as changes in the quoted market prices of securities ordinarily should not result in adjustment of the financial statements because such changes typically reflect a concurrent evaluation of new conditions.
- F. When financial statements are reissued, for example, in reports filed with the Securities and Exchange Commission or other regulatory agencies, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. Events occurring between the time of original issuance and reissuance of financial statements should not result in adjustment of the financial statements unless the adjustment meets the criteria for the correction of an error or the criteria for prior period adjustments set forth in Opinions of the Accounting Principles Board. Similarly, financial statements reissued in comparative form with financial statements of subsequent periods should not be adjusted for events occurring subsequent to the original issuance unless the adjustment meets the criteria stated above.
- G. Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his report an explanatory paragraph directing the reader's attention to the event and its effects.

II. Auditing Procedures in the Subsequent Period

- A. There is a period after the balance sheet date with which the auditor must be concerned in completing various phases of his examination. This period is known as the "subsequent period" and is considered to extend to the date of the auditor's report. Its duration will depend upon the practical requirements of each examination and may vary from a relatively short period to one of several months. Also, all auditing procedures are not carried out at the same time and some phases of an examination will be performed during the subsequent period, whereas other phases will be substantially completed on or before the balance sheet date. As an audit approaches completion, the auditor will be concentrating on the unresolved auditing and reporting matters and he is not expected to be conducting a continuing review of those matters to which he has previously applied auditing procedures and reached satisfaction.
- B. Certain specific procedures are applied to transactions occurring after the balance sheet date such as (1) the examination of data to assure that proper cutoffs have been made, and (2) the examination of data which provide information to aid the auditor in his evaluation of the assets and liabilities as of the balance sheet date.
- C. In addition, the independent auditor should perform other auditing procedures with respect to the period after the balance sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements. These procedures should be performed at or near the completion of the field work. The auditor generally should:

1. Read the latest available interim financial statements; compare them with the financial statements being reported upon; and make any other comparisons considered appropriate in the circumstances. In order to make these procedures as meaningful as possible for the purpose expressed above, the auditor should inquire of officers and other executives having responsibility for financial and accounting matters as to whether the interim statements have been prepared on the same basis as that used for the statements under examination.
2. Inquire of and discuss with officers and other executives having responsibility for financial and accounting matters as to:
 - (a) Whether any substantial contingent liabilities or commitments existed at the date of the balance sheet being reported on or at the date of inquiry.
 - (b) Whether there was any significant change in the capital stock, long-term debt, or working capital to the date of inquiry.
 - (c) The current status of items, in the financial statements being reported on, that were accounted for on the basis of tentative, preliminary, or inconclusive data.
 - (d) Whether any unusual adjustments had been made during the period from the balance sheet date to the date of inquiry.
3. Read the available minutes of meetings of stockholders, directors and appropriate committees; as to meetings for which minutes are not available, inquire about matters dealt with at such meetings.

4. Obtain from legal counsel a description and evaluation of any litigation, impending litigation, claims and contingent liabilities of which he has knowledge that existed at the date of the balance sheet being reported on, together with a description and evaluation of any additional matters of such nature coming to his attention up to the date the information is furnished.
5. Obtain a letter of representations, dated as of the date of the auditor's report, from appropriate officials, generally the chief executive officer and chief financial officer, as to whether any events occurred subsequent to the date of the financial statements being reported on by the independent auditor that in the officer's opinion would require adjustment or disclosure in these statements.
6. Make such additional inquiries or perform such procedures as he considers necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures, inquiries and discussions.

III. Dating of Independent Auditor's Report

- A. Generally, the date of completion of the field work should be used as the date of the independent auditor's report.
- B. The auditor has no responsibility to make any inquiry or carry out any auditing procedures for the period after the date of his report.

IV. Events Occurring After Completion
Of Field Work But Before Issuance of Report

- A. In case a subsequent event of the type requiring adjustment of the financial statements occurs after the date of the independent auditor's report but before its issuance, and the event comes to the attention of the auditor, the financial statements should be adjusted or the auditor should qualify his opinion. When the adjustment is made without disclosure of the event, the report ordinarily should be dated in accordance with paragraph III-A. However, if the financial statements are adjusted and disclosure of the event is made, or if no adjustment is made and the auditor qualifies his opinion, the procedures set forth in paragraph IV-C should be followed.
- B. In case a subsequent event of the type requiring disclosure occurs after the date of the auditor's report but before issuance of his report, and the event comes to the attention of the auditor, it should be disclosed in a note to the financial statements or the auditor should qualify his opinion. If disclosure of the event is made, either in a note or in the auditor's report, the auditor would date his report as set forth in the following paragraph.
- C. The independent auditor has two methods available for dating his report when a subsequent event disclosed in the financial statements occurs after completion of his field work but before issuance of his report. He may use "dual dating," for example, "February 16, 19__, except for Note__ as to which the date is March 1, 19__," or he may date his report as of the later date. In the former instance, his responsibility for events occurring subsequent to the completion of his field work is limited to the specific event referred to in the note (or otherwise disclosed).

In the latter instance, the independent auditor's responsibility for subsequent events extends to the date of his report and, accordingly, the procedures outlined in paragraph II-C generally should be extended to that date.

V. Reissuance of the Independent Auditor's Report

- A. An independent auditor may reissue his report on financial statements contained in annual reports filed, with the Securities and Exchange Commission or other regulatory agencies or in a long-form report subsequent to the date on which his report on the financial statements included therein was first issued. An independent auditor may also be requested by his client to furnish additional copies of a previously issued report. Use of the original report date in a reissued report removes any implication that records, transactions or events after that date have been examined or reviewed. In such cases, the independent auditor has no responsibility to make further investigation or inquiry as to events which may have occurred during the period between the original report date and the date of the release of additional reports.
- B. In some cases, it may not be desirable for the independent auditor to reissue his report in the circumstances described in paragraph V-A because he has become aware of an event that occurred subsequent to the date of his original report that requires adjustment or disclosure in the financial statements. In such cases, adjustment with disclosure or disclosure alone should be made as described in paragraph I-F. The independent auditor should consider the effect of these matters on his opinion and he should date his report in accordance with the procedures described in paragraph IV-C.

- C. If an event of the type requiring disclosure only occurs between the date of the independent auditor's original report and the date of the reissuance of such report, and if the event comes to the attention of the independent auditor, the event may be disclosed in a separate note to the financial statements captioned somewhat as follows:

Event (Unaudited) Subsequent to the Date
of the Report of Independent Auditor.

Under these circumstances, the report of the independent auditor would carry the same date used in the original report.

VI. Independent Auditor's Report
In Filing Under Securities Act of 1933

- A. Section 11 of the Securities Act of 1933 makes specific mention of the independent auditor's responsibility as an expert when his report is included in a registration statement filed under that Act. Section 11 states, in part, that no person shall be liable as provided therein if such person shall sustain the burden of proof that as to the part of the registration statement purporting to be made on his authority as an expert

he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading....

Section 11 further provides that, in determining what constitutes reasonable investigation and reasonable ground to believe, "the standard of reasonableness shall be that required of a prudent man in the management of his own property."

- B. To sustain the burden of proof that he has made a "reasonable investigation" as required under the Securities Act of 1933, the auditor should extend his procedures with respect to subsequent events from the date of his report up to the effective date or as close thereto as is reasonable and practicable in the circumstances. In this connection, he should arrange to be kept advised by his client of the

progress of the registration proceedings so that his review of subsequent events can be completed by the effective date. The likelihood of the auditor discovering subsequent events must necessarily decrease following the completion of field work and, as a practical matter, subsequent to that time the independent auditor may rely, for the most part, on inquiries of responsible officials and employees. In addition to performing the procedures outlined in paragraph II-C at or near the effective date, the auditor generally should:

1. Read the entire prospectus and other pertinent portions of the registration statement.
 2. Inquire of and obtain written confirmation from officers and other executives having responsibility for financial and accounting matters as to whether there have occurred any events other than those reflected or disclosed in the registration statement which, in the officers' opinion, have a material effect on the audited financial statements included therein or which should be disclosed in order to keep those statements from being misleading.
- C. Because the independent auditor has not examined the unaudited financial statements which may be included in the registration statement, 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 he concludes on the basis of facts known to him that the unaudited financial statements are not in conformity with generally accepted accounting principles, he should insist upon appropriate revision; failing that, he should add a comment in his report calling attention to the departure; further, he should

consider, probably with advice of legal counsel, withholding his consent to the use of his report on the audited financial statements in the registration statement.

D. A registration statement filed with the Securities and Exchange Commission may contain the reports of two or more independent auditors on their examinations of the financial statements for different periods. An auditor who has not examined the financial statements for the most recent audited period included in the registration has a responsibility relating to events subsequent to the date of the financial statements on which he is reporting which continues to the effective date, and he generally should:

1. Read pertinent portions of the prospectus and of the registration statement.
2. Obtain a letter of representations from the successor independent auditor as to whether his examination (including his procedures with respect to subsequent events) revealed any matters which, in his opinion, might have a material effect on the financial statements reported on by the predecessor auditor or would require disclosure in the notes thereto.

E. If the predecessor auditor becomes aware of any events or transactions which require adjustment or disclosure in the financial statements examined by him, the financial statements should be adjusted or the subsequent event should be disclosed in a note to the financial statements or the auditor should qualify his report. The predecessor auditor should follow the procedures set forth in paragraph IV-C with respect to dating his report. He should satisfy himself as to the propriety of any adjustment or disclosure affecting the financial statements

covered by his report. This may be done by performing appropriate auditing procedures or by obtaining a letter of representations from the successor auditor. In the latter instance, he may decide to express reliance on the successor auditor.

STATEMENT NO. 48

LETTERS FOR UNDERWRITERS

(Supersedes statement No. 35)

I. General

- A. The services of independent certified public accountants include examining financial statements and schedules contained in registration statements filed with the Securities and Exchange Commission (the "SEC") under the Securities Act of 1933 (the "Act"). In connection with this type of service, accountants often are called upon to confer with clients, underwriters, and their respective counsel concerning the accounting and auditing requirements of the Act and of the SEC as well as to perform other services. One of these other services is the issuance of letters for underwriters, commonly called "comfort letters."
- B. Underwriters, in requesting comfort letters, are generally seeking assistance on matters of importance to them. They wish to perform a "reasonable investigation" of financial and accounting data not "expertized" (covered by a report of independent accountants, who consent to be named as experts, based on an examination made in accordance with generally accepted auditing standards) as a defense against possible claims under the Act. Accountants have a corresponding wish arising in response to the same statutory phrase, "reasonable investigation," with respect to audited financial statements included in a prospectus in reliance on their audit report and their consent. The accountants' reasonable investigation must be premised upon an audit; it cannot be accomplished short of an audit. In contrast, what constitutes a reasonable investigation of unaudited financial and accounting data sufficient to satisfy an underwriter's purposes has

never been authoritatively established. It seems clear, however, that the purposes of the investigations are quite different. Accountants normally will be entirely willing to furnish to the underwriters such assistance as is within their professional capabilities; however, the extent of the assistance which accountants can provide by way of comfort letters is subject to limitations. One such limitation is that an independent certified public accountant can properly comment in his professional capacity only upon matters to which his professional expertise is substantially relevant. Another limitation is that procedures short of an audit (which are all that a comfort letter contemplates) by their nature are ordinarily not such as to furnish accountants grounds for expressing an opinion, but, at the most, negative assurance. Finally, the Committee has concluded that it is not practicable to establish standards comparable to generally accepted auditing standards by which the sufficiency of procedures to support negative assurances can be measured; therefore, such assurances in specific situations cannot reasonably imply any definite or uniform degree of certainty regarding the matters to which they relate. Accordingly, there is necessarily a risk that matters against which negative assurance is sought may prove to be present even though negative assurance has been given.

- C. Comfort letters are not required under the Act, and copies are not filed with the SEC. It is nonetheless a common condition of an underwriting agreement in connection with the offering for sale of securities registered with the SEC under the Act that the accountants are to furnish a comfort letter. Some underwriters do not make the receipt of a comfort letter a condition of the underwriting agreement but nevertheless ask for such a letter.

- D. The accountants should suggest to the underwriter that they meet together with the client to discuss the procedures to be followed in connection with a comfort letter; in this connection, the accountants may describe procedures frequently followed. Because of the accountants' knowledge of the client, such a meeting may substantially benefit the underwriter in reaching his decision as to the procedures to be followed by the accountants. However, because of the lack of clear-cut standards, it is advisable to accompany any discussion of procedures with a clear statement that the accountants cannot furnish any assurance as to the sufficiency of the procedures for the underwriter's purposes and it is advisable for the comfort letter to contain a statement to this effect.
- E. Comfort letters will generally refer to one or more of the following subjects:
- (a) The independence of the accountants.
 - (b) Compliance as to form in all material respects of the audited financial statements and schedules with the applicable accounting requirements of the Act and the published rules and regulations thereunder.
 - (c) Unaudited financial statements and schedules in the registration statement.
 - (d) Changes in selected financial-statement items during a period subsequent to the date and period of the latest financial statements in the registration statement.
 - (e) Tables, statistics and other financial information in the registration statement.

These matters are discussed in greater detail below. Matters dealt with in a particular letter

usually are limited to ones specified in the underwriting agreement.

- F. Because the underwriter will be looking to the accountants to furnish a comfort letter of a scope to be specified in the underwriting agreement, the client and the underwriter, when they have tentatively agreed upon a draft of the agreement, are well advised to furnish a copy of it to the accountants so that the latter can indicate whether they will be able to furnish a letter in acceptable form. A desirable practice is for the accountants, promptly after they have received the draft of the agreement (or have been informed that a letter covering specified matters, although not a condition of the agreement, will nonetheless be requested), to prepare a draft of the form of letter that they expect to furnish. To the extent possible, the draft should deal with all matters to be covered in the exact terms to be used in the final letter (subject, of course, to the understanding that the comments in the final letter cannot be determined until the procedures underlying it have been performed). The draft letter should be identified as a draft in order to avoid giving the impression that the procedures described therein have been performed. This practice of furnishing a draft letter at an early point permits the accountants to make clear to the client and the underwriter what they may expect the accountants to furnish, and gives the client and the underwriter an opportunity to change the proposed underwriting agreement if they so desire. The underwriter thus furnished with a draft letter is afforded the opportunity of discussing further with the accountants the procedures that the accountants have indicated they expect to follow, and of requesting any additional procedures which the underwriter may desire. If the additional procedures pertain to matters to which the accountants' professional competence is relevant, the accountants would ordinarily be willing to

perform them and it is desirable for them to furnish the underwriter an appropriately revised draft letter. The accountants may reasonably assume that the underwriter, by indicating his acceptance of the draft comfort letter, and subsequently, by his acceptance of the letter in final form, considers the procedures described sufficient for his purposes. It is important, therefore, that the procedures to be followed by the accountants be clearly set out in the comfort letter, in both draft and final form, so that there will be no misunderstanding as to the basis upon which the accountants' comments have been made and so that the underwriter can decide whether the procedures performed are sufficient for his purposes. Statements or implications that the accountants are carrying out such procedures as they consider necessary should be avoided since this may lead to misunderstanding about the responsibility for the sufficiency of the procedures for the underwriter's purposes. A suggested form of legend which may be placed on the draft letter for identification and explanation of its purposes and limitations is as follows:

This draft is furnished solely for the purpose of indicating the form of letter which we would expect to be able to furnish [name of underwriter] in response to their request, the matters expected to be covered in the letter and the nature of the procedures which we would expect to carry out with respect to such matters. Based on our discussions with [name of underwriter], it is our understanding that the procedures outlined in this draft letter are those they wish us to follow. Unless [name of underwriter] informs us that there are additional procedures they wish us to follow, we shall assume that they consider those procedures outlined sufficient for their purposes. The text of the letter itself will depend, of course, upon the results of the

procedures, which we would not expect to complete until shortly before the letter is given and in no event before the cutoff date indicated therein.

II. Dating

- A. The letter ordinarily is dated at or shortly before the "closing date" (the date on which the issuer or selling security holder delivers the securities to the underwriter in exchange for the proceeds of the offering). The underwriting agreement ordinarily specifies the date, often referred to as the "cutoff date," to which the letter is to relate (e.g., a date five business days before the date of the letter); the accountants should see that the cutoff date will not place an unreasonable burden on them. The letter should state that the inquiries and other procedures carried out in connection with the letter did not cover the period from the cutoff date to the date of the letter.
- B. Letters may also be dated at or shortly before the "effective date" (the date on which the registration statement becomes effective) and, on rare occasions, letters have been requested to be dated at or shortly before the "filing date" (the date on which the registration statement is first filed with the SEC). If more than one letter is requested, it will be necessary to carry out the specified procedures and inquiries as of the cutoff date for each letter. Although comments contained in an earlier letter may on occasion conveniently be incorporated by reference in a subsequent letter, any subsequent letter should relate only to information in the registration statement as most recently amended as of the cutoff date of the subsequent letter.

III. Addressee

- A. Because the letter is a result of the underwriter's request, many accountants address the letter only to the underwriter, with a copy furnished to the client. When this is done, the appropriate addressee is the underwriter who has negotiated the underwriting agreement with the client, and with whom the accounts will deal in discussions as to the scope and sufficiency of the letter, rather than the group of underwriters for whom that underwriter acts as representative. Some accountants address the letter instead to the client, or to both the client and the underwriter. If the accountants are requested to address the letter to any person other than the underwriter or the client, they would do well to consult their counsel.

IV. Introductory Paragraph

- A. It is desirable to include an introductory paragraph substantially as follows:

We have examined the [identify the financial statements and schedules examined] included in the Registration Statement (No. 2-00000) on Form _____ filed by the Company under the Securities Act of 1933 (the "Act"); our reports with respect thereto are also included in such Registration Statement. Such Registration Statement, as amended as of _____, is herein referred to as the "Registration Statement."

V. Independence

- A. It is customary for the underwriting agreement to provide for the accountants to make a statement concerning their independence in the letter. This may be done substantially as follows:

We are independent certified public accountants with respect to The Blank Company, Inc. within the meaning of the Act and the applicable published rules and regulations thereunder and the answer to [identify the item number that refers to the relationship with registrant of experts named in the registration statement; e.g., Item 24 of Form S-1] of the Registration Statement is correct insofar as it relates to us.

VI. Compliance With SEC Requirements

- A. The accountants may be requested to express an opinion concerning compliance as to form of the financial statements covered by their report with the pertinent published accounting requirements of the SEC. This may be done substantially as follows:

In our opinion, [include phrase, "except as disclosed in the Registration Statement," if applicable] the [identify the financial statements and schedules examined] examined by us and included or incorporated by reference in the Registration Statement comply as to form in all material respects with the applicable accounting requirements of the Act and the published rules and regulations thereunder.

If there is a material departure from the pertinent published requirements, the departure should be disclosed in the letter. Normally, representatives of the SEC will have agreed to such departure; when this occurs, such agreement should be mentioned in the comfort letter.

- B. Since published SEC requirements do not deal with the form of pro forma financial statements or pro forma adjustments applied to historical financial statements, there is no basis for accountants to comment on whether such pro forma information complies as to form with SEC requirements.

VII. Accountants' Report

- A. Underwriters occasionally request that the accountants repeat in the comfort letter their opinion with respect to the audited financial statements included in the registration statement. Because of the special significance of the date of an accountants' report, the accountants should not repeat their opinion. Underwriters sometimes request negative assurance as to the accountants' report. Because accountants have a statutory responsibility with respect to their opinion as of the effective date, and because the additional significance, if any, of a negative assurance is unclear and such assurance may therefore give rise to misunderstanding, it is inadvisable to give such negative assurance.

VIII. Unaudited Financial Statements and Subsequent Changes

In General

- A. Comments included in the letter will often concern (i) unaudited financial statements and schedules included in the registration statement, (ii) changes in capital stock and long-term debt, (iii) decreases in other specified financial-statement items, and (iv) pro forma financial statements. In commenting on these matters, the following guides are important:
- (1) Any statements by the accountants with respect to unaudited financial statements and schedules and subsequent changes or decreases should be limited to negative assurance.
 - (2) The agreed upon procedures performed by the accountants should be set forth in the letter.

- (3) Terms of uncertain meaning such as "review," "general review," "limited review," "check," or "test" should not be used in describing the work, unless the procedures comprehended by the term are described in the comfort letter.
- (4) The letter should specifically identify any unaudited financial statements and schedules to which it refers. The letter should state that the accountants have not examined such financial statements and schedules in accordance with generally accepted auditing standards and do not express an opinion concerning them.
- (5) The accountants should not give negative assurance with respect to unaudited financial statements and schedules or changes or decreases unless they have made an examination of the client's financial statements for a period including or immediately prior to that to which the negative assurance relates or have completed an examination for a later period.
- (6) The accountants should not give negative assurance with respect to financial statements and schedules that have been examined and are reported on in the registration statement by other accountants.
- (7) The accountants should not give negative assurance on pro forma adjustments applied to historical financial statements unless they have made an examination of the historical financial statements of the client (or, in the case of business combinations, of a significant constituent part of the combined financial statements) (1) for the period presented, or (2) in the case of interim periods, for the latest fiscal period which includes or precedes the interim period.

- (8) The procedures followed with respect to interim periods may not disclose changes in capital stock or long-term debt or decreases in the specified financial-statement items, inconsistencies in the application of generally accepted accounting principles, instances of noncompliance as to form with accounting requirements of the SEC, or other matters as to which negative assurance is requested.
- (9) The working papers relating to comfort letters should be prepared in a manner so as to constitute adequate evidence of what has been done.

Unaudited Financial Statements

- B. Comments in the comfort letter concerning the unaudited financial statements, summary of earnings, and schedules appearing in the registration statement should always be made in the form of negative assurance. Frequently, such comments relate to (a) conformity with generally accepted accounting principles, (b) consistency with the audited financial statements, summary of earnings, and schedules included in the registration statement, and (c) compliance as to form with applicable accounting requirements.
- C. When the most recent figures included in a summary of earnings (or statement of income) are for a period of less than one year, the SEC usually requires that comparative figures be shown for the corresponding short period of the preceding year. Frequently the financial statements for the latest interim period are unaudited, and financial statements for the interim period of the preceding year are ordinarily unaudited, even though that period is

part of a year for which the financial statements have been audited. In these circumstances the unaudited status of the financial statements of the earlier period should be made clear in the comfort letter.

Capsule Information

- D. In many registration statements, the information shown in the summary of earnings (or statement of income) is supplemented by unaudited information as to subsequent sales and earnings (commonly called "capsule information"). This later information (either in narrative or in tabular form) is often shown in a paragraph following the summary, for a period within the current year and for the corresponding period of the prior year, and usually consists only of selected income-statement items. "Fair presentation," as used by independent certified public accountants, ordinarily relates to presentation in conformity with generally accepted accounting principles of financial statements as a whole, including the notes thereto; therefore accountants, in giving negative assurance regarding selected income-statement items, should not make reference to fair presentation but should only refer to whether the dollar amounts were determined on a basis substantially consistent with that of the corresponding amounts in the audited statement of income.
- E. In connection with capsule information, the underwriter occasionally asks the accountants (a) to give negative assurance with respect to the related unaudited financial statements and (b) to state that the capsule information agrees with amounts set forth in such statements. Although this is another means of accomplishing the same objective as the method described in paragraph D, it is ordinarily not practicable. Even though trial balances, sum-

mary financial data, or financial statements normally prepared for management use may be available in final form so as to provide an appropriate basis for the company to present capsule information, they will seldom have been prepared in such form or detail, including relevant notes, as to permit the independent public accountant to give negative assurance on fair presentation in conformity with generally accepted accounting principles. If the underwriter requests it, however, and if it is practicable for the client to prepare financial statements on a timely basis in conformity with generally accepted accounting principles, it is appropriate for the accountants to agree to the underwriter's request described in the first sentence of this paragraph.

Subsequent Changes

- F. Comments as to subsequent changes also should be in the form of negative assurance. They should not relate to "adverse changes" since, despite long use under Statement No. 35 and prior thereto, that term has not acquired any defined or clearly understood meaning in an accounting sense. In fact, upon reexamination, it appears that the term may, on some occasions, have been misinterpreted by underwriters as encompassing judgments and conclusions not contemplated by the accountants. For example, there has been no agreement among accountants, clients, and underwriters as to whether the term relates only to absolute changes or also includes trends in amounts or ratios. Further, there are differences of view as to whether an adverse change in results of operations is indicated solely by a decrease in net income or whether it also encompasses changes in sales, cost of sales, and other factors which separately or together might indicate the beginning or accentuation

of an adverse trend. Also, the term has sometimes been construed as contemplating comments by accountants regarding matters to which their professional competence has little relevance, such as evaluating whether certain types of expenses that may decrease current income but are designed to increase future income (e.g., research and development costs, major advertising campaigns, and systems installations) are adverse or not. In order that comments on subsequent changes be unambiguous and their determination be within the professional competence of accountants, the comments should not relate to adverse changes, but should ordinarily relate to whether there has been any change in capital stock or long-term debt or "decreases" in other specified financial-statement items during a period known as the "change period." Usually these items would include the amounts of net current assets, net assets (stockholders' equity) and net sales, and the total and/or per-share amounts of income before extraordinary items and of net income.

- G. The discussion concerning subsequent changes is not intended to suggest that accountants should avoid mentioning in their letter any changes other than defined decreases or any other matters known to them which in their opinion would be of interest to the underwriter. However, since matters to be covered by the letter should be made clear in the meetings with the underwriter and should be contemplated by the underwriting agreement and in the draft comfort letter, and since there is no way of anticipating other matters which would be of interest to an underwriter, accountants should not make a general statement in comfort letters that, as a result of carrying out the specified procedures, nothing else has come to their attention which would be of interest to the underwriter.

H. In the context of a comfort letter, a decrease occurs when the amount of a financial-statement item at the cutoff date or for the change period (as if financial statements and their notes had been prepared at that date and for that period) is less than the amount of the same item at a specified earlier date or for a specified earlier period. With respect to the items mentioned in paragraph F, the term "decrease" means (a) any combination of changes in amounts of current assets and current liabilities that results in decreased net current assets, (b) any combination of changes in amounts of assets and liabilities that results in decreased net assets, (c) decreased net sales, and (d) any combination of changes in amounts of sales and expenses and/or outstanding shares that results in decreased total and/or per-share amounts of income before extraordinary items and of net income (including, in each instance, a greater loss or other negative amount). The change period for which the accountants give negative assurance in the comfort letter ends on the cutoff date and ordinarily begins (a) for balance-sheet items, immediately after the date of the latest balance sheet in the registration statement, and (b) for income-statement items, immediately after the latest period for which such items are presented in the registration statement. The comparison relates to the entire period and not to portions thereof. A decrease during one part of a period may be offset by an equal or larger increase in another part of the period; however, because there was no decrease for the period as a whole, the comfort letter would not report the decrease occurring during one part of the period.

- I. Underwriters occasionally request that the change period begin immediately after the date of the latest audited balance sheet (ordinarily also the closing date of the latest audited statement of income) in the registration statement, even though the registration statement includes a more recent unaudited balance sheet and statement of income. The use of the earlier date may defeat the underwriter's purpose since it is possible that an increase in one of the items referred to in paragraph F occurring between the dates of the latest audited and unaudited balance sheets included in the registration statement might more than offset a decrease occurring after the latter date. A similar situation might arise in the comparison of income-statement items. In these circumstances, the decrease occurring after the date of the latest financial statements included in the registration statement would not be reported in the comfort letter. It is desirable for the accountants to explain the foregoing considerations to the underwriter; however, if the underwriter nonetheless requests the use of a change period or periods other than those described in paragraph H, the accountants may use the period or periods requested.
- J. The underwriting agreement usually specifies the dates and periods with which data at the cutoff date and for the change period are to be compared. For balance-sheet items the comparison date is normally that of the latest balance sheet included in the registration statement (i.e., immediately prior to the beginning of the change period); for income-statement items the comparison period or periods might be one or more of the following: (a) the corresponding period of the preceding year, (b) a period of corresponding length immediately preceding the change period, (c) a

proportionate part of the preceding fiscal year, or (d) any other period of corresponding length chosen by the underwriter. Whether or not specified in the underwriting agreement, the date and period used in comparison should be identified in the comfort letter in both draft and final form so that there is no misunderstanding as to the matters being compared and so that the underwriter can determine whether the comparison period is suitable for his purposes.

- K. In addition to making the comparisons indicated above using the financial statements made available to them, the accountants will ordinarily be requested to read minutes and make inquiries of company officials relating to the whole of the change period. For the period between the date of the latest financial statements made available and the cutoff date, the accountants must necessarily base their comments solely on the limited procedures actually performed with respect to that period (which in most cases will be limited to the reading of minutes and the inquiries of company officials referred to in the preceding sentence), and their comfort letter should make this clear.

Disclosure in Registration Statement

- L. Comments on the occurrence of changes in capital stock or long-term debt and decreases in other specified financial-statement items are limited to changes or decreases not disclosed in the registration statement. This limitation is referred to in the letter by the phrase, "except for changes or decreases which the Registration Statement discloses have occurred or may occur." Whenever it appears to the accountants that a change or decrease has occurred during the change period, they should refer to the registration statement to determine whether the change or decrease is disclosed therein.

IX. Effect of Qualified Opinion

- A. The foregoing discussion contemplates that the accountants' opinion on the financial statements and schedules and the summary of earnings in the registration statement is unqualified. This usually is the case. Except in extraordinary circumstances, the requirements of the SEC do not permit a registration statement to become effective when the accountants' opinion is qualified as to the scope of their examination or as to the accounting principles reflected in the financial statements and schedules and the summary of earnings. However, such circumstances do occasionally arise and, although the SEC may permit the registration statement to become effective even though the opinion is qualified, the accountants may not be in a position to give an unqualified opinion that the financial statements in the registration statement comply as to form in all material respects with the published rules and regulations of the SEC under the Act.
- B. The SEC ordinarily will accept a "subject to" type of qualification in the accountants' opinion when there is uncertainty as to (a) the outcome of controversial matters such as litigation, renegotiation of contracts, or disputes concerning income taxes; (b) recovery of research and development costs or other deferred charges; or (c) other matters which are not susceptible of reasonable accounting determination, but which might have a material effect on financial position or results of operations.
- C. If the opinion is qualified, the qualification should be referred to in the opening paragraph of the comfort letter by saying, for example, "... our reports (which contain a qualification as set forth therein) with respect thereto are also included in such Registration Statement."

- D. If the letter includes negative assurance with respect to subsequent unaudited financial statements included in the registration statement or with respect to an absence of specified subsequent changes or decreases, the effect thereon of the subject matter of the qualification should also be considered.

X. Other Accountants

- A. Comfort letters are occasionally requested from more than one accountant (for example, in connection with registration statements to be used in the subsequent sale of shares issued in recently effected mergers). In these circumstances, each accountant must, of course, be sure he is independent within the meaning of the Act and the applicable published rules and regulations thereunder. In connection with opinions expressed prior to the acquisitions, the accountants for previously nonaffiliated companies recently acquired by the registrant would not be required to have been independent with respect to the company whose shares are being registered. In such a case, the accountants should modify the wording suggested in paragraph V-A and make a statement regarding their independence along the following lines:

As of [insert date of the accountants' most recent report on the financial statements of their client] and during the period covered by the financial statements on which we reported, we were independent certified public accountants with respect to [insert the name of their client] within the meaning of the Act and the applicable published rules and regulations thereunder and the answer to Item 24 of the Registration Statement is correct insofar as it relates to us.

- B. There may be situations in which more than one accountant is involved in the examination of

the financial statements of a business and where the reports of more than one accountant appear in the registration statement. For example, certain significant divisions, branches, or subsidiaries may be examined by other accountants. The principal accountants (those who report on the consolidated financial statements and consequently are asked to give a comfort letter with regard to information expressed on a consolidated basis) should read the letter or letters of the other accountants reporting on significant units. Such letters should contain statements similar to those contained in the comfort letter prepared by the principal accountants, including statements as to their independence. The principal accountants should state in their comfort letter that (a) reading letters of other accountants was one of the procedures followed, and (b) the procedures performed by the principal accountants (other than reading the letters of the other accountants) relate solely to (1) companies examined by the principal accountants and (2) the consolidated financial statements. If the letters of the other accountants disclose decreases in financial-statement items or any other matters that affect the negative assurance that is given, the principal accountants should make mention of these matters in their letter. Where appropriate, the principal accountants may comment that there were no decreases in the consolidated financial-statement items despite the decreases mentioned by the other auditors. In such a case, the principal accountants could give negative assurance that nothing had come to their attention regarding the consolidated financial statements as a result of the specified procedures (which, so far as the related company was concerned, consisted solely of reading the other accountants' letter) that caused them to believe that

- C. At the earliest practicable date, the client should advise any other accountants who may be involved as to any letter that may be required from them and should arrange for them to receive a draft of the underwriting agreement so that they may make arrangements at an early date for the preparation of a draft of their letter (a copy of which draft should be furnished to the principal accountants) and for the performance of their procedures.
- D. When a comfort letter is furnished to other accountants, it should be addressed in accordance with paragraph III-A, with copies furnished to the principal accountants and their client.

XI. Tables, Statistics and Other Financial Information

- A. The underwriting agreement sometimes calls for a comfort letter which includes comments on tables, statistics and other financial information appearing in the registration statement.
- B. The accountants should refrain from commenting on matters to which their competence as independent public accountants has little relevance. Accordingly, except as indicated in the next sentence, they should comment only with respect to information (a) which is expressed in dollars (or percentages derived from such dollar amounts) and has been obtained from accounting records which are subject to the internal controls of the company's accounting system or (b) which has been derived directly from such accounting records by analysis or computation. The accountants may also comment on quantitative information which has been obtained from an accounting record if the information is of a type that is subject to the same controls as the dollar amounts. Accountants should not comment on matters involving primarily the exercise of business judgment of

management. For example, changes between periods in gross profit ratios or net income may be caused by factors that are not necessarily within the expertise of accountants. Similarly, even though the accountants might appropriately comment on amounts shown as profit contributions for each line of business as defined by management, it would seldom be appropriate for them to comment on the reasonableness of management's determination of the client's lines of business. The accountants should not comment on matters merely because they happen to be present and are capable of reading, counting, measuring or performing other functions which might be applicable. Examples of matters that, unless subjected to the internal controls of the formal accounting system (which is not ordinarily the case), should not be commented on by the accountants include square footage of facilities, number of employees (except as related to a given payroll period) and backlog information. The accountants should not comment on tables, statistics and other financial information relating to an unaudited period unless they have made an examination of the client's financial statements for a period including or immediately prior to the unaudited period or have completed an examination for a later period.

- C. As with comments relating to financial statement information, it is important that the procedures followed by the accountants with respect to other information be clearly set out in the comfort letter, in both draft and final form, so that there will be no misunderstanding as to the basis of comments thereon. Further, so that there will be no implication that the accountants are furnishing any assurance as to the sufficiency of the procedures for the underwriter's intended purpose, it is advisable for the comfort letter to contain a statement to this effect.

- D. In order to avoid ambiguity, the specific information commented on in the letter should be identified by reference to captions, tables, page numbers, or specific paragraphs or sentences. It should not refer, for example, to "all financial and statistical information" set forth (a) in the registration statement, (b) under specific captions, or (c) in response to specific item numbers in the registration statement.
- E. Comments in the comfort letter concerning tables, statistics, and other financial information appearing in the registration statement should be made in the form of a description of the procedures followed, the findings (ordinarily expressed in terms of agreement between items compared), and in some cases, as described below, statements with respect to the acceptability of methods of allocation used in deriving the figures commented upon. Whether comments upon the allocation of income or expense items between such categories as military and commercial sales, or lines of business, may appropriately be made will depend upon the extent to which such allocation is made in, or can be derived directly by analysis or computation from, the client's accounting records. In any event such comments, if made, should make clear that such allocations are to a substantial extent arbitrary, that the method of allocation used is not the only acceptable one, and that other acceptable methods of allocation might produce significantly different results.
- F. In comments concerning tables, statistics, and other financial information the expression, "presents fairly" (or a variation of it), should not be used. That expression, when used by independent certified public accountants, ordinarily relates to presentation of financial statements and should not be used in commenting on other types of information. Except with

respect to requirements for financial statements, the question of what constitutes appropriate information for compliance with the requirements of a particular item of the registration statement form is a matter of legal interpretation outside the competence of the accountants. Consequently, the letter should state that the accountants make no representations as to any matter of legal interpretation. Since the accountants will not be in a position to make any representations as to the completeness or adequacy of disclosure or as to the adequacy of the procedures followed, the letter should so state. It should point out as well that such procedures would not necessarily disclose material misstatements or omissions in the information to which the comments relate.

XII. Concluding Paragraph

- A. In order to avoid misunderstanding as to the purpose and intended use of the comfort letter, it is desirable that the letter conclude with a paragraph along the following lines:

This letter is solely for the information of, and assistance to, the underwriters in conducting and documenting their investigation of the affairs of the Company in connection with the offering of the securities covered by the Registration Statement, and is not to be used, circulated, quoted or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the Registration Statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the Registration Statement.

XIII. Miscellaneous

- A. Accountants who discover matters that may require mention in the final comfort letter but which are not mentioned in the draft letter that has been furnished to the underwriter, such as decreases or changes in specified items not disclosed in the registration statement, will naturally want to discuss them with their client, so that consideration can be given to whether disclosure should be made in the registration statement. If such disclosure is not to be made, the accountants should inform the client that mention thereof will be made in the comfort letter and suggest that the underwriter be promptly so informed. It is recommended that the accountants be present when such matters are discussed between the client and the underwriter.

STATEMENT NO. 49

REPORTS ON INTERNAL CONTROL

I. General

- A. Independent auditors are sometimes requested to furnish reports on their evaluation of internal control for use by management, regulatory agencies, other independent auditors, or the general public. The purpose of this Statement is to improve the understanding of such reports with reference to the nature and effectiveness of internal control and the independent auditor's evaluation of it.

- B. As used in this Statement, management includes directors, officers, and others who perform managerial functions; regulatory agencies include both governmental and other agencies, such as stock exchanges, that exercise regulatory, supervisory, or other public administrative functions; and the general public includes present and prospective investors, creditors, customers, and others who have an interest in particular organizations.

II. Nature and Effectiveness of Internal Control

- A. Internal control is described in Statement on Auditing Procedure No. 33, as follows:

In the broad sense, internal control includes...controls which may be characterized as either accounting or administrative, as follows:

- 1. Accounting controls comprise the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization

and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing.

2. Administrative controls comprise the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls.

- B. The establishment and maintenance of a system of internal control is an important responsibility of management. In exercising this function, it is appropriate for management to recognize that the cost of internal control should not exceed the benefits derived. The benefits consist of reductions in the risk of failing to achieve the objectives implicit in the definition of internal control. Although the cost-benefit relationship is the primary conceptual criterion that should be considered in designing a system of internal control, precise measurement of costs and benefits usually is not possible; accordingly, any evaluation of the cost-benefit relationship requires estimates and judgments by management.
- C. There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal control. In the performance of most control procedures errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends on segregation of duties can be circumvented by collusion.

Similarly, control procedures can be circumvented intentionally by management with respect to (1) the execution and recording of transactions or (2) the estimates and judgments required in the preparation of financial statements.

- D. A satisfactory system of internal control can be expected to provide reasonable, but not absolute, assurance that its objectives will be accomplished. Conversely, weaknesses in a system do not necessarily mean that errors and irregularities will occur.
- E. In addition to the limitations discussed above, any projection of a current evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions, and that the degree of compliance with the procedures may deteriorate.

III. Purpose and Scope of Auditor's Study and Evaluation

- A. The purpose of the auditor's study and evaluation of internal control incident to his examination of financial statements is to establish a basis for reliance thereon in determining the nature, timing, and extent of audit tests to be applied. This is expressed in the second standard of field work:

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.

Suggestions for improvement in internal control frequently arise from audit engagements and may also arise from special engagements undertaken for that or other purposes.

- B. The subdivision of internal control into accounting control and administrative control was made primarily to clarify the scope of the study required under generally accepted auditing standards. The conclusions in that respect, as expressed in Statement on Auditing Procedure No. 33, were as follows:

The independent auditor is primarily concerned with the accounting controls. Accounting controls, as previously described, generally bear directly and importantly on the reliability of financial records and require evaluation by the auditor. Administrative controls, also previously described, ordinarily relate only indirectly to the financial records and thus would not require evaluation. If the independent auditor believes, however, 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. For example, statistical records maintained by production, sales or other operating departments may require evaluation in a particular instance.

- C. The overriding criterion inherent in the preceding excerpt is the bearing that particular controls have on the reliability of financial records, regardless of their classification as accounting or administrative controls. For practical purposes, this is tantamount to including within the definition of accounting control any administrative control procedures that have been evaluated by an auditor because he believed they had an important bearing on the reliability of the financial records. This concept of accounting control is applied for convenience hereafter in this Statement.
- D. The study made as the basis for the auditor's evaluation of accounting control includes two phases, as indicated by Statement on Auditing Procedure No. 33:

Adequate evaluation of a system of internal control requires [1] knowledge and understanding of the procedures and methods prescribed and [2] a reasonable degree of assurance that they are in use and are operating as planned.

These two phases of the study are referred to in this Statement as (1) the review of the system and (2) tests of compliance with the system, respectively.

- E. Since the purpose of the evaluation required by the second standard of fieldwork is to provide a basis for determining the "extent of the tests to which auditing procedures are to be restricted," it is clear that its purpose is to contribute to the "reasonable basis for an opinion" comprehended in the third standard which is quoted below:

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.

- F. The evidential matter required by this standard is obtained through auditing procedures designed to test the validity and the propriety of accounting treatment of transactions and balances. The second standard does not contemplate that the auditor should place complete reliance on internal accounting control to the exclusion of other auditing procedures with respect to material items in the financial statements. Consequently, the auditor's review and tests of internal accounting control should be recognized as being only a part of his examination of financial statements.

IV. Usefulness of Reports on Internal Control

- A. Because of the technical nature and complexity of internal accounting control and the consequent problem of understanding reports thereon, questions have been raised as to whether such reports serve a useful purpose for all persons to whom they might be issued. The usefulness of such reports depends on the understanding of the reports and on the action that can be taken by those to whom the reports are issued. The expected usefulness to the principal classes or groups of such persons is discussed in the remainder of this section.

Management, Regulatory Agencies, and Independent Auditors

- B. Management is responsible for establishing and maintaining internal accounting control. Regulatory agencies may be concerned with such control because it is relevant to their primary regulatory purpose or to the scope of their examination functions. Independent auditors of one entity or organization unit may be concerned with internal accounting control of another because it is relevant to the scope of their examination. It may be presumed that these groups include persons whose training and experience or intimate knowledge of the organization should provide a reasonable basis for understanding the nature and effectiveness of internal accounting control and the auditor's evaluation of it. Consequently, it is evident that reports on internal accounting control can serve a useful purpose for management, regulatory agencies, and other independent auditors.

General Public

- C. In contrast to the foregoing groups, the usefulness of reports on internal accounting control to the general public is questionable. The groups discussed in the preceding paragraph are

directly concerned with internal accounting control and are in a position to take direct action as a result of reports thereon. On the other hand, any possible action that could be taken by the general public as a result of such reports would be indirect since it ordinarily would be limited to making decisions about either a company's financial statements or its management. The usefulness of reports on internal accounting control for these purposes is discussed in the next three paragraphs.

- D. Insofar as audited financial statements are concerned, the auditor's evaluation of internal accounting control is only an intermediate step in forming the opinion he expresses on such statements. Therefore, an auditor's report on his evaluation of internal accounting control would not provide any additional credibility to audited financial statements.
- E. Insofar as interim or other unaudited financial statements are concerned, a report on an auditor's evaluation of internal accounting control for an earlier period could only be used to project the evaluation into the future as a basis for reliance on the unaudited statements. Depending on the evaluation expressed in the report, such projections into the future could either increase or decrease the reliance that otherwise would be placed on the unaudited statements. Some believe that such projections would serve a useful purpose because the public is interested in unaudited statements and because the effectiveness of internal accounting control has a bearing on the probability that such statements will be reliable. Although conceding the relevance of internal accounting control in this respect, others believe that projections of auditors' evaluations thereof would result in either unwarranted reliance on, or unduly negative inferences concerning, unaudited financial statements. The latter group believes that unwarranted reliance would result

from improper understanding of the inherent limitations on any system of internal accounting control, of the purpose and scope of the auditor's evaluation, and of the risks of projecting such evaluations into the future. Conversely, this same group believes unduly negative inferences would result from improper understanding that weaknesses in internal accounting control relate to conditions that could, but would not necessarily, cause unaudited financial statements to be misleading.

F. There are also different views as to the usefulness of reports on internal accounting control for the purpose of making decisions about management's performance. Some believe such reports would be useful for that purpose because internal accounting control is an important area of management responsibility. Others believe the relative importance of this area of management responsibility, as compared to other areas for which reports are not presently available or feasible, is such that reports on internal accounting control alone would result in distorted appraisals of management performance.

G. Although the general public has been defined broadly in this Statement, the Committee recognizes that within this group there may be considerable variation in the degree to which the conflicting expectations expressed in paragraphs E and F will materialize. This variation may arise from, and reflect differences in, circumstances such as the type and extent of investment or other interest in the organization and the related influence on management action, and the level of understanding of the nature and limitations of internal accounting control.

H. Considering the conflicting views discussed above and the limited experience with such reports, the Committee has concluded that the decision as to whether reports on an auditor's

evaluation of internal accounting control would be useful for some portion or all of the general public in particular cases or classes of cases is the responsibility of management and/or any regulatory agencies having jurisdiction.

- I. In no event, however, should an auditor authorize a report on his evaluation of internal accounting control to be issued to the general public in a document that includes unaudited financial statements.

V. Form for Reports on Internal Control

Reports Based on Audits

- A. If reports on auditors' evaluations of internal accounting control are to be issued, the Committee believes the risk of misunderstanding can be reduced by adopting a form of report that describes in reasonable detail the objective and limitations of internal accounting control and the auditor's evaluation of it. Therefore, the following language should be used for such purpose except as discussed in the subsequent paragraphs in this Statement.

We have examined the financial statements of ABC Company for the year ended December 31, 1970 and have issued our report thereon dated February 23, 1971. As a part of our examination, we reviewed and tested the Company's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. Under these standards the purpose of such evaluation is to establish a basis for reliance thereon in determining the nature, timing, and extent of other auditing procedures that are necessary for expressing an opinion on the financial statements.

The objective of internal accounting control is to provide reasonable, but not absolute, assurance as to the safeguarding of assets against loss from unauthorized use or disposition, and the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management.

There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends upon segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management with respect either to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions, and that the degree of compliance with the procedures may deteriorate.

Our study and evaluation of the Company's system of internal accounting control for the year ended December 31, 1970, which was made for the purpose set forth in the first paragraph above, was not designed for the purpose of expressing an opinion on internal accounting control and it would not necessarily disclose all weaknesses in the system. However, such study and evaluation disclosed the following conditions that we believe to be material weaknesses.

The above paragraphs should be followed by appropriate description of the material weaknesses. The descriptions should indicate whether the weaknesses relate to the prescribed procedures or to compliance with them. The report may also include recommendations for improvements, comments concerning corrective action taken or in process, or other comments appropriate in the circumstances. The basis for any comments concerning subsequent corrective action should be indicated, including the scope of any review and tests by the auditor. Although the Committee believes the first paragraph of the foregoing form of report clearly indicates that weaknesses in the system are considered in determining the nature, timing, and extent of auditing procedures necessary for expressing an opinion on financial statements, some auditors may want to include further comments in this respect.

- B. In some cases the auditor may conclude that for certain weaknesses corrective action by management is not practicable in the circumstances and he may decide to exclude such weaknesses from his report. If such weaknesses are excluded, the last sentence of the above form of report should be modified as follows:

However, such study and evaluation disclosed the following conditions that we believe to be material weaknesses for which corrective action by management may be practicable in the circumstances.

Such a report should include appropriate description of material weaknesses for which the auditor has either (1) concluded that corrective action by management is practicable, or (2) formed no conclusion in this respect.

- C. If there are no conditions to be reported in accordance with the two preceding paragraphs, the word "no" should be substituted for "the following" in the above form of report.

- D. The auditor may want to report other weaknesses, regardless of his judgment as to materiality or practicability of corrective action by management. The latter might include situations in which the organization is too small to permit adequate segregation of duties of employees. In any of these situations the language in paragraph A should be modified as appropriate. If some weaknesses are reported to one group but not to another (for example, to management but not to regulatory agencies or to the general public), the more extensive report should distinguish the weaknesses that are excluded from the other report and the auditor should be prepared to support, if necessary, his judgment in making the distinction.
- E. In some cases reports on internal accounting control may include comments on additional matters. For example, a regulatory agency may require comments on certain aspects of administrative control or on compliance with certain provisions in contracts or regulations. In such cases the language in paragraph A should be modified to identify clearly the additional matters and distinguish them from internal accounting control, to describe in reasonable detail the scope of the review and tests concerning them, and to express conclusions in language comparable to that in paragraphs A through D as appropriate. The identification of the additional matters covered in the report should be as specific as the auditor considers necessary to prevent misunderstanding in this respect. Such identification can be made in some cases by reference to specific portions of other documents such as contracts or regulations.
- F. Since auditors are aware of the objective and limitations of internal accounting control and of auditors' evaluations of it, use of the form of report in paragraph A is optional for reports issued solely for another independent auditor.

- G. Use of the form of report in paragraph A is optional also for reports issued solely for the internal information of management. Suggestions or other comments concerning specific aspects of internal accounting control and various other matters are often submitted to management by auditors as a result of observations made during their examinations of financial statements. These comments are often submitted by letters, memoranda, and other less formal means. The Committee encourages this practice and this Statement is not intended to preclude the use of such means of communication.

Reports Based on Special Studies

- H. Reports on internal accounting control sometimes are issued as a result of special studies. As used in this Statement, special studies are those in which the scope of the study and evaluation being reported is substantially more extensive than that required for an examination of financial statements in accordance with generally accepted auditing standards. Special studies may relate either to an existing system or to a proposed system.
- I. If reports on special studies of internal accounting control are to be issued to regulatory agencies or to the general public, the form of report in paragraph A should be adapted by replacing the first paragraph and modifying the fourth paragraph therein. The first paragraph should describe the purpose and scope of the study. This description should be in reasonable detail and should indicate whether the scope included both a review of the system and test of compliance with it. The fourth paragraph should be modified to refer to the purpose of the special study and any related limitations and to refer to the weaknesses disclosed or the absence thereof by using the language included in paragraphs A through C as appropriate in the circumstances.

J. For reports issued solely for use by management or other independent auditors, the flexibility in reporting provided for in paragraphs F and G applies also to reports based on special studies.

STATEMENT NO. 50

REPORTING ON THE STATEMENT OF CHANGES

IN FINANCIAL POSITION

(Supersedes paragraphs 6 of Chapter 10 of
Statement No. 33)

- I. The purpose of this statement is to revise the recommended short-form auditor's report in order to foster uniformity of language in giving recognition to the provisions of APB Opinion No. 19 in reporting on financial statements that purport to present financial position and results of operations.
- II. Short-Form Report

- A. The following short form of independent auditor's report is recommended to replace the report set forth in Statement on Auditing Procedure No. 33:

We have examined the balance sheet of X Company as of December 31, 19__ and the related statements of income and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19__, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

III. Variations in Format and Presentation Between Periods

- A. In APB Opinion No. 19, the Board concluded that "... the statement summarizing changes in financial position should be based on a broad concept embracing all changes in financial position. ..." In APB Opinion. No. 19, however, the Board recognized "... the need for flexibility in form, content, and terminology ..." of the statement of changes. Accordingly, variations between periods in the format of the statement of changes, such as changing to or from a balanced form, are deemed to be reclassifications. If such variations materially affect comparability, they should be disclosed in the financial statements and ordinarily will not be referred to in the independent auditor's report.
- B. However, variations between periods in the terms used to express changes in financial position, such as changing from cash to working capital, constitute a change in the application of accounting principles and involve the consistency standard. When such a change occurs, and the independent auditor deems it to be material, he should express in his opinion an exception as to consistency. An entity making such a change in the current period may present comparative financial statements for a prior period that have been restated to conform with those of the current period. Such a restatement places both periods on the same basis with respect to the use and application of accounting principles. The restatement should be disclosed and the auditor should refer to it in his report.

IV. Omission of Information Considered Essential for a Fair Presentation

- A. APB Opinion No. 19 sets forth various types of information that should be disclosed in the statement of changes. When the auditor believes that information essential for a fair presentation has been omitted from the statement of changes, he should provide that information in his report and appropriately qualify his opinion.

V. Omission of Statement of Changes

- A. If an entity issues financial statements that purport to present financial position (balance sheet) and results of operations (statement of income and retained earnings) but omits the related statement of changes, and if the omission is not sanctioned by Opinion No. 19 of the Accounting Principles Board, the omission should be treated in accordance with the provisions of the Special Bulletin of the American Institute of Certified Public Accountants issued in October 1964 relating to disclosures of departures from Opinions of the Accounting Principles Board. Accordingly, the auditor normally will conclude that the omission requires qualification of his opinion as discussed in paragraph B below.
- B. An entity's failure to disclose required information normally results in the auditor including that information in his report. Although this procedure is appropriate with respect to specific disclosures relating to financial statements that are presented, the committee has concluded that it is not appropriate to require the auditor to prepare a basic financial statement (a statement of changes for one or more years) and include it in his report when the client's management has declined to present such a statement. Accordingly, in these

cases the auditor should qualify his report, ordinarily in the following manner:

We have examined the balance sheet of X Company as of December 31, 19__ and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The company declined to present a statement of changes in financial position for the year ended December 31, 19__. Presentation of such a statement summarizing the company's financing and investing activities and other changes in its financial position is required by Opinion No. 19 of the Accounting Principles Board.

In our opinion, except that the omission of a statement of changes in financial position results in an incomplete presentation as explained in the preceding paragraph, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19__, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

- C. A certified public accountant may be associated with unaudited financial statements that purport to present financial position (balance sheet) and results of operations (statement of income and retained earnings), but omit the related statement of changes. In such a case, the accountant is not required to prepare a statement of changes and include it in his accompanying report. However:

- (1) When such statements are restricted to internal use by the client, the accountant normally will conclude that the omission requires him to add to his accompanying disclaimer of opinion, in addition to other required information, an indication that the statement of changes has been omitted.
- (2) When such statements are not so restricted, the accountant normally will conclude that the omission requires him to add to his accompanying disclaimer of opinion, in addition to other information that may be required, an indication that such financial statements do not conform to generally accepted accounting principles because the related statement of changes in not presented.





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