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A Banker Looks at Audit Reports

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WHEN I was first asked to speak to your group this evening I recalled an experience during my first days in public accounting. I had a friend in middle management of a bank-loan department in New York. We frequently discussed our experiences and problems. He mentioned several times that he hadn't slept well because of a recurring nightmare. This aroused my curiosity. One day I questioned him about the nightmare. He answered that he had dreamt of an unexpected turn of events, resulting in heavy losses on commercial loans he had approved; depositors, stockholders, bosses, and government authorities called him on the carpet and indignantly asked questions about his management of the bank's assets. Having just gotten out of school I knew all there was to know, as those of you who have sons of that age can readily attest. I quickly explained that all he need do was to insist upon an audit report from each borrower and from then on he could rest easy. Now that I'm older and wiser I know of course that bankers can never rest easy.

In all seriousness, gentlemen, I hope tonight to tell you what an audit report can and cannot do.

An audit report cannot, of course, eliminate nightmares. Can it replace a banker's judgment? Certainly not, although it does provide reliable evidence upon which to base this judgment. Is the audit report able to replace collateral? Ridiculous, of course. At this point you are probably thinking "Well, what does an audit report do?"

AUDIT REPORTS

An audit report is nothing more or less than a presentation of significant information. In its most common form it comprises an auditor's opinion and financial statements, usually composed of a balance sheet, income statement, and footnotes, and perhaps some supplemental schedules. Since you are all quite familiar with financial statements I shall limit myself to comments about the auditor's opinion.

CPA's Opinion

The objective of an audit is to permit the CPA to say that in his opinion the balance sheet and income statement fairly present the financial

position and income in accordance with generally accepted accounting principles applied on a consistent basis. These last phrases mean that, in the judgment of an independent expert, the description and classification of items and the allocation of income and expenses to appropriate time periods are on a sound basis and that all material facts known to him and necessary for the proper interpretation of the statements are included in the report. If, for example, there is uncertainty about the outcome of a pending lawsuit or of an income tax adjustment of substantial amount, this fact would have to be noted in order to make the presentation of the statements fair.

Generally Accepted Accounting Principles

Before continuing I should like to say a few words about the last phrase of the CPA's opinion—that is, "generally accepted accounting principles," or as defined quite simply a moment ago, "a sound basis." The term originated about thirty years ago in correspondence between the American Institute of Certified Public Accountants and the New York Stock Exchange. It was intended to refer to certain broad principles of accounting that had won common acceptance. However, just as today, businessmen were permitted to select the *detailed* accounting methods that they believed best suited their specific circumstances. There is at present considerable agitation among some members of our profession to narrow the choice of the businessman in selecting the specific accounting methods appropriate for himself. I lean more toward the belief that conditions quite often vary sufficiently to preclude the promulgation of detailed standard accounting methods.

One example of variation familiar to all of you is the treatment given unearned discount on the balance sheet. I would say that it is a generally accepted accounting principle to deduct unearned discount from the receivable or loan balance; almost all finance companies use this method of reporting. On the other hand it is a generally accepted trade practice among banks to include unearned discount as a liability. Although I may have a strong preference for one method or the other I do not believe that I should be required to qualify my opinion on a bank examination in either case as long as both methods are accepted in bank reporting. I feel that disclosure of the method followed and consistency in its application allow the banker to judge the customer's ability to repay a loan even though another company may treat a similar accounting matter differently in its financial statements. But enough of the accounting profession's problems—I merely hoped to give you a little better understanding of the background of generally accepted accounting principles.

If all audits resulted in unqualified accountants' opinions, loan officers

would not have to read them. Unfortunately for you and ourselves they frequently do not.

Exceptions

Generally, opinions that take exception to the content of the statements fall into three categories.

Perhaps the most common qualification is the auditor's exception concerning the fairness of presentation of one specific matter in the financial statements. This type of qualification usually will contain the expression "except for." For example, the opinion might say: "except for the fact that no overhead is included in the valuation of the work in process and finished goods inventory, the financial statements present fairly, etc." From such a statement the loan officer should be able to determine from the accountant's opinion the dollar effect of the qualification and what the statement would be like if there had been no qualification.

Another common qualification is the so-called "subject to" phrase—appropriate when there is uncertainty concerning the outcome of an unsettled matter such as a pending lawsuit or a tax deficiency. In these instances neither the auditor nor anyone else is reasonably certain of the outcome; however, the effect is not expected to be so large that the auditors could not issue an opinion, subject to the uncertainty.

A third type is the adverse opinion—required when the exception is so large that the auditor has decided the financial statements are not presented fairly. It is most common in financial statements of specialized businesses, perhaps among those that follow accounting methods prescribed by a regulatory agency. In these instances the financial statements do not purport to conform to generally accepted accounting principles, and the opinion would so state.

Scope of Examination

Now that we are all experts on the second paragraph of the standard auditor's report, the opinion paragraph, let's revert to the first, the scope paragraph.

In this section the auditor states that he has examined certain statements, and that this examination was made in accordance with generally accepted auditing standards. Incidentally, as some of you may have noticed, auditors seem to have adopted as a favorite phrase the term "generally accepted." At this point perhaps I should say what some of the more salient factors of "generally accepted auditing standards" comprise. The first question to resolve is whether the auditor checks every transaction and balance. The answer is a very loud and resounding no. The general tech-

nique, a very basic auditing standard, is to review first the company's internal control. Then, based upon its effectiveness, we *test* the accounting records. You as bankers know, probably better than anyone else, that the volume of paper work required for even a single transaction has become enormous. It would obviously be extremely uneconomical to examine every transaction and fortunately, it can be shown both mathematically and from experience that this is not necessary for the formulation of sound opinions.

Materiality

Another doctrine on which the auditor relies heavily is materiality—an action that results in placing the greatest emphasis on dollar amounts. The term "fairly presents" contained in our opinion does not mean that the financial statements are correct to the last penny; rather it means that they are close enough so that any exception is not important enough to affect the over-all position of the company and this is not likely to affect the judgment of a reader. As you can readily see, an audit *may* very well *not* disclose a defalcation unless it is significant enough to affect fair presentation of the statements.

Analytical Techniques

In testing the accounting records the auditor uses many techniques. If he can physically see the record, he may do so. This he would do in examining inventories, cash on hand, securities held, physical plant, and similar items. If he can't see the record, he must use other means. The method normally giving the next greatest assurance is confirmation through an outside source. Common examples of this technique are confirmations of receivables, bank balances, and inventories or securities held by others. Inspection of externally generated documents, such as vendors' invoices or statements, usually would be the next best evidence. In addition to these methods, the auditor makes computations to substantiate a tax liability, reviews internally generated documents and records, and makes inquiries of company employees. To complement these audit procedures, the modern auditor also makes extensive use of analytical techniques similar to those that a loan officer might use but they are in some ways more extensive. He will, for example, often make *monthly* comparisons of financial statements, gross profit ratios, and other meaningful figures, and investigate variations. During the application of these diverse techniques the auditor, based on his study and experience, must determine that the disclosure, classification, and allocation of items are proper.

In the application of these procedures lies a basic difference between audited and unaudited statements—the auditor's study and experience. A company accountant may be the finest of bookkeepers, but he may not be qualified to determine the proper way to record a certain transaction or how to report an item in the financial statements. Poor judgment in the treatment of an item may result in unintentionally misleading or overly optimistic financial statements. If this should occur, the auditor must see that necessary adjustments are made or else qualify his opinion, as mentioned before.

Disclaimers

But what happens if the auditor is precluded from performing some or all of the things he needs to satisfy himself of the propriety of the statements? If the statements are unaudited they should bear a notation that they have been prepared from the books *without* audit. In addition, the auditor will usually state that he has not carried out any auditing procedures and therefore cannot express any opinion concerning the statements. You, as credit grantors, are therefore warned that the auditor assumes no responsibility whatsoever for the statements.

When the scope of our work is partially restricted—for example, when we are not permitted to observe the taking of physical inventories or to request selected debtors to confirm with us directly the amount shown as receivable—we ordinarily must either qualify our opinion or disclaim one. The scope paragraph would then generally end by saying "except that we were not permitted to observe the physical inventories or to confirm accounts receivable." Usually in these circumstances, inventories and receivables would be significant in relation to the balance-sheet totals, and we would be required to disclaim responsibility for the statements as a whole. The report would then say that the auditor does *not* express an opinion concerning the financial statements.

Significance of Audit

Let us assume for the moment that an independent audit has been made and that the banker has received the audit report containing an unqualified opinion. Has the banker then done his duty? I think not. It is my firm belief that he should be concerned with the *quality* of the audit. Obviously, an audit is only as good as the individual or the firm who made it, so the first thing to do is to find out who the auditor is. If he is a certified public accountant, definite assumptions may be made: He has satisfied certain educational and experience requirements of the state law and has

passed a written two-and-a-half day examination in accounting, auditing, commercial law, and financial reporting. He also subjects himself to severe penalties should he violate any of the ethical, moral, and legal responsibilities he assumes.

If he is a member of the American Institute of Certified Public Accountants or of a state society of CPAs, as most of us are, he is required to observe generally accepted auditing standards, to state in his report the degree of responsibility that he accepts, and to refrain from having any financial interest in a business on whose financial statements he expresses an opinion.

CONCLUSION

One final word. The certified public accountant's report most frequently reads to this effect: the financial statements have been examined in accordance with generally accepted auditing standards and in the accountant's opinion present fairly the financial position and results of operations in conformity with generally accepted accounting principles, consistently applied. Such an opinion does not mean that the accountant is indicating the company is a good credit risk. It means only that all the information is there, presented fairly, for your use. A decision concerning the enterprise's ability to repay a loan rests only on your own sound evaluation.

We CPAs feel that in the business world we represent the "men from Missouri"—people who say "seeing is believing," or "show me," or less succinctly (and more provokingly) "I'll believe it when I see it."

Part of our duty, in effect, is to *show* you, the bankers, for you too are men from Missouri, and you too want to be shown. After that it's up to you and your own good judgment.