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An Address delivered before the Massachusetts Society of Certified Public Accountants

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Merchants National Bank, Boston, Massachusetts

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"What does a banker expect an audited statement to show? He expects that it will set forth a correct picture of all the assets and all the liabilities of the company. And he expects that these various assets and liabilities will be classified and described with sufficient detail and exactness to enable him to form a satisfactory estimate of their value as a basis for granting credit.

While we feel that this is what an audit *should be,* our experience has been that many concerns have an entirely different conception of an audit. While many have the thought that an audit will correct irregularities in their accounting, and will show the executives ways of improving their accounting system, it appears that in the majority of cases the paramount thought in their minds is that an audited statement is an aid in obtaining credit. Apparently many concerns have an auditor go over their books with the latter thought only in mind, simply to enable them to show an audited statement. They do not care what the auditor does so long as he makes up a statement and signs it, and does not give the banks too much information about the business.

I think everyone here will agree that a plain condensed balance sheet gives one little idea of a company's operations. Without knowing how the figures have been determined, an intelligent analysis of them is impossible. It gives the present position only, and no idea of how this position was reached. Altogether too many of our audited statements are of this character. They are of little more value than the company's own statement of its condition. Of course, we all like to see an accountant's name at the bottom of a statement, indicating that an outside expert has been over the books, but if the concern has in mind having the audit made as an assistance in obtaining credit, the object is almost entirely defeated if the bank is not furnished with details enabling it to make a proper analysis of the figures. To make this proper analysis one must know the *quality* as well as the *quantity* of assets; the liquidity of the receivables, the marketability and method of valuation of the merchandise. One wants to feel assured that all the liabilities are included. In this latter connection, I feel that the auditor should not only verify the bills payable appearing on the books, but should ascertain, through correspondence *with all of the company's banks,* whether there is any existing liability, direct or contingent, through them which may not appear on the books at statement date. If the statement indicates only the amount of liabilities as shown on the company's books, without such a verification, it is of no more value to the banker than the company's own statement without an audit. Here are a few cases to illustrate this point:

"A statement came in prepared by ...., who certified that the statement was true and correct. In checking the matter up, however, we found about $90,000 more outstanding on statement date with various banks and subsequently found that the cash books had been held open until late in January and collections in the meantime had been applied to a reduction of the indebtedness. This, of course, was a case of window dressing. This incident does not compare unfavorably with the accountants who recently audited .... and followed the same procedure. This resulted in the withdrawal of our line to the company, so I fail to see where the client had been benefited in any way."

"A statement of the ...., as of ...., showed bills payable of $50,000. In checking the figures with the company's other bank we ascertained that besides owing us $50,000, the company was also indebted there for another $50,000. This statement was certified to by ...., a local firm of accountants. An investigation brought forth the information that the President of the company had borrowed the $50,000 from the other bank for his personal use and the entries never reached the books of the company."

"A clothing house, whose December 31, 1920, statement was made up by ...., an accountant of this city, showed total Notes Payable of $35,000. On that date the firm owed its own bank $57,500. The additional amount of loan was a personal matter of the partner, but the note given the bank was the firm's note. It did not appear on the books of the concern, and as the accountant had not verified bank loans he knew nothing about it."

In addition to the quality of the assets, other important facts which a bank likes to know are: Sales, indicating the rapidity of merchandise turnover and productivity of capital invested in fixed assets; Earnings, showing percentage of profit on Sales and on Capital invested; and Distribution of Earnings, which is necessary in order that one can reconcile the Surplus account.

While a condensed statement without the above details is of little value, it *is* to be presumed that such a statement, over the signature of a reputable auditor, *does* contain the essential facts, even if it is impossible to analyze them. We assume that the Accounts Receivable item, for instance, if not commented on, is due for merchandise sold, and that in making a comparison of the various ratios one may compare this item with sales, thereby getting a picture of the management's ability as collectors over a period of years. I regret to say, however, that the practice of some accountants in making up a company's statement for its banks, without properly separating the receivables, makes such a comparison very uncertain without a full knowledge of the facts. If the receivables contain items of any material size which are not for merchandise, the customary analysis of receivables to merchandise, receivables to sales, etc., is absolutely impossible. Many examples are presented illustrating this point:

"A statement included in current assets an item of loans receivable..$344,000. Of this amount $200,000 was due from two of the officers and had been advanced to them for the purpose of paying income taxes on the previous year's business when the concern was a firm rather than a corporation. The balance of the item, $140,000, represented a loan made to one of the officers for the purpose of investing in real estate for the benefit of the corporation, and was handled this way because they did not want to show a real estate item in the figures."

"Another statement included in the current assets an item of over $3,000,000 of accounts and notes receivable, etc., less reserve. This item included $1,000,000 due from subsidiaries of which $600,000 had gone into permanent investments in these subsidiaries, and the item also included some stock in subsidiary companies, one of which it was said had a substantial surplus, while another was unsuccessful." The accountant admitted that these items should be set up separately, and said that the figures were drawn up for the annual report to the stockholders and the management had asked that they be condensed as much as possible.

"Another accountant prepared a statement for .... as of ...., and failed to indicate that $100,000 of the notes receivable were pledged to the .... Bank to secure a loan there."

"A large percentage of the Receivables item of another statement, upon investigation, was found to consist of claims for rebate of Federal taxes."

"One concern had a claim from the Government and also owed a considerable amount for past due taxes. Instead of listing as a liability the taxes which *must* be paid, the accountant deducted this from the amount which it was *hoped* might be rebated, and the net amount was carried as an account receivable."

Of course, the customary analysis of Sales to Receivables, and of Receivables to Merchandise, etc., would be of no value in such cases because a large percentage of the so-called Receivables have no relation to Merchandise or Sales. All too frequently an investigation finds that the receivables include accounts from individuals and many other kinds of items giving an entirely false impression of the company's condition. It would not be difficult to recall dozens of such cases. They work greatly against the concern and also against the accountant, when they come to light. In an audited statement where there is nothing to indicate to the contrary, I should like to feel, and I think I should have the right to feel, that the Receivables item is what it is expected to be—that it is for merchandise sold. If any of the receivables are from foreign countries, these should be separated from the others and the conditions regarding them commented upon.

Many times we see an item "Reserve." This is too general a word; it may mean many things, and I think proper accounting calls for a clear statement of the nature of such an item. Oftentimes it includes taxes, a quick liability.

While lack of information regarding details makes it impossible to make an intelligent analysis, that which upsets our calculations perhaps more than anything else, is the omission of information regarding existing contingent liabilities. Of course, Contingent Liabilities are of many kinds; it is not necessary to enumerate them here. But from whatever cause they may arise and no matter how remote may be the possibility of the company having to pay them, a contingent liability *is* a contingent liability and if it exists, the accountant, in my opinion, is neglectful of his duty if he places his signature on a statement without indicating in some way that there is such a thing. He may not wish to give the details, but there should be *something* to put the banker on notice and enable him to look into the details if he considers it advisable Probably two of the most common kinds of Contingent Liabilities which are overlooked are those found in purchase commitments for the following season and in Letters of Credit Liability. In the latter there should be indicated not only the amount of the Letter of Credit which has been used, but also the amount unused, giving an intimation of what real liabilities are contemplated.

I have on file a large number of examples of audited statements which make no mention of contingent liabilities which existed, but will call your attention to just a few of them as follows:

"We received two separate statements of December 31, 1920, from a corporation, each certified to by a different firm of auditors. They agreed in every particular; no mention was made of a contingent debt, whereas we ascertained that under date of the statement they had $65,000 of notes and acceptances rediscounted. We have not discussed this with ...., but .... admitted it was a slip-up on their part, as they relied too much on the detailed audit of the other firm when they were making up their own figures."

"A statement of .... submitted by a note broker, showed no contingent debt, whereas the detailed audit showed $30,000 bills receivable discounted. The explanation given by the auditing firm was that the certificate had been made by their representative in another city who apparently did not appreciate the necessity for incorporating the contingent debt in the statement which was distributed at large. This brings up an interesting point of whether branch offices always work on the same platform as the home office."

"The statement of ...., prepared by ...., made no mention whatever of a contingent liability of a substantial amount of outstanding bills of exchange. The only excuse of the accountant was that as the bills of exchange were drawn on an affiliated concern the company did not consider them a liability."

"An accountant addressed a client's depositary banks for information regarding balances and outstandings with the banks on the statement date, December 31, 1920. One bank reported a direct liability for bills payable and a contingent liability for bills receivable discounted, but when the statement appeared signed by the accountant, there was no reference whatever to contingent liabilities."

I have known of cases, when concerns have made no reference to existing contingent liabilities, where there has been some excuse for it because of the lack of appreciation of the importance of mentioning them in a statement to their bankers. I feel, however, when there is a liability of such a nature, that there is absolutely no excuse for an accountant making up a concern's statement for its banks, or for any other purpose, without making a notation of it before placing his signature on the statement. Some accountants are very particular on these points, but I am forced to believe that many give little thought to the matter. The following is a copy of a certificate accompanying a statement prepared by an accountant who appreciates the importance of showing a concern's true condition.

"*Cash*

Amounts on deposit in foreign banks included in this item are computed at current rates of exchange on December 31, 1920.

Accounts Receivable—Customers

This item includes a balance on one account of $137,362.49 on which the goods have been billed, but on which we understand that shipment has not yet been consented to by the customer; $72,532.81 of this account is included in the $132,379.62 of overdue accounts shown in note on Page 1.

Merchandise Inventory

Goods seen and quantities checked on Raw Materials, Supplies and Manufactured Goods amounting to $289,562.57.

This inventory is stated not to contain certain Merchandise bought for next year's business which was on hand when Inventory was taken amounting to $45,269.00 net.

Accounts Payable

These Accounts Payable are stated not to include any liability for certain Merchandise bought for next year's business which was on hand when Inventory was taken amounting to $45,269.00.

Contingent Liability

Contingent Liability on account of accommodation endorsement of contractor's note in connection with purchase of lumber $25,000.

Contingent Liability under joint and several letter of guaranty for advances on purchases for X Company $257,000.

The Y Company states that its commitments for Merchandise on December 31, 1920, did not exceed $1,500,000 and were all for immediate use, and that all estimated losses on same have been provided for in the financial statement; they also state that construction contracts uncompleted on December 31, 1920 did not exceed the sum of $500,000.

Materials and Supplies Commitments on December 31, 1920 amounted to $400,000 of which $250,000 were for immediate delivery and $150,000 were for deferred delivery; of this latter class $50,000 were deliverable at option of the Company, and on many of the Commitments deliveries are now being made at reduced prices.

Cumulative Preferred Dividends

Cumulative Dividends on Preferred Stock amounting to $85,000 not included in this statement as a liability."

The following notes from a number of other certificates also indicate an intention to show the banker how far the accountant has gone and to call his attention to anything unusual which may be hidden in the balance sheet:

"Accounts Receivable, Accounts Payable, Personal Balances, were not confirmed by correspondence."

"Analysis of Customers' Accounts shows:

$113,572.94 for shipments over four months old on Domestic Accounts.

$27,098.29 for shipments over four months old on Cuban Accounts.

$189,645.27 for shipments over four months old on other Foreign and Canadian Accounts."

"These accounts include $42,539.26 for goods which, since December 31, 1920, have been transferred from Customers to the Company's foreign selling agents for resale."

"Merchandise Inventory is stated by the Company to be valued at cost or market, whichever was lower. Quantities are as stated and sworn to by Employees of the Company. Extensions and footings verified by us."

"Merchandise Inventory and Accounts Payable are stated to include all Merchandise and Liability on account of same December 31, 1920."

"The Company states that the outstanding commitments December 31, 1920 were less than $197,000 and in the aggregate would show no loss as compared with market prices as of that date."

"The Notes Payable were confirmed by correspondence."

"Dividends on the Preferred and Common Stock amounting to $79,034 declared on January 5, 1921, have not been deducted from the surplus as shown above."

Many cases are constantly coming to light of so-called audited statements where an accountant has made a superficial examination or has made up a condensed statement from his full audit without showing points of vital importance. I feel very strongly that every audited statement should be accompanied by the Accountant's certificate stating what he has done. I think this has been one of the most common omissions in the work of accountants. Many simply state that the subject's books have shown such and such figures. In cases where a banker is not to be shown the full audit report, he should at least have a report stating as clearly as possible how far the accountant has gone and how the figures have been determined. This report or certificate should, among other things, report on the age and quality of Receivables, Merchandise valuations and marketability, verification of liabilities, and notation of amount of commitments or other contingent liabilities. We see many so-called certificates which mean absolutely nothing—they cannot be taken seriously. Here are a few samples of many of which have come to my notice:

"I hereby certifiy that the above is a true and correct *transcript* of the Assets and Liabilities appearing on the books of the ...., on December 31, 1920."

There is no information as to the basis at which the merchandise was taken, no reserves for taxes, depreciation or bad debts, nothing to show whether a real audit was made or not.

"I certify that the Balance Sheet herewith presented is a true copy of the Assets and Liabilities of ...., as on their books as of December 31, 1920."

"We have examined and audited the books and accounts of .... for the period January 1, 1921 to August 31, 1921, and herewith present the above statement of Assets and Liabilities, *subject to such allowances for accrued and deferred items, as may not have been considered.* The inventory herein shown is furnished, prices being taken at market value."

"We hereby certify that the above is a true statement of Assets and Liabilities as disclosed by the company's books as of April 30, 1921."

"We hereby certify that to the best of our professional knowledge the foregoing is a true statement."

"I hereby certify that the above Balance Sheet is a fair statement of the condition of the company at December 31, 1920."

"I have examined the above account and find it correct."

"The above figures are in accordance with the books of the ...., as of August 1, 1921, and represent the true financial condition of the company as of that date."

In the last case the accountant admitted that he had made no audit whatever, but simply made up a statement from the company's books of that date for the client to show his bank, and did not know whether the books showed the true financial condition of the company or not.

While a concern may not have had any contingent liability on statement date, it is of great importance if one is considering the extension of a line of credit direct, or wishes to handle intelligently an inquiry from some other source where credit is being sought, that information should be available as to whether the concern may customarily have contingent liabilities at other times of the year. An audit seldom reveals this information. But it is not infrequent for a concern to have a window dressing before statement date. Sometimes a contingent liability is shifted to affiliated interests. If it is customary for a concern to have contingent liabilities of important amounts during the year which may be eliminated preparatory to making up a statement, it would be of great assistance to the banker if the accountant should note this fact. In one illustrative case of this kind which recently came to light, the accountant, upon being questioned regarding it, admitted his wrong and offered no defense except that the company felt there was no likelihood of its being called upon to meet the obligation. *The banker is entitled to know the facts,* and prefers to form his own opinion as to the probability or improbability of a contingent liability becoming a direct one.

If an audit is intended to assist a concern in obtaining credit, why should any of the information it contains be withheld from the banks? Why should figures made up for the banks frequently give so much less information than those made for the company itself? If the information is favorable, the credit will be granted more freely. Information withheld or covered up creates suspicion—telling the worst, if the case is bad, may create sympathy and induce help when dealing with the right kind of a banker. Many concerns have an entirely wrong impression of the bank man. They look at him as one who is trying to take their last penny! In reality, the concern is asking the bank man to trust it with the bank's funds—with very little actual information on which to base judgment as to the value of the credit risk. Instead of trying to get something to which he is not properly entitled, the banker of the highest type is interested in every detail of his customer's business, is ready and anxious to help him, and is usually qualified to do so because of the training and experience he has gained through dealings with others.

If an audit is to be used to assist in obtaining credit, how is it so used—what is its purpose? Is it simply made to give the banker the assurance of the concern's honesty, to prove that the figures give a true picture of the company's books? A banker is always glad to know that an outside expert has examined a borrower's book, but very few of a bank's losses come from false statements. I have before me a list of sixty-eight prominent concerns from all over the United States, that have been in difficulties the past year and a half. So far as I have been able to learn, only one of them made a false statement, and the head of that one concern had for years been in ill repute, and there was little excuse for a bank being caught with his notes in its pocket book. Of these sixty-eight concerns forty were issuing audited statements when they got into trouble. Gentlemen, if you had asked me five years ago if I felt like asking all our borrowers to have their accounts audited, I would have said "Yes," but to be perfectly frank, I have seen so many faulty and useless audits during that time, I feel much less like giving any such blanket recommendation. *Altogether too many of them report what the* *company wants reported,* rather than what ought to be reported. Too many accountants are afraid of losing business. It is to one's credit to lose business sometimes. If the standards of audits are not raised there is little future for your profession.

While some losses are the result of falsified figures, which a proper audit would discover, most of a bank's losses come, not from false statements or lack of financial audits, but from the improper manufacturing and merchandising methods of those to whom they are loaning money. Many concerns of course need a financial audit, but in my opinion what they most need is an *industrial* audit; if a concern's management is able and honest and the business appears well handled and profitable, if its own accounting methods give evidence of competency and clearness as shown by the information available, it gives me little added confidence to have its statement signed by an accountant. Under such conditions, granting of credit is not a mechanical process. A large percentage of the credit risk is to be found in the personnel of the management, its character, ability and application. Of course, many concerns do not have a system of their own which enables them to show the important details to their banks in a clear and intelligible manner. An audit of any kind helps these people and helps their banks. But the audit which is of *real* value is not an audit to enable a company to *borrow* more money, but one which will enable a company to *make* more money —an audit which will promote better management, full knowledge of costs, proper routing, proper industrial processes, efficiency, and point out the economic factors affecting the expansion and contraction of the whole industry. The whole idea of the audit, as it is usually referred to, is wrong. If the manufacturing and selling are properly handled, the financing will be a simple matter.

I feel that a great deal of time and money is wasted by concerns having their accounts examined by auditors who do very little but check back over a lot of bookkeeping accounts, following up some minor details that are not of importance, and spend little time in determining the value of the receivables and merchandise, and give little or no help or suggestions which would lead to greater efficiency and economy in managing the business. Of course, a good financial audit is, without doubt, of some help. A great deal of real auditing is done which is not the type first referred to as being satisfactory to one who simply wishes a statement, bearing an auditor's signature, to present to his bank as a basis for credit. A *good* financial audit can be of much benefit to a mercantile concern and to its bankers, but I feel that when you gentlemen make simply a so-called financial audit, you are losing your opportunity for helpful and constructive work. If a concern spends $1000 for the kind of audit which is frequently given, they would better spend $1500 or $2000 and get something which, as I said before, would help them to *make* more money rather than *borrow* more money.

You will say, of course, that you do what you are paid to do. Right there is an opportunity for you to do constructive work. If what you do is of little value to your clients, educate them to allow you to do something that is of real value to them. A good accountant, like a good banker or a good business man, does not mind turning away business when it is not of the right kind. To do the work I think you ought to do of course necessitates your having trained and skilled workmen. I believe there is a field for such work. I know some are doing it now. Work of your kind poorly done is little better than work not done at all. I feel that in your line above all others, there is an opportunity for service far greater than is usually realized. The banker is in a position to turn a great deal of business your way. He does recommend your service, but—you will pardon my frankness—he would recommend it more strongly if he were sure his customer would get his money's worth.

I think the banks can do a great deal for their customers by recommending that they employ the services of those who are known to do thorough and conscientious work, and I think the accountant can do a great deal more for his clients by educating them to be open and frank with their banks and to show them everything there is to see, with the feeling that if they withhold unfavorable information they are deceptive, but if they tell the whole story of their affairs, their banks are going to help them work out their problems. Nothing will help your profession more in this respect than for you to insist to your clients, and for us to insist to ours, upon the right of the banker to discuss his customer's affairs with the accountant. The banker and the accountant should work together in promoting this harmony and co-operation, which will be of great benefit to your clients and to ours, and a corresponding help to your work and to our work."