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John S. Schumann

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Functions of the Certified Public Accountant

by John S. Schumann
Partner, New York Office

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When invited to meet with you today, I was asked to talk about the function of the certified public accountant in relation to the financial statements of clients—in other words, to discuss what accountants do and what they do not do. I was not asked to philosophize about the contribution of professional accountants to the workings of the business world, nor to try to defend the profession in a climate where those who make bad investments seem to think that we are the patsies who will make good losses due to investors' errors in judgment or to their stupidity. We can discuss this hostile climate, if you wish, but for the present I will try to stay with the assigned subject.

As a basis for discussion, I think we should all keep in mind that public accountants are not "accountants" in the simple sense of the word. We do not "account" for our client's operations.

THE ACCOUNTANTS' OPINION

By far the most important service we render—in terms of the amount of effort put forth and of our estimate of contribution to the public—is in expressing an opinion on representations of the management of our clients. Our services are in *auditing*. Management "accounts"—we "examine." Without further reflection, you might consider that the distinction is in the words only. That distinction is all-important, however, to any understanding of the function of a public accountant, and it does bear on some of the matters to be discussed today.

The management of a company is paid to operate the company and to report results and financial condition to the stockholders—the owners. As auditors, we are employed to review management's representations of those results and of condition and to express an opinion on our appraisal of management's representations in making the display. Management keeps the necessary records to make its report—we do not. Management selects the principles of accounting to be employed where there are alternative practices—we do not. Management proudly or shamefacedly reports to the owners—we do not. Our function is to make an independent review as experts in examining—in auditing—techniques and as individuals especially knowledgeable concerning accounting principles that are generally accepted.

Having concluded an examination of management's representations, we do prepare one thing—a letter describing the scope of our work and concluding with our opinion on whether or not management's representations are fair when measured by accepted principles and whether or not those principles are the same as management used when reporting in prior periods.

As a frame of reference, let's look at this typical auditor's letter—sometimes called a report, or an opinion, or a certificate. The easiest way to discuss it might be to read it and then take it apart.

ACCOUNTANTS' OPINION

Blank Company:

We have examined the balance sheet of Blank Company as of December 31, 1966 and the related statement 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.

In our opinion, the accompanying balance sheet and statement of income and earned surplus present fairly the financial position of the Company at December 31, 1966 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.

HASKINS & SELLS

New York,
January 25, 1967

This typical letter consists of two paragraphs, only. The first describes the work we did; we'll call that the "scope" paragraph. The second sets forth our opinion based upon that examination; we'll call that the "opinion" paragraph.

Many stockholders, many creditors, many otherwise sophisticated attorneys and bankers share a popular misconception that our report says we have "checked the books"; that we made sure no one has been getting his fingers into the cookie jar; that we acted as detectives (rather than as auditors) to ensure that the company's properties have been safeguarded; that there has been no collusion among those selected by stockholders and directors to safeguard properties; and that the auditor did a great many other things (possibly stopping short of surgery) that, in fact, we do not do, that we have no intention of doing, and that your people tell me we are not expected to do.

I sometimes have the feeling that an interested party—especially one who lost money and would now like to claim reliance upon us—sees our letterhead and our signature, but does not take the time to read the words between. Today, let's take the material between and analyze it a bit.

The Scope Paragraph

The first sentence is easy reading (Box 1). It says nothing more than that we examined the financial statements enumerated. It does not say we have *prepared* something—it says we *examined.*

BOX 1

> We have examined the balance sheet of Blank Company as of December 31, 1966 and the related statement of income and retained earnings for the year then ended.

Note that we do not say we examined "books and accounts." That would be a little vague, since the reader would not know what books and what accounts we were talking about, nor be able to evaluate if we named the books and accounts. Instead, we name the only thing we intend to talk about—the financial statements.

Now, we do not spell out in words that the statements examined are those prepared by management; you might consider this a failing. It might be your view that the usual reader would benefit by having this spelled out: Just who did prepare and publish the representations made? In some foreign countries, the company's statements actually are signed by responsible company personnel, including directors. Some day we may come to this approach. The courts, however, have taken the position that we did not prepare the statements, and the literature abounds with support for that conclusion.

The first part of the next sentence (Box 2) is very important as a short explanation of the work done by the auditor. It explains that, in making the examination of the statements, we did not pose as detectives, chemists, or appraisers of current market values.

BOX 2

Our examination was made in accordance with generally accepted auditing standards . . .

It says that our examination was made—how?: "In accordance with generally accepted auditing standards." We do nothing more and, without negligence or fraud on our part, nothing less.

Our profession's recognized body for an organized approach to our work—the American Institute of Certified Public Accountants—has from time to time defined what is meant by "generally accepted auditing standards" and has published the definitions.

These Institute pronouncements in the area of auditing procedures are the "law of the land" so far as the auditor is concerned. When we agree to make an examination in accordance with generally accepted auditing standards—and when, on conclusion of that examination, this letter says that we did—we mean exactly what we, through our own organized body, have announced is what we intended to say.

The last part of the sentence (Box 3) makes mention of "tests" and may be unnecessary wordage. It does to some extent stress the fact that we have not examined every transaction or balance, and it does remind the reader that the amount of work done by us was governed by judgment. For these reasons, it may be that the words do no harm and possibly some good. In theory, though, the publicized accepted standards automatically result in tests being made and cause exercise of judgment. It may be that the words are unnecessary.

BOX 3

. . . and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Auditing Standards

The standards we have been talking about are not published in the form of an audit program, listing specific procedures that should be followed. Instead, the literature sets out important criteria—establishing objectives to be obtained by applying procedures and the quality of performance under those procedures.

The standards are generally discussed in three categories:

1) General standards
2) Standards of field work
3) Standards of reporting

The *general standards* specify:

> The examination is to be performed by persons having adequate technical training and proficiency as auditors;
> That independence of mental attitude is to be maintained; and that
> Due professional care is to be exercised in the performance of the examination and in reporting.

The *standards of field work* specify that:

> The work is to be adequately planned and supervised;
> Internal control is to be studied and evaluated for a determination of the extent of tests to be made; and
> Sufficient competent evidential matter is to be obtained to afford a reasonable basis for an opinion regarding the financial statements covered.

Standards of reporting stipulate:

> The report is to state whether the statements are presented in conformity with generally accepted principles of accounting;
> Whether those principles have been consistently employed in relation to the preceding period;
> Informative disclosures are to be regarded as reasonably adequate unless otherwise stated in the auditor's report; and
> The report is to conclude with an opinion—or conclude that no opinion is to be expressed and explain why.

AUDITING STANDARDS

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 supervised properly.
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 conformity 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 over-all 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.

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.

In all, I have enumerated ten auditing standards (page 189). Every time I read these words—and this may be your reaction, too—I am amazed that so much is expressed in so few words; they express volumes in auditing standards.

Questions calling for the exercise of judgment will occur to you when considering the ten matters discussed—questions such as:

How do we measure "due care in performance"?

How do we determine whether we are maintaining "an independence in mental attitude"?

What is "adequate planning and supervision"? (My idea might be different from that of any one of my partners—and from that of someone in another firm.)

What is "proper study and evaluation" of controls?

What is "sufficient" when we talk of "sufficient competent evidential matter"?

It doesn't take a legal mind or the mind of an expert auditor to appreciate that the answers are not all black or white—judgment differs between people, and judgment of the same individual will differ as the circumstances are slightly altered. And in the long run a firm's reputation can be made or destroyed in these areas requiring exercise of judgment, especially.

One illustration of the application of judgment is, obviously, when we consider the evaluation of internal control. As an example, the adequacy of controls adopted by management for the safeguarding and productive utilization of a company's property and people will vary among companies. One could hardly expect that controls of a giant corporation, with its ability to attract competent personnel, to be the same as controls in a very small business, with but few employees low on the pay-scale. Under these different circumstances, the controls would be expected to vary in quality, and the extent of the auditor's tests must vary—requiring the direct application of personal judgment.

The elements of generally accepted auditing standards discussed earlier are very general; they certainly do not constitute a program of work to be done. The actual work done will generally vary among people and companies, and the extent of application of any procedure will vary. I should mention, though, that there are two procedures you are entitled to assume have been employed in any case where we say we have followed generally accepted auditing standards. These are the confirmation of receivables and the observation of physical inventories. You may assume that these procedures have been employed in any case where the amounts are material—although, again, the *extent* of tests to be made is still a matter of personal judgment.

The Opinion Paragraph

One of the standards of reporting we covered a moment ago called for a conclusion in the auditor's letter—an "opinion." The second paragraph of our report is a response to that requirement. It reads "in our opinion" (Box 4). Notice that we are not making a statement of fact—we are carefully not doing so. Our opinion is that the statements "present fairly" both financial condition and results of operations in conformity with "accepted principles."

BOX 4

> In our opinion, the accompanying balance sheet and statement of income and earned surplus present fairly the financial position of the Company at December 31, 1966 and the results of its operations for the year then ended, in conformity with generally accepted accounting principles . . .

Note we do not say that these statements are "correct" or "right." We say, instead, that the information submitted by management presents *fairly* both condition and results under definite standards. Here we are not dealing with the *auditing* standards governing our work, but with *accounting principles* acknowledged as being generally accepted, which are employed by management in its work of preparing its presentation of condition and results.

The work we did, covered by *auditing* standards, was done so that we could determine to our satisfaction that management had followed accepted *accounting principles* when making its representations.

In determining whether accepted principles have been used, we do not act as appraisers. So, except for discovered loss in realizable value, we are not talking about appraised values or market values when concluding about financial condition or results. We are talking about whether management has prepared the material in conformity with one thing—"accepted principles."

We are measuring against accepted principles—conventions—supposedly understood by the public. We are *not* measuring against principles adopted by other professions. As an example, historical cost is our basic definition for measurement, modified when realizability of specific items is doubtful.

You realize, of course, that the application of something even as basic as historical cost will lead to different results in different companies, for one management will consider that the use of a "moving average" best presents historical cost while, for exactly the same type of merchandise, another company will decide that the *first* item acquired is to be accounted for as the *first* item sold (the so-called FIFO method) and another company would decide that the *last* item acquired should be accounted for as the *first* item sold—LIFO. These are alternatives that have been generally accepted by the business community and, unless clearly inappropriate, we so far have considered that any one of these methods could result in a fair presentation in conformity with generally accepted accounting principles.

To look to the last part of the second paragraph (Box 5) : It is not enough that our procedures cause us to conclude that accepted principles have been applied. We must commit ourselves on whether or not those principles have been applied in the same manner as in the previous period or, where a table of, say, five or ten years is displayed, whether or not the principles have been applied in the same manner among all the periods displayed. So we speak of "consistency."

BOX 5

... applied on a basis consistent with that of the preceding year.

Under this approach, we could not, for example, use the word "consistent" without modification if the moving-average method had been used in one period displayed and the first-in first-out method used in another period displayed—assuming a material difference.

In this analysis of the second paragraph, I hope it is clear that we really are expressing an opinion and not making a statement of fact. It should be clear, too, that the measure of fair presentation is a set of eslished principles. Why, under these circumstances, should anyone conclude that the accountant is a "guarantor," or that he has "certified" (much as beef would be certified), or that the financials are "correct"? With the reinforcement of that scope paragraph, which speaks of "auditing standards"—calling for tests, only—it should be clear, too, that the financial statements are not penny-wise accurate. Some segments of the public and the investment community (the sophisticated, with tongue in cheek) might try to base claims on a "guarantor" approach or on extreme accuracy, but we can hardly be said to be guarantying anything when we express an opinion only; and tests, rather than covering all items, obviously do not provide for extreme accuracy.

So much for the extent of our work and the extent to which we report our conclusions. Let's cover briefly the things we do *not* do. Some of these I have already mentioned in passing.

As the business world well knows—but, I suspect, many times overlooks—the auditor does not *prepare* financial statements of clients. He does not prepare the statements, and he does not prepare the explanatory notes accompanying the statements. We do not "prepare" anything even resembling a representation concerning which direct evidence is in the hands of the client's management.

It might appear to you inconsistent on our part that we do many times "push the pencil" and actually draft or assist in drafting the statements and their notes, and yet insist we do not *prepare* them. It is true that the auditor many times will "push the pencil." But he cannot be accused—and the literature well supports this—of preparing the material any more than the printer of the published report can be charged with having prepared the statements merely because he "pushes the type." We render assistance in the drafting, partly because so many companies do not have personnel that are talented in financial reporting, and we save endless editing and time-consuming discussions with proud authors by first drafting it ourselves. We push the pencil partly because we then can work in the required disclosures, without attempting to educate every client's controller or bookkeeper in the financial reporting we know is necessary. In short, it is either because the client does not have the proper type of personnel or because we can achieve a desirable objective in less time, without friction.

AUDITING PROCEDURES

Turning to auditing procedures themselves, there probably are many things we do not do that the uninformed public thinks we do. It might help explanation if we inspect a typical balance sheet (page 195).

BLANK COMPANY
Balance Sheet
December 31, 1966

Assets		*Liabilities*	
Cash	$ 125,000	Accounts Payable	$ 125,000
Accounts Receivable—Trade, less $15,000 allowance for doubtful accounts	300,000	Accrued Salaries	75,000
Inventory—at lower of FIFO cost or market	400,000	Accrued Taxes	125,000
Prepayments	50,000		325,000
Total	875,000	NET WORTH	
Land—at cost	200,000	Common stock (10,000 shares authorized, par $50 each)—5,000 shares issued and outstanding	250,000
Plant and equipment—at cost less $750,000 accumulated depreciation	800,000	Paid—in Surplus	50,000
		Retained Earnings	1,425,000
Goodwill	175,000	Total	1,725,000
TOTAL	$2,050,000	TOTAL	$2,050,000

Cash

In what appears to be the simple matter of reporting cash balances, we do not count all cash in a large company where funds are in a number of locations under different accountability. In some situations, we will not actually count and confirm balances as of the balance-sheet date. For example, we may be satisfied as to the adequacy of controls and audit balances as of November 30, with scrutiny of December transactions as a basis for accepting December 31 amounts.

Securities

The public should not assume that we inspect the actual certificates backing up reported investments in securities. If the certificates are held by a bank as custodian, many times we will accept the bank's letter—in effect relying on the bank's capital to make good any shortage.

Receivables

As to receivables: In most cases, we certainly do not confirm all of them, nor even examine all documentary evidence of a sale, such as sales orders and shipping documents. We will test in these areas, but never represent in the usual examination that we examined everything. If collateral is important to the eventual collectibility of a receivable, we will examine the collateral—sometimes obtaining independent appraisals—but where there are a great number of items, we are not expected to evaluate all the collateral or to have it evaluated.

Inventories

Keep in mind—and I feel obliged to say this, even though I do not question whether you know it—we do not *take* or count inventories—raw materials, in process, or finished. We work with the client in planning the taking of the inventory by the client's personnel; we observe the inventory-taking procedures; we obtain opinions of other independent experts where necessary; but we do not attempt to make the counts ourselves.

When the actual quantity counts have been made by company personnel, we do not then proceed to price the quantities. Company personnel do this type of work and we review it. Our review of pricing and of computations is on a test basis, only, just as are our test counts and other reviews of quantities.

Property

As to property accounts, we become familiar with locations and the appearance of production lines and that sort of thing during our usual tour of the facilities. Here, though, we are becoming acquainted with the nature of the operations so that our examination is not made in a vacuum. The tour of facilities and observation of production methods are not for the purpose of comparing property items against recorded amounts; we are not engaged at that point in taking or observing a physical inventory of the property.

One thing we certainly do not do is evaluate land, buildings, and equipment. The accounting convention here calls for the use of historical cost, as discussed before, which is not modified except in rare situations—such as where recorded cost grossly overstates utility or economic value, indicated by substantial loss and prospective loss for a number of years. The allowance for depreciation on the balance sheet (page 195) is nothing more than the result of amortizing cost over an estimated period of useful life of the properties. Market values or replacement costs do not enter the picture here. We are dealing with actual cost and the spreading of that cost as consumed.

Goodwill

When we see goodwill on the balance sheet—the $175,000 figure shown here—we are again dealing with a convention, and our opinion does not imply that $175,000 is the computed value of excess earning power—nor the value of anything else, for that matter. In most cases, this item represents no more than the excess of the cost of acquiring a business over amounts considered reasonable for allocation to the property or other tangible items acquired. So long as there is no evidence of deterioration in the goodwill purchased, management is under no obligation to amortize it (although we would prefer seeing it amortized, for conservative reasons), and the auditor has no obligation to point out the fact that management's method in this instance is not the most conservative.

Accounts Payable

We ordinarily do not confirm accounts payable. We do test the transactions that lead to the balances. In addition, we do see creditors' statements as a check on those recorded balances. But the important financial fact actually is whether or not all payables are recorded, and confirming or examining statements of the admitted balances would not necessarily point out the unrecorded items. We use examining techniques, but, here again, we do not act as detectives.

In a well-run company, important transactions are spelled out in the company's minutes—in those of directors and committees. We have no firm assurance that we have even seen all the minutes of meetings, however, or whether those we did see report all important matters covered that might have accounting consequences.

Representations Concerning Liabilities

At the conclusion of our examination we do have management give us a written representation that all known liabilities are reflected in the statements and that all commitments and contingencies are disclosed. It does not take too much imagination to envision situations where we would not be told about these matters. Even though we might take the trouble to obtain representations from more than one person in the organization, we might at any time be misinformed or uninformed because of collusion among those persons.

Representations Concerning Inventories

Among the representations we obtain in writing is a representation concerning inventory values. Here again we have no assurance that information given us is not false or misleading. We do a great amount of work in every examination, but we have no assurance that some product carried in inventory is not unsaleable. Statistical analysis helps us to spot such items, but we would be especially lost, you can see, if something happened after the year end to make inventories unsaleable.

I have known of situations where an important facility was destroyed by fire after the year end, with an important loss of both property and use of the facility in production—and the company had no intention of advising us. Worse still, when we did discover the event by other means, we wound up in an argument about whether or not disclosure should be made.

AREAS OF THE CPA'S EXPERTISE

The usual firm of certified public accountants has expertise in a number of areas:

Accounting principles
Auditing techniques
Financial analysis
Taxes
Electronic data processing
Operations in special industries
Statistical sampling capabilities
Planning for organization; production control; planning for profitable operations

We even assist clients in locating personnel and assist our men and outsiders in locating positions.

CONCLUSION

Naturally, all our background and capabilities are used to some extent in any situation where we examine financial statements. The public should know, however, or learn, that the amount of work done by the auditor when examining financial statements, and his opinion based on that work, are as we discussed today—nothing more. Our function should by now be known to credit grantors, stockholders, the business world generally, and every attorney whose practice brings him into contact with financial matters and the work of the certified public accountant.

Our functions should be known, and some day they may be. But in today's climate of losing investors and ambulance-chasers flailing about to find a patsy—fruitlessly, I suspect—we have a long way to go in public education and other aspects of public relations.