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Certification of income statements

United States. Securities and Exchange Commission

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CERTIFICATION OF INCOME STATEMENTS

It has come to the attention of the Commission that wide variations have developed in certificates of independent accountants contained in registration statements filed under the Securities Act of 1933 with respect to representations concerning the verification of inventories of prior years in first audits. This development has been noted particularly in situations involving the offering of securities of closely held corporations which have failed to maintain and preserve accounting records and data necessary to permit verification of financial statements. In some cases a question arises whether the certifying accountant intended to limit his opinion as to the fairness of presentation of the income statements.

The following is the pertinent part of an example of this type of certificate:

> "* * * Except as noted in the succeeding paragraph, 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.
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> "Since this was our initial examination of the Financial Statements of the Company, September 30, 1961, was the only date at which we observed the taking of physical inventories. However, based on other tests we applied, including tests of gross profits and review of physical inventory records, we have no reason to believe that inventories at September 30, 1958, 1959, and 1960, were not also fairly stated.
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> "In our opinion, with the foregoing comment regarding inventories * * *."

In view of the large number of companies which are now offering securities to the public for the first time and which have this problem, the Commission deems it advisable to remind the financial community that the Securities Act requires that registration statements contain a certificate of an independent accountant based on an audit conducted in accordance with generally accepted auditing standards and meeting the reporting requirements of the Commission.

After testimony was taken from twelve expert witnesses called by the Commission in the investigation of McKesson & Robbins, Inc. 1/, the membership of the American Institute of Accountants at the 1939 annual meeting approved the extension of auditing procedures to require observation of inventory taking.

In January 1942 the Commission, to avoid any possible interruption in the production and delivery of war material, announced a liberalized policy with respect to physical inventory verification by independent public accountants. (Accounting Series Release No. 30) After specifying information to be furnished in the certificate the release said:

> "In many cases, it is probable that by means of their alternative and extended procedures the independent public accountants will have satisfied themselves as to the substantial fairness of the amounts at which inventories are stated, and in such case a positive statement to that effect should be made. In some cases it may be that, while the scope of procedures followed will not be such as to have so satisfied the accountants, they will be able to take the position that on the basis of the work done they have no reason to believe that the inventories reflected in the statements are unfairly stated.
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> "Of course, if the scope of the work done or the results obtained from the procedures followed or the data on which to base an opinion are so unsatisfactory to the accountants as to preclude any expression of opinion, or to require an adverse opinion, that situation must be disclosed not only by an exception running to the scope of the audit, but also by means of an exception in the opinion paragraph as to the fairness of the presentation made by the financial statements. * * *"

In the Drayer-Hanson matter (Accounting Series Release No. 64, March 15, 1948) the accountants' opinion included a now-familiar sentence: "On the basis of the examinations and tests made by us, we have no reason to believe that the inventories as set forth in the accompanying statements are unfairly stated." The Commission found in this case that in addition to the work done on the inventories, other effective procedures could have been applied and hence that the representation cited was entirely without justification.

The first-time audit situation was considered in Accounting Series Release No. 62 which dealt with the circumstances under which independent public accountants may properly express an opinion with respect to summaries of earnings. Concluding that the accountant can express an opinion on completion of a first audit, the release said "It is recognized that some auditing procedures commonly applicable in the examination of financial statements for the latest year for which a certified profit and

1/ See Report on Investigation and Testimony of Expert Witnesses, G.P.O. 1940 and 1939.

loss statement is filed, such as the independent confirmation of accounts receivable or the observation of inventory-taking, are either impracticable or impossible to perform with respect to the financial statements of the earlier years and, hence, would not be considered applicable in the circumstances."

This statement in the Commission's release is consistent with interpretations of "extensions of auditing procedure" approved by the membership of the Institute at the 1939 annual meeting. Such extension of auditing procedures to require observation of inventories and confirmation of receivables applies where either of these assets represents a significant proportion of the current assets or of the total assets of a concern. As to inventories, Codification of Statements on Auditing Procedure says "The procedures, it will be noted, must be both practicable and reasonable. In the province of auditing, practicable means 'capable of being done with the available means' or '. . . with reason or prudence'; reasonable means 'sensible in the light of the surrounding circumstances.' For example, the observation of physical inventories at the beginning of the period or year under examination would seldom, if ever, be practicable or reasonable in initial or 'first' audits. However, the independent accountant must satisfy himself as to such inventories by appropriate methods."

It seems clear from the discussion above that if an accountant reports that his 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 he considered necessary in the circumstances, an exception as to failure to observe beginning inventories is contradictory and should be omitted. A middle paragraph explaining that the certificate covers a first audit is informative and in some cases is essential to describe the alternative procedures applied. A negative type conclusion to this paragraph appears to be a carry-over from wartime usage and is not acceptable. Lost and inadequate records may give rise to questions as to the reliability of the results shown in the financial statements and may make it impracticable to apply alternative audit procedures. Alternative procedures must be adequate to support an unqualified opinion as to the fairness of presentation of the income statements by years.

If, as a result of the examination and the conclusions reached, the accountant is not in a position to express an affirmative opinion as to the fairness of the presentation of earnings year by year, the registration statement is defective because the certificate does not meet the requirements of Rule 2-02 of Regulation S-X. If the accountant is not satisfied with the results of his examination he should not issue an affirmative opinion. If he is satisfied, any reference from the opinion paragraph to an explanatory paragraph devoted solely to the scope of the audit is inconsistent and unnecessary. Accordingly, phrases such as "with the foregoing explanation as to inventories" raise questions as to whether the certifying accountant intended to limit his opinion as to the fairness of the presentation of the results shown and should be omitted.

A "subject to" or "except for" opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The "subject to" qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matters which cannot be resolved at statement date.

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