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American Institute of Accountants. Bureau of Information

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Accounting Questions

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QUALIFICATIONS IN PRESENTATION OF FINANCIAL STATEMENTS

Question: I have a problem confronting me which deals with the correct and ethical treatment and presentation of financial statements. If you are in a position to render me an opinion as to your interpretation of the matter, it will be greatly appreciated.

Recently I was called upon to conduct an audit for an investment trust during its first year of corporate existence. To my mind a great many practices of questionable nature were being carried on. However, in conference with the officers and their attorney, who is of the most excellent standing in the community, censure was made of certain proceedings, criticism being spread upon the minutes of the corporation and prohibiting further questionable transactions. After proper action had been taken, a detailed report was rendered by me which set forth the history of activities, and all statements were qualified on the statements themselves. This report was, naturally, of such a character that the officers of the corporation deemed it inadvisable to make a general distribution of it to their stockholders.

Nevertheless, statements have been promised to the stockholders, who number for the most part residents living in the rural section of this part of the state. They have proposed that I prepare a financial statement at the close of July, 1931, for general distribution among their stockholders.

The problem which confronts me is this: Could I prepare a balance-sheet without reference to my prior report, after all activities that border on unethical practices have ceased and since these practices apparently will not be engaged in again? Or, should I qualify or refer on the statement itself to a report rendered under a prior date? Or, could I submit an unqualified statement of condition as at the first of August?

I feel that a great responsibility is vested in me, due, primarily, to the class of stockholders involved. I have discussed the problem with other local practitioners, one thought being advanced that, since it was apparently the desire of the officers of the corporation to conduct an ethical business enterprise

and as the activities had not ceased just temporarily for statement purposes, in all probability reference to prior reports and qualifications might cause a great deal more harm than good to the stockholders themselves.

Answer No. 1: We are of the opinion that, if the questionable practices which were being carried on at the time of the first audit have been corrected prior to the second audit and it appears that they will not again be engaged in and the client is acting in entire good faith in the matter, your correspondent should not find it necessary, in certifying the accounts, to refer to prior reports and qualifications, provided the accounts to be certified require no qualification and disclose all pertinent facts. It would appear to us that reference to the prior reports and qualifications in such circumstances would undoubtedly do more harm than good to the stockholders to whom the report would be mailed. If, on the other hand, there is any doubt in the mind of your correspondent that the questionable practices were only temporarily abandoned and will subsequently be revived, he should refuse to certify the accounts and would be well advised to sever his professional connection with the company.

Answer No. 2: Any answer to the query propounded in the letter submitted must, of course, be subject to such changes as a full knowledge of the practices—which are not explained but merely referred to as being “of questionable nature” and “unethical”—might require.

Assuming that these practices do not have an actual bearing on the correct statement of the assets, liabilities and net worth at July 31, 1931, and in view of the fact that “all activities that border on unethical practices have ceased” and that “these practices apparently will not be engaged in again,” we would ordinarily see no reason for any reference to such practices in the balance-sheet at that date or in the certificate related thereto. If the practices in question are of such a nature that a statement of the income account for some period ending with the balance-sheet date should properly bring them to light, but no such income account is to be submitted in the proposed report to be published to the stockholders, then, of course, care should be exercised to the end that the reader of the proposed report may not erroneously construe the accountant's certificate as in any way extending beyond the verification of assets, liabilities and net worth as at July 31, 1931, to the point of implying also a certification of the propriety of past transactions which such an income account (were one presented) might reasonably be expected to disclose. The accountant should not merely restrict himself to the preparation and certification of a proper balance-sheet at July 31, 1931, but should go beyond that to see what use was made of it in the proposed report to be published to the stockholders. In other words, the remarks of the president, or other officer, to such stockholders should be submitted to the accountant for approval, to make sure that nothing is implied in such remarks to the stockholders that the accountant might object to as unwarranted by the certificate he has rendered.

Answer No. 3: After a careful reading of the question we are uncertain whether the practices of questionable nature were such as to affect the financial statement at July 31, 1931. If the practices referred to were such that the accountant could not be certain as to the accuracy and integrity of the July 31,

Accounting Questions

1931, financial statement, there would seem to be no question that a qualification should be made on the statement or in the certificate.

On the other hand, if the practices which we understand stopped prior to July 31, 1931, did not affect the integrity of the balance-sheet and the accountant is satisfied that the balance-sheet is properly stated, we do not see any necessity for a qualification in the balance-sheet or certificate attached thereto, nor any need for reference to a prior report.

You understand, of course, that without specific information as to the nature of the practices in question it is impossible to render a definite opinion. The foregoing will express our views on the general question, but it is quite possible that a full knowledge of the facts would lead us to change the opinion expressed above.