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AUDITED PERSONAL FINANCIAL STATEMENTS

Did Somebody Goof?

by JAMES F. PITT and E. PALMER TANG

Presidential Campaign 1968 is over and the votes tallied. Fading into history are the primaries, platforms, promises and platitudes. We wonder, however, how many noticed the conspicuous absence of the CPA's opinion on personal financial statements published in connection with this campaign.

Having been personally involved with the statements of one candidate in 1964 who ran for top honors in 1968, we waited anxiously to see how the profession would resolve the controversies generated in 1964 among professional and academic people. But in contrast to 1964, when it was the vogue to issue audited personal financial statements, the CPA's opinion did not accompany the candidates' financial statements published in 1968.

What happened? Was the audited personal statement a fleeting fancy, or has the accounting profession been so unrealistic in its pronouncements in this area that the disclaimer of opinion, now required in virtually every case, offers little appeal to the potential buyer of our services?

Accounting Research Bulletins issued by the American Institute of CPAs have been specifically directed to "accounting practices reflected in financial statements and representations of commercial and industrial companies" and not to "accounting problems or procedures of religious, charitable, scientific, educational, and similar nonprofit institutions, municipalities, professional firms, and the like."[1] Until 1968 virtually no printers' ink had been consumed in defining the standards for personal financial statements.

Banks have long required personal balance sheets from their personal borrowers and from guarantors, but, since audited statements were hardly ever required, the certified public accountant has exerted little or no influence over their form and content or the method of reporting.

In most instances, the forms provided by banks to personal borrowers for reporting upon their financial position have provided specifically for reporting assets at fair market value, without regard to historical cost. While this method of reporting assets has long been considered unacceptable for commercial and industrial enterprises, it has been used almost exclusively by investment companies and stock brokers.

Much like an individual, these companies emphasize financial condition in their reports rather than the matching of revenues and expenses. Market values, therefore, provide the most timely criteria of that condition. Market values also provide comparability for measurement of total investment performance by including the effect of realized gains (dividends on income stocks) and unrealized gains (appreciation on growth stocks).

The financial statements published by the 1964 candidates were not models of consistency—which is quite natural considering the previous lack of attention to this subject. Perhaps the greatest divergency existed between the statements of President Johnson, which were basically at cost, and those of Vice President Humphrey, which were basically at market.

At any rate these divergencies, particularly the basis of reporting, caused the greatest furor within professional and academic circles. Important differences in the form and content of these two reports and financial statements are shown here.

[1] Accounting Research Bulletin No. 43, American Institute of Certified Public Accountants, 1953, page 8.

	President Johnson	Vice President Humphrey
Family members included in the financial statements	President and Mrs. Johnson and daughters	Vice President and Mrs. Humphrey
Titles of the financial statements	Statement of assets and liabilities; statement of capital	Statement of financial condition
Basis of reporting assets	Cost (stock in family corporation reported at cost plus share of retained earnings, reduced by applicable capital gains taxes)	Present market value (stock in family corporation reported at share of book net equity; deferred taxes reported as liability)
U. S. government pension fund	Not included	Included
Assets in trust	Included	Not included; disclosed by footnote
Household goods and personal effects	Not included	Included
Personal documents and memorabilia	Not included	Not included
Designation of excess of assets over liabilities	Capital	Net assets
Auditors' scope paragraph	Substantially standard	Substantially standard, with two additional sentences: "In this connection we have received and relied upon appraisals by real estate agents as to the present market value of real estate and upon representations from the principals as to the present market value of household goods and personal effects. We have also received and relied upon representations from the principals as to the completeness of the statements."
Auditors' middle paragraph	Explains basis of reporting stock in family corporations and real estate; specifically disclaims any representation that reported amounts are representative of present market values	Explains that assets are reported at present market values and recites auditors' approval of that method of reporting
Auditors' opinion paragraph	Substantially standard	Substantially standard except no reference to consistency

In an attempt to clarify some of the more controversial questions posed by the inconsistencies enumerated, an ad hoc committee on personal financial statements was appointed by the American Institute of CPAs. In June 1968 this committee issued an audit guide entitled "Audits of Personal Financial Statements."

In summary, the guide sets forth the following recommendations:

1. Ordinarily a combined statement of assets and liabilities of both spouses, and possibly those of minor children, will be the most appropriate representation.
2. The title of personal financial statements should be "Statement of Assets and Liabilities," instead of the more traditional "Balance Sheet" or "Statement of Financial Condition," and "Statement of Changes in Net Assets," instead of other customary descriptions.
3. The accrual method of reporting should be employed.
4. Assets should be reported primarily on a cost basis, but preferably in columnar form with present market values shown also. Apparently, however, the committee takes the position that absence of the cost column would require an auditor's exception while absence of the present market value column would not.
5. Business interests of significant size, whether corporate shares, partnership interest, or single proprietorship, should be reported as a single line item. Stocks in corporations should be reported at cost and, except for corporations maintaining Subchapter S elections, should not reflect earnings retained since acquisition of the shares.
6. Cost is defined substantially the same as basis for federal income tax purposes, except that property acquired by gift or by nontaxable exchange is regarded as having a cost equal to the value when received.
7. Vested rights in pension or profit sharing funds, deferred compensation plans and property residuals should be reported in the financial statements in the absence of unusual circumstances. Non-vested interests and those subject to indefinite restrictions should be disclosed by footnote but should not be reported as assets.
8. Household goods, personal effects, etc. may be omitted, or reported at a nominal amount, unless such items are material in relation to total assets.
9. The excess of assets over liabilities should be designated in just those words, and not as "capital" or "net assets."
10. Internal control is a prerequisite in the case of personal financial statements, no less than those of business enterprises, and the absence of reliable control requires the auditor to disclaim an opinion.
11. Formal representations from the principals should be procured but should not be regarded as satisfying any of the auditor's procedural responsibilities.
12. When the auditor is unable to satisfy himself as to the existence of unreported assets or liabilities, he should disclaim an opinion.
13. A separate expression should be given by the auditor with respect to the "present market value" column of the financial statements.

While this guide represents a valuable addition to accounting literature, we take issue with several major areas.

In the first place, we disagree strongly with the recommendation that the historical cost basis of reporting should be regarded as a primary reporting method. We feel that personal financial statements are more comparable with those of investment companies, where assets are customarily included at present market value, rather than with those of typical commercial and industrial enterprises, where assets are customarily included at historical cost.

We feel that the dual basis of reporting serves a sound transitional purpose, but we disagree that cost data, without present value data, should be regarded as being in conformity with generally accepted accounting principles. On the contrary, we feel that the generally accepted reporting practice today is the one bankers have established over a long period of time—namely present market values —and that the omission of cost data would be much less critical than the omission of present market values.

We feel the committee's approach to internal control is impractical, self-defeating and out of touch with reality. Few individuals, even with sophisticated records, maintain effective internal control as that term is defined in our literature. Therefore, if we are to follow the guide with integrity, we must disclaim an opinion in virtually every case. And this practice can only lead to the discontinuation of our services in this area. Could the absence of auditors' opinions on financial statements published by the 1968 Presidential and Vice Presidential candidates be the beginning of such a trend?

No system of internal controls, however elaborate, could prevent an individual from secretly acquiring valuable property on credit, thereby creating both a material asset and a material liability. Further, no practicable audit procedures can be devised which will disclose such a transaction in the face of an effort to suppress it. An auditor is not charged with procedures which are impossible or impractical to perform, and therefore it is an unfortunate fact of life that he must rely on representations from the principals as to the completeness of personal financial statements.

Yet this need not be fatal to the expression of an opinion. There are responsible ways in which to express the nature and results of an auditor's work in the examination of personal financial statements without resorting to stereotyped terminology which evolved from completely different facts and circumstances. We feel that the committee's energies would have been more fruitful if they had been pointed in that direction.

We also take issue with the committee's suggested language for the auditor's report on the present market value data in the statement of assets and liabilities. The committee suggests a sentence beginning: "We have also determined that the additional information set forth in the accompanying statements on the estimated value basis . . ."

Must we regress!

"We have determined" is only a whisper away from "We hereby certify," the phrase we abandoned long ago on advice of counsel. We would substitute simply: "Further, in our opinion, the additional information set forth . . ."

Last, and perhaps least important, we feel there is a confusing inconsistency in recommended reporting terminology. On the Statement of Assets and Liabilities, the committee uses the caption "Excess of Assets Over Liabilities." Yet the recommended title for the related statement which reconciles the beginning and ending amounts so reported is "Statement of Changes in Net Assets." Nowhere else is the term "net assets" suggested. We think there should be consistency here.

This item should be identified in the Statement of Assets and Liabilities as "net assets" or else the caption of the related statement should be "Statement of Changes in Excess of Assets Over Liabilities." Our preference is rather obvious, although "net equity" also would be quite acceptable.

The many excellent recommendations made by the committee should not be obscured by our criticisms.

We believe, however, that corrective action should be taken in the areas discussed and a new committee appointed by the AICPA to restudy the entire area. Certainly the public interest would be served best by a realistic approach to reporting on personal financial statements.

Such an approach must recognize that internal controls for an individual cannot be measured against those of the behemoths of industry. Further, it must recognize that an individual thinks of his worldly goods in terms of today's market values, not historical costs.

Looking forward to Campaign 1972, as well as everyday service in an important field, we must be able to report on personal financial statements after performing realistic audit steps. We accomplish nothing for the profession or for those using our services by establishing artificial criteria which virtually negate the opportunity for service. We believe that there is a "place in the sun" for auditors' reports on personal financial statements. But in our opinion, the existing guide puts it many moons away.