1940

Accountancy and Your Pocketbook: A Public Relations Pamphlet (Draft Before Correction).

American Institute of Accountants

Draft before correction:

Accountancy and Your Pocketbook

A Public Relations Pamphlet

Foreword   When industry outstripped agriculture more than half a century ago as the chief employer of the American wage-earner, need arose for new capital with which to create and develop new means of transportation, new industries and new plants.

Among the earliest large investors in American enterprise were the owners and custodians of capital in the British Isles. They were among the first to note and take advantage of the new trend, and to see that an industrial revolution was changing the nature and the map of the United States.

When these investors overseas sent their capital to the new country, they sent also skilled accountants - chartered accountants, as they were called in the old country - to help them keep track of their investments, and to establish sound accounting systems for the new undertakings they were helping to create. These skilled practitioners were the forerunners of those professional men who practice accountancy in the United States today.

The scene has changed since the days when great transportation systems, infant industries and companies destined to be great in the world of trade first were born. Trade and manufacture are more complex. Management is a highly diversified and complicated art. There are more things to know, more things to do. But, the certified public accountants who have succeeded those first American accountants have not changed in the accepted conception of what an accountant's responsibility must be. They still accept the obligation to do everything in their power to safeguard investors, creditors and others interested in the nation's business, and to aid management, by provision of financial statements which fairly reflect the facts.

. . . .

<u>Why You Are Interested In Accounting</u> When everything is said and done, your concern with accountancy from the viewpoint of your pocketbook's best interest comes down to the question of where accountancy has its place in helping you to safeguard your invested funds.

In seeking to learn where your money is at present, what is being done with it and where it is going, you have one major source of information. That is the financial statement of the company in whose keeping you have placed your money.

Depending upon your understanding of certain factors in accounting and finance, factors which are relatively easy to understand, the statement is merely a neat array of problems in addition, division and substraction, or it is a living document telling a story which you very much want to read.

The purpose of this booklet is to recite for the intelligent investor, and for anyone else interested enough to read, the facts about accounting. These are not details involving the technical procedures of the accountant, but the steps which accountants by professional habit take to give form and substance to financial statements.

Stuart Chase, noted economist and writer on the general subject of business, has said:

"Once a business becomes too big for one brain to handle, accounting takes over the job".

Accounting is the medium through which those who handle other people's money report what they have done with it. Banks "account" to depositors; insurance companies to policyholders; building and loan associations to shareholders; corporations to stockholders, government officials to taxpayers, debtors to creditors.

If you entered business in South America, you probably would acquire a working knowledge of Spanish, so you could know what was going on. If you enter any financial transactions, you should learn a little about accounting, for the same reason. Accounting, in a real sense, is the language of business.

Like any other language, accounting has its own words and phrases. In the case of accountancy, these have special meanings which are generally not understood by the public, even by those who invest their money and expect to know something about the way in which it is managed. These words and phrases relate to and describe processes and operations by which accountancy renders its services to the public and to business.

"Evaporated Oil earns fifty cents a share" says the newspaper. The anonymous financial writer bases this statement on long division applied to a few items in financial statements. But, there are other things to consider - certain words and terms to know about - if useful information is to be derived from a financial statement.

In the case of "Evaporated Oil", was there any provision for <u>depletion</u>? Are the earnings in countries where <u>currency is blocked</u>? Were there <u>non-recurring items of income or expense</u>? Does the profit reflect merely a change in method of <u>inventory valuation</u>?

These and many other questions should be asked and answered to your satisfaction before you buy or sell. But, you cannot ask the questions intelligently or answer them with any degree of certainty unless you read and, more important still, understand the financial statements and auditor's report correctly.

No one can manage a business of any size without the aid of accounting. Whether the interested person be an individual proprietor, an executive or a stockholder, he canot know what is going on unless he has the help of accountancy. It is a fact often demonstrated that an increase in the bank account does not necessarily mean profitable operation. Sometimes it means impending bankruptcy.

With respect to taxes, no corporation, partnership or individu with varied sources of income can be absolutely sure without the help of accountancy that there has been no <u>over</u>payment or <u>under</u>payment (which is equally important) of tax charges.

A man who entrusts his money to others without demanding - and understanding - an accounting is at least distantly related to the babe in the woods. A banker rarely lends money without the borrower's financial statements. Is your money less important to you?

<u>How Accountancy Serves</u>

The investor who seeks to learn something about accountancy, in order that he may bring new interest and new understanding to his study of the financial statements of undertakings into which he places his money, naturally has one question to ask. He wants to know something about the ways in which accountancy serves his interests as well as those of all persons interested in business.

In the complex economic conditions of today, both public and private funds are increasingly administered by others than those investing such funds. It is impossible for those to whom the wealth of the country ultimately belongs to know for themselves that their funds are intact and honestly administered, or to inform themselves adequately as to the facts regarding these funds. This situation has brought into a position of importance the independent public accountant.

What the independent auditor does is to bring expert accountin knowledge and practice to bear on the problem of the investor or the executive who wants to know if his company is making money, if his investments are properly safeguarded.

It must be understood by everyone studying the financial statements of companies that the auditor's report attached to each statement is not a guaranty that the facts as set forth in the statement are true. The factors involved in the preparation of a statement include records of many day by day transactions noted on the books of the company. It is not possible for the independent auditor to go back over each of these transactions to prove that the records are authentic.

On this matter of the place of the accountant in the report by a company to its stockholders and the public, a sub-committee of the New York Stock Exchange has said that "it is apparently necessary to emphasize again and again that financial statements of industrial companies are not statistical presentations of fact fixed in the form which the stockholder reads".

"While properly based on facts" this sub-committee goes on to say, "these statements represent the judgments of the company's management in the application of conventional methods of stating assets and liabilities and in appropriate allocations of income and outgo items to specific periods of time ..... The importance of a periodic review by outside experts to see that these numerous judgments have been made <u>in accordance with accepted accounting principles consistently followed by the company</u> must be apparent to everyone - entirely apart from any methods the business world may employ to assure itself of the authenticity of the data underlying the accounts. The independent public accountant is thoroughly qualified to make such a review. For this he has been specially trained. The public is entitled to rely upon his opinion regarding the soundness and consistency of the accounting judgments made by the company in the preparation of its reports to stockholders".

The public should understand that, although the accountant's work is based upon carefully planned and executed auditing procedure, the expression of his opinion does not impose upon him a measure of responsibility which the nature of his work does not justify. It should be emphasized that the certified public accountant is never an insurer or guarantor.

Accountants find that a very large proportion of the public firmly believes that because accounting deals with figures, even including odd cents which have every appearance of accuracy, that it must be a kind of mechanical exercise permitting measurement with scientific exactitude. Some business men and investors are startled to find that fixed assets are usually carried in the balance-sheet at a figure having no relation whatever to the present worth of the properties; that surplus may consist of bricks and mortar and has no relation to available cash; that profit is determined by more or less arbitrary allocation of transactions of a given twelve month period, but that true profit of an enterprise cannot be determined except over a long period of years.

<u>Internal Check and Control</u>

The misconception still prevails that an auditor is a kind of detective who besides checking every available scrap of paper and every entry in every book of record, exercises a sort of second sight into the minds and hearts of the officers and employees of the business.

It has been pointed out that the profession of accountancy in the United States stems from beginnings rooted in the British Isles. This is true, though the profession in America has developed its own individuality and methods. What one British jurist said about the accountant as a detective is interesting.

Forty-two years ago, in the British Court of Appeals, Lord Lopes, a member of that august tribunal, rendered an opinion which read in part as follows:

"An auditor is not bound to be a detective or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided that he takes reasonable care ....".

The reference by the honorable lord justice to the honesty of employees of companies whose accounts are under examination by auditors brings into focus one of the most important factors involved in the work of the independent auditor. This is the factor of internal check and control. Without it, the work of the auditor in the cases of large companies would be difficult, indeed.

The term internal check and control is used to describe those measures and methods adopted within a company organization to safeguard the cash and other assets, and to check the clerical accuracy of the bookkeeping. These safeguards cover such matters as the handling of incoming mail and remittances, the proceeds of cash sales, the preparation and payment of payrolls, the disbursement of funds generally, and the receipt and shipment of goods.

It has long been the accepted custom of public accountants to consider the adequacy of the systems of internal check and control in companies in determining the extent of the examination required to satisfy himself as to these records, since they form an important part of the corporate story on which he bases his expert opinion. The Securities and Exchange Commission officially recognizes this principle in its instructions and regulations.

What is Accounting?
What is Auditing?

The work of an accountant in examining the records of a company before he attaches his opinion to the financial statement involves two basic functions. These are accounting and auditing. Accounting- It involves proper classification of items as assets, liabilities, expense or income. This is a highly complex task. Whether a charge should be made against income or surplus, for example, is often a most involved question. Accounting covers all questions of valuations and reserves.

Auditing is the art of examining accounting records and supporting data, invoices, vouchers, checks, contracts, minutes, etc., plus independent inquiry from outside sources of information to satisfy the auditor that the transactions recorded actually took place and have been recorded properly.

It is in his work as an auditor that the certified public accountant brings into play his greatest skill as a professional specialist, and it is on the results of his audit that he bases his final professional opinion. He satisfies himself as to the adequacy of the internal check and control. In his work today, the technique of sampling and testing has largely taken the place of the detailed audit. This is for the reason that in the case of large companies anything approaching a detailed audit would be so expensive as to be prohibitive. At best the auditor takes only hearsay evidence, that is, written records, of what took place in the past. He cannot be present when the transactions occur and to that extent must rely on second-hand data. His experience and skill permit him to give all assurance that it is humanly possible to give within the reasonable limits of economy that the financial statements on which he reports fairly present the facts, but his professional opinion cannot be taken as a financial guarantee. He charges professional fees for the work on which his professional opinion is based. He does not charge the premiums of an insurer.

Inventories and Receivables ???

Inventories are a vitally important part of every examination made by an independent public accountant, but there is general misunderstanding on the part of the public as to the extent to which an accountant is called upon or competent to report on inventories. It usually is not possible for him to go beyond the procedure of sampling and testing in accounting for inventory items. This limitation is necessary for several reasons, one of which is the prohibitive cost which would be involved were an accountant to make a careful count of quantities and individual items. Another reason is that the certified public accountant is not competent to pass on quality, condition, value and marketability of all items. It is not possible for him to certify in any case that he definitely knows from his own knowledge and from actual detailed physical inspection that the inventory is 100% correct.

Of course, in the matter of inventories, the accountant must examine very carefully the nature of the material or the articles which he is subjecting to the usual physical tests, and must be prepared to determine to what extent those physical tests will be needed to tell him what he knows about inventory items. He must of necessity rely upon the representations of management for information concerning quality, condition, style, salability and similar characteristics. In no case does a reputable accountant in expressing his opinion hint or imply that his physical inspections or tests have gone farther or have given him a greater degree of certainty about the nature and characteristics of the inventory than is actually the case.

Limitations also exist as to the extent to which the independent auditor may proceed in examining into and certifying accounts receivable. These, of course, represent amounts due the company under examination for goods or services rendered. The accountant must satisfy himself in every reasonable way that these amounts actually are due. The accepted practice today is for the accountant to use his professional judgment in determining the extent to which verification of accounts receivable shall be necessary. He must decide whether all receivables or only a part of those listed shall be confirmed by direct communication with the debtors. In the majority of cases the item of cost and other factors compel reliance upon sampling and testing by communication with a selected list of debtors. When this is done, the accountant is required by professional practice to assure himself that such testing will reflect the probable accuracy of the whole list of accounts receivable.

The Accountant's Report

The services which independent auditors render usually culminate in a report, which is often termed, though perhaps inaccurately, a certificate. In some cases a detailed report is rendered, accompanied by statements and supporting schedules; in other cases, the report is limited to a concise statement of the scope of the examination and the related opinion of the independent auditor concerning the accompanying financial statements of the clients. In each case where the accountant does not concur in the results of the judgments of management reflected in a financial statement he takes an exception to the company's method or judgment by a statement in his auditor's opinion accompanying the financial statement. If his exception is of sufficient importance he will express no opinion and explain in his report why it is withheld. The accountant's opinion on the soundness of judgments and consistency of methods is of real importance for, even with correct factual data at the base, the possibilities of accounting errors are great.

When an auditor reports his opinion without exceptions, he means two things: (1) he believes from his audit that assets and liabilities are as stated and that transactions indicated have actually occurred, (2) he believes from his accounting judgment that items have been classified properly and are fairly presented in the financial statements.

It must be remembered that an auditor's report or certificate is not the same thing as an appraisal of worth and guaranty of value. No auditor, and no government bureau, can absolutely guarantee value in a corporate security or asset. It is most important that the general public know and understand this basic fact. In the simplest form, an audit is a test of the correctness of the bookkeeping as a record of facts and a verification of such assets as bank cash, securities and other assets capable of such verification, without such a complicated process as, for instance, a physical verification of every material item in inventory. As one important business daily newspaper has said editorially, almost everywhere in the audit process somebody's word must ultimately be taken for something. No audit of large dimensions can be absolutely immune to error or bad judgment, or worse, when the auditor must through necessity rely in large measure upon the internal check and control of the company under examination.

In carrying out his work, the independent certified public accountant must always be on his guard against collusive fraud and be alert in detecting any sign of such collusion. However, on the basis of his examination by tests and checks, he relies upon the integrity of the client's organization unless circumstances are such as to arouse suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified. The detection of fraud rests primarily uopn the maintenance of adequate and effective internal control. The auditor must satisfy himself that the system of internal check maintained by the company justifies his reliance upon that system. From that premise, he should proceed to examine the accounting records and related evidence consistent with such reliance.

<u>The Accountant's Responsibility</u>

It is the responsibility of the accountant - and one which he cannot escape, to determine the scope of the examination which he should make before giving his opinion on the statements under review. This is his responsibility which cannot be shared by the client. The independent certified public accountant should determine the scope of his examination, and the client must rely upon the professional integrity and standing of the accountang for his assurance that no work unnecessary in the circumstances will be undertaken.

It is well for the reader to know that published financial statements are primarily the representations of management. The function of the certified public accountant is to undertake such work as may be necessary to enable him to form an opinion as to the fairness of the representations of management. This means, of course that the function of the independent auditor is limited to reporting and expressing opinions upon situations arising out of business transactions that have taken place in the past.

<u>How Independent Auditors Are Selected</u>

In common with the general public, the accounting profession itself has been deeply interested in the question as to the most desirable method by which independent auditors should be engaged. The special committee on auditing procedure of the American Institute of Accountants has stated it as its belief that this question of the appointment of the independent auditor and the related question of his status in relation to the client are subjects of great importance to stockholders and creditors.

To emphasize the auditor's independence of management, some corporations affected by public interest have adopted the practice of having the independent auditor engaged or nominated by the board of directors or elected annually by the stockholders. Other corporations have provided that the stockholders be given an opportunity to ratify the selection made by the directors.

Generally speaking, independent auditors have been and are appointed in one of three ways: by the officers of the company, by the directors of the company or by the shareholders. Today, several companies wherein the auditors were formerly appointed otherwise, now provide for their election by the shareholders. Practically all companies of importance where auditors were formerly appointed by the officers are now providing for their appointment by the directors as a body or by a committee of the directors from which officers are either excluded or on which they form a minority. One authority in a recent article on the general subject published in a professional accountancy magazine stated it as his belief that there is little doubt that appointment in this way or by the shareholders will become the general practice. It is generally agreed by accountants that, whatever the method of his selection may be, the auditor should be appointed early in each year so that he may carry out part of his work in the course of that year.

<u>Professional Standards</u>

Who are these certified public accountants? Why is their opinion on financial statements of any value?

Because they have been granted certificates under state laws after satisfying educational and experience requirements and after passing two or three-day written examinations in accounting and related subjects. (The average of passes is less than 20 per cent.) Because they spend their lives studying accounts. Because their professional societies enforce standards of professional conduct.

But chiefly because they cherish their independence and integrity with jealous pride. If these qualities are doubted, an accountant is no good. And he knows it. When a shadow of suspicion may ruin his professional career, it is natural that he should emulate Caesar's wife. And he does.

One of the tests of a profession is its code of ethics. The worthiness of a profession may well be judged by its idealism. Few, if any, professions can boast of higher standards than those expressed in the rules of professional conduct of the American Institute of Accountants and most of the state societies of certified public accountants. The rules adopted are not merely concerned with relationship of accountants to each other and with their clients, but especial emphasis is put upon the accountant's responsibility to those in whose behalf his reports are rendered.

The rules governing the practice of accounting demonstrate unmistakably the determination of the profession to maintain its independence and to keep itself free from all shadow of suspicion that its work has been influenced by any considerations other than the determination and statement of unbiased facts.

The development of accountancy has naturally carried with it the problem of education. Starting with the establishment of the first collegiate courses in accounting in the Wharton School of Finance in 1883, the growth of education in this field has been most remarkable. While the educational standards adopted for admission to the accounting profession in the various states differ widely, there is a general recognition of certain minimum educational attainments and the minimum standards are constantly being advanced.