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Accountants' Certificates*

BY HENRY B. FERNALD

As a first step to the discussion of accountants' certificates, let us consider what is meant by the term. We have the well known form which appears at the foot of financial statements or accompanies them, which begins, "We hereby certify." We might well say that any reference to accountants' certificates or certified statements should be limited to those cases where the accountant does carefully and deliberately sign his name to a declared certification, wherein he uses some such words as "we certify."

It is undoubtedly a commendable practice for accountants carefully to limit the use of the words, but however careful they may be, the accountants' certificate is liable to misconstruction. There are two important facts which we must recognize. One is that the accountant practically never presents a statement which he certifies to as being in all respects correct as to its statement of values. The other is that regardless of the phrases which an accountant may use, any statement which bears the signature of a certified public accountant is popularly referred to as a certified statement.

If we look to the dictionary for aid, we find that the *Standard Dictionary* defines "certificate" as "1. A documentary declaration regarding qualifications, service, conduct or other advantageous facts. . . . 2. *Law*. A writing so signed and authenticated as to be legal evidence. . . ." It defines "certify" as "to give certain knowledge or information of; to make evident; vouch for the truth of; attest. . . . To make attestation either in writing or orally as to the truth or excellence of something. . . ."

What is it that the accountant makes certain or vouches for? He can, of course, certify that a statement is "in accordance with the books." It is possible for him to determine absolutely whether or not each figure in the statement is in accordance with the figures which are shown by the books. He may verify that the books do show accounts receivable in the exact amount which is shown by the statement. He does not, however, certify that every dollar of these accounts will be collected. He can, of course,

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at some future date certify, if he will, that of a stated amount of accounts existing at a certain date so much has been collected and so much has not been collected, but as of the date of the balance-sheet he could not and is not supposed to certify to the future event. He may state that in his opinion the accounts are good and collectible but this is an expression of opinion and not a certification of fact. Similarly, he may certify that plant and equipment accounts are shown on the books at the stated figure. This does not mean that he certifies that this is their actual value. He may certify that the books show the plant and equipment to have cost the stated amount, but it would only be under exceptional circumstances that he would attempt to verify that this was the actual cost of the plant and equipment at that date existing and in use in the business. He may even certify that the figure included in the statement is an appraisal made at a certain date. He may go so far as to state that in his opinion this is a fair valuation of the property but if he does this, it is the statement of an appraiser rather than the certificate of an accountant. An individual accountant may possibly be the best man obtainable to pass on certain property values, but as soon as he starts to set forth his own opinions and judgments he leaves the field of accounting determination and enters the field of appraisal. It is, therefore, manifest that no matter how careful an accountant may try to be in withholding his certificate from any statements which he believes are false and misleading, this does not mean that every statement to which he attaches his certificate carries his valuation and appraisal of all the assets.

After all, the position of an accountant in certifying to statements seems to me to be in many respects similar to his position as witness in court. He may be called to present figures as they appear in the books and records and he may encounter little difficulty so long as he confines his testimony to the presentation of the exact book entries. But let the questioning once turn to his opinion of the correctness, the meaning or the propriety of entries or accounts, and the court will insist on his being duly qualified to give expert testimony on these questions and will draw a careful line between the facts to which he can testify from personal knowledge and the opinions which he may express as a qualified expert. Nothing will more promptly discredit his testimony than a confusion of fact and opinion. Furthermore, even if he be duly qualified to testify as an expert accountant regarding the correct-

ness, the meaning or the propriety of entries and accounts, he will not be permitted to express his opinion as to values unless he can show special qualifications and experience or definite personal knowledge which would make his evidence admissible. Must we not recognize these same distinctions as applicable to our certifications?

This does not, however, meet the second fact that we must face: viz., that whether or not the accountant couples his statements with the phrase "we certify," any statement which carries the name of a certified public accountant is by many considered to be a certified statement. We have all seen accountants' statements in which the accountant never even used the term "we certify" and in which he stated definite qualifications and even exceptions, received as certified statements and given a reliance which they were clearly never intended to receive.

For the purpose of this discussion I shall therefore refer to accountants' certificates as being the written declarations signed by accountants which set forth the nature of the financial statements they submit, and this regardless of whether the expression "we certify" is or is not used therein.

Your special committee on coöperation with bankers is giving its careful consideration to the question of accountants' certificates used on statements for credit purposes and the standards of work performed by accountants before issuing such certificates. It is eminently desirable that we should have the best standardization possible for our work and our certificates. But however much we may recognize the desirability of standardization and however much we may hope to see more uniform standards ultimately adopted, we are today faced with a wide range of demands for services and for many different kinds of statements and certifications. The entire work of the practising accountant is not confined to statements for credit purposes. It is true that the accountant must always be on his guard to be sure that statements which were obtained and were intended for some other purpose are not improperly used as a basis for credit. But were he to refuse to give statements in any form other than that which a banker would wish to have before him as a basis for granting credit and were he to refuse to issue statements unless he could give a certificate such as would be acceptable for a credit statement, he would be unjust both to himself and to his clients, because there are many cases where statements are not desired

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for credit purposes and the credit form is neither necessary nor most desirable. In issuing such statements and certificates the accountant must find his protection by making his certificate so read that it will not be misleading and will not justify a misinterpretation of the statement.

Even when we know that statements are intended to be used for banking or credit purposes, we can not always do the work and give the certificates which we would like to give. Sometimes this is the fault of the bankers, sometimes the fault of the clients. Sometimes it is the fault of no one, but is because of unusual conditions. For example, I have in mind a bond agreement which was so drawn that it required the company to furnish to the bankers "prior to the delivery of the bonds and stock" a certificate as to the financial condition of the company "at the time of the delivery" of the shares and stock to the bankers. This was no clerical error in drafting the contract, but the bankers insisted that the certificate as to the condition of the company on the very day they took the bonds should be in their hands that day. The only thing we could do was to agree with them as to the form of certificate we would give, which needless to say was very far from the standard certificate recommended for credit statements. Our certificate was, of course, distinctly qualified and the bankers fully recognized the qualifications we made, yet the certificate gave them something which they wanted as a reasonable assurance that there had been no material change in the financial condition of the company between the date of the prior balance-sheet which they had and the date when they paid over several million dollars to the company. This was an unusual demand which could not be met on standard lines, and yet I believe we would have failed to render a service both to the bankers and to our clients if we had failed to give them such assurance as we could give them under these conditions.

Of course, if there had been an attempted misuse of this certificate and it had come into the hands of one wholly unacquainted with the circumstances under which it was issued, he would rightly have felt that it represented an unsatisfactory certification for credit purposes and he might have felt that we were subject to criticism for issuing it. I know of no way in which an accountant engaged in a varying practice can fully protect himself against such criticism, any more than he can fully protect himself against the mutilation of a report or the incomplete publication of

a report. We seem powerless to prevent bankers from publishing statements ascribed to certified public accountants but omitting their certificates and any qualifications which they may have made. We, of course, each, have our remedy of refusing again to serve one whom we feel we can not trust, but this will not wholly prevent a possible misuse of our statements.

Another feature which is often very unsatisfactory to us is the question as to the amount of information given in the balance-sheet. I remember one time laboring earnestly with a client to convince him that a statement which grouped in a single item accounts receivable, inventories, and prepaid charges did not give the proper information which a banker would want, only to have him tell me finally that since we had begun our audit he had taken his statement in that form to the bank, uncertified, and borrowed all he needed on it, so he did not care particularly whether we certified to it or not.

It is hard for the accountant to say how much detail must be given in a published statement. If the statement is wrong he has clear ground for refusing to certify to it. If, however, the statement itself is right, is he justified in refusing to sign it merely because he feels that greater detail should be given? Our position is, of course, quite different if we are employed by a banker and asked to render to him a report giving him the information which we think he should have. We can not then, in justice to him, curtail any information which we think should come before him. But this is not the accountants' position when we are employed by a company which asks us to certify to a statement which it proposes to make public. It is the company, not ourselves, that will issue the statement. We can not insist on divulging facts which our client is unwilling to have known. Except as we may be able by our personal influence to get a company to publish the form of statement we think most proper, we are forced to a decision of whether we will certify to the statement the company desires or whether we will refuse to render our certificate. Sometimes we are forced to recognize that we would be doing the stockholders of the company a greater injustice by a refusal of our certificate, with a consequent inference by many that there was something radically wrong in the statement published, than we would in certifying to it even though it were subject to the criticism of giving inadequate information to the stockholders.

We all have a natural pride in having our names attached to reports which win general commendation as being models for corporate statements, but we can not hope ourselves to dictate the form of statement that each corporation must present unless we can get the adoption of the English system, whereby the accountant is duly appointed as representing the stockholders and renders his report directly to them.

In addition to the special cases where for one reason or another we are not able to follow the standards we would like to in certificates for credit or certificates for publication, accountants have a large demand for statements which are never intended to be published in any way. There is the case of the lengthy report made to officers, managers or stockholders of the company who are concerned not with technicalities of a certified balance-sheet, but desire our summary and discussion of its accounts and affairs. To those who receive the report the form of certificate is of little interest. They are interested in our narrative comments. At the same time we must, for our own protection, make our certificate such that the report will not be subject to misinterpretation if attempt should be made to use it for credit purposes. I have here in mind a company which for many years has used a form of statement which personally I think might be materially improved. Yet it is useless to try to convince the owners of this business, some of whom are aged men, that they should change the form of statements to which they have been long accustomed. They receive and welcome our comments and any criticisms and explanations regarding the various items, but they hold, perhaps rightly, that any change in form and presentation of balance-sheet and profit-and-loss statements would rob them of the comparison with prior statements which they desire. Moreover, they have no intention at their age of starting in to study modern accounting methods.

To illustrate the unusual nature of many of these reports and to make the illustrations actual rather than theoretical, I have been looking over a number of reports and note the following:

1. Report on a privately owned corporation, which had no bank loans, in which receipts, disbursements and accounts receivable were examined in detail but, at the request of the client, no verification of the securities was made. Although the accounts receivable were verified they were not included among the assets on the balance-sheet. No

formal certificate was given but a 21-page report was submitted.

2. Report showing liquidation of an old partnership and formation of a new. In so far as the accountant certifies to this statement it is as follows:

"From the various tests and verifications made, it is our opinion that the books and accompanying statements properly set forth the operations for the year and the transactions in liquidation at the close thereof."

3. A consolidated balance-sheet, partly estimated, for a corporation having subsidiaries in various foreign countries, some at points not readily accessible, where a statement was demanded before final reports from abroad could be received. The certificate reads:

"The above consolidated balance-sheet . . . has been prepared as to general office accounts on the basis of the accounts and records; as to other items the figures represent what appeared to be reasonable estimates based on the November reports and such other information as is available at the New York office.

"We believe the statement thus prepared fairly reflects the general condition of the . . . corporation and its subsidiaries substantially as it will be shown after complete information has been received and all entries up to December 31, 1925, have been made."

This statement and certificate were given after the accountant had definitely pointed out that no certified balance-sheet could be available until some two months later when full reports had been received from abroad and the audit and verification had been completed. It is not ordinarily a desirable practice to give statements "partly estimated" in this manner, and yet occasions arise where there seems to be a real demand for them and the accountant renders a legitimate and proper service in putting at the disposal of his clients and bankers or others who desire it his best abilities along this line. I do not think I have ever given such a statement without assuring myself that there were legitimate reasons for it and without assuring myself as far as I could that these conditions were fully understood by those to whom the statement was to go. I hope I have always succeeded in making the certification (if we may call it that) which accompanies the balance-sheet so definite that it could not be misconstrued.

4. An estimate of the last quarter's income was desired by the directors before full reports from foreign subsidiaries were

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received. A statement of estimated consolidated income for the quarter was prepared. The certificate reads:

“We have reviewed the figures used in preparing the above statement of estimated consolidated income and in our opinion this statement represents a carefully prepared and fair estimate of the earnings for the period which may reasonably be expected to be shown by the books of the companies after complete information has been received (from foreign companies) and all entries up to December 31, 1925, have been made.”

5. A 60-page report on a New Jersey municipality, about one-half schedules and one-half comments, largely directed to meeting the requirements of the New Jersey commissioner of municipal accounts.
6. Report on an examination of the New York office accounts, where the accountants brought into the statement accounts payable of over \$300,000 which had not been entered on the books, but where they were required to record that entries relating to the operations of an out-of-town plant “are submitted to the New York office for recording but are not accompanied by sufficient detail to permit verification by us.” This is a very unsatisfactory statement to issue but there seems little danger that it could be improperly relied on.
7. A sworn statement in Spanish to meet the requirements of foreign governmental authorities for a certified trial balance of the books and a statement of assets and liabilities and of profit & loss and surplus which the accountant certifies “has been prepared from the books and accounts of the company.”
8. A balance-sheet which was called for as preliminary to proposed financing, and, with the full knowledge and approval both of corporation and of the bankers, presents a statement based on the New York books and on reports from foreign branches. The accountants state this basis in their certificate but add “and according to the best of our information properly presents the financial condition of the corporation at that date.” Any satisfactory audit and verification would have taken time which did not need to be lost in the preliminary steps of the consideration of possible financing.
9. A rather unusual statement is a condensed income account for eight years past “in accordance with the federal income-tax returns.” The certificate shows clearly what

it is and I believe the statement would not be misleading to one who received it although he would promptly recognize that it was totally inadequate for a credit statement.

10. In another case a condensed statement reads:

"The above balance-sheet has been prepared from the accounts as kept in New York, which we have audited, and from the statements of . . . chartered accountants, covering the branch offices in China. The inventories of merchandise are stated as shown on the records without verification by us. We believe that the above balance-sheet fairly reflects the financial condition of . . . at December 31, 19—."

This concluding statement could be made because the inventories were not really material in amount.

11. A report to a closely held corporation states:

"These statements, which are in agreement with your books, show your financial condition at December 31, 1924, and the results of your operations for the year ended on that date, subject to our comments which follow the statements and are a part of this report."

I realize that this is a type of certificate and report to which bankers distinctly object. One banker told me they objected to this kind of report because it made it necessary for them to read the entire report so as to reach their own conclusions with regard to it, whereas what they wished was a simple statement in which the accountant would take full responsibility for the figures. This banker's attitude is perhaps warranted as to certificates and statements which are intended as a basis for credit purposes. But is the accountant called on to insist that he will never give any reports which do not conform entirely to the banker's standpoint? In this case the stockholders were all actively engaged in the business. They wanted their own particular form of statement. They did not look to the accountant in any way to pass upon the values of assets. They were interested in knowing what, if any, exceptions were found to the accounts as the company prepared them. They did not want a restatement of the accounts to conform to the opinions of outsiders. As far as I know, the statement was not intended for credit purposes. If a banker accepts and extends credit on such a statement, is it reasonable then for him later to criticize it because he was either unwilling to read the report he received or disinclined to insist on the form of report and certificate which he felt should really be given?

12. A statement of annual rentals based on leases in effect at a certain date. The accountants certify to the total rentals called for by the leases, but figures of area and rent per square foot are stated as supplied to them but "without verification or check by us."

We might continue to multiply the instances in which the accountant is called on for statements and some form of certification wholly different from what is involved in statements for credit. Therefore, whatever standardization may be brought about in credit statements, we shall still have the need for writing certifications to deal with special conditions.

It will be an undoubted relief if we can have general adoption of the requirements of the *Federal Reserve Bulletin* as a basis for balance-sheet audits and certificates. How long it may be before such a standard can become general would seem to depend largely on how long it will be before bankers will be unwilling to extend credit on any statement which does not conform to this standard. So long as bankers are ready to extend credit on uncertified statements or on statements with distinctly qualified certifications, many of our clients will feel it is entirely unnecessary for them to pay the expense of full verification when bankers by their attitude seem to feel such full verification is entirely unnecessary.

Perhaps there is no feature of an accountant's work which is more important from his own financial standpoint than is a good standing with banks and other financial interests. From this standpoint, therefore, perhaps this is the most important consideration. From the moral standpoint, however, he has probably a greater responsibility as to his statements to stockholders. The banker presumably, with the ability and resources at his command, is able properly to read and interpret certificates and statements. The ordinary stockholder is notoriously unable to do so.

Professor Ripley's article on "Stop, Look and Listen" in the September *Atlantic Monthly*, I will assume every accountant has read. Whether or not we agree with his conclusions as to the work which the federal trade commission might do along this line and whether or not he is justified in brushing aside as he does the reasons urged by certain corporations for not furnishing to their stockholders full information, we must nevertheless agree that the accountant has placed upon him a particular responsibility as to any statement to stockholders which carries his certificate.

I wish I knew better how to draft reports and certifications which could not be misunderstood. One thing to contribute to that end, I believe, is the use of what may be termed the "long form" of certificate, rather than the "short form." In the "long form" the accountant is able to give explanations which materially aid in the proper understanding of the statement. In the "short form" he is practically limited to a statement of his exceptions or qualifications, the technicalities of which stockholders little understand.

One of the best ways of meeting this situation seems to be with the explanatory statement such as has been adopted by various corporations, where under each item of assets or liabilities is given a statement as to what the account represents. This gives less ground for misunderstanding than any other form which seems to have been devised for presenting a statement to stockholders. For example, the statement of the Consolidated Gas, Electric Light & Power Company of Baltimore gives, under the heading "fixed capital," the following explanation:

"(This represents the company's cost of land, buildings, equipment, poles and fixtures, wires, cables, gas mains, gas and electric services, gas and electric meters, transformers, lamps, transportation equipment, shop equipment, storeroom equipment and all other property and miscellaneous equipment used in connection with the production, distribution and utilization of gas and electric energy. It also includes the cost of the twenty-story Lexington building and the two Lexington building annexes.)"

As to the item "special deposits" it states:

"(This represents money deposited with fiscal agents and trustees for the purpose of paying interest on long-term debt, dividends and sundry other obligations.)"

As to "casualty and insurance reserve" it states:

"(This is the reserve set aside to provide for liabilities arising because of loss or damage to property of others or of injuries to employes or other persons.)"

To the usual form of audit certificate is added:

"We believe the explanations given therein fairly present the nature and scope of the several accounts."

Not merely do I believe this is the best form of statement to be rendered to stockholders, but it is most satisfactory as a basis for discussion between the auditors and the company's officials. We all know how often we have to raise questions as to whether or not it is proper to include items of a certain kind under some particular designation in the balance-sheet and how prone company officials are to make their own interpretations of

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what they consider are mere words of broad generality. The descriptions such as are given above serve in themselves largely to settle these questions when they arise, but, more important, they give to every official a much clearer conception than he otherwise would have of what the various accounts are intended to be and prevent many of these difficult and embarrassing questions ever arising.

In preparation of this paper I have been reviewing a number of published reports and examining the certificates thereon.

I find in the report of a prosperous company of which I am a stockholder the following certificate:

"We hereby certify that the above is a consolidated statement of the assets and liabilities of . . . at the close of business February 28, 1926 as shown by our general report of audit dated April 3, 1926."

This to me is a very unsatisfactory certificate. I wonder if the accountant refers to his report because it contains something which casts reflection on the accounts or whether it was simply an unwillingness on his part to place himself definitely on record as saying that "in his opinion it correctly presents the financial condition of the company." Whether or not bankers may want the statement of the accountant's opinion, I think stockholders do. I think, in fact, stockholders give more for the declaration that in the accountant's opinion the statements are correct than they do for the technicalities of his certification or presentation.

I find another report which states:

"The quantities and valuation of the inventory of finished and partly finished products, raw materials and supplies, prepared by the company, have been certified to be correct by responsible officials."

From a practical standpoint this means very little to me. It does mean something to me that the accountants in this case do certify that the balance sheet "in our opinion, correctly presents the financial position of the company." Of course, I as an accountant appreciate that what the auditors mean to say is that they have accepted the inventory figures as stated to them and take no responsibility for their correctness. Would it not, however, be fairer to the ordinary stockholder if the statement were made in this form rather than in the form which the stockholder is apt to consider is the accountant's certification of inventories?

In contrast to the statement previously made, I would quote the following:

"Inventories have been certified by responsible officials and we are satisfied that they are accurately and conservatively stated."

This, of course, goes much further than the statement previously quoted.

Another feature I note in reviewing these reports is that some are stated "subject to possible adjustment of final liability for federal taxes," whereas others make no reference thereto. We can not assume that every company whose report is not so qualified has had final settlement of all its tax liabilities nor can we assume that the auditor by his silence is taking the responsibility of saying that he is satisfied that reserves have been set up sufficient to cover any possible liability along that line. Does it mean that the accountants only make reference to possible federal tax liability where they are closely enough in touch with the tax situation of that company so that they feel there is real danger of additional liability or where the federal government has already made some determination, tentative or otherwise, of such additional taxes. I must admit that I myself am somewhat at a loss to say what is the correct attitude of the accountant in regard to this matter. I know cases where preliminary findings of the department would indicate large additional taxes far in excess of any amount that I am sure the company will ever be required to pay. In other cases no demands have yet been made by the department, although personally I expect the department will make substantial additional demands. I can only reach my own conclusions, however, by such a study of each company's tax situation as would be far beyond the scope of any ordinary audit. We all know that usually not until five years have elapsed can we feel that any year's past taxes are finally settled. Should we on this account adopt a principle of qualifying every certificate we give or should we take the attitude that this is such a generally known condition that no qualification is required?

As to this question of tax liabilities, I find the following interesting statement:

"We have certified your provision for current federal tax liability, but have made no study of the reserves which you have established as sufficient to meet any tax adjustments applicable to prior years, since the corporation has a special department to handle such federal tax matters."

This is from a report which Professor Ripley cites as a model.

Another question arises as to inventories. I know a banker who insists that the accountant's certificate should cover such a verification of inventories that the bank can rely upon their correctness in all particulars. Yet I know many a business in which I would personally be totally unqualified to pass upon the

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character and value of goods on hand. Only an expert in that particular line could do it, and its cost would be practically prohibitive. At the same time, we must recognize that the banker is, after all, somewhat justified in wanting some better assurance regarding inventories than he usually receives. Is there any way for the accountant reasonably to give it to him?

There is much more which might be said along these lines and I hope the discussion to follow will amplify and clarify some of the points I have raised and bring out others which I have had to omit.

Before closing this paper I would mention the constructive action of the New York stock exchange in requiring that companies in listing securities must agree to publish their reports substantially in the form in which the listing statements are submitted to the exchange. Sometimes, unfortunately, this has resulted in what I think is a less desirable form of statement than that which the company had previously been following because the stock exchange authorities have undoubtedly been working towards uniformity in type of information required. In some cases, this results in having the form of statement which goes to the exchange not as well adapted to the peculiar affairs of the particular company as was the form of statement previously in use. Personally, I have found the stock-exchange authorities very ready to recognize such differences and accept a reasonable statement from the corporation even though it may differ substantially from what might be termed the standard listing form. If, however, this matter is not particularly raised, the company is apt to submit its statement in a standard form and then later find that it has committed itself to what is, after all, not the best form for it to use, but nevertheless it follows the line of least resistance and thereafter follows the newer form. In spite of this weakness which always exists in regard to standardized statements, there is no question that the stock exchange has accomplished much by its action. It is needless to say that the right form of statement helps greatly to simplify the question of the accountant's certificate.

In this connection it may be interesting to note the form of certificate which the New York curb market suggests, which is as follows:

"I have examined the minutes of all meetings of the stockholders and board of directors and have audited the books and accounts of the . . . Company and hereby certify that the accompanying balance-sheet, more fully shown in the detailed exhibits and schedules which are a part thereof, truly represents the condition of the said company as at . . ."

A particular feature of accountants' certificates under English and Canadian law is a statement to the effect that

"All my requirements as auditor have been complied with."

Under the corporation laws of these countries the auditor is in a position to state definite requirements and the stockholders are interested in knowing whether or not his requirements have been complied with. The nearest we can come to this under American law seems to be in using the phrase "in our opinion."

I need not here discuss the matter of accountants' certificates to statements "after giving effect to proposed financing," since this has been so well covered by the committee reports in the 1923 Institute Year-book, page 167, and 1925 Year-book, page 190. I would, however, mention that definite recommendation by a committee of the Institute seems to have had an excellent effect in providing a standard to be followed. I hope and believe that further progress along the line of standardization of certificates will result from the careful consideration which your committee on cooperation with bankers is giving to the matter of certificates for credit statements.

But the practising accountant is still left with the need of careful thought as to wording he will use in the many varying certificates to which he must attach his name and a constant watchfulness that he may, as well as may be, guard his own good name and reputation, avoid misleading those who receive his certificate and, at the same time, make the certified statement of some real value to the clients and to the public.