Accounting and Your Pocketbook

American Institute of Accountants

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"A public accountant has one of the most responsible and trusted positions in the world."

President Franklin D. Roosevelt

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* *The public is asking questions about accounting and its relation to the pocketbook of the average citizen. This booklet attempts to answer those questions.*

In the dialogue below, the "Inquiring Citizen" repeats questions which have been stated or implied in newspaper editorials and elsewhere in the past twelve months.

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If the "Inquiring Citizen" had an opportunity to talk with an accountant about accounting, he might ask about its place in the scheme of things, somewhat as follows: I have read a great deal about this subject in the papers recently, and realize it is something I should know at least a little about.

Is accounting important to me, an average citizen? I am not a big executive, nor a captain of finance. I have no contacts with accountants. What does their work mean to me?

The Certified Public Accountant probably would say something to this effect: Accounting has a direct relation to your income and your job, because without it business couldn't operate on a scale bigger than a one-man enterprise. Stuart Chase has said:

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

Accounting, for one thing, is the means of keeping track of infinite numbers and varieties of involved business transactions. It's the language with which business management tells its employees, stockholders, and creditors, the government and the general public how the funds entrusted to it are safeguarded and used.

I don't mean to say that accounting tells everyone everything he wants to know about a business. Accountants are not forecasters, for example. Accounting doesn't pretend to predict or interpret economic trends or the business outlook.

But accounting is the only medium through which reliable information may be secured about the financial condition and results of an enterprise, be it private business or government itself.

The results of accounting are expressed in balance-sheets, profit and loss statements, analyses of surplus, and other forms of financial statements.

The conversation then might proceed as follows, taking up first the question —

WHAT IS ACCOUNTING?

CITIZEN: That's quite clear, but I still don't understand just what accounting is, how it accomplishes all these things. How does it work?

ACCOUNTANT: Accounting has two purposes: first, to record in an orderly fashion in books of account what happens in a business — where money comes from, where it goes; second, to interpret those records — telling whether the concern is solvent or not, whether it made a profit or loss. That sounds simple, but it isn't. It is a complicated job.

It's often difficult, for example, to decide whether an expenditure of money is a current expense to be deducted from the earnings of the year, or an expense which should be spread over a period of years and, if so, how many? The decision, of course, is reflected in the financial statements as more or less profit or loss, or more or less surplus. This decision may determine whether or not the concern pays dividends, and what its future policy shall be.

It's also difficult to determine the amount at which securities, debts due the company, stocks of merchandise, buildings and machinery, should be shown in the balance-sheet. These decisions again affect the surplus, and add to or subtract from the profits set forth in the statements.

Facts Plus Judgment

You can see at once that financial statements, although expressed in dollars and cents, are not statistical presentations of facts. They represent the *judgment* of a company's management and its accountants as applied to the facts. Accounting is not, as some believe, an exact science.

No one can possibly state with complete certainty the exact value of anything appearing on the books of a company, because present value of an asset depends upon what somebody might pay for it, or what income it might produce, in the future. The future cannot yet be read by anyone.

CITIZEN: I can see your point; but, if financial statements represent nothing but estimates about what might happen, how can they be very helpful to those who want to know what's happening to their money?

ACCOUNTANT: There's a lot of difference between a random guess and an expert estimate. The job of accounting is to assemble the data and to make the approximations as accurate as possible. The experience of generations plus persistent studies of the theories underlying accounts has developed a body of accounting conventions, precedents, procedures and principles, which have been found to work well in practice.

For example, take buildings and machinery. There are a number of ways of estimating the value of buildings and machinery, an asset which appears in almost every balance-sheet. Any one of these can be supported by logic and precedent.

A basic concept of accounting is to show what has happened to money *invested* in the business. Therefore, accountants generally recommend showing buildings and machinery in financial statements at the amount it cost to buy or build them. As a matter of fact, the use of cost rather than "present value" is recommended because estimates of present value will change each year according to variations in the probable cost of reproducing the property, or the probable price at which someone else would buy it. Furthermore, if the concern expects to continue in business, and to use this plant and equipment indefinitely, it makes little difference what it is worth today, anyhow.

CITIZEN: Can you give me a good example?

ACCOUNTANT: Yes. Assume this simple illustration: A man bought an office building, five years ago, for $50,000. At what amount should it be shown in the balance-sheet?

One way of deciding is to start with the price which the present owner paid for it. But the building today is five years older than when it was bought. It has been wearing out, or depreciating, in the meantime. So we must make a deduction for depreciation. There are several accepted methods of calculating depreciation, each supported by logic and authority.

Valuation Methods

But accountants generally would agree that in a case of this kind the so-called "straight line" method would be appropriate. Architects and engineers estimated that the building, when purchased had about twenty more years of useful life, so we write off one-twentieth of its cost a year. Therefore, we show it today at: cost, $50,000, less depreciation, $12,500, equals $37,500. This accounting isn't exact, because the building might last eighteen or twenty-two years, but it is a fair presentation of the present situation.

If the present owner had to sell this property right away to obtain ready money, he might be compelled to accept an unreasonably low price. This would be a "liquidation value." However, it would be quite unfair to show this value in the balance-sheet if the present owner did not sell, but continued his business. Or the owner might find out how much it would cost to construct an identical building in the same place. Perhaps it would cost $100,-000. This would be "reproduction value," which is a good basis in some situations, but would be misleading here.

As I have outlined this case, you must have noted how the elements of judgment and opinion have entered into it. Without sound accounting judgment, the present owner's efforts to place an honest valuation upon the property might result in a statement highly misleading to someone who wanted to invest money in the building.

Another good illustration is money due the company, or receivables.

No business executive nor accountant is enough of a prophet to tell *exactly* what percentage of the money due a company will actually be collected. Experience and training enable the accountant to estimate pretty accurately, from data available, the percentage of receivables which will be paid, but the figure in the balance-sheet is to some extent an estimate.

The same problem is presented by goods on hand, or inventories.

A commonly accepted method for estimating the value of goods on hand is "cost or market, whichever is lower." But just what do we mean by cost — the actual money paid out for each unit of goods in stock or the average cost of all, or the cost of the latest unit purchased? Is market today's selling price? Who knows whether this product will actually fetch that figure? Or is market the cost of replacing the unit under today's conditions? Accounting has to find a fair answer — it can't be exact — depending upon the particular trade, business conditions and previous experience.

I could go on like this forever. Do you see why accounting isn't "exact," but is none the less useful?

CITIZEN: For the first time, I do. But I'm a little up in the air about your statement that there are so many different accepted accounting methods for doing these things. Why don't accountants adopt one method for each situation and stick to it, so the public would know what the figures were based on, at least?

ACCOUNTANT: Accounting should present fairly the condition of an individual business and the results of its operations. The "right" accounting method in one business or under one set of circumstances might distort the picture seriously if applied in another. Remember our problem of valuing the office building.

Consistency Is Essential

In the long run the method doesn't matter so much as consistency in its application. What I mean is this: any one of several acceptable methods of figuring depreciation or valuing inventories, for example, will, if properly applied, work out to the same results over a period of years, though they might show varying results from year to year. But good accounting doesn't permit changes of method from year to year in order to improve the picture. A company should pick the method that seems best adapted to the particular circumstances of its business and then stick to it. If it changes, and change sometimes can be fully justified, it must disclose the facts to all concerned.

WHAT IS AUDITING?

CITIZEN: I see the point. But, another thing. What's the difference between accounting and auditing? It happens that I have a few shares of stock in two or three companies. I notice at the end of their reports some kind of statement by the "independent auditors." Just what purpose does that serve? Where do the auditors fit in the picture?

ACCOUNTANT: We've been talking about accounting. Well, auditing is a check-up on accounting. Almost every enterprise, institution and governmental unit represents a *trust* which holds and manages the savings of others. Naturally, this has led to a demand for a competent and disinterested review and check of the accounting records and of the accounting judgment of managing officials, as expressed in their accounting statements. This outside check is generally known as the independent audit, and is generally performed by a certified public accountant, who has the required technical skill and professional judgment.

The Securities and Exchange Commission and the New York Stock Exchange require audits by independent public accountants of companies subject to their jurisdiction. Many banks require independent audits of the financial statements of prospective borrowers, and many business agreements call for annual audits of the accounts of the companies concerned. In addition, many state laws demand independent audits of certain types of corporations, and of municipalities and other governmental units.

Purposes of An Audit

CITIZEN: What are the basic purposes of an independent audit?

ACCOUNTANT: In making an independent audit, a certified public accountant reviews the accounts and records of a company for two purposes: to see whether the accounting judgment of the management, as reflected in the financial statements, is sound; and to satisfy himself reasonably that the assets reflected in the financial statements really exist, that the liabilities are correctly stated, and that income and expense were really as reported. These two purposes are quite separate, though closely related. You will have a clearer picture of the function of the auditor if you keep this dual nature of his work in mind.

Some people think that an auditor is a kind of detective who not only checks every available scrap of paper and every entry in every book of record, but also exercises a kind of second sight into the minds and hearts of the officers and employees of a business concern.

Certified public accountants are skilled in a highly specialized type of professional work, it is true; they are independent in their approach to their work, and they don't get fooled very often. But there are limitations inherent in the very nature of their work which they are eager to have the public understand.

THE AUDITOR'S RESPONSIBILITY

CITIZEN: What do you mean by limitations? Doesn't the auditor guarantee the accuracy of the statements?

ACCOUNTANT: I think that you will see in a minute that no human being could possibly "guarantee the accuracy of the statements." We've already seen that accounting itself doesn't result in accurate measurement, in the sense of exactitude, but only in close approximation based on the best available judgment. What the auditor does is to express his opinion, which results from his checking of the accounting records, as to whether this accounting judgment is sound or not. This opinion, for which the auditor takes full responsibility, states whether the various items in the financial statements are presented in accordance with generally accepted accounting principles so as to reflect fairly the position of the company, and the results of its operations.

Checking the Records

The check of the records on which the auditor bases his opinion is, of course, an essential part of his job. In a small and simple business, it is possible for the auditor to examine each voucher and invoice, each bill of lading, each cancelled check and every other document supporting every item in the books. But most business units today are much more extensive, the volume of transactions involved usually is enormous, and the records in most cases are so voluminous that it would be next to impossible to look at each entry in the books and every piece of paper behind it, unless an auditor stood beside each bookkeeper and clerk throughout the year and audited each transaction as it was recorded. This process would be prohibitively expensive and, on top of that, would constitute a foolish and unwarranted interference with the normal course of business.

In taking steps to satisfy himself that the reported assets and liabilities actually exist, and the transactions resulting in profit or loss actually occurred, the auditor's usual procedure is sampling and testing, varied in extent according to the adequacy of the internal check and control of the company under examination.

INTERNAL CHECK AND CONTROL

CITIZEN: What is meant by internal check and control?

ACCOUNTANT: The term internal check and control is used to describe those methods adopted within a company, usually through its own accounting or financial department, to safeguard the cash and other assets, and to check the clerical accuracy of the bookkeeping.

As part of an adequate system of internal check and control, duties are assigned to employees within the company itself in such a manner that one employee becomes a check on another. For example, the cashier makes no entries on customers' accounts and takes no part in the preparation of their statements; and neither he nor the ledger-keeper has authority to issue or approve credits to customers. The clerk recording the labor time and preparing the payroll is not permitted to handle the funds. Approval and entry of vouchers are made by others than the disbursing officer. The stock records and inventory control are kept independent of both the shipping and receiving departments. Mechanical devices, such as turnstiles and check protectors, might also be used.

The auditor places great reliance upon the internal check and control system of the company, if he is wholly satisfied that the system is adequate and functioning effectively. He may expand or contract the extent of his own testing and sampling according to the degree of reliance he finds he can place on the internal check and control. Of course, there is an irreducible minimum beyond which his own testing and sampling cannot be contracted.

TESTING AND SAMPLING

CITIZEN: What do you mean by the auditor's testing and sampling?

ACCOUNTANT: The accounting profession has developed a planned and orderly technique of testing which consists of examining in detail, and of verifying by reference to original records and by independent correspondence with customers and creditors shown in the books of account, various "samples" of the entries in the books. This testing is made as extensive as necessary to satisfy the auditor that the records in their entirety may safely be accepted as reliable.

For example, the auditor might examine the payroll records of each department covering several payroll periods out of the year; he might write to ten persons in every hundred who are shown by the records to owe the company money, in order to confirm the accounts receivable. In checking inventory, that is, products and materials on hand, he might watch the company employees count, measure or weigh a substantial sample of the goods on hand, or he might check them himself.

Inventories — A Special Problem

Inventories present a special problem. The certified public accountant does not claim to be an appraiser, valuer or expert in prices, styles and grades for all the many types of goods in the inventories of his clients. However, from the accounting records, he can determine what the company paid for the materials in its inventory, and he can usually find credible evidence of market prices. The accounting records show shipments in and out, prices paid out and received, and other data which, together with physical tests or observation of inventory taking, permit the accountant to form a pretty shrewd opinion as to whether the amount of inventory is fairly stated.

Fraud

The testing and sampling method often reveals irregularities and fraud. It does not permit the accountant, however, to assert that there have been no minor irregularities or small errors in bookkeeping, or petty thievery, concealed through clever manipulation of records or collusion between employees who under a proper system of internal control are supposed to act as checks upon one another. Sometimes, detailed examinations are undertaken for the purpose of detecting fraud. Ordinarily, it would be unjust and uneconomical to burden all business with the tremendous extra expense of complete detailed audits in order to catch an occasional fraud.

Business history shows that in rare instances high officials of an individual company may act in collusion to commit a fraud by forging large numbers of documents, and by taking advantage of their executive positions to juggle the accounts. If they are clever they might, admittedly, fool the auditor. But, then again, they might not. At any rate, such cases have been so extremely rare that they cannot serve as a basis for normal procedure.

THE AUDITOR'S REPORT

CITIZEN: Can you tell me something more about the accountant's certificate which is found at the bottom of a financial statement?

Accountant: It is not so much a certificate as a report, or an opinion. The work of the auditor culminates in this report or, as you have called it, and many others call it, "certificate." This report presents the auditor's professional opinion, offered after sufficient investigating and testing to satisfy himself that the opinion is sound. This opinion should and does have great weight, but the report — as you realize by now — is not a guarantee by the auditor. He charges professional fees for the work on which his professional opinion is based, but he does not charge the premiums of an insurer.

In some cases, the auditor submits a detailed report accompanied by statements, comments and supporting schedules. This is usually true in examinations for credit or special purposes. In other cases, usually in connection with periodical reports issued regularly by business concerns for the information of stockholders and other interested persons, the independent auditor's report is limited to a concise statement of the scope of his examination and his opinion concerning the accompanying financial statements of the company.

Citizen: There is another point I would like to know about. What happens when the company executives and the independent auditor disagree upon the proper treatment of a particular item in one of the company's financial statements?

Accountant: If the auditor's judgment differs from that of the management, the auditor states his exception in his report. If his exception is so important as to throw doubt on the validity of the statements as a whole, he will express no opinion but explain in his report why the opinion is withheld.

The Auditor Says —

All investors and other interested persons should read carefully the auditor's report accompanying a financial statement. If the auditor's examination has disclosed any item, situation or fact which he desires and feels in duty bound to bring to public attention, and if he fails to persuade the management to change its accounts accordingly, the only place where he can speak is in this report. Often there are expressions of opinion of fundamental importance in the accountant's report which do not show up in the statements themselves.

A financial statement, it must be remembered, is the statement of the company and not the direct statement of the auditor to the stockholders. On this point, the Securities and Exchange Commission recently said: "The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests with management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting."

PROFESSIONAL STANDARDS

CITIZEN: I am convinced that what the accountant does to check the records of a company, his judgment on the accounting decisions made by the management, and his final expression of opinion are of the utmost importance to all interested parties who want to know about the company's finances. But how do I know the accountant knows his business? How do I know he is independent? What controls are there over him?

ACCOUNTANT: The designation certified public accountant is the hall-mark of the accredited practitioner of accounting. This title is granted by the state after the candidate has satisfied educational and experience requirements, and has passed searching written examinations in accounting and related subjects conducted by legally constituted state authorities. In the public interest and their own, certified public accountants have set up within their profession high standards of professional conduct enforced by their state and national societies. Penalties for misconduct may be reprimand, suspension or expulsion from the societies, and revocation of the C.P.A. certificate.

On the side of education, the certified public accountant has rapidly developed the background of scholarship in his work. He has encouraged gradual raising of the intellectual standards which must be met by every candidate for a C.P.A. certificate. He has been a pioneer in the field of business education and has played a leading part in the establishment of schools of business, commerce and accountancy.

Self-Interest Is Public Interest

No accountant's work would be acceptable to those interested if he were believed to be incompetent, or to lack integrity or independence. A certified public accountant, by the very nature of his work and its relation to the financial interests of others, must emulate Caesar's wife. He cannot bear even the shadow of suspicion. His whole professional career is at stake every time he signs his name to a report.

Therefore, in guarding his professional reputation, the certified public accountant is not only acting in the public interest, but in his own enlightened self-interest. In fact, these two interests are identical. The accountant has far too much to lose to risk discredit, no matter how great the immediate temptation. Certified public accountants recognize and accept their professional obligation to serve not only the companies which are their clients, but the general public as well.