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Briefly stated the object of a balance-sheet audit is to verify by satisfactory evidence the existence, possession and ownership of all assets and the values at which they are shown in the balance-sheet and to ensure the disclosure thereon of all liabilities—all as at a particular moment of time. The basis for such verification is found in the books of account, subsidiary records and collateral and even external sources of information which circumstances may suggest and an effective audit demand.

Thus, it is not sufficient that all assets appearing on the balance-sheet be on hand or in proper custody or under proper control, but it must be definitely ascertained whether other assets not shown on the balance-sheet and not available for verification should be so available, and, as to liabilities, that the liabilities as shown are actual obligations, that they comprise all the obligations and have all been properly contracted. The outstanding capital stock, surplus and undivided profits in the case of corporations or investment accounts of a co-partnership or individual business representing the net worth are determined both as a result of and concurrently with the verification of the assets and liabilities, and are also susceptible to verification in themselves. A certificate by the auditor that the balance-sheet has been audited by him and sets forth the true financial condition of the concern follows, and a report, informative and explanatory of the balance-sheet, usually accompanies it. No certification as to profits is involved.

It is not intended, in this paper, to discuss balance-sheet audit procedure except as it may be affected by the purposes for which the audit is undertaken or by the limitations imposed. Textbooks with which we are all familiar furnish us, in a greater or less degree, with the pro-forma procedure appropriate to the audit of a balance-sheet; but experience brings the inevitable conclusion that the requirements of each particular case call for more or less deviation from stereotyped formulæ and demand the exercise of individual judgment, initiative, tact and courage on the part of the auditor who would maintain a high professional standard, satisfy his own conscience and retain the respect and confidence of his client.

What, then, must be our guide in the use of such skill as we possess in auditing a balance-sheet, the work on which is inextricably bound up with the purposes for which the audit is made and the limitations which may restrict it? The purposes of a balance-sheet audit are numerous, but it will perhaps suffice to mention the following as being those usually behind the undertaking of such work.

1. To secure credit;
2. To furnish a certified balance-sheet to prospective purchasers of stock;
3. For the information and assurance of stockholders, directors and partners;
4. To furnish a basis for merger or other reorganization;
5. In the termination and settlement of a co-partnership;
6. In the purchase or sale of a business;
7. In bankruptcy or insolvency as a basis for the construction of a statement of affairs.

Balance-sheet audits are called for both as of a current date and as of a date long past, as in the case of bankruptcy, where a statement showing an insolvent condition long prior to the date of petition is required.

A natural question arises at this point, namely, to what extent the auditor's duties are affected by the purpose for which the audit of the balance-sheet is undertaken, and to what extent the auditor himself may be influenced by such purpose.

The purpose of the audit is of course conveyed to the auditor by the client in his instructions. If it is not, the auditor should request information on this point. Lack of knowledge as to the purpose of an audit can only deprive the client of intelligent coöperation on the part of the auditor. Instances are not unknown in which certain purposes have been alleged by the client and the real object in seeking the auditor's services concealed. Alertness on the part of the auditor and care in the presentation of the results of his work will generally defeat any ulterior motive in such cases, and the client usually loses rather than gains by withholding his full confidence from the auditor he employs.

In considering the auditor's duties in the audit of a balance-sheet as affected by its purpose and limitations one's mind not unnaturally turns to the various oft-quoted judicial definitions with which we have been regaled under the subject of the auditor's duties and responsibilities.

We are told that "he (the auditor) must be honest; that is, he must not certify what he does not believe to be true." "He must exercise all reasonable care, skill and diligence in ascertaining that the balance-sheet correctly reflects the true financial condition." "It is no part of his duty to take stock." "He is not called on to seek for knowledge outside the company or to communicate with customers or creditors." "He is not an insurer against fraud or error." "He must do more than ascertain the mere arithmetical accuracy of the accounts." "He must examine the books, but he does not discharge his duty by doing this without enquiry and without taking any trouble to see that the books themselves show the company's true position; he must take reasonable care to ascertain that they do so." "What is reasonable care in any particular case must depend on the circumstances of that case."

It is not difficult to discover from the foregoing excerpts the legal conception of the limitations which an auditor himself may place on his work in the audit of a balance-sheet. Surely under these definitions no undue hardship nor unreasonable onus handicaps the competent and conscientious auditor. On the other hand, the moral conception of the auditor's duties may well add much to what has been established from the bench. In instances where limitations are imposed by the client, there may not be and often there is not any relation to the purpose of the audit. On the other hand the client's instructions might call for work in excess of the bare requirements of the auditor's duties as judicially defined, and, if accepted, the auditor must faithfully perform such work.

Limitations imposed by the client cannot always be observed. They may, from their nature, prevent the attainment of the very purpose for which the audit is undertaken, or, as in the illustrative case referred to later, they may in themselves present a moral barrier. On the other hand, the limitations imposed by the judgment of the auditor himself, based on his individual recognition of moral and legal responsibility, are affected by the purpose of the audit, the circumstances peculiar to the individual case and the instructions of the client.

From the brief statement, at the outset of this paper, of the object of a balance-sheet audit, it will be readily apparent that limitations to a degree which impairs the efficacy of the verifications called for removes the audit from the scope of our subject. The audit cannot be deemed a balance-sheet audit—it is a partial audit.

A plea for the time-honored institution, the audit report, may not be out of place in the light of the present tendency to eliminate the report or at least abbreviate it to almost the vanishing point.

If the client is content with the assurance of the auditor's certificate, it might be urged that no report is necessary; but if he is, can the auditor in justice to himself dispense with the means offered him for confirming his instructions, placing himself on record as to what limitations have governed his work and, in view of the many uses to which an audited balance-sheet may be put, of generally protecting his client and those who may be interested in the balance-sheet, and incidentally himself, from possible misunderstanding? Should not the client or the reader of an audited balance-sheet be placed on notice as to both the purpose and the limitations of the audit and have accessible information without which, unless the audit certificate is to do away with all need for intelligent interpretation on the part of the reader, the audited balance-sheet is too often merely a comprehensive note of interrogation? Average clients or readers of a balance-sheet are not familiar with the legal definitions of auditors' duties. More often they entertain fanciful notions regarding them, and, if the auditor is to be fair with his client, it does seem important that the extent of the audit work and its limitations should be succinctly stated; what has not been done being perhaps emphasized more than what has been done. Many a misunderstanding may be thus avoided. This appears especially true when we remember that the average balance-sheet must bear on its face certain assumptions and conclusions reached as a result of inquiry into relative facts, and that the ramifications of the audit work depend largely on the nature and character of the enterprise, the actual conditions and requirements of the business as a whole and its relation to other businesses and to the community. The provisional character of many of the items appearing thereon, contingent and potential values, reliance on certain premises, conventional or otherwise, all call for careful consideration in the presentation of the result of the auditor's work.

No limitations can be recognized in the verification of cash assets, the existence of which, in proper custody, must be determined.

Accounts receivable need not be, and often are not, verified by independent communication, although in cases where the books and records of the concern bear evidence of their unreliability and are not susceptible to satisfactory internal verification, the auditor is in duty bound to except them in any certificate he may furnish; or if the accounts receivable constituted the principal asset of the business, he might not be justified in certifying the balance-sheet at all unless he were permitted to communicate with the parties concerned.

Notes are accepted at their face value, and nothing short of warranted suspicion as to their bona-fides would ordinarily justify an auditor in going further.

From the history of these receivable items and careful inquiry, the auditor should satisfy himself that due provision has been made for probably uncollectible items.

The verification of merchandise inventory is subject to limitation as to the physical correctness of its make-up and the condition of the items listed thereon. It is customary to take a certificate from the parties responsible for the inventory and confine the audit work to checking its clerical accuracy, the prices used, and ascertaining that no items are included thereon for which payment has not been made and the liability therefor not duly set up. While this procedure would ordinarily cover the legal responsibility of the auditor, the importance of the terms "reasonable care, skill and diligence" must not be overlooked. An instance recently occurred where the procedure outlined above had been followed. In reviewing the balance-sheet after audit, three salient features of the inventories were apparent—

1. The inventories were by far the largest items on the balance-sheet.
2. The inventories at the end of the year under review were more than twice what they were at the end of the previous year (nearly all the increase was in manufactured stock).
3. The concern had sustained a substantial operating loss during the year.

Further investigation disclosed the fact that about ninety per cent. of the finished stock had been manufactured under contracts, according to special specifications, for certain mushroom growth manufacturers of world-war origin, delivery had been refused, and the other parties to the contract were financially unable to accept delivery and practically bankrupt. As a result of this disclosure, the inventory was adjusted to reflect the anticipated loss from cost to junk value, and by reason of this adjustment alone a friendly receivership ensued. The concern is slowly recovering. It has since been clearly demonstrated that had attention not been called to the conditions, the receivership would have been deferred, but it would not have been a friendly one and its termination unquestionably would have been disastrous.

A careful review of the manufacturing or trading account will sometimes reveal abnormalities which point to evident error in the inventory. In such cases the auditor must exhaust every reasonable means to ascertain the cause of such abnormality and as a result thereof may require a revision of the inventory.

The degree of limitation in the audit work in relation to inventories must also depend largely on the relative importance which the inventory bears to the balance-sheet as a whole.

In the case of mining or oil-producing companies, the auditor would not be expected to pass on depletion reserves, except to assure himself that the estimate of ore or oil on hand had been furnished by some competent person or source and that the reserve set up had been correctly calculated on the output or yield in its ratio to such estimate.

In the verification of fixed assets, such as real estate, buildings, machinery, equipment, furniture and fixtures, no limitation would ordinarily operate against the verification of title record, cost, propriety of all items charged to such accounts, and the absence of any liens or liabilities thereon not disclosed on the books. It is sometimes deemed advisable to take a certificate from the client, or in the case of a corporation from a responsible officer, to the effect that no liabilities other than those shown on the books exist. This is especially desirable in the case of partnerships or individual businesses, or what are known as one man or family corporations, where transactions in their recording are given neither the attention nor formality which they should receive, and such a thing as the mere giving of a note is not always shown on the books.

In conclusion, the following instance of what might be termed "unlimited limitations" may not be inappropriate or without interest:

A certified balance-sheet was requested. The purpose of the audit was to furnish such certified balance-sheet to prospective purchasers of stock, although this purpose was not disclosed till later. The company owned investments (common stock) in subsidiary companies for which the holding company had paid nothing—the stock was received in payment for services in promotion and organization. This stock was carried on the holding company's books at about $1,000,000.00. The books of the subsidiary companies, which numbered twenty, showed that twelve had an aggregate earned undistributed surplus (no dividends paid) of about $32,000.00; while the other eight showed an aggregate deficit (all operating loss) of about $15,000.00. The holding corporation owned about 90% of each subsidiary company's common capital stock. The auditors were requested to increase the value of this investment in the subsidiary companies to $2,000,000.00 on the balance-sheet of the holding company, on the ground that the stock could be readily sold at a price to yield that amount.

Unwillingness on the part of the auditors brought the corporation's attorneys to convince them and to disabuse their minds of any misunderstanding as to what they were engaged to do. After some discussion as to auditors' duties generally, the following accommodating suggestion was offered:

Either the auditors might receive limited instructions withdrawing the troublesome investments which would then appear at a value of $2,000,000.00 from within the scope of the audit, and the auditors might protect themselves by stating in the accompanying report, if they thought it necessary, that under the instructions received the said investments were not verified, or they would be furnished with affidavits as to the value sought to be placed upon these investments in the balance-sheet. The attorneys impressed the auditors with the fact that they would thus have fully protected themselves and fully discharged their duty legally.

A counter suggestion was made by the auditors that if a value of about $30,000.00 was used in the balance-sheet and the manner in which such value was computed was set forth in the report, there would be nothing to prevent any intelligent person from being convinced as to any potential value beyond that shown on the balance-sheet which this investment might have, but that for audited balance-sheet purposes fanciful valuations could not be accepted.

The investment in the subsidiary companies was shown on the audited balance-sheet at an amount equal to 90% of the $32,000.00 aggregate undistributed surplus. The audited balance-sheet was rejected by the holding company, which refused to pay the audit fee on the grounds that the auditors had presumed to appraise property which the clients held was not within the duties or functions of an auditor. As a matter of fact, the auditors had refrained from any attempt to appraise, but had declined to accept an appraisal by interested parties, and this of course was the real reason for the clients' objection. A suggestion that the courts be asked to pass on the clients' contention led to the acceptance of the audited balance-sheet, and thus ended an unpleasant incident in which the auditors had been tempted by instructions with limitations and by assurances as to legal immunity to become a party to deliberate misrepresentation.