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ACCOUNTING and auditing have rapidly become recognized as matters of fundamental importance to investors, credit grantors, business managers, and many other members of the community. Note, for example, the following quotation from the *New York Times* of several weeks ago of remarks by Jerome N. Frank, newly elected chairman of the Securities and Exchange Commission:

"In Mr. Frank's opinion, one of the most important activities of the Commission is to maintain and improve the standards of accounting practice.

"'Accounting,' he said, 'is the language in which the corporation talks to its existing stockholders and prospective investors. We want to be sure the public never has reason to lose faith in the reports of public accountants. To this end the independence of the public accountant must be preserved and strengthened.'"

Accordingly, it might be appropriate to emphasize certain basic principles which underlie the work of independent certified public accountants. With these in mind, those who rely on financial statements may gain a clearer understanding of their meaning.

ACCOUNTING *v.* AUDITING

When business organizations were small and simple, the principal purpose of audits was to prevent thievery, or to find out how much had been stolen; as business organizations have grown larger and more complex, the primary purpose is to ascertain that the client's accounting methods are sound, and that the financial statements fairly present the position of the company and the results of its operations, in conformity with generally accepted principles, applied on a basis consistent with the preceding year.

These underlying principles may have meanings to the public accountant which may not be immediately evident to others. Let me illustrate: There are several accepted bases of valuing inventories, some more appropriate in certain businesses than in others. If the basis of valuation were changed in a given year, there might result a substantial overstatement of income for that year. The independent certified public accountant is expected to disclose any such condition as this, which obviously might be far more important to credit grantors or to investors than a defalcation by an employee even of several thousand dollars. Improper charges to surplus, improper valuation of securities, inadequate depreciation, and other unsound methods of accounting may easily result in an overstatement of income or in a statement of current position which might be misleading. Audits by independent certified public accountants protect the interests of creditors and stockholders against misinformation of this kind. Businessmen should be warned that it is no easy task to determine what are proper or improper methods of accounting. The element of judgment enters into this determination to an important extent, because accounting is not an exact science and complicated business transactions cannot be reflected in simple, clear-cut terms. Since judgment enters so largely into accounting, it is important that credit grantors and others interested know that the independent accountant is qualified by training and experience to express an informed opinion. Evidences of such

NOTE.—Based on papers presented before the National Association of Credit Men, Grand Rapids, June 14, 1939, and the North Carolina Association of Certified Public Accountants, June 15, 1939.

qualification are possession of a certified-public-accountant certificate, membership in the American Institute of Accountants, and membership in a state society of certified public accountants.

Now, of course, in addition to expressing an opinion on whether or not the financial statements are in accordance with good accounting, the auditor is supposed to satisfy himself that the transactions reflected therein have actually taken place. This is one distinction between accounting and auditing. Accounting is concerned with the systematic recording of transactions on the books and with the interpretation and presentation of financial statements; auditing is the examination of the records and supporting data in substantiation of the transactions entered in the books and summarized in the financial statements. As business units have grown larger, they have provided more and more efficient and elaborate systems of internal check and control, and many have even arranged for internal audits. Consequently, it would be a tremendously expensive procedure, and a waste of money in most cases, for independent certified public accountants to check again every transaction in a concern which had already been checked by the internal accounting staff. To avoid this wasteful procedure, certified public accountants have developed techniques of sampling and testing which enable them to determine to what extent internal check and control, and internal accounting or auditing, are effective, and to determine by tests whether the accounting seems to be accurate and whether there is any indication of fraud. Through this well established procedure, of course, many defalcations have been discovered.

Whose Statements Are They?

I have been surprised to learn that many accountants accept the idea that the financial statements, when accompanied by an independent auditor's report, are the statements of the independent auditor and not of the client. I had been under the impression for years that the financial statements and explanatory data and footnotes were and must be the representations of the client and that the auditor's report merely expressed an authoritative opinion upon such representations. So many prominent accountants have expressed the contrary view that I think it is time the question should be fully discussed in order that some conclusion be reached.

The question is:

> Are financial statements, when accompanied by a report and opinion of an independent certified public accountant, the representations of the client or of the independent auditor?

To answer this question properly, we must consider other questions:

Q. Where do the figures entering into the financial statements come from?
A. From the books of the client.

Q. What evidence is there as to the substantial accuracy of the figures in the client's books?
A. Client's vouchers, minutes, bank checks, deposit slips, etc., together with confirmatory matter received from outside sources and oral statements by the client and his representatives as a result of careful inquiries by the auditor.

With this background of questions answered, we may now proceed. Let us assume a case in which the independent certified public accountant, upon presenting himself at the client's office, finds financial statements completely prepared with full explanatory notes ready for his examination. In such an instance, the independent certified public accountant acts almost solely in his capacity as a professional auditor in making an examination of the records and supporting data of the client, extensive enough to justify him in giving his opinion upon the financial statements and notes thereto as submitted. His services as a public accountant in this case would be limited to passing upon the accounting procedures and principles applied to the transactions by the client. In the hypothetical case cited, the financial statements are obviously the representations of the client, and the independent auditor has made a sufficient examination to give his opinion. I am assuming that a case as described above could not have been possible, of course, unless the client had a well organized accounting system and staff to record the transactions and prepare the statements.

Apparently there is considerable opinion throughout the country that in an extremely dissimilar case where the accounting system of a client is poorly organized with an inadequately trained accountant in charge of the books, the financial statements prepared by the independent certified public accountant are his representations when he signs the accompanying report. In such a situation, the independent auditor may find that no final books of account are maintained, that the company may have a check book of its bank transactions, a memorandum book of its purchases and sales, and very little else. Consequently, the independent certified public accountant may complete the writing up of the books of account and himself prepare financial statements to which he attaches his report and opinion. What functions is the independent certified public accountant performing when he does such work? It is clear that, if the company had an experienced controller or accountant in charge of its books, the certified public accountant would not have to do all of this work. Therefore, he is on the one hand carrying out the functions of an accountant in preparing an accounting of the transactions for the period, and on the other hand he is functioning as an auditor by checking or passing upon transactions for the period. What he examines is to a large extent, so far as the independent auditor is concerned, hearsay evidence. In other words, he cannot of his own knowledge state the purpose of each transaction represented in the accounts, because he was not a party to the consummation of these transactions. He has examined vouchers, paid checks, sales tickets, and purchase invoices and other supplementary data in order to secure from the accounts statements that fairly present the position and results of operations of the concern. No doubt he has had to make many inquiries of the management and employees regarding transactions. He finally completes his work and has before him financial statements which have been concurrently prepared from the books of account and audited by himself. Some independent auditors may say, "Well, these are the independent certified public accountant's statements and his representations." Is the independent auditor not assuming too much responsibility when he assumes this? Should he not go back to the client and say in effect to him: "Here are the results as I see them, prepared from your books. Are you willing to acknowledge these as your representations as the owner of the business?" If the client, having no doubt been consulted frequently during the examination, agrees that the financial statements are a fair representation of his affairs, then it seems logical that he should assume them as his representations, for, after all, he cannot avoid responsibility for the financial statements of his concern. On the other hand, the independent certified public accountant, having carried out his work as an accountant and at the same time having made an audit of the transactions, is able to give an authoritative opinion upon the affairs of the concern. This, I think, should be the limit of his responsibility and it would be unwise for him to assume voluntarily any further extension thereof. The representations of the client cover the complete details of the transactions, the genuineness of the underlying data such as vouchers, invoices, sales tickets, etc. It is from this collateral evidence that the books are written up and the financial statements prepared.

No doubt a number of public authorities or the courts may be cited in support of the theory that financial statements of a concern, issued with the knowledge and consent of the management, are primarily representations of the client.

In reporting upon the Interstate Hosiery Case, the Securities and Exchange Commission has this to say:

"The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon 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. In our opinion, the conduct of Interstate's management in respect of information which was to be the basis of reports submitted to stockholders and to the New York Curb Exchange and the Commission indicated a complete abdication of responsibility. They brought to bear upon the figures presented by their auditors no judgment of their own, no test from their independent acquaintance with the company's affairs, none of the purposeful skepticism which every author of a public financial statement should direct at his material.

"We conclude that the officers of Interstate were at fault in failing to discover the falsification of the financial statements filed with the Commission."

Again, Robert E. Healy, Commissioner of the Securities and Exchange Commission, in a speech before the Mid-Western Conference of the Controllers Institute of America on May 15, 1939, stated:

"What we need, it seems to me, is a return to the recognition that the primary responsibility for proper accounting rests on the corporate management in the person of the controller. Whether the books are audited or not, the stockholder has a right to look to the corporation's own accounting system for an adequate, intelligible, and honest reporting of its affairs. Unless in its daily bookkeeping the corporation recognizes a responsibility to stockholders and investors, the most conscientious audits lose much of their meaning."

A divergence of views sometimes arises when the standard form of report (certificate) is under discussion. Some object to the statement in the form of report, "We have examined the balance-sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the year then ended," intimating that they had examined the books and accounts of the company rather than the financial statements. I do not see why there should be any objection to this statement, even though it may be argued that it is unnecessary. I think that the first paragraph of the short form of report adopted by the American Institute of Accountants and by the New York State Society of Certified Public Accountants sets forth a comprehensive and brief statement of what has been done. Let us see just what is said in that form:

1. We have examined the financial statements,
2. Have reviewed the system of internal control,
3. Have reviewed the accounting procedures of the company,
4. Have examined or tested accounting records of the company and other supporting evidence,

all by methods and to the extent deemed appropriate. There is no reason why the independent certified public accountant cannot state that he has examined the balance-sheet and statements of income and surplus, even though he has prepared such financial statements from books of account. In this connection, there may be noted from the report of the Institute's special committee on auditing procedure, page 5, last paragraph, the following:

"The services which independent auditors render usually culminate in a report, which may take varying forms. 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 client."

Again, on page 6, third paragraph:

"If the revised short form recommended herein be adopted, the independent certified public accountant should recognize that in some cases it may not be altogether appropriate. For instance, there may be cases where the auditor may prefer to alter the first sentence of the standard short form, substituting some words to the effect that the accounting records (instead of the financial statements) have been examined. Obviously, also, it would be erroneous to mention internal control if none existed. Accordingly, while the proposed form is submitted as a standard, it is not prescribed or recommended for invariable use but should be adapted to the needs of the particular case. For example, the report may be used in connection with an examination covering a period of years, in which case a modification of language would be necessary. Also, in new engagements appropriate investigation relating to prior years will have to be made to justify the use of the short-form report. However, in the interest of reasonable uniformity it is recommended that the substance of appropriate phrases in the standard form be used unless inappropriate."

On page 7, last paragraph, first column, there is the statement:

"It should be borne in mind that the financial statements, with all supplemental descriptive and explanatory data, including footnotes, are regarded as representations of the client. It is upon all these representations that the independent certified public accountant renders his opinion. If he considers explanations essential or desirable, and they have not been made in the financial statements, it will be necessary for him to make such explanations in a separate paragraph of his report."

I think it is a dangerous position to cling to the theory that financial statements accompanied by an independent auditor's report are the representations of the independent certified public accountant. I am quite sure that sound banking procedure would call for a statement signed by the borrower in the case of a loan, in addition to the report and opinion on his affairs made by the independent certified public accountant. I can only advise the independent certified public accountant to be wary of assuming full and complete responsibility for financial statements of others to an extent which the nature of his work does not justify.

Extensions of Auditing Procedure

As business itself has been in an evolutionary state, so likewise has auditing procedure evolved over the years to keep pace with the developments in business. Certified public accountants are continually refining and improving their technique so as to provide, upon an economical basis, reasonable assurance that a fair and adequate presentation of pertinent information has been made in the financial statements.

While businessmen have sometimes resisted extensions of auditing procedure as causing unnecessary expense, the intense public interest arising from the McKesson & Robbins case has resulted in virtual demand for an extension of procedure with respect to inventories and receivables—a demand which the accounting profession is willing to meet. Accordingly, an Institute committee has made recommendations (see "Extensions of Auditing Procedure," THE JOURNAL OF ACCOUNTANCY, June, 1939), now officially approved by the governing body, that in the future it shall be regarded as normal procedure, where reasonable and practicable, for auditors to corroborate inventory quantities by physical tests or attendance at the inventory taking. If for any reason such tests are not made, the auditor shall so state in his report. Similarly, it shall be regarded as normal procedure, where reasonable and practicable, to make tests of accounts receivable by direct communication with debtors and, again, if such tests are not made, it shall be clearly disclosed in the auditor's report.

Physical tests of inventories and direct confirmation of accounts receivable have both been common practices in the past, but they have not invariably been considered required procedure.

FORM OF REPORT

With these recommendations the committee presented a new short form of report of independent auditors, which seems clearer and more to the point than the forms previously used, reading as follows:

"To the Board of Directors (or Stockholders) of the XYZ Company:

"We have examined the balance-sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company, and have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate.

"In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at April 30, 1939, and the results of its operations for the fiscal year, and conform to generally accepted accounting principles applied on a basis consistent with the preceding year."

"REPORT" OR "CERTIFICATE?"

It is not inappropriate to consider for a moment the question of the use of the term "report" instead of "certificate." The Institute's special committee states in its report:

"For present purposes the discussion is confined to the short form of auditor's report, which is sometimes described as a certificate. The terms 'report,' 'report and opinion,' and 'certificate' have been used interchangeably. As uniformity is desirable, the word 'report' is recommended for general use and has been adopted in the following comments."

If we go back into the history of public accountancy in the United States we will find that the term "auditor's certificate" or "certificate of auditors" came into use very shortly after the first C.P.A. law was passed. It was common practice for many years to use the words "certificate" and "certify" without thinking much about the meaning of the words. As I recall it, in many cases the independent auditor would give a "certified opinion," whatever that means, substantially in the following language: "We hereby certify our opinion that . . ." Gradually practitioners got away from that phrase, stating somewhat as follows: "We (hereby) certify that in our opinion . . ." Perhaps the use of the words "certify" and "certificate" had some relation to our title "certified public accountant." Perhaps we felt in the early days that we were practising an exact science. This idea has been dissipated long ago. What does the word "certificate" mean? According to Webster's *New International Dictionary*, second edition unabridged, the following meanings of "certificate" are given:

1. Act of certifying; certification; attestation. *Obs.*
2. A certified statement; a written testimony to the truth of any fact; hence, anything that produces the same result as such a document; a certification.
3. A written declaration legally authenticated; hence, specif., in England, a paper by which the majority of an insolvent's creditors agree to his discharge.
4. *Educ.* A document certifying that one had met the requirements of a course or school or passed a final examination.

The meanings of the word "certify" are given as follows:

1. To give certain information of; to make certain, as a fact; to test authoritatively; to verify.
2. To testify to in writing; to make a declaration concerning, in writing, under hand, or hand and seal.
3. To give certain information to; assure; make certain.

Many practitioners in the light of the definitions of the words "certificate" and "certify" feel that we are going beyond our function in using them. After all, the purpose of an examination of accounts is to enable the independent certified public accountant through his training and experience to form and give an opinion upon the financial statements of a concern. It follows that such an opinion should be sound and authoritative. No doubt more will be said upon this subject, but evidently the trend at the present time is away from using such words as "certificate," "certify," "verify," etc.

It is expected that this form of report will be widely adopted. If found without qualification, the reader may assume that the auditor has satisfied himself by all the usual methods, now including physical tests of inventories and test confirmations of accounts receivable, that the financial statements are a fair presentation of the balance-sheet position and operating results.

Qualifications

However, it is from time to time necessary for independent auditors to add qualifications or exceptions, or explanations, in their reports. No reputable accountant wishes to avoid responsibility by dodging behind technical phraseology, but there are frequently circumstances in which all he can do to clarify his position is to insert a qualification or explanation in his report. For example, it may be impossible for various reasons to make physical tests of inventory quantities. The auditor may have no reason in the world to doubt that the representations of management are correct, but he will be required to insert in his report an explanation that for reasons indicated physical tests of inventories were impracticable. In other cases there may be honest differences of opinion between the client and the independent auditor as to the accounting treatment of a given item, and in such cases the auditor will take exception which the reader can weigh in the light of his own judgment.

Obviously, no accountant should express an opinion that financial statements fairly present the position of the company and the results of operations, when his exceptions are so numerous or so important as to negative the opinion, or when his examination has been less in scope than he considers necessary.

Inventories

It seems unnecessary to state that the accountant does not assume the responsibilities of a general appraiser, valuer, or expert in materials. However, this cannot be repeated too often at the present time—for the purpose of making clear to the public that the extension of auditing procedure in respect to inventories is not in any sense in the nature of a guarantee or insurance as to their accuracy. No certified public accountant would be foolish enough to regard the opinion contained in his report as an insurance policy, and the reader of his report should also have this in mind. On the other hand, it will be recognized by stockholders and creditors of companies that there are great advantages, tangible and intangible, in having the independent auditor come into direct contact with the physical properties of the company, for in this way he becomes familiar to a greater degree with the business he is examining. In time he acquires valuable knowledge of the company's production and operating methods, which will assist him in arriving at sound conclusions in connection with the accounts. If he is alert and vigilant in performing his duties, persistent in seeking the truth, and imbued with a spirit of exploration, it will be difficult to inflate inventories to any material degree. Therefore, in undertaking physical tests of inventory quantities, certified public accountants wish to make it quite plain that they are not prepared to accept responsibility for quality, condition, or value of inventories. They are not appraisers, nor experts in materials. They have no means of telling of their own knowledge as accountants that what is alleged to be ten-year-old Scotch whiskey is not in reality a greatly inferior liquid. They cannot pretend to know the value of diamonds, or various grades of coffee, tea, or tobacco. They cannot pretend to appraise the style factor as an element of marketability of textiles and garments. As accountants, they must depend essentially on the accounting records of the company to show the cost of inventory and price received for finished products, and to trace the income and outgo of materials. Within these limitations, however, their physical tests of inventory quantities are valuable in serving to substantiate and corroborate the accounting records.

Physical checks on inventories by independent auditors involve certain conditions which do not apply to the audit of bank balances, accounts receivable, accounts payable, and the various other business accounts. These conditions relate to the date of the accounting, the volume of the inventory, the time and number of men necessarily required.

The general accounts can be, and usually are, examined many weeks after the closing date of the period covered by the audit. The information obtained as a result of transactions after the closing date is often of considerable value to the auditor.

A large percentage of manufacturing and mercantile concerns close their accounts as at December 31st of each year—and one of the greatest practical difficulties involved relates to the question of simultaneously making physical checks of numerous inventories, all as of the same date.

The volume of detail work must also be considered. In many concerns practically the whole office staff, together with the storekeepers and foremen, assisted by a large number of the operatives, is employed in the taking of the inventory. Often it is found to be necessary to close down the manufacturing operations during the period of inventory taking. It is obvious that for all practical purposes independent auditors should not do more than test the taking of any large physical inventory. Calculations will be made, of course, at a later date.

The practice of keeping perpetual inventory records by business concerns has been steadily increasing for many years and will probably increase still further. It is usual to make continual physical check of these inventory records throughout the year and a practical solution of a physical check by independent auditors may be found to lie in a series of checks at dates independently decided upon by them.

The numerous practical problems involved will require careful consideration by independent accountants, but I am confident that these problems will be faced and solved.

Summary

If I were to attempt to sum up in a few words the position of the independent auditor, I should say something like this: Every corporation is primarily responsible for representations of its financial condition to its creditors and stockholders, and there is a valid presumption that such representations are generally honest. Independent auditors are employed as outside experts who recognize a duty to the public as well as to the client, to make an objective review of the company's affairs and report an impartial opinion as to whether or not the representations of the company are adequate and fairly presented. The independent auditor's function is a necessary one, because without his skilled examination and his critical and dispassionate judgment the public might be misled through the company's ignorance of proper accounting methods; through overoptimism on the part of the management; through fraud or error on the part of employees.

Certified public accountants have always been highly sensible of their obligation to the public at large, to investors, to credit grantors, and to all others interested. They know full well that their chief asset is a reputation for integrity, ability, and objectivity. Quite obviously, there would be little demand for their services if the public generally doubted whether they possessed these qualities. It may be accepted without hesitation, therefore, that on the grounds of enlightened self-interest alone, to leave out of consideration for the moment the elements of professional pride and natural honesty, the certified public accountant will strive to the utmost of his ability to present an opinion that will be clear, helpful, adequate, and independent for the purposes of those who read it.