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Accountant's Report from the Standpoint of the Several Parties at Interest

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The Accountant's Report*

From the Standpoint of the Several Parties at Interest

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The practice of accounting in the United States may, in general terms, be classified under three captions, viz.:

1. Current audits—covering the annual or periodical examination of public or private corporations, co-partnerships or individuals.
2. Special examinations or investigations for one or more definitely stated purposes. Under this caption may be included such work as the examination of several properties for the purpose of (1) merger or consolidation; (2) the sale to the public of securities; (3) examinations in respect of liquidation, reorganization or bankruptcy; (4) adjustment of partnership affairs; (5) the determination of the reasons for material reduction in gross or net revenues; (6) investigation of charges of mismanagement or fraud, diversion or misapplication of funds or other property; and (7) such other special data as may with propriety be specifically requested by the client.
3. Preparation and installation of systems of accounting, costs, efficiency, etc., and the organization of the departments directly affected thereby.

In addition to the work of the accountant indicated above, the American accountant is, to a large extent, the confidential advisor of his client in many matters appertaining to the production and distribution of commodities dealt in, as well as in matters of finance. In his valuable work on *Auditing*, Robert H. Montgomery says:—

> It is always a question as to how far a professional auditor should go in giving advice. Some accountants of long experience and large practice unqualifiedly recommend that an auditor's duty is to state facts, and facts only, and that inferences therefrom as applied to past or future are not to be drawn by professional auditors. The author feels, however, that

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this is another point in practice where an auditor can frequently be of substantial assistance to his client by going somewhat beyond the facts and figures and stating, modestly and without prejudice, the effect certain methods have had or may have in the future.

In the same work, Mr. Montgomery says that "auditing, in its broadest sense, is the most important branch of accountancy"; and further states "the purposes of an audit" as follows:—

In what might be called the formative days of auditing, students were taught that the chief objects of an audit were:

(1) The detection or prevention of fraud;

(2) The detection or prevention of errors;

but in recent years there has been a decided change in the demand and in the service. That is to say, the financiers and business men who originally retained professional auditors to look for fraud or errors have enlarged their demands and now require a vastly broader and more important class of work, which those who have advanced in skill and knowledge have been able to understand and perform. We must therefore relegate the former "chief objects" to a subordinate position without in any way depreciating their importance.

The relative position of the present-day purposes are:

(1) To ascertain the actual financial conditions and earnings of an enterprise for

- (a) Its proprietors (partners or stockholders).
- (b) Its executives (managers, officers, or directors).
- (c) Bankers or investors who are considering the purchase of securities.
- (d) Bankers who are considering the discounting or purchasing of its promissory notes.

(2) The detection of fraud or errors as hereinafter explained.

The results secured by auditors are required for the following, among other purposes:

- (a) In order that stock and bond holders and other owners may have submitted to them at regular intervals a comprehensive, even though a condensed, statement of the financial position and the net results of the operations of the business in which they have a proprietary interest, and that the fairness and accuracy in all essential particulars of the statement submitted may be attested by means of a certificate or report of a disinterested and competent authority.
- (b) Upon a proposed sale or incorporation or other change in form or management, such as an attempt to bring in additional capital or the death of a partner or large stockholder. Matters of the highest importance arise in connection with the interests of partners in the event of death or other change in the partnership relations.
- (c) To submit similar statements in more detail to banks and note brokers as a basis of credit.
- (d) To submit certified statements to the mercantile agencies and to other organizations which call for periodical reports.
- (e) To ascertain the true causes of fluctuations in profits or expenses.
- (f) To state the facts in dispute or litigation, and to investigate the causes of bankruptcy for creditors or stockholders.

This is a partial list only of the manifold purposes for which audits or investigations are being demanded.

The nineteenth century auditor who looked chiefly for fraud or errors no doubt served a useful purpose, but his methods now illustrate the history rather than the modern practice of auditing.

In *Accounting Practice and Procedure,* A. L. Dickinson defines the duties and responsibilities of the public accountant as follows:—

(1) Those in respect of the prospectus, or the preparation and certification of accounts of past results for the purpose of the sale of a business or the issue of new securities.
(2) Those in respect of an audit, or the examination, audit and certification of the annual statements of accounts.
(3) Those in respect of liquidation and reconstruction, involving the preparation of statements and reports upon the condition of a business which, by reason of financial difficulties, is put into bankruptcy or into the hands of a receiver, and the preparation of further statements and reports for the purpose of its reorganization.

For the purposes of this discussion, I have considered the accountant's report as covering either an audit for a current fiscal period or an examination covering several fiscal periods—the report in either case stating the financial condition at the beginning and the end of the period under review and the revenues, expenses and other items entering into the profit and loss, surplus or deficit for the same time.

The accountant's field of labor is being so rapidly enlarged that any statement as to those interested should, within a comparatively short time, be materially increased. Some of the principal interests at this time may be summarized as follows:—

1. The management—including
   (a) Operating officers
   (b) Financial and administrative officers
   (c) Executive officers
   (d) Directors.
2. The owners—being
   (a) Partners (if a co-partnership)
   (b) Stockholders (if a corporation)
   (c) Taxpayers (if a municipality).
3. The investor—including
   the holders of bonds, debentures, mortgages or other deferred or long-time obligations of the business—considering such obligations as part of the capital invested in fixed property or working capital.
4. The creditor.
5. The banker.
6. The attorney.
7. The insurer—including under this caption

(a) Sureties on fidelity bonds of officers and employees
(b) Insurance companies liable for the value of physical property destroyed or damaged by fire, tornado or other causes.

8. The prospective investor
9. The promoter—
   or broker on whom devolves the sale of securities.
10. The federal government—
    (Department of internal revenue) in relation to the federal income tax.
11. Federal and state commissions—
    being those bodies charged by the duly constituted authorities with supervision or control of common carriers, public utilities, etc.
12. The accountant.

In beginning the preparation of this paper, I did not fully realize the numerous phases of the subject, any one of which would furnish grounds for an interesting discussion. In attempting to discuss some of the many viewpoints of the rather numerous and sometimes widely divergent interests, it must be remembered that this article is intended to promote discussion rather than be considered as a conclusive argument.

I have therefore endeavored to cover such of the principal matters as present themselves most forcibly, and submit same for your consideration and discussion.

THE MANAGEMENT

As to income—

(a) The volume, nature and source of gross revenue, under appropriate captions.
(b) The cost of producing the revenue—with data as to proportionate cost of production, distribution, selling, administration, taxes, interest, etc.
(c) Comparison of gross revenue, costs, expenses and net results with preceding fiscal periods, and the reasons for important fluctuations.
(d) Specific items of cost; so that there may be determined the most profitable lines, branches, or departments, to the end that capital and the property created by it may

be used to the best advantage and the maximum of efficiency be attained.

(e) To what extent has the productive capacity of the plant been employed.

(f) That all items, known or ascertainable, applicable either as revenue or expenses, are included in the results stated, and that the proceeds are properly accounted for without misappropriation, conversion or diversion.

As to financial condition

(g) That the balance sheet well and truly states the assets and liabilities of the business under such appropriate classification as will reflect the true condition.

The proper classification of assets and liabilities is so largely a matter of the special line of industry that any attempt to state a general classification would be out of place at this time. It is safe to say that the classification should always be so full and complete that the fixed or permanent assets may be readily distinguished from current or liquid assets, accrued, deferred and contingent assets. Similar attention should be given and somewhat similar captions used to state liabilities, but with additional captions showing appropriated surplus in the form of reserves for various purposes.

THE OWNER

Speaking in general terms, the owner's direct interest is in the payment of dividends or return on invested capital, but especially that any such payments are from revenue earned and realized. He is further concerned to know that (1) the property has been fully maintained; (2) that all accounts have been honestly and faithfully recorded without misappropriation or unauthorized conversion or diversion; (3) that the productive capacity has been employed to the largest extent compatible with profitable operations; (4) that the statements of income, profit and loss, and financial condition (together with detailed exhibits or schedules necessary) are clear and accurate and include all transactions, and (5) the disposition or application of the net income during the period and of the net assets at the beginning of such period.

THE INVESTOR

That (1) the physical property pledged as security for mortgages and funded debt has been fully maintained as to its physical condition and is protected against loss by adequate insurance; (2) that sufficient reserves are provided out of revenue for the extinguishment of the debt; (3) that the net earnings are sufficient for the creation of such reserve as indicated in the preceding paragraph and for the prompt payment of interest when due, and (4) that unwarranted or excessive dividends are not paid, resulting thereby in impairment of the security, or in deferring payment of interest and principal.

The report which most appeals to the average investor is that which, eliminating technical terms as far as possible, briefly states results in plain yet comprehensive language.

THE CREDITOR

That (1) such assets are available as may be converted into cash prior to maturity of current liabilities and applied to the discharge of such liabilities, and (2) that the business is operated on such a basis as will produce returns which will enable the management promptly to meet maturing obligations.

The standpoint of the creditor is very ably stated in a recent article on *Credit* by A. N. Hogg, credit manager of the Corn Exchange National Bank of Philadelphia, in which he says (in part):

A concern may be honest in the ordinary acceptance of the term, and yet make a statement which, while not actually fraudulent, may be misleading enough to secure for that concern an unwarranted line of credit.

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In addition to the regular questions covering the various items of assets and liabilities, a statement form should also call for certain special information. We might list these special items in order, as follows:

Amounts due by officers, stockholders or sales agents.

Amounts due by subsidiary or controlled companies. (In the case of a firm this item should read "amounts due by members of firm.")

Amount of assets pledged as collateral.

In the liability column the amount of liabilities secured by collateral, judgment note, or otherwise, should be specified.

Other information should also be obtained on the following points:

Amount of contingent liability, either by accommodation indorsement, bills receivable outstanding, or any form of guarantee.

Annual volume of sales.

Losses by bad debts.

Total amount of expenses.

Net profit.

Annual dividends, or amount withdrawn by partners.
Amount charged off for depreciation to plant and machinery.
Are all bad or doubtful assets excluded from statement?
Amount of fire insurance.
Bank accounts.
Are books audited? If so, by whom, and on what date?

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The practice of having statements certified to by a certified public accountant is rapidly growing in favor, especially among the better class of business concerns. Such statements help immensely in the attitude assumed towards the risk, for such certification indicates a disposition on the part of the borrower or purchaser to be fair and frank with the creditor as well as with himself.

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The audit by reputable accountants is desirable. Such accountants will not countenance flagrant misrepresentations of value, and they will not indorse any estimates or methods which are not in accordance with a fair standard of ethics. Care, therefore, should be observed about statements audited by obscure accountants who might be tempted to overlook breaches of honesty, or might do so through ignorance.

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Finally, in forming an estimate of any risk, based on the financial exhibit, it is of primary importance to keep in mind, not only the quality of the risk based on the enterprise as a going concern, but the probable situation from a creditor's standpoint, should the business at any time be wound up or liquidated.

THE BANKER

At a recent meeting of the Association of Reserve City Bankers, L. F. Kiesewetter, vice-president of the Ohio National Bank of Columbus, Ohio, read a very interesting paper on *Audited Statements,* in which he most ably discusses the interest of the banker in the accountant's report. In this article, Mr. Kiesewetter says (in part):

At the meeting in Cincinnati last year this association resolved unanimously to favor, in the purchase of commercial paper on the open market, such concerns as furnish audited statements.

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When we speak of audited statements, we have reference to the practice, common enough by now in this country to be very well known, of the furnishing by certified public accountants, or auditors, of reports over their signatures of the condition of the affairs of an individual, firm or corporation, as far as it (the condition) can be expressed in figures and in the form of a balance sheet; a certificate being appended explaining in more or less detail what the investigation has covered. If this is extended to a tabulation of revenues and expenses we have the element of time introduced, which adds to our ability to judge what the business under inspection looks like at a given date, also the very important and supplemental fact as to whether, and what kind of, progress is being made.

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I will now take up the detailed analysis of audited statements. It is not alone important, but positively necessary, that we analyze such reports and know how to do so; else they lose their value to us altogether;

else how are we to determine so far as the statement shows, whether, upon maturity of the proposed paper, there is a reasonable certainty that the borrower will have funds with which to pay the obligation; whether, if unforeseen circumstances prevent payment at maturity, we can rely upon the ultimate settlement of the obligation.

Assets are of two classes, quick and variable, or slow and permanent. While it is desirable to analyze both classes, the commercial banker's interest centers more often, and rightly so, in the quick assets; I believe it to be a good general rule for the commercial banker's guidance that he confine his credit to any concern to an amount governed by the extent to which it (the concern) can expand and contract without injury; if he goes further than this he does himself and the concern harm. This is the object of his analysis of a statement, to determine within what limits the concern can comfortably enlarge or retrench. Any further credit than this is becoming a part of capital resources, and should be treated by other methods and in accordance with other facts and standards.

Quick assets are:

First—Cash on hand or in bank.

These should be segregated. The cash drawer may contain items which would not circulate at par; cash in bank may be tied up by liens, or it may disappear a few days after the report through dividends or other special disbursements. It is useful to know whether the cash balance shown is normal or temporarily large in anticipation of giving a statement.

Second—Notes, bills, accounts receivable.

How do they compare with amounts shown on previous reports? Are they larger than customary in the applicant's line of business? Do they indicate lax credit methods or poor collections? Are they all good, and of what maturity? Do any of them represent renewals or are they past due? Do they arise in the regular course of business or do they represent loans to officers, employees or others? Have they been taken in payment of capital stock or from partners? If so, they represent a decrease of capital. Notes or bills receivable particularly may mean slow paying customers and extended credit. Has sufficient allowance been made for bad debts? If the business is national in its scope, is the geographical distribution of the accounts good or is the bulk of them confined to territory where business is poor? Are advances to salesmen for expenses included? Are any of the notes or accounts in the hands of attorneys for collection? Do they, perhaps, represent balances due from branches or subsidiary and affiliated companies, being, therefore, investments? Are any accounts for rents included, for consignments, for shrinkage on merchandise, for extra allowances, rebates, etc., any charges to customers subject to completion of contracts? Have any accounts been sold to discount companies?

This list of questions could be continued much further.

Third—Merchandise.

How soon can it be turned into cash or accounts receivable? Is the proportionate amount of it abnormally large, indicating overstock? Were the figures obtained by actual or by book inventory? If by the latter, is the system correct and is it faithfully followed? If by the former, did the method insure accuracy as to quantities? Was cost price used or market price? Was any profit included? Was clerical work in computing quantities or values done accurately? Does inventory include goods that are shop worn or out of date? Is any part pledged as security or subject to lien? Is merchandise located in one place or is it distributed in warehouses, branch offices or sales agencies? Were consigned goods included by mistake or otherwise? Does the inventory include goods just received for which invoices have not yet been entered as accounts payable?

From these few suggestions you can see how far reaching must be the investigation by the auditor and the analysis by the banker, to be of value. I think I have indicated enough to establish this point beyond question.

Turning to the other side of the balance sheet we have a similar situation as with assets, namely, two classes of liabilities, the quick and the slow. Again the banker's interest centers more largely in the quick liabilities, which represent usually the obligations of the concern to the public. Its slow liabilities are its obligations to its own shareholders or partners, or debts that are specifically secured, as in the case of bond issues.

Quick liabilities are:

First—Notes payable.

How much is due to the applicant's own bank or banks? How much for paper sold through brokers? How much consisted of notes in payment for merchandise? Are bank loans used to discount merchandise bills? Does applicant depend upon banks permanently for working capital? Are lines of credit used to the limit or has the concern left a place open for emergencies? Are any notes payable to officers, stockholders, relatives, friends, partners? Are any of these specially secured by liens on assets? Have notes been given for purposes other than the regular business?

Second—Accounts payable.

What is the practice of the applicant regarding the entry of accounts payable on his books? Is this done promptly? Are any accounts past due? Are there any particularly large items in the notes or accounts which should be investigated?

Third—Long time obligations, in the way of mortgages or bonds.

These involve quick liability for interest. If they are of serial maturity, that part coming due shortly should be classed as quick. Does the mortgage cover more than permanent assets? Does it cover after-acquired property? May it be a prior lien on all current assets?

Fourth—Contingent liabilities.

A very important matter. Are notes receivable discounted? Does the concern endorse for subsidiary or allied companies? Has it entered into any contract, such as for the purchase of additional equipment, supplies, real estate, or for the erection of new buildings? Is insurance to a sufficient amount kept in force? Is it assigned?

Fifth—Profit and loss account.

Here we get the measure of the ability and success of the management. Needless to say that it is an account which should be scrutinized very carefully. We find many concerns reluctant to furnish the needed figures, but the item is of such vital consequence in connection with assets and liabilities that the lender of credit should have the facts. Are all the credits properly classed as income? Do they perhaps represent sales of assets? Comparing debits with previous statement, are depreciation charges omitted or reduced so as to make a good showing in lean years? Has there been a change in the method of taking the inventory? Are repairs and maintenance costs capitalized? Is any large portion of the earnings due to a single, a big, or lucrative contract which may soon expire?

Sixth—Ratio of quick assets to quick liabilities.

An interesting figure which it is important to watch, which may, it is said by authorities, be lowest among jobbers, should be higher with retailers and highest in the case of manufacturers.

Finally, the certificate of the auditor attached to the report with his comments. This should be read very carefully by the banker and every word considered.

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We, in this country, might do well to ponder over the English custom of having the shareholders of a corporation designate and employ the accountants who are to look after their interests, and who, by such appointment, are officers of the company and can be held responsible as such. Directors can suppress an auditor's findings; but a report to shareholders reaches those who are primarily interested. I believe this is very important.

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What is equally important is that the accountant's certificate should be more explicit, much more so; the items in the report should be explained at greater length; I am thoroughly of the opinion that certificates usually are inadequate and liable to be considered of greater value than they, as a matter of fact, possess.

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To recapitulate, what are our conclusions:

First—Auditing attempts to summarize in figures the condition of any business as a basis for determining net worth, but does so only approximately.

Second—Tendency in modern banking, sustained by rulings under the new banking law by the federal reserve board, is to require reports of condition and collateral information from borrowers. It is believed by many that independent persons, who are experienced and skillful in accounting and are honest and fearless in their methods, furnish more desirable information to the lender than would be obtained if supplied by the borrower himself.

Third—Audits represent conditions at a given date only, and at best are only estimates.

Fourth—Positively necessary for banker carefully to analyze statements, which is demonstrated by suggesting some of the questions which should be asked about them.

Fifth—Certificates attached to audited statements by accountants should be much more explicit and complete.

Sixth—Auditor cannot be held responsible for his representations, but only for use of skill, experience, good faith and honesty in his work; he is more than a bookkeeper, but is not a guarantor.

Seventh—This point of view, of an auditor's responsibility, is occasioned by the difficulties encountered in determining what is price, what is value, and the accuracy with which the assets and liabilities of a business have been estimated in either or both.

Eighth—Opinions of those who have observed the business history of many thousands of this country's most important concerns, which are, that, while audits are desirable, they do not at all prevent failures—they bring to light bad conditions quicker, they need able, honest and fearless men to make them, and at that they are not a cure-all.

Finally, therefore, as one of my friends, who is an accountant, well states: "Credit is founded on three essential things, the borrower's character, his business capacity, his capital. The last item, we learn from the analysis of his statement; it may throw some light on the other two factors.

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If we clearly understand how much they mean, audited statements will assist all of us very materially.

THE ATTORNEY

In matters appertaining to receivership, bankruptcy, executorship and the like, as well as to accounts in litigation, the attorney —as well as the court— is interested in accurate reports, stating all information which has any bearing on the matter at issue. In matters of this kind, the accountant must remember that his findings must be such as may be maintained or corroborated in accordance with the rules of evidence.

THE INSURER

The surety on fidelity bonds is interested in the audit to the extent of knowing that the accounts of all officers or employees covered by such guaranty are accurately stated, and that no misappropriation or diversion exists which would result in legitimate claim on the surety.

The insurer or guarantor against loss by fire, tornado or other destruction of physical property is interested to the extent of knowing that the accounts and records are so kept that the then value of plant, buildings, equipment, merchandise, etc., may be accurately determined in event of such loss as would result in claims against the insurer. Further interest is involved in the so-called moral hazard, which, as a general thing, is created through undue losses from operation or realization—ultimately resulting in insolvency. It may be stated as a general rule that, if a business is prosperous, there is no inducement to sell out to the insurance companies.

THE PROSPECTIVE INVESTOR

Under this caption may be included such persons as have under consideration investment of capital, in any form, in the enterprise. Such persons require definite and exact information as to (1) financial condition at the present time as compared with prior dates; (2) comparative gross revenue, cost and expenses of operation, net revenues and all charges against same, such data being stated for a period long enough to determine the stability of the business (such stability may not be determined so much by averages as by the study of results for a successive period of years); (3) disposition of the net profits, and (4) the business ability, financial standing, integrity and general character of the management. The prospective investor is interested perhaps even more than the banker, for the banker's interest is, as a rule, more of a temporary nature than that involving a permanent investment which is usually converted either into property assets or fixed working capital.

THE PROMOTER

This title is not meant to apply to the irresponsible or unauthorized persons who have so largely brought the term into disrepute, but is intended as a reference to the reputable broker, agent, or salesman who in good faith undertakes to act as an intermediary between the investor seeking legitimate application of available funds and the business or enterprise seeking new or increased capital for creation of or additions to legitimate fields of industry. Such a promoter to continue in business must consider safety first; the integrity of the investment of his clients' funds must be of more importance to him than his immediate personal profit.

His interest in the accountant's report is that it shall be complete and accurate in all particulars, and, within the greatest possible limits, conservatively state results and conditions. Reasonable and conservative statements should naturally contain fair and proper provision for depreciation, either by waste or obsolescence, as well as all other contingencies, but not to the point of extreme pessimism. The accountant must be neither optimist nor pessimist; he must be fair, just and reasonable, and, to the utmost of his ability, steer a middle course between the extremes. There are, unfortunately, some recent instances where investments have resulted in heavy losses through failure to state contingent liabilities as well as by over-valuation of assets and understatement of liabilities. On the other hand, the capitalist has sometimes lost the opportunity for an excellent investment through extreme pessimism or excess of caution on the part of the auditor.

THE FEDERAL GOVERNMENT

The interest of the internal revenue department of the federal government—in connection with the federal income tax—is apparent.

The officers of this department have announced their intention of examining the accounts and records of many corporations and individuals, but it is reported that some of the officers of the treasury department have said that returns filed with the department, corroborated by the certificate of reputable accountants, would probably be accepted without question unless there were reasonable grounds for belief or specific evidence of misrepresentation or fraud.

FEDERAL AND STATE COMMISSIONS

The several federal and state commissions, charged with the supervision or control of common carriers, public utilities and the like, are interested in the accountant's report in so far as such report either corroborates or is in conflict with the reports filed by such companies with the commissions as required by statutes relating thereto.

THE ACCOUNTANT

The interest of the accountant in his reports is a subject which might well receive exhaustive and serious consideration and discussion. All that may be said on the subject must finally be condensed, in the last analysis, into a single word—*reputation*.