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What's Behind the Figures?

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Presented before the North Coast Chapter of The California Society of Certified Public Accountants, Petaluma, California — February 1959

DURING the past few years a great deal of attention has been directed by the accounting profession, and particularly by the American Institute of Certified Public Accountants and our own California Society of Certified Public Accountants, to promote better understanding between independent public accountants and bankers as well as other credit grantors.

In reaching a decision whether to extend credit, a banker considers many factors. Among the more important of these are the financial position of the borrower and the results of its operations as shown by its financial statements. To a great extent, bankers have come to rely upon us, the independent accountants, for an opinion as to whether the financial statements present fairly this information.

The banker desires the unqualified opinion of the independent accountant, expressed in language similar to that contained in the standard short form of report developed by the American Institute of Certified Public Accountants. The language of the standard short form has been developed to express precisely and concisely the independent accountant's representations as to the examination performed and his conclusions as to the financial statements. While these representations could be stated at greater length, added words would not alter the essential character of what is stated, and the general acceptance of this short form unqualified opinion gives it added weight as a symbol of fair presentation in conformity with generally accepted accounting principles.

Perhaps one point should be stressed above all others. The accountant's opinion, whether unqualified or qualified, is not formed merely by checking figures in the books or other records. Many questions arise during an examination that require the exercise of mature, experienced judgment. Obviously the value of a CPA's opinion rests on the quality of his judgment and his independence. In expressing an opinion, the accountant assumes a heavy responsibility for the professional competence of his work.

One question which a credit grantor asks when he ponders the question, "What's behind the figures?" is really, "*Who* is behind the

figures?" On the one hand he evaluates the other factors connected with the prospective borrower—reputation, quality of management, product, trends in both the business and the industry, and many others. On the other hand, however, he considers *who* is the independent accountant behind the figures, and in this connection the credit grantor is looking not for size, but quality. Every time we express an opinion on financial statements that meet standards of good reporting, we add our contribution to the stature of the CPA in general and of ourselves in particular in the minds of the credit grantor and public. When we allow our name to appear on an opinion associated with financial statements that are something less than a fair presentation with adequate disclosure, we do our entire profession and ourselves a disservice.

Let us get back to the question "What's behind the figures?" If we had to answer that question in a few words we might say, "The Accountant's Opinion." Through the years the accountant's opinion has come to mean the same thing to the banker in Providence, R. I., or the underwriter in Los Angeles, the Securities and Exchange Commission in Washington or the Pacific Coast Stock Exchange in San Francisco. It is the hallmark of a profession in which we can all take pride.

SHORT-FORM REPORT

We might well devote a few moments to certain parts of the standard short-form opinion.

The first is "auditing standards." Whereas auditing procedures must be varied to meet varying degrees of internal accounting control, size of the engagement, and other factors too numerous to mention, standards to be observed in selecting and applying the procedures are the same in all examinations. There is not one set of standards for a manufacturing company, another for a non-profit association, and a third for a professional firm submitting a statement of assets and liabilities arising from cash transactions. We might be surprised if we knew what proportion of the business community read the expression "our examination was made in accordance with generally accepted auditing standards" every working day of the week and have never once read what those standards are. These standards include general standards, standards of field work, and standards of reporting, and compliance with these standards requires no little education and technical proficiency.

To summarize these standards, or ground rules of our profession, the general standards are:

- The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
- In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
- Due professional care is to be exercised in the performance of the examination and the preparation of the report.

The standards of field work include:

- The work is to be adequately planned and assistants, if any, are to be properly supervised.
- There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
- Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Finally, the standards of reporting are:

- The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
- The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
- Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
- The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report shall contain a clear-cut indication of the character of the auditor's

examination, if any, and the degree of responsibility he is taking.

When we state in our opinion that our examination was made in accordance with generally accepted auditing standards, we accept the responsibility, which goes hand in hand with that statement, that each and every one of the standards have been met.

The program of procedures for any particular engagement is developed through the exercise of the experienced judgment of the Certified Public Accountant. This philosophy is summed up in the standard opinion in the words, "our examination . . . included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

What is the significance of the expression "present fairly"? Many of the items in financial statements require approximations by company management, at least in part, such as the determination of an adequate allowance for doubtful accounts or the portion of costs incurred in the current period which will benefit future periods. For this reason, it is not possible to say "exactly present" and accordingly the CPA usually states that the financial statements "present fairly" in the sense he believes they are substantially correct. It should be borne in mind, however, that this judgment is an informed one and is guided by generally accepted accounting principles.

What then are "generally accepted accounting principles?" They are a body of conventions for dealing with accounting problems. They have been developed over the years as a result of study and experience in presenting useful financial information, and have come to be widely recognized as sound guides in making accounting decisions. When financial statements have been prepared in conformity with generally accepted accounting principles, they should reflect financial facts fairly, even though approximations and estimates have been necessary. The series of Accounting Research Bulletins issued by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants are expressions of generally accepted accounting principles with respect to the matters covered by the bulletins.

LONG-FORM REPORTS

Are the auditing standards for a short-form report any different than those for a long-form report? No. The auditing standards to be

observed by an independent accountant, as already stated, are the same regardless of whether he prepares a short-form or a long-form report. The important difference between the two kinds of reports is that the long-form report generally includes supplementary financial information in the form of schedules or otherwise, and perhaps even commentary relative to significant items in the balance sheet and statement of income or description of the scope of the auditor's examination beyond that which normally appears in the short-form reports. In some cases both a long-form and a short-form report are issued on the same engagement, but in many cases the long-form report constitutes the only report issued by the auditor. The accountant's opinion which makes up part of the long-form report is very often identical in form to the standard short-form opinion; however we should be sure we are conversant with Auditing Procedure Bulletin 27 on "Long-Form Reports."

This bulletin states in part under Paragraph 6, "It is the opinion of the committee that, in the absence of a statement by the auditor to the contrary, it may be presumed that he assumes responsibility for such other data in the long-form report, to the same degree that he does for individual items in the basic financial statements; that is, that they are fairly stated in all material respects in relation to the basic financial statements taken as a whole." The bulletin continues under Paragraph 7, "The committee believes that in some instances the auditor may wish to clarify his position in the foregoing respects by a brief statement in his comments, or as a preface to a separate section of the report which includes the other data explaining:

- a) That the auditor's examination has been made primarily for the purpose of formulating his opinion on the current year's basic financial statements taken as a whole,
- b) That the other data included in the report, although not considered necessary for a fair presentation of the financial position and results of operations, are presented primarily for supplementary analysis purposes, and either 1) that they have been subjected to the audit procedures applied in the examination of the basic financial statements and are, in his opinion, fairly stated in all material respects in relation to the basic financial statements, taken as a whole, or 2) that they have not been subjected to the audit procedures applied in examination of the basic financial statements, stating the

source of the information and the extent of his examination and responsibility assumed, if any.”

One of the complaints occasionally heard from credit grantors is that they want to know more about “what’s behind the figures” or to be more specific, they want more figures. In this connection we should be most careful that the rendition at the same time or at some later date of additional information or of a long-form report does not leave us open to liability for failure to make adequate disclosure in our short-form report.

The State Street Company case*, one of the more mildly publicized cases concerning accountants’ liability, pertained to the rendition of a long-form report to the client only, thirty days after a condensed report had been issued in ten copies and was used for the purpose of securing a \$300,000 loan. The plaintiff contended that the condensed statement carried with it the unqualified opinion of the accountants, while the long-form report was, in effect, qualified by making it subject to comments that did not accompany the earlier condensed statement. The long-form report disclosed certain information about accounts receivable which led to conclusion by plaintiff that the allowance for doubtful accounts was not adequate and that the accountants were guilty of gross negligence in rendering their condensed report. The jury rendered a verdict in favor of plaintiff whereupon the trial judge directed a verdict for the defendants which was affirmed by the Appellate Division of the Supreme Court, and finally reversed by the Court of Appeals of New York.

If bankers and other credit grantors want details and comments regarding financial position and results of operations, the independent accountant should be asked at the outset of the engagement to prepare his report accordingly.

Another “deficiency” attributed to CPAs by some credit grantors is that we do not present details as to the scope of the examination.

To cite some specific examples:

As to receivables:

- What, statistically speaking, were the results of direct confirmation of accounts receivable?
- What was the extent of tests to verify aging of portions of outstanding receivables classified as 60 days, 90 days, or over 90 days old?

* State Street Trust Company v. Ernst, 278 N.Y. 104, 15 N.E. 2d 416 (1938).

- Were subsequent collections inspected, and to what extent?

As to inventories:

- What was the extent of observation of physical inventories?
- What procedures were followed in verifying accuracy of compilation of inventories, including pricing?

As to property:

- What steps were taken to determine that substantially all property shown on the balance sheet is still physically on hand and in use unless segregated as non-operating property?

As to liabilities:

- What procedures were followed in satisfying ourselves that there are no material unrecorded liabilities?

These are but a few, but you will notice that in most cases these questions have one common denominator. The credit grantor finds himself substituting his judgment for that of the independent accountant in arriving at a conclusion that adequate verification procedures have been followed.

Although some long-form reports comment in considerable detail on auditing procedures employed, many independent accountants believe such comments might be misunderstood rather than being informative to bankers and therefore omit them. It is just not practicable in a report to describe fully the program followed and the considerations pertinent to setting up the particular program. However, of even greater importance is the fact that no one can judge solely from a description of audit procedures whether an examination was adequate in the circumstances unless he is familiar with all of the facts in the particular case and with developments during the examination as it progressed.

CONCLUSION

When a CPA states his examination was made in accordance with generally accepted auditing standards he takes responsibility for having made an adequate examination. Accordingly, bankers are justified in placing the same reliance upon a short-form report containing that statement as they do upon a long-form report.

If we can succeed in getting this one point generally accepted by credit grantors, we will clear up a great many questions that arise regarding various figures in financial statements—questions that can be summed up generally as reflecting the query “What’s Behind the Figures?”