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Special reports

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Special Reports

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Whenever I undertake to write a paper on a technical accounting subject, I inevitably conclude that we must be a very young profession, for we do seem to have so many unanswered problems. Yet, I suppose one could equally support the proposition that an awareness of unanswered problems is really a sign of increasing maturity, for without maturity of some degree we would be unable to recognize our problems.

In any event, I am certain that we do have problems. And in the field of auditing, our Committee on Auditing Procedure of the American Institute exists to give us help with our problems. This is the function of that Committee and this is why they periodically issue their Statements on Auditing Procedures.

Statement No. 28, entitled *Special Reports,* is one such statement and it is the particular one which is now to occupy our attention.

Since we are in the field of reports, I suggest we start our present consideration with audit reports as they existed when I started in the practice of public accounting about thirty years ago. This is a good starting point, not because it coincides with my entry into the profession, but because it was just prior to some significant changes in the accounting profession, and particularly in our reporting practices.

Consider, if you will, a typical opinion (I should say *certificate* because that's what we called it then and that's what it said it was) as of the year 1929:

We have examined the accounts of the XYZ Company for the year ended December 31, 1929 and hereby certify that the annexed balance sheet and statement of income and profit and loss are in accordance therewith. We further certify that said statements, in our opinion, present a true and correct view of the financial condition of the Company at December 31, 1929, and the results of its operations for the year then ended.

To those interested in *antiques,* viewed from hindsight, this certificate is a little gem. Please note that the auditors—

(1) Say the financial statements are in *accordance with the books of account.*

(2) *Certify* the financial statements as being *true and correct.*

This, then, is our starting point of thirty years ago. Then things began to happen quickly during the decade of the thirties.

Without any attempt to lead you through a chronological record of the thirties, these things occurred, among others:

- The Congress passed the Securities Act of 1933 and its chief companion act, the Securities Exchange Act of 1934.
- The Securities and Exchange Commission was created and granted broad powers of regulation under these acts.
- In a desire better to regulate our own profession and to avoid the undesirable result of having the Securities and Exchange Commission prescribe accounting principles and auditing standards if we did not formulate our own, the American Institute formed our present committees on Accounting Procedure and on Auditing Procedure.
- The *Ultramares* case was decided, and Justice Cardozo asserted a dictum of great importance to the public accounting profession.

Now all of these events had a profound effect on accountants' reports. For one thing, the Securities and Exchange Commission insisted that the profession develop *standards,* both for accounting principles and for auditing procedures. And the *Ultramares* case made it eminently clear that accountants, in their reports, should carefully distinguish between *fact* and *opinion.*

The *Ultramares* case was a very interesting one. In their report the accountants stated that the financial statements were in accordance with the books of account of the Company as, for example, in the certificate given you earlier. Now surely this is an innocuous statement! How could this get the accountants in trouble?

Well, it so happened, in this case, that some of the entries in the *general* records of the Company were not adequately supported in the *underlying* records, and it was subsequently proven that the financial statements were misstated and, accordingly, misleading.

In this regard, Justice Cardozo said:

The defendants certified as a *fact,* true to their own knowledge, that the balance sheet was in accordance with the books of account.

If their statement was false, they are not to be exonerated because they believed it to be true. (Emphasis supplied)

The difference between a statement of *fact* and one of *opinion* can be all important, as the accountants for *Ultramares* learned to their sorrow!

Now, let's see how these various developments were reflected in the standard short-form report subsequently adopted by the American Institute:

> We have examined the balance sheet of X Company as of December 31, 19__ and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19__, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

You will notice here that our conclusion, which appears in the second, or *opinion,* paragraph, is stated only as an *opinion,* not as a "fact"; and, further, that the opinion is concerned only with "fair presentation."

Accordingly, a clear understanding of the vital distinction between *fact* and *opinion* is fundamental to a full understanding of our standard short-form report.

And, if I may digress for a moment, I would like to impress upon you the necessity of distinguishing between fact and opinion in *all* reports you issue, particularly in long-form reports and in special reports, the latter being the topic of this paper.

Referring again to the standard short-form report adopted by the American Institute, please note the reference, in the scope paragraph, to *generally accepted auditing standards* and, in the opinion paragraph, to *generally accepted accounting principles.*

The use of this standard short-form report presupposes that we know what these *generally accepted* auditing standards and accounting principles are; and that, in our examination, we have observed these auditing standards and have satisfied ourselves the financial statements have employed these accounting principles.

Here again are areas where the profession had a right to expect leadership from the American Institute.

As to auditing standards, the Committee on Auditing Procedure developed the very excellent booklet entitled *Generally Accepted Auditing Standards*; this booklet should be a part of the basic library of each practicing public accountant.

As to accounting principles, the Committee on Accounting Procedure has also made a substantial contribution to the profession, principally through the issuance of its Accounting Research Bulletins. However, the problems in this area are most difficult ones, and I cannot point to a booklet corresponding to *Generally Accepted Auditing Standards* for a concise summary of our generally accepted accounting principles.

To further complicate the problem in this area, the distinction between *principles* and *practices* is not always clear. This may not be too serious, however, as, what we are really saying in our standard opinion paragraph is that the statements have been prepared in accordance with generally accepted methods (whether you care to regard them as being principles *or* practices) and that these methods have been applied on a basis consistent with the prior year.

Another problem, too, is that sometimes there appears to be more than one accounting principle that may be applicable in the circumstances. In this event, a decision has to be made as to which one controls.

Following the creation of the Institute committees on Accounting Procedure and on Auditing Procedure, these committees set diligently to work to identify "guide-posts" to help us in our professional practice.

The task was imposing, and it was obvious that decisions had to be made as to what to tackle first. The decision was a very natural one—to tackle the field of greatest importance, namely, the customary short-form report on accrual basis, profit-intending enterprises. And so, much of our effort and literature has concerned this area.

Yet, when we consider the vast number of reports issued that concern other than accrual basis, or profit-intending enterprises, or that, for one reason or another, are "off the beaten track" so to speak, it is apparent that, sooner or later, some guidance had to be given the profession in those other areas.

And that is the purpose of Statement No. 28—to give us guidance in these special situations.

In this regard I should like to start with a brief review of our generally accepted auditing standards, which, as you know, fall into three main areas:

GENERAL STANDARDS

- 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.

STANDARDS OF FIELD WORK

- 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.

STANDARDS OF REPORTING

- 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 regard-

> ing 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 should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

Our basic problem is to determine the extent to which these generally accepted auditing standards apply to special reports.

Paragraph 6 of Statement No. 28 makes it quite clear that the substance of the general standards and the standards of field work (two of our three main areas) apply (where applicable) to special reports just as much as to *standard* reports. Paragraph 6 reads as follows:

> *Generally Accepted Auditing Standards* characterizes the term generally accepted auditing standards as used in auditors' reports on financial statements in such a way as to include (a) general standards, (b) standards of field work, and (c) standards of reporting. It is the opinion of the committee that, to the extent appropriate in view of the character of the engagement, the substance of the *general standards* and of the *standards of field work* applies to engagements involving special reports. (Emphasis supplied)

However, when we consider the application of the *reporting standards* (our third main area) to special reports, our problem becomes more difficult.

The crux of the problem concerns the first standard of reporting —the opinion as to conformity of financial statements with generally accepted principles of accounting.

There are many competent accountants who contend that this wording should be reserved for accrual-basis statements; that this is the province of accrual-basis accounting.

But are there not generally accepted principles of accounting applicable to financial statements prepared on other than an accrual basis?

Personally, I think there are. Principles of accounting are developed through use by the entities concerned, the entities that, not so incidentally, have the primary responsibility for the fairness of the financial statements. Those principles that, through use, are found useful become *accepted* principles of accounting. And when this acceptance becomes widespread, they are called *generally accepted* principles of accounting.

I see nothing in this reasoning that would restrict its application solely to accrual-basis statements.

The Auditing Procedure Committee, in considering these problems, concluded that the first standard of reporting (i.e., conformity with generally accepted principles of accounting) does *not* apply in the event the financial statements (or information) do not purport to present financial position and results of operations. This conclusion is contained in Paragraph 8 of Statement No. 28 which says:

> Although there may be occasions when it is appropriate for the auditor to report upon conformity with generally accepted accounting principles of incomplete financial presentations, such as in reports upon compliance with certain provisions of bond indentures, the Committee is of the opinion that the requirement of the first standard of reporting does not apply to statements which do not purport to set forth financial position and results of operations. Statements prepared on the basis of cash receipts and disbursements, for example, usually do not purport to present financial position or results of operations. In reporting on statements which do not so purport the auditor should make sure that it is clearly stated what they do purport to present and the basis on which they have been prepared. He should express his opinion as to whether or not the statements fairly present the data on the basis indicated. The Committee believes it to be generally preferable in these circumstances to avoid the use of the terms "balance sheet," "income statement," or similar titles with respect to such statements; notwithstanding this preference, the Committee recognizes the long-established acceptance of these terms and accordingly feels that it should not, at this time, do more than express its preference.

Now let's see how we apply Statement No. 28 to various of our special areas.

I suggest we look first at cash-basis statements. What changes, if any, in our standard short-form report are required? I think it soon becomes apparent that we have our greatest trouble with the last, or *opinion,* paragraph.

Can we say, for example, that the *balance sheet* fairly presents the financial position of the entity when material amounts of assets and liabilities have been omitted? (The position expressed here is that the receivables, inventories, and accounts payable are no less assets or liabilities, merely because unrecorded, than they would be if the entity had elected accrual-basis accounting and they were then recorded.)

Similarly, can we say that the *income statement* fairly *presents* the *results of operations* of the entity knowing that material amounts of income and expense applicable to operations of a prior year have been *included* in the current year or that other material amounts applicable to operations of the current year have been *excluded* on the basis that they will be included, in due course, in the succeeding year?

Now all of the foregoing matters were considered rather extensively by the Auditing Procedure Committee in the preparation of Statement No. 28.

In Statement No. 28 the Committee included an example of an opinion paragraph in an accountants' report on cash-basis statements. This example opinion paragraph is as follows:

> In our opinion, the accompanying statements present fairly the assets and liabilities of the XYZ Company, at December 31, 19__, arising from cash transactions, and the revenues collected and expenses disbursed by it (and changes in proprietary interest, fund balances, etc., where reflected in cash-basis statements) during the year then ended, on a basis consistent with that of the preceding year.

In comparing the wording of this example with the standard short-form report given near the outset of this paper, you will note these differences:

(1) The example avoids use of the term *balance sheet* and instead uses the terms *assets and liabilities . . . arising from cash transactions.*

(2) The example avoids use of the term *statement of income* and uses the terms *revenues collected and expenses disbursed* (the words *collected* and *disbursed* connote cash basis, hence that expression is not repeated in the example).

(3) The example omits any reference as to the conformance of the financial statements with generally accepted accounting principles.

The first thing that should be made abundantly clear is that the example opinion paragraph is suggestive only. The Committee did not intend, I know, that all reports on cash-basis statements should conform to this suggestion. As a matter of fact, while the Committee expressed itself (Paragraph 8 of Statement No. 28) as believing it to be generally preferable to avoid use of terms such as *balance sheet* and *income statement,* it specifically did not prohibit their continued use.

But, although the Committee did not prohibit use of the terms *balance sheet* and *income statement,* it is nonetheless clear, both from the narrative and from the example, that the Committee prefers expressions such as *assets and liabilities . . . arising from cash transactions* and *revenues collected and expenses disbursed.* The Committee apparently believes that these latter expressions both more accurately describe what results from cash-basis accounting and avoid the inference that the resulting financial statements constitute a *balance sheet* and *income statement* in the sense that they would were the accrual basis used.

The omission of any reference in the example opinion paragraph as to conformance of the financial statements with generally accepted principles of accounting is interesting.

I have already indicated the Committee's justification for the omission of this first standard of reporting, namely, the Committee's belief that this standard does not apply to statements which do not purport to set forth financial position and results of operations. Further, Paragraph 8 of Statement No. 28 says that *Statements prepared on the basis of cash receipts and disbursements . . . usually do not purport to present financial position or results of operations.*

I do not have too much difficulty with the position that cash-basis statements do not present (at least do not fairly present) financial position or results of operations where material amounts of assets and liabilities have been omitted. (Even here, though, cash-basis proponents would probably argue that the terms *financial position* and *results of operations* remain appropriate when qualified that they are predicated on the cash-basis of accounting.)

But I do have some difficulty in proceeding from this position (that statements prepared on a cash basis usually do not purport to present financial position, etc.) to the conclusion that, therefore, compliance with the first reporting standard is not required.

Possibly the Committee in adopting reporting standards did not intend the first standard of reporting to apply to statements that do not purport to present financial position or results of operations. But

I am not sure they intended this. And even if they did, I am not sure that noncompliance with the first reporting standard as to cash-basis statements is the best answer to the problem. But this is the official position of the Committee at the present time.

Next, I suggest we look at the problems of nonprofit organizations. Paragraph 3(b) of Statement No. 28 describes these special reporting areas as including:

> Reports on financial statements of some nonprofit organizations which follow accounting practices differing in some respects from those followed by business enterprises organized for profit. These organizations may include municipalities, hospitals, co-operatives, and educational institutions.

Paragraph 11 of Statement No. 28 sheds some light on our problem. It reads as follows:

> If the statements are those of a nonprofit organization they may reflect accounting practices differing in some respects from those followed by business enterprises organized for profit. It is recognized that in many cases generally accepted accounting principles applicable to nonprofit organizations have not been as clearly defined as have those applicable to business enterprises organized for profit. In those areas where the auditor believes generally accepted accounting principles have been clearly defined (as indicated by authoritative literature and accepted practice, etc.) he may state his opinion as to the conformity of the financial statements either with generally accepted accounting principles, or (alternatively, but less desirably) with accounting practices for nonprofit organizations in the particular field (e.g., hospitals, educational institutions, etc.), and in such circumstances he may refer to financial position and results of operations; in either event, it is assumed that the auditor is satisfied that the application of such accounting principles and practices results in a fair presentation of financial position and results of operations or that he will state his exceptions thereto. In those areas where the auditor believes generally accepted accounting principles have not been clearly defined, the other provisions of this statement apply.

Reading Paragraph 11 carefully, it is apparent that an auditor may use the standard short-form opinion on financial statements of nonprofit organizations if he is satisfied as to two things:

- That generally accepted accounting principles in the particular field involved have been clearly defined (as indicated by authoritative literature and accepted practice, etc.) and

- That the application of such accounting principles and practices results in a fair presentation of financial position and results of operations.

It seems appropriate to me that we should have the last indicated requirement, but I do have difficulty in visualizing a situation where it would apply. For if we, in fact, have clearly defined accounting principles generally accepted in the particular field, then when wouldn't they result in a fair presentation?

In a number of nonprofit fields it does appear that accounting principles have been clearly defined.

In the municipal field, for example, the National Committee of Governmental Accounting (formed by the Municipal Finance Officers Association of the United States and Canada), in 1951, published a manual entitled *Municipal Accounting and Auditing*. Numerous advisory committees, including one appointed by the American Institute of Certified Public Accountants, were consulted in the preparation of the manual. This manual represents a revision and consolidation of several earlier publications which had received wide acceptance.

The manual includes a summary of recommended accounting principles and procedures applicable to municipal accounting.

It would seem that this field meets the *clearly defined* test and, accordingly, the standard short-form opinion can appropriately be used.

However, if you want to use alternative wording in this field, consider the following suggestions:

"In our opinion, the accompanying financial statements present fairly the financial position of the City of XYZ as of June 30, 1958, and the results of its operations for the year then ended, in conformity with:

(a) Generally accepted accounting principles applied on a basis consistent with that of the preceding year, and also in conformity with the recommendations of the National Committee on Governmental Accounting.

OR

(b) Accounting practices used by municipalities and applied on a basis consistent with that of the preceding year.

Again, remember the wording is suggestive only; you may well be able to improve on it.

Educational institutions also seem to fall in the *clearly defined* area.

In 1935 the National Committee on Standard Reports for Institutions of Higher Education published a report entitled *Financial Reports for Colleges and Universities.* This report was accepted and applied in most institutions throughout the country.

In 1952 the American Council on Education published Volume 1 of a two volume report entitled *College and University Business Administration,* which included a revision of the material contained in the publication of 1935. This volume was prepared by the National Committee on the Preparation of a Manual on College and University Business Administration, with the cooperation of a special committee on College and University Accounting of the American Institute of Certified Public Accountants.

On the basis that we do have here a *clearly defined* area, the accountant may use the standard short-form opinion or follow the essence of the suggestions made earlier as to municipalities.

Hospital accounting, too, has received considerable attention. In 1922 the American Hospital Association developed a manual on hospital accounting, which has since been revised from time to time. Again we appear to have a *clearly defined* area justifying the use of the standard short-form opinion; or of the type of alternatives suggested earlier as to municipalities.

Now, as to the three fields on which I have just commented (municipalities, educational institutions, and hospitals), it should not be assumed that the accounting principles or practices are identical with those followed by commercial enterprises organized for profit.

On the contrary, the principles and practices in these nonprofit fields do differ from those of commercial enterprises organized for profit. The position taken in Paragraph 11 of Statement No. 28 is that these fields (as illustrations) do have their own accounting principles and practices just as surely as do steel companies and grocery stores.

(Incidentally, in case you don't happen to serve any municipalities, educational institutions, or hospitals, you may be interested to know that the chief difference in practice seems to relate to allowance for depreciation.)

In issuing Statement No. 28 the Committee recognized that regulated companies (financial institutions, insurance companies, railroads, etc.) have special reporting problems since they follow accounting practices prescribed by regulatory authorities. While the Committee did not attempt to deal with these problems in Statement No. 28, it is continuing to study them. For various reasons, however, I believe progress in this area will be slow.

Statement No. 28 also deals with special reports in which incomplete financial presentations or no financial statements are made. Illustrations would be calculations of royalties, profit-sharing bonuses, rentals, etc.

It is, of course, difficult to give specific guidance here for each report must be rather "tailor-made" for the particular problem.

However, some words of caution are in order. Bear in mind that the usual examination of financial statements is designed for the purpose of formulating an opinion with respect to financial statements *taken as a whole* and not necessarily with respect to specific accounts. Accordingly, where the auditor renders an opinion on a specific account (for example, the adequacy of the allowance for doubtful accounts or the liability for income taxes), he should be cognizant of the added responsibility he may thereby be assuming and of the possible necessity of extending the scope of his examination.

Statements prepared on printed forms designed by the authorities with which they are to be filed may also pose problems. Oftentimes, they require inappropriate classifications or other similar procedures that, in the auditor's opinion, do not fairly present the financial position or results of operations of the particular company filing the statements, even though they purport to do so.

Also, such forms often prescribe a pre-worded auditor's opinion, or certificate, that does not accord with professional standards.

Some forms, or opinions, can be made acceptable by typing in additional captions or wording; others require full revision. When the printed forms, or opinions, require the auditor to make assertions he believes he is not justified in making, he has no alternative but to reword them or submit his separately typed report.

Incidentally, wherever any of us have the opportunity of suggesting *modernization* of such forms to the appropriate regulatory authorities, we should do so. I am sure there must be situations where the regulatory authority just isn't aware of the professional deficiencies of their forms.

I should also tell you that the Research Department of the Institute is working on a rather extensive booklet illustrating the application of Statement No. 28 to the various areas covered in the Statement. This booklet will be most helpful, I am sure, to all of us in treating with special reports.

This is, however, an ambitious program and will take some time to complete.

In concluding, I should also tell you I feel I have undertaken an ambitious task in giving this talk to you. The field is so large that I know I have not covered nearly all of it. It is my hope, however, that I have touched upon a sufficient number of areas to be helpful to you in your continuing study of the interesting field of special reports.