1967

Auditor's contribution to financial reporting

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Recommended Citation
Haskins & Sells Selected Papers, 1967, p. 177-184

The Auditor's Contribution to Financial Reporting

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Presented before the Rotary Club of Memphis—December 1967

IF THE AMOUNT OF PUBLICITY devoted recently to accountants and accounting problems is any criterion, we must conclude that there is, today, a new and growing interest in the accounting profession. We welcome this interest. I believe, however, that it has come as a surprise to many people. It has even surprised newspapermen, who, more than most people, respond quickly to public interest. For instance, William Clark, who wrote a series of articles about the accounting profession in the *Chicago Tribune* earlier this year, said that, in the beginning, he wouldn't have given a plugged nickel for the chances of articles on accounting principles possessing a modicum of general interest. But then he found that as he talked with people in the business, the subject of accounting took on a new appeal.

GROWING INVESTING PUBLIC

For the most part, I believe this new interest in our profession is a natural result of the substantial increase in the number of people investing in American and foreign businesses. To give you an idea of just how tremendous that increase has been, when Keith Funston became head of the New York Stock Exchange sixteen years ago, average daily trading volume was less than two million shares, and there were 6½ million stockholders in this country. This year, as Mr. Funston steps down, volume has been averaging about 10 million shares daily. There are now an estimated 22 million shareholders in the United States, and the number has been growing by a million a year.

PUBLIC INTEREST IN ACCOUNTING

As this growing investing public concerns itself more and more with the increasingly complex financial affairs of business, its attention has very naturally turned to the accounting principles used in financial statements of companies and to the role of the independent public accountants whose opinions accompany those statements.

We accountants haven't done much to stimulate this attention. Basically, we're a rather close-mouthed group. We'd like people to know more about us, and about what we do, but until lately we seem to have been reluctant about telling our story. Some of this reluctance comes naturally. Accountants are not permitted to advertise their services. That would be a violation of our code of professional ethics. Nor do we consider it proper to discuss publicly the reasons why our clients use particular accounting practices in preparing their financial statements. That would violate our confidential relationship with our clients. But it has become increasingly clear that CPAs must take the steps necessary to inform the public about the nature of accounting and the financial reporting process and about the auditor's role in that process.

PUBLIC IMAGE

It is interesting to speculate on the public's impression of the CPA. Certainly we're no longer pictured as the high-stooled, green-eyeshaded men described by Dickens. Nor, hopefully, are we still the more modern auditor depicted by Elbert Hubbard. In an oft-quoted passage, Mr. Hubbard once described the typical auditor as "a man past middle age, spare, wrinkled, intelligent, cold, passive, non-commital, with eyes like a codfish, polite in contact, but at the same time unresponsive, calm and damnably composed as a concrete post ... without charm ... or a sense of humor. Happily [he said], they never reproduce and all of them finally go to hell."

We in the accounting profession, of course, have quite a different view of ourselves. We have seen our profession grow from its obscure beginning in the late 1800s to become a vital part of today's financial community. We have seen our members rise to assume important positions in industry and in government and community service.

In 1900, there were only 243 CPAs in the United States; today, there are more than 100,000. While this growth in numbers is impressive, it does not adequately measure the growth of the CPA's participation in the financial aspects of our society. The demands of business have lifted the CPA from the narrow world of the verifier to a position in which he renders a wide range of services to important segments of our economy. The heavy flow of capital and federal securities laws have increased significantly the demands for audit services by CPAs; the growing number of taxpayers and frequent changes in our intricate tax laws require more and more tax services on our part; and the need for businesses to achieve operating efficiencies to stay competitive has increased the need for our systems services and other management advisory services.

This wide range of services has necessitated a strengthening of the educational and professional standards of our profession. The typical CPA, today, is a college graduate who has passed a comprehensive professional examination and has satisfied regulatory authorities that his education, experience, and moral character meet the requirements for obtaining a license to practice public accounting. The typical CPA is also a member of the American Institute of CPAs, which requires adherence to a code of professional ethics and to established standards of auditing and reporting as a condition for continuing membership.

PUBLIC MISUNDERSTANDING

There are some serious misunderstandings about accountants today, held even by otherwise well-informed people. Some of them even seem to think that auditors should be infallible. Of course, if we were we would hardly be human. There are also some misunderstandings about our function in the financial reporting process.

The first point to be borne in mind is that the financial statements of a business enterprise are primarily the responsibility of its management, and that the management is expected to adopt those accounting and reporting procedures that in its judgment will best portray the financial position and operating results of the enterprise. The auditor's function is to consider the soundness and acceptability of the procedures adopted by the management, ascertain whether they have been consistently applied, and see that all necessary informative disclosures are made.

An auditor does not, and cannot, guarantee that the financial statements on which he expresses an opinion are true and correct. The accounting process is not a precise one, but is based upon the use of estimates and exercise of judgment to a significant extent. In fact, these are among the most important features of accounting. Because of the use of numbers and the mathematical processes, many people are misled into attributing a preciseness to accounting that does not exist. While the auditor does not guarantee the accuracy of financial statements, his special training and experience do qualify him to give an expert opinion on whether or not management's estimates and judgments are reasonable, within the framework of generally accepted accounting principles. The word "opinion" is important. An auditor does not examine each and every transaction, but bases his conclusions on tests of the accounting records; the extent of his tests is based on his evaluation of the adequacy and effectiveness of his client's system of internal control. Judgment enters into the selection and timing of those tests and into the extent of their application. Therefore, it is not possible for the auditor to state as a literal fact that the financial statements are true. All that the circumstances warrant is an expression of opinion that the statements "fairly present." In that opinion he is concerned only with material misstatements and not with immaterial errors.

I have had a number of personal experiences, as have some of my partners, that illustrate the misunderstanding many people have of what auditors do. Possibly some of you have had similar experience of misunderstanding in your own businesses or professions. These incidents point out, I think, how very far many of us have to go in presenting a true and realistic image to the public. For us in the accounting profession, this is a matter of long-range education and a comprehensive program of public relations.

INDEPENDENCE

The CPA has a unique quality that has given rise to his role in financial reporting. That quality is independence. Independence, in fact, put the CPA in business and is keeping him there today. In terms of the audit function, it is his very reason for being.

This requisite of independence has long been codified by the accounting profession. Among the standards adopted by our profession is the requirement that, in all matters relating to an engagement, an independence in mental attitude is to be maintained by the auditor. The by-laws of the American Institute of CPAs provide for a trial board which may warn, suspend, or expel a member who violates this requirement of independence.

There is also a very practical financial side to this matter of independence. The concept has always meant that the auditor can have no financial interest in his client. Basically, this means that, among other things, the auditor may not be a stockholder in his client's company. The practical result of this proscription is that, in adhering to the professional requirements as to independence, the CPA is thereby voluntarily giving up any opportunities for financial gains he might have had in a combined role as stockholder and auditor.

DIFFERENCES OF OPINION

Having discussed the nature of our role in financial reporting, let me now come back to the recent publicity about accountants that I mentioned earlier. I believe it is coincidental that some of the developments responsible for bringing about the increased interest in our work have been such things as well-publicized stories of differences within the accounting profession. This is not uncommon. As Mr. Clark of the *Chicago Tribune* said, there are differences of opinion even in the newspaper business. In fact, every profession has them. They are inherent in the nature of professional services, particularly accounting services. Accounting is not an exact science. There may be more than one way to look at a transaction or business event and more than one way to account for it.

The swing between the conclusions of two mature, responsible persons approaching even the same facts from different viewpoints can sometimes be a wide one. For example, just think of the varying conclusions that can be drawn about the state of our economy from a report, say of 3½ million unemployed. Is this level of unemployment good or bad? In accounting, a good case in point is the recent controversy over accounting for the investment credit. The circumstances surrounding the investment credit clearly call for only one way of accounting, but there continues to be substantial disagreement among accountants and business leaders concerning whether the investment credit should be added to earnings in total in the year it appears on the tax return or piecemeal over several years.

The circumstances surrounding many other business transactions are not so clear-cut as they are surrounding the investment credit. For example, it is not easy to say whether all businesses should be optimistic about the costs of developing new products and of spreading those costs over the anticipated sales of the products; or whether business should be conservative about such costs and write them off as they are incurred.

Either of these alternatives may be valid for a company engaged in developing new products, depending on the particular conditions encountered by that company.

There are areas, however, in which alternative accounting practices are, at best, unnecessary—and at worst, undesirable. In an effort to eliminate these unnecessary differences and inconsistencies, the American Institute of CPAs has established the Accounting Principles Board, consisting of twenty members selected from public practice, the academic community, and industry. The Institute has also established a research arm to assist the Board in conducting independent studies of topics under consideration. Opinions have been issued by the Board on many areas where undesirable alternatives in accounting principles previously existed, and many more areas are now under consideration.

While the work of the Board is important to the development of accounting principles, there is no thought that its work will produce a rigid set of rules the enforcement of which will eliminate all differences in accounting for business transactions. Too much rigidity may lead financial-statement users to infer that things are alike when they are not. It seems natural to me that the attitude of a company's management will and should be reflected in the financial statements. One management will push ahead with an investment or with expansion when another will hold back. One will abandon research efforts before another. One will favor a particular form of financing over another. One will seek diversification, another will concentrate its efforts. One will adopt certain practices in employee compensation, others will try something else. These differences are pertinent to accounting measurements and, accordingly, accounting determinations should not make a constant out of them. To do so would mislead, because not all pertinent facts and conditions are brought into the comparison.

CLIENT PRESSURES

Failure to recognize this need for accounting to reflect the varied attitudes and decisions of management had led some people to criticize the accounting profession for what seems to them to be a compromising position toward the application of accounting principles, implying that the CPA may have yielded to client pressures.

There is no question that accounting, making use of estimates and judgment as it does, subjects the auditor to pressures from clients to follow those alternatives best satisfying management's objectives. So long as those alternatives are justified by the circumstances, the auditor and his client will try to come to a solution that will satisfy all the parties. If the alternatives exceed the range of fairness and reasonableness, then a line must be drawn. If that line is crossed, the CPA runs the risk of doing irreparable harm to his professional reputation.

Reputation, of course, is something with which every professional man concerns himself. Yet, to a certified public accountant the public's full trust may be of even greater consequence than to men of other professions. For not only does the CPA need his client's trust; he needs also the trust of others who place reliance on his work. A client will find the CPA's service of small value if the client's bank, for example, lacks faith in the CPA's report.

Thus, the substantial injury to his reputation that may befall the auditor who fails to resist unreasonable pressures by his client may result in losses in prestige and future income far greater than the fees from the particular engagement. Certainly no client is worth such risk.

Incidentally, it might be well to remember, too, that the client has a reputation to preserve. Today, business is exceedingly responsive to public opinion, and, with the growth in broadly based ownership of companies, business is especially responsive to that special public—the investor. The publicity that would attend the withdrawal of a firm of auditors would raise doubts in the minds of a company's stockholders and among investors in general. This is to say nothing of the questioning stares such withdrawal would bring from the Securities and Exchange Commission and other regulatory agencies. Unfavorable attention is something no company can afford today, and something it will spare no effort to avoid. Therefore, a company's desire to preserve its own reputation effectually limits the degree and kinds of pressures it can put on its auditors.

CONCLUSION

When the spotlight is on alleged specific faults of CPAs, I hope you will reserve your opinion until those allegations are proved true. At times, in the interest of writing a more interesting or readable story, a writer will draw, unwittingly, certain unwarranted conclusions by misinterpreting a given set of facts. Even if the alleged matters are eventually proved true, it is well to remember that the effect of playing a spotlight on one troublesome area may leave unnoticed in the background the profession's record of major accomplishments and good performance.

I believe auditors fill a vital role in today's financial reporting process, but the value of that role can be enhanced considerably through a better public understanding of our responsibilities. That understanding will undoubtedly lead to further improvements in communication of financial information to investors and creditors.

Even today, I believe that financial reporting in the United States is the best in the world. I like to think that the accounting profession has made an important contribution toward that achievement. Moreover, I like to think that the accounting profession, through the independent audit function, "has probably made a greater contribution to morality in business in these days than has any other group" in private industry. In our era, when morality seems to be eroding in so many segments of life, this is indeed a significant contribution.