Journal of Accountancy

Volume 51 | Issue 2 Article 3

2-1931

Auditor's Reports and Certificates

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Some comments made at the annual meeting of the Illinois Society of Certified Public Accountants, September, 1930, by a committee composed of Harold Benington, Walter H. Andersen, John P. Dawson and F. J. Duncombe

In issuing reports and certificates the professional auditor assumes a grave moral responsibility, not only to the clients directly employing his services but to all others into whose hands such reports and certificates may come. The most scrupulous care should therefore be exercised to the end that reports and certificates be expressed in language so clear that their meaning is evident to all concerned. They should contain the truth, the whole truth, and nothing but the truth regarding the financial affairs of the client, and should, above all, indicate beyond possibility of misunderstanding the exact measure of responsibility assumed by the auditor in regard to the figures contained therein. That we all attempt to accomplish this goes without saying, but it must be reluctantly admitted that even the best of us sometimes fail to achieve complete success.

The aid of the law courts is constantly being invoked to construe the meaning of wills and contracts drawn by the most eminent firms of attorneys. Is it surprising, then, that in the language of their reports and certificates, auditors occasionally fail to state completely their position and to protect the interests of all concerned?

Our first practical suggestion therefore is that all draft reports and certificates should be reviewed by someone other than their author so that the statements made therein may mean what they say, say what they mean, and be expressed in language which is as affirmative and helpful to the client as is consistent with impartial statement of the facts. An unhappily worded sentence can often convey an impression to its reader quite other than was intended by its author. That is the unfortunate thing about the qualifications which we are so often obliged to make as to the extent of our verifications of the figures submitted. Such phrases as "we accept no responsibility for quantities or condition of merchandise" or "we did not, however, verify the accounts receivable by direct correspondence with the debtors," while entirely proper, often seem to convey to the layman a sinister significance entirely unwarranted by their language.

Certificates should be concise, and to that end it is desirable that all qualifications, reservations and comments be expressed, as far as possible, in the descriptive wording appended to the individual balance-sheet captions concerned rather than in the text of the certificate.

If only few or minor complications are involved in the audit, it is possible to use the so-called "short form" certificate, and there are many instances where this is all that is requisite or desired. Often, however, it is necessary to make qualifications, reservations and comments which if condensed into a short certificate may be misunderstood or may give rise to the inference that the audit is practically valueless as a portrayal of financial results and conditions. It is of course the nature and extent of the necessary qualifications and comments which determine whether a certificate or a report is most appropriate and govern the form of certificate, if used. Where qualifications or comments exist, however, it is important that the financial statements themselves indicate their character, by caption or descriptive wording, in sufficient detail to make them understandable without collateral reading of the certificate or report, and that the financial statements be clearly associated, where necessary, with any amplified comment in the certificate or report.

It should always be the aim of the auditor so to perform the work entrusted to him that qualifications will, as far as possible, be unnecessary. Carrying out such an ideal implies an acceptance of responsibility beyond that of merely producing a result acceptable to the client. If the auditor's work is hampered by limitations imposed by the client, he should endeavor to show the client why these limitations should be withdrawn or modified in the client's own best interests. If it is urged by the client that full verification is impossible due to lack of time, it should be pointed out by the auditor that it may be better to consume this extra time than to be obliged to issue a qualified report. In short, the auditor must accept the responsibility of endeavoring to render the report which will be the most effective from the client's point of view, and therefore may have to think for the client. This is in accord with conditions in any of the professions.

As regards adjustments found necessary in the accounts as a result of the audit, these should be brought to the attention of the client, his acquiescence therein obtained and appropriate entries made on the books to give effect to them so that the statements which the auditor certifies may be in agreement with the books. If from one cause or another effect has not been given to these adjustments on the client's books at the date when the auditor's report is issued, then it is desirable that full particulars thereof be included in the report.

Reservations and qualifications are, of course, objectionable to all concerned, but they are often inevitable. In his interesting book *Auditors' Certificates*, published in 1927, our fellow member and ex-president David Himmelblau gives ninety-two examples of actual certificates issued by various firms which are largely illustrative of the kinds of qualifications which the auditors found themselves obliged to make in each instance.

It is interesting to note the criticisms made by leading London financial editors regarding English auditors' certificates and quoted by C. Hewetson Nelson, in a paper read by him before the international congress on accounting. The most significant of these criticisms were

> "That the idiom employed in the auditor's certificate was much too subtle for the average shareholder and investor and that only the general body of accountants or a comparatively small and select body of people who are gifted with suspicious minds could be expected to understand the true meaning of the certificate"; and
>
> "That when an auditor made a reservation in his certificate, too much was left to inference."

It must be admitted that these criticisms apply with equal force to the certificates of American practitioners.

A somewhat detailed report is, of course, almost always more informative and satisfactory to all concerned than is a briefly worded certificate attached to an exceedingly condensed balance-sheet and statement of earnings, and we would draw attention to the unwisdom of auditors in issuing certificates except in strictly appropriate circumstances. A report is a much safer and smoother vehicle in which to convey the auditor's comments to his client than is a certificate, and if certified statements are issued it is suggested that they should be accompanied by a more or less detailed report when it is practicable to do so. However, where certified statements, accompanied by a report, are presented by the auditor to the client, he should of course exercise the utmost vigilance that no material qualifications appear in the text of his report which are not in substance repeated in the language of his certificate. The certified statements may fall into the hands of persons who do not have access to the full report, and it is obvious that the auditor can not set up the defense that perusal of his report would have prevented such persons from being misled by ambiguities or failure to make full disclosure in his certified statements.

We are so accustomed to reading and listening to speeches by distinguished members of our profession relating to the investigation of the financial affairs of gigantic enterprises that there is perhaps a danger of our overlooking the pitfalls awaiting the feet of the auditor when examining the affairs of corporations and partnerships whose annual sales range from five to six figures and which do not possess as elaborately organized accounting and cost-finding records as do the larger corporations.

After all, the largest portion of the clientele of the members of the society consists of medium and small sized industrial organizations. If a report is rendered as a result of the audit of such an organization, the auditor can expand his usefulness by presenting accounts and comments more extensive and informative than would be appropriate to certified statements or than would be necessary in regard to a larger corporation where statistics are currently and carefully compiled by its own accounting employees.

Moreover, in the course of practice, we are called upon to undertake a great many examinations, the scope of which is largely determined by the client, and in such instances a report setting out clearly the limitations placed upon us is always preferable to a certified statement which under the conditions would be undesirably lengthy and restrictive.

In suitable cases a compromise between certificate and report can be effected by the use of what is generally referred to as the "long form certificate," which seems to be gaining popularity.

Regarding the general arrangement of reports, the practice of different firms varies considerably and each practitioner will, of course, always continue to use his own judgment. However, the desirability of indicating in general language the purpose and scope of the examination in the opening paragraph of the report is worthy of mention. It is, perhaps, worth while also to draw attention to the fact that unless the auditor has something informative to say regarding a particular balance-sheet or profit-and-loss item, he should be silent regarding it. On the other hand, it must always be borne in mind that silence regarding such an item can be construed by the reader of the report in only one way, namely, that the auditor is entirely satisfied regarding it.

Where comparative figures relating to past years' operations and statistics generally are included, the auditor should be exceedingly careful to indicate which have been verified by him and which are simply taken from the client's records without further investigation.

The extent to which an auditor should disclose in his report the steps taken by him to verify the figures submitted is a very debatable question. Many of us confine ourselves to making a general statement such as "we have satisfied ourselves as to the general correctness of the accounts by means of selective tests of detailed transactions," while others go so far as to describe somewhat fully under appropriate captions throughout the report the procedure followed. Others again submit as a schedule to the report full details of the audit programme. Many of us, however, follow the somewhat dangerous and illogical plan of describing in detail the work performed regarding certain items and preserving a deep silence as to what was done regarding others. Here again silence can only be interpreted as implying that sufficient investigation was made by the auditor to satisfy himself regarding such items.

To make full disclosure of the auditing procedure followed has the advantage that it puts the client on notice as to what has been done and precludes the subsequent claim that he believed a much more searching examination to have been made than was actually the case.

The desire to demonstrate to his client that he is something more than a mere bookkeeper, coupled with the very laudable desire to be of as much service as possible, often prompts the auditor to discuss matters in his report which carry him far beyond the strict boundaries of auditing. Obviously where a special report is being made at the instance of bankers, prospective purchasers, or others not intimately associated with the management of the business under investigation, it is entirely proper that the auditor should, if requested and if qualified by his experience to do so, include in his report informative historical and statistical data, comments on the capacity and efficiency of the plant and its management, discussion of the condition of the industry concerned as a whole, the potential market for the product manufactured, the adequacy or otherwise of the capital available, etc., etc. Where this sort of report is rendered, however, the auditor has entered the field of the economist and the industrial engineer, and it becomes exceedingly important that throughout the text of his report he indicate clearly whether the facts and figures discussed have been verified by him in an auditing sense or whether he is merely quoting statistics and information supplied him by others and accepted by him in good faith without verification. The auditor should, however, be careful not to run needless risks of stultifying himself or impairing his professional standing by accepting engagements of this character unless thoroughly qualified by training and experience to perform the assigned task. An individual or firm, specializing in a particular industry, may be well equipped to make a critical and analytical survey of the business conditions surrounding any corporation engaged in that industry but may be totally unfitted to make a similar survey relating to a corporation engaged in an entirely different kind of industry.

Let us consider the type of audit contemplated in the federal reserve bulletin entitled *Verification of Financial Statements* published in 1929, which you will recollect is a revision by a committee of the American Institute of Accountants of an earlier bulletin published in 1917 entitled *Approved Methods for the Preparation of Balance-Sheet Statements.*

This is the most usual type of investigation with which auditors have to cope.

The examination outlined contemplates "the verification of the assets and liabilities of a business enterprise at a given date, a verification of the profit-and-loss account for the period under review and incidentally an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal checks." The procedure outlined in the bulletin is of course not intended to be mandatory in every instance. The bulletin concludes its procedure instructions, however, with the following somewhat significant paragraph, "In some concerns certain details of procedure suggested in these instructions may be impracticable, and an effective system of internal check should make them unnecessary. In such cases tests only need be made, but the auditor must always be prepared to justify his departure from these instructions."

In discussing the form of the auditor's certificate, the bulletin confines itself to stating that the certificate should be as concise as may be consistent with a correct statement of the facts, and that, if qualifications are necessary, the auditor must state them clearly. The bulletin further draws attention to the fact that the balance-sheet, the profit-and-loss statement, the auditor's certificate, and any report or memorandum containing reservations as to the auditor's responsibility and qualifications as to the accounts or any reference to facts materially affecting the financial position of the concern should be connected in such a way as to insure their use conjointly.

If the auditor is convinced that the examination has been adequate and in conformity with the general instructions contained in the bulletin, that the balance-sheet and the profit-and-loss statement are correct and that any minor qualifications are fully stated, then the following form of certificate is suggested:

> "I have examined the accounts of .... Company for the period from .... to .... I certify that the accompanying balance-sheet and statement of profit and loss, in my opinion, set forth the financial condition of the company at .... and the results of operations for the period."

However, as reference to Mr. Himmelblau's 92 varieties demonstrates, auditors at times find themselves not in a position to issue such an unqualified certificate and it is proposed now to review briefly some of the most frequent reasons why this is so, how qualifications can be reduced to a minimum, and when their insertion in certificates is absolutely necessary.

It is interesting to note in the first instance that the bulletin itself particularly states that the procedure outlined "will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operating transactions or by manipulation of the accounts," but evidently does not consider it necessary that attention should be drawn to this limitation upon the auditor's responsibility in his certificate. However, where in addition to certified statements a detailed report is furnished it is considered proper by most auditors to draw the client's attention to this limitation in such language as "Our attention has been devoted primarily to the verification of the assets and liabilities as at .... While we have not attempted to audit the accounts in complete detail and our examination is not, therefore, as comprehensive as would have been necessary to disclose all possible errors and irregularities, we have made tests of the accuracy of the operating results reflected in the profit-and-loss statement for the .... ended .... sufficient to satisfy ourselves as to their general accuracy."

Unnecessarily lengthy qualifications and comments by the auditor can be avoided if the basis of valuation assigned to each group of assets is disclosed on the face of the balance-sheet. Great care should be exercised by the auditor, however, to make sure that the language used embodies such explanatory detail as he considers necessary. For example, where the auditor has not investigated the value assigned to plant acquired prior to the year under review by him, he would not be justified in certifying the balance-sheet without comment, if the fixed assets shown are described as "at cost." An auditor should not resort to the unqualified use of the meaningless phrase "at book value." Where an appraisal has been given effect on the balance-sheet, it is always desirable that the auditor should mention the name of the appraisers in order that the readers of his report or certificate can form their own opinion as to the degree of reliance to be placed upon the valuation. It is not the province of the auditor to pass upon the competence of the valuers, but he should put all concerned on notice as to who they were.

Similarly, care should be taken in describing the basis of inventory valuations. Where standard costs are in use by the client and were applied to the closing inventory of finished and partly finished merchandise, it is obvious that the phrase "at cost or market whichever is lower" is not descriptive of the situation. Where a good cost system is in operation, investigation of the "variance accounts," reflecting the difference between "actual costs" and "standard costs," would enable the auditor to adjust the inventory to approximate "actual cost," but cases arise where the client absolutely prohibits such adjustments and in such instances there is nothing left for the auditor to do but qualify his certificate or else insist that the basis of valuations be very clearly set out on the face of the balance-sheet with a notation as to the approximate variance from actual cost.

Attention is directed to the fact that wherever capital stock has been issued as the consideration for the acquisition of property, particularly that of an intangible nature, such as patents, trademarks, etc., it is generally impossible for the auditor to ascertain the actual cash value of the assets so acquired (resolutions contained in the board minutes notwithstanding) and it is therefore desirable that notation be made on the face of the balance-sheet that such assets were acquired in exchange for stock if the amount involved is large.

During the last few years the responsibility of auditors for quantities and condition of inventories has been the subject of continual debate. The findings of a special committee of the New York State Society of Certified Public Accountants was published early this year, which, while not presuming to settle the matter one way or the other, submits a number of alternative ways in which inventory responsibility can and should be limited by auditors in their reports and certificates under varying conditions.

As regards direct communication with trade debtors, the federal reserve bulletin on *Verification of Financial Statements* states (paragraph 33)—"It is best to verify open balances by confirmation from customers," but does not state whether or not failure to do this calls for restrictive wording in the auditor's report though it states (paragraph 34) that "in small concerns with imperfect systems" it would be quite possible for accounts to have been paid without their being correctly credited on the accounts-receivable ledgers. This committee is of opinion that as regards such small concerns the auditors' report or certificate should state definitely whether they have or have not communicated with the debtors.

Failure to enumerate and evaluate contingent liabilities is one of the most common sins of omission in auditors' reports and certificates. There are obvious limitations upon the auditor's ability to discover what liabilities of this character exist, but the duty of diligent inquiry is imposed upon him in this regard and it is always advisable for him to require the appropriate officers of the corporation under investigation to go on record in regard to the matter.

Auditors often fail to make suitable comment regarding reserves. It is, however, the obvious duty of the auditor to pass upon their adequacy and if he is not satisfied in this regard he should insist on their increase or decrease to meet the facts or else make appropriate comment in his report and certificate. It should be borne in mind that over-provision of reserves is as common as under-provision and that both should receive the auditor's careful consideration. So-called "contingent reserves" predicated upon no known contingency should always be shown as a part of surplus and any other treatment should be commented upon by the auditor. It is important that material changes in reserve accounts during the period should be disclosed. It is an altogether too common practice for corporations to write off large losses against "contingent" or other reserve accounts without showing the nature and amount of such losses in the published accounts. For example, it might be quite proper for a corporation to make a blanket reserve of $1,000,000 in 1930 to provide for possible damages arising in patent litigation, bonuses to employees, and other contingencies, but if in 1931 it charges against this account $700,000 of inventory adjustments, $100,000 by way of bonuses to employees, $120,000 for damages, and $80,000 for legal fees, its stockholders are surely entitled to this information and should not be expected to be satisfied with a disappearance of the reserve without any explanation.

The surplus shown in the balance-sheet should be adequately and appropriately described as to its nature and source. Obviously, the reader of a certificate or report may be misled as to the earning power of the company if surplus arising from sources other than earnings is not clearly indicated.

The auditor is definitely obligated to take cognizance of matters which to his knowledge have arisen subsequent to the date as of which the audit is being made and have materially affected the financial condition of the client. In fact he is to some extent charged with the duty of making inquiry and investigation in this direction. For example, large commitments, as at the date of the balance-sheet under audit, for future delivery of materials at a cost considerably in excess of current market prices, should unquestionably be made the subject of comment. Similarly, a substantial drop in market value of the inventory, destruction of plant by fire, large defalcations or other detrimental happenings call for comment and possible adjustment of balance-sheet figures.

Attention is directed to the fact that where large advances have been made to company officers or to subsidiary and allied companies during the year under audit but repaid prior to its close, the auditor is charged with the duty of satisfying himself that the repayment is a bona-fide transaction and was not merely a window-dressing manœuvre to make the balance-sheet look pretty at the close of the year.

Attention is directed to the fact that the 1929 bulletin, *Verification of Financial Statements*, lays considerably more stress upon the profit-and-loss statement than did its 1917 predecessor. This is in line with the broad general trend of business, in that capital structure now involves stocks rather than funded debt, that earnings have a more vital meaning in these times of wide-spread stock ownership, that industry in the past ten years has passed through shorter and more violent fluctuations, and that new products, substitute markets, keener competition and changing trends have undermined much of the old-time stability of individual businesses or even of industries. A closer scrutiny of operations is called for, and semi-annual or even quarterly publications of earnings statements are not unusual. The management, the stockholders and the bankers are all concerned with results from operations, perhaps even more vitally than with balance-sheet position.

Any comments in the report dealing with results from operations are dependent largely, of course, upon the form and completeness of the statements which have been prepared, and these in turn are governed by the purpose and scope of the audit. If comparative operating statements have been presented, however, there is a fruitful field for comment on the trends thus disclosed in sales and in the various items of expense. At least it should be possible for the auditor to indicate broadly whether the various ratios of expense are in line with the normal for the business and industry. Excessive production costs, selling expense, administrative salaries or unusual development or advertising expense should be the subject of comment. Significance may be found in an abnormally high or low gross profit ratio. A further service may be rendered if the auditor is able to associate irregular operating ratios with known operating conditions of the business or conditions in the industry, thus providing a basis for study of the situation by the management, looking toward correction.

Technical exactitude in the make-up of operating statements must be demanded. For example, inter-departmental profits must be eliminated, though often obscured, as in the pricing of branch inventories at an arbitrary figure. Similarly, it should be insisted that profits or losses carried over from a prior period or deferred to a succeeding period be properly treated in the operating statements. Slightly different is the matter of classifying profits or losses not applicable to the normal going business.

It is obvious that a technical subject of this kind can not be discussed exhaustively in an after-dinner talk and many important points have necessarily been dealt with in the briefest possible way.

In conclusion we would urge that it be a matter of personal pride with each member of this society that his reports be at all times, in every respect, a credit, not only to himself and his firm, but to the profession to which he belongs.