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Coöperation between Accountants and Bankers*

BY WILLIAM B. CAMPBELL

It is a great pleasure to have the opportunity this evening of meeting the Cleveland chapters of the Robert Morris Associates and of the American Institute of Accountants.

I have been asked to speak on the work of the committee on coöperation with bankers of the American Institute of Accountants in coöperation with the corresponding committee of the Robert Morris Associates.

Two years ago Frederick H. Hurdman, one of the members of the American Institute committee, spoke at a regional meeting of the American Institute in Cleveland on the same subject. I do not intend to repeat Mr. Hurdman's remarks on that occasion, but in summarizing our work for the benefit of the Cleveland members of the Robert Morris Associates some of the same ground may be covered.

The work of the two committees began more than five years ago. During the years immediately preceding 1922 the Robert Morris Associates had accumulated a record of instances in which the bank credit men criticized the work of public accountants in the certification of statements for credit purposes, and the first work of the Institute committee was an analysis of those cases. One of the main points raised by the credit men was that there did not seem to be any standard of verification followed by the accountants in their audits and that the certificate of one accountant might mean something very different from a precisely similar certificate given by another.

It developed that many of the bank credit men and many of the accountants either did not know or had forgotten that the same question had been discussed some five years previously by the federal reserve board and by the American Institute of Accountants, and that there had been put out by the federal reserve board a tentative programme of audit of balance-sheets and

*An address before a joint meeting of the Cleveland chapters of the Robert Morris Associates and of the American Institute of Accountants, Cleveland, Ohio, November 30, 1927.

profit-and-loss statements for credit purposes which had the approval of the American Institute.

The analysis of the cases accumulated by the Robert Morris Associates, to which I have referred, further developed the fact that, had this programme of audit been followed by the accountants, the bankers in most instances would have had no cause for complaint. From that day to this our committee has never lost an opportunity of impressing upon the accountants the need for making this programme of audit the minimum requirement of a verification of a balance-sheet and statement of profit and loss for credit purposes.

It might be said at this point that the federal reserve board in the preface to the programme of audit invited suggestions for its improvement in the following words:

> "The federal reserve board, after conferences with representatives of the federal trade commission and the American Institute of Accountants, and a careful consideration of the memorandum in question, has accepted the memorandum, given it a provisional or tentative endorsement, and submitted it to the banks, bankers and banking associations throughout the country for their consideration and criticism.
>
> The recommendations in the memorandum apply primarily to what are known as balance-sheet audits. This is an initial step which may easily be succeeded by future developments tending still further to establish uniformity and covering more fully the field of financial statements."

So far as I know, in spite of this invitation there have not been any constructive suggestions made to the board. Every accountant who has studied the programme will testify that it is an excellent piece of work, and it has stood the test of actual practice over a period of many years. However, there are several respects in which this programme might be improved, and in this relation I would draw your attention to a resolution presented at the fall meeting of the Robert Morris Associates last October in Wernersville, Pennsylvania:

> "There is constantly brought home to the Robert Morris Associates the very real service performed by the federal reserve board for accountants, business men and bankers in the publication several years ago of the pamphlet *Approved Methods for the Preparation of Balance-sheet Statements*. It has helped to standardize accounting methods, given business an accurate view of its own operation and enabled it to present the facts in a more intelligent manner to its bankers. There have been many changes in business practices since the first issue and we believe that the good work already done would be augmented by adequate revision in the light of present-day knowledge. We believe also that in any such revision the American Institute of Accountants should have an important part. It is therefore resolved that the federal reserve board be urged to revise this pamphlet and to consult with the American Institute of Accountants to effect the most efficient result."

It would be premature to discuss at this time any changes in the programme, but it is very interesting to read the acknowledgment by an organization of bankers of the value of the existing programme of audit which our committee in season and out has urged upon the members of the accountancy profession.

The work of the two committees has continued without interruption since they were first appointed and it may be of interest to you to know how they function. In the first place, the most important work we do, in my opinion, is the clearing up of misunderstandings and criticisms as they arise. The members of the Robert Morris Associates throughout the country refer any questions which they may have to the chairman of their committee in New York, and he in turn refers them to the Institute committee. They usually come to me as chairman of that committee and in many instances, in order to save time, I give my own tentative reply to the chairman of the bankers' committee, Harvey E. Whitney. The questions are subsequently taken up with the Institute committee or with the New York members of that committee, who can usually easily be reached, and if necessary a confirmatory or supplementary communication is made to Mr. Whitney. In some cases where the work of a particular accountant or firm of accountants has been questioned, an opportunity has been given them to present their view of the situation. In other cases the bankers have asked our committee for an expression of opinion as to the best accounting practice in particular cases which have come to their notice, without disclosing the name of the accounting firm or the name of the bank's customer involved, and our committee has endeavored to answer these questions as clearly as possible.

Many of the questions and answers were quoted by Mr. Hurdman in his paper some two years ago and from time to time have been quoted by Mr. Whitney in his reports to the Robert Morris Associates. Mr. Whitney's reports are, of course, available in the monthly *Bulletin*, which you have read. However, to give you some idea of the types of questions with which we deal I would like to quote one or two of the more recent communications between the two committees.

In a recent communication received from Mr. Whitney he submitted a statement received by him from one of his members in which an accountant, a member of the American Institute of Accountants, had signed a balance-sheet including all of the

assets other than cash and goodwill, etc., under one caption with the following wording:

> "Notes and accounts receivable from customers, officers and employees, etc., Merchandise stocks on hand, securities, real-estate, buildings, equipment and personal property located in thirty-one cities, $25,000,000."

The American Institute's reply was:

> "The first comment which I should naturally make is that which you anticipated—that it is unfair to blame the accountant any more than the borrower or the lender for the existence of such a credit statement. A further comment which occurs to me is of a broader character. Probably the borrower, the lender and the accountant all felt that the position of this particular concern was so strong that no real credit risk was involved. Consciously or unconsciously they perhaps regarded this as relieving the concern from the ordinary requirements of a proper financial statement; otherwise there would be no possible justification of the combination of heterogeneous assets in one total of $25,000,000.
>
> "Such an attitude is not uncommon. In much the same way you will find prospectuses, issued by houses of the very highest standing, which fall far short of conforming to the standards commonly set for houses of lower standing. One view of such cases is that the houses in question assume a correspondingly greater responsibility and that the investor is asked to buy on their reputation rather than on the specific information presented. From the point of view of our committees, however, it would be far preferable if all concerns in the highest class, whether bankers, commercial corporations, accountants or others, would apply in such cases the theory of 'noblesse oblige' and adopt a procedure which does not depend for its justification on their own standing but which would be equally satisfactory in the case of concerns whose reputation has not been established."

Another communication from the Robert Morris Associates read:

> "I have just received a letter from one of the members of the Robert Morris Associates from which I will quote as follows:
>
> "'There have just recently come to my attention very interesting remarks on the part of a local auditing firm here in connection with a detailed report covering a certain financing concern. For your consideration I should like to quote a number of these remarks:
>
> 'It is apparent that the funds of the company have been fully employed during the year.
>
> 'The ratio of current assets to current liabilities is 6.00 to 1.00—*indicating a very strong position financially.*'
>
> "'The report ends by saying:
>
> 'The company was chartered during the year 1922, but operations did not begin till the year 1923. It is well known that the cost of transacting business by a new company is greater in proportion to the income of the company, than that of an old established organization. This is true of the ——, yet it can be seen that the company has done well, and as it is now engaged in making loans which are very satisfactory from the standpoint of capital turnover and earnings, its growth should be more marked in the future than it has been in the past. It is apparent, also, that a larger amount of capital could be employed very profitably, for though it would afford a larger income, yet it would entail little if any additional expense.'

"'It occurs to me that the real purpose of an audit is to give a complete picture of the business as the auditor finds it, in so far as the facts and figures are concerned. It seems to me, however, that the remarks quoted above have no place in any auditor's report. They represent conclusions, the expression of which is entirely outside the field of the public accountant. One gets the impression upon reading the report that the auditor, in addition to his actual findings is attempting to recommend the company to the favorable consideration of the reader. Does it not strike you that this materially weakens the report?'"

To this inquiry the American Institute replied as follows:

"Replying to your letter of February 14th, it seems to me that there must be a line drawn between an auditor's certificate intended for general circulation and a report which may possibly have been prepared for a special purpose.

"It is axiomatic that an auditor's certificate or a report upon an audit should not indulge in forecasts but should be confined to a statement of the auditor's opinion upon the correctness of the accounts which he has examined. A detailed report, however, may be prepared for a variety of purposes and may possibly have been prepared by an accountant as an 'accountant' and not as an 'auditor.' It frequently happens that an accountant is asked by business or financial interests to make a general financial investigation of a concern and to give his opinion to the business man or financier to enable them to decide as to the profit-making possibilities of a concern. Of course, such reports are usually confidential and are not prepared for the information of anyone except the parties immediately interested. A great many accounting firms are asked to make such reports but it is usually understood that these reports are not to be regarded as 'certificates.' Such an opinion is given by the accountant as a business man and not as a professional auditor, and he should not put himself in the position of being quoted in his professional capacity regarding the subject matter of such an investigation.

"I feel, and I am sure that our committee will agree with me, that the accountant's responsibilities in the two types of work referred to are entirely different and the accountant's certificate as an auditor and his report as a financial investigator should be kept entirely separate and distinct. I am not sure from the extract you quote from your correspondent's letter as to which type of report he saw, but I would regard an accountant as unwise who included in an audit report a paragraph such as you have quoted, if that is what has been done. On the other hand, he may have been justified in including it in a report made for a specific purpose."

The two committees down to date have done a great deal of valuable work both for the bankers and for the accountants. There is, however, a great deal yet to be done. The American Institute has in hand several pieces of constructive work regarding the classification of accountants' services and certificates which will tend to a still better understanding of their work by the bankers and other interested parties.

With this brief review I would like to say something about some of the main points on which the commercial banker and the accountant may have slightly different views. The commercial banker is apt to look at all balance-sheets and profit-and-loss accounts and the accompanying accountants' certif-

icates from the credit viewpoint, and where only a balance-sheet and profit-and-loss account accompanied by a short certificate are given he may feel there are sometimes facts he should know which are not disclosed in those accounts.

Where the accountant is instructed to make an examination for credit purposes and is asked to present a detailed report upon his examination, then, of course, the banker should receive in the accountant's report all the information which he needs to supplement the borrower's own statement. It frequently happens, however, that the accountant is asked to audit the accounts of a concern where there is no indication that his work will be presented to a credit man of a banking institution as a basis of credit and he is frequently asked to prepare only a short certificate to the accounts and is specifically informed that a lengthy detailed report upon his work is not required. Such instructions are quite usual in cases where a certified statement is required for submission to a large group of stockholders. In such a case the accountant should follow in his audit the procedure laid down in the federal reserve bulletin, to which reference has already been made, and if he gives an unqualified certificate the banker is entitled to assume that he has done so and is thoroughly satisfied as to the correctness of the accounts which he has certified. In such a case, however, the banker to whom the statement is presented as a basis for credit should ask his customer to permit the accountant to talk to him freely about the accounts. I have known of many cases where in such circumstances the bank credit departments have, without the knowledge of their customer—or prospective customer—approached the accountant and asked him to discuss his client's accounts. The relation between the accountant and his client is, of course, a confidential one and the accountant would be violating this confidence if he should discuss his client's affairs without permission. The accountant, therefore, almost invariably asks the banker first to obtain the permission of his customer and says he will then be only too glad to discuss the accounts. If the banker does so, the accountant will be able to give him a great deal of information and atmosphere which could not possibly be conveyed in the balance-sheet as at a given date and in the usual summarized profit-and-loss account.

The accountant is frequently criticized for the form of the statements to which his certificate is attached. The critic must always bear in mind, however, that, technically, the statements

are the statements of the client, and while the accountant may not regard the form of presentation as an ideal one, nevertheless he can not make any very strenuous protest if the cardinal principle has been followed that every material fact should be disclosed in the statement and if sufficient information has been given for the reader to place his own construction upon any debatable item.

For instance, it sometimes happens that such items as "tools" or "dies", while generally regarded by the accountant as well as by the banker as capital assets, may in a particular case be claimed by a client as more in the nature of current assets, since they may be used in current production in a comparatively short period of time (say two or three months) and the cost recovered through manufacture and sale of the ultimate products. In such a case, if the client is willing to show the item separately in the balance-sheet, even if he insists upon calling it a current asset, the accountant can hardly refuse to sign the accounts.

Similarly, the accountant is not particularly concerned whether notes receivable discounted are shown in a balance-sheet as a contingent liability or whether they are shown on both sides of the balance-sheet as current assets and liabilities so long as the fact is disclosed in one form or the other.

The basis of valuation upon which the capital assets of a company are stated in the balance-sheet is another point upon which some difference of opinion may exist. Some companies for one reason or another have restated their capital assets upon the basis of appraised valuations instead of on the basis of original cost. The accountant can not object to such a statement, but he should insist where such a valuation is a material fact in the accounts that the basis of valuation of capital assets should be shown.

A company may own 100 per cent. of the stock of a subsidiary company, which in turn may have substantial indebtedness. The value of the parent company's equity depends to some extent upon the nature and amount of such indebtedness. The accountant may consider in a particular case that a disclosure of the situation should be made in the accounts. He is not particularly interested in the form in which such disclosure is made. It may be by the consolidation of the accounts of the two companies, it may be by the presentation of separate balance-sheets—one for the parent company and one for the subsidiary—

or it may be by a footnote on the parent company's balance-sheet showing the composition of the parent company's equity in the subsidiary company's assets.

The important point is that the accountant can not refuse his client the choice of legitimate alternatives so long as all of the facts are shown. If the client refuses to adopt one of these alternatives but insists upon a statement which the accountant regards as failing to disclose the true situation, then, of course, the accountant must qualify his certificate. This makes it imperative for a bank credit man, who relies upon accounts accompanied by a short certificate, to read carefully both the accounts and the certificate.

It has been suggested that accountants should refuse to give any certificate if they can not give unqualified ones, but this is a suggestion which is hardly practicable or fair to the client. Until an audit is completed the accountant does not know whether or not he can give an unqualified certificate, and it would surely be unjust to refuse to give the client some report or certificate upon the accounts qualifying the certificate in respect of such points as could not be agreed upon.

This does not mean that the accountant likes a qualified certificate any more than the banker does. The best accountants look upon a qualified certificate with distaste, but frequently in justice to their client and themselves there is no alternative.

Incidentally, it has been frequently stated that bank credit men should not be satisfied with a short certificate but should receive a detailed report upon the accounts which are presented to them. I would, however, like to draw your attention to the wording of the federal reserve bulletin with regard to the accountant's certification which appears on page 23 of that document in the following language and, you will observe, recognizes and in fact recommends a short form of certificate:

"The balance-sheet and certificate should be connected with the accounts in such a way as to ensure that they shall be used only conjointly. This rule applies also to any report or memorandum containing any reservations as to the auditor's responsibility; any qualification as to the accounts, or any reference to facts materially affecting the financial position of the concern.

"The certificate should be as short and concise as possible, consistent with a correct statement of the facts, and if qualifications are necessary the auditor must state them in a clear and concise manner.

"If the auditor is satisfied that his audit has been complete and conforms to the general instructions of the federal reserve board, and that the balance-sheet and profit-and-loss statement are correct, or that any

minor qualifications are fully covered by the footnotes on the balance-sheet, the following form is proper:

"'I have audited the accounts of Blank & Co. for the period from —— to —— and I certify that the above balance-sheet and statement of profit and loss have been made in accordance with the plan suggested and advised by the federal reserve board and in my opinion set forth the financial condition of the firm at —— and the results of its operations for the period.

(Signed) A. B. C.'"

A second point of difference of opinion between the banker and the accountant frequently arises with respect to the information which is included in the certified accounts. Some bankers take the position that there should be shown such items as the amount of purchase commitments of their customers, particularly in industries which are subject to sudden price changes, as, for instance, the rubber industry. Most of their customers, however, would strongly object to showing such an amount in certified accounts which are presented to the public generally, and the accountant's position is that if he has satisfied himself that the purchase commitments are not above the current market, or are covered by firm sales orders, accounting and commercial practice do not require any reference to the purchase commitments in the certified accounts.

Incidentally, I may say that the item of commitments is one which is not covered as fully as it might be in the federal reserve bulletin audit programme. The point became really acute in the lives of accountants of the present generation in the post-bellum adjustment period of 1920–1921, some years after the federal reserve bulletin was published.

Another case falling under this head is the question of whether or not the accountant should disclose in his certified accounts such facts as the action of a president of a company in obtaining during the fiscal year large advances from the company which are repaid before the end of the year and possibly reborrowed after the end of the year and after the annual statement has been prepared and certified. The accountant's position in such a case is a somewhat delicate one, and when the point was raised recently with our committee we took the position that if the fact was a really material fact in the financial position of the concern, it would have to be referred to in the accountant's certificate, or, alternatively, he would refuse to give any certificate.

It is in the settlement of such points as these that judgment and skill are required. It is obvious that it would be possible

for an accountant who did not possess these qualifications to do an irreparable injury to the credit and, incidentally, to the innocent stockholders of a sound and prosperous concern.

Last, the bankers sometimes disagree with the extent to which an auditor has verified the accounts of his client. The banker would naturally like the accountant to verify in every way possible every item in the balance-sheet and profit-and-loss account and to assume full responsibility for having done so. From a practical viewpoint, however, this is impossible. I would like to draw your attention to the following paragraph from the report of the chairman of the committee on coöperation with public accountants presented at the Wernersville, Pennsylvania, meeting of the Robert Morris Associates in October:

> "We hear rumblings off and on from the accounting fraternity in the form of articles, speeches, etc., indicating an attitude of aloofness and irresponsibility so far as concerns the inventory item. This is too comprehensive a subject to be dealt with at length in a report of this committee, but speaking by and large it is our firm conviction that as time goes on, accountants should be held to a greater rather than a lesser responsibility as concerns this very important item, and it behooves us all to work towards this end, which we should do not only with the accountants, but with our customers as well."

Some bankers have gone even further than this and suggested that the responsibility for the taking of physical inventories should be placed on the accountant. Long experience, however, has shown the accountant that the instances in which he is qualified to take a physical inventory are few, and if the bankers in granting credit should rely entirely upon physical inventories taken by public accountants they would be resting in a false sense of security. Undoubtedly there are some cases where an accountant is fully as capable of taking a physical inventory as anyone else, but these cases are in the minority.

The suggestion regarding physical inventories is hardly a practicable one since at the present time there are not enough qualified accountants to carry out the accounting work which is offered to the profession, and even if the added work could properly be said to come within the scope of an accountant's duties the accountants could not find the necessary staffs. The taking of physical inventories in most modern industrial and commercial businesses requires the services of a very large number of people for a few hours or days once in six months or once a year, and it would manifestly be impossible for an accountant to take the inventories of any substantial number of his clients. Further,

it would not be possible for the accountant to carry on his staff men having sufficient technical knowledge of materials and products to identify the items in every physical inventory. I would like to ask how many of you think that accountants possess the knowledge to go through the inventory of a jeweler, for instance, and be sure that the diamonds, rubies, emeralds, etc., which are shown to them are actually genuine stones of a certain weight and quality? Do you think the same men could take the inventory in a department store with its thousands of items, that of a silk mill with its different grades of expensive raw material and with finished products depending for their salability largely upon fashion, or that of a chemical company where strange substances would be presented for inspection?

On the other hand, however, it must be made clear that the accountant does not endeavor to avoid a proper responsibility with respect to the inventories of commercial and industrial enterprises. In the first place, the accountant must be satisfied that there is a reasonably good accounting system in use and if possible a perpetual inventory system which shows all receipts and issues of materials. He must also satisfy himself that the book records are checked periodically by actual physical inventories and that these physical inventories are carefully taken by responsible employees who certify to the accuracy of their count and if necessary make sworn statements to that effect. The accountant should also verify thoroughly the valuation of the items in the inventory to satisfy himself that they are taken at cost or market, whichever is the lower, and, further, should satisfy himself that the inventory is accurate from a clerical viewpoint. The skilled professional accountant can also apply a large number of other tests to the inventory to insure that it is not overstated.

He should also take particular care to see that no obsolete or slowly moving stock is included in the inventory except at appropriately discounted values, and this can almost invariably be done if the client's records are properly kept.

The astonishing thing is not that there are so many overstatements of inventories in commercial practice but that there are so few. It would surprise most people if they knew the number of cases, which never come to their notice, in which the inventories have been adjusted as a result of the accountant's work. The credit men merely see accounts which contain the inventory item finally agreed upon by the accountant. They do not know

how much that item has been adjusted as a result of his work. Furthermore, it may interest you to know that in my experience the grossest cases of misrepresentation of inventories have been in respect of inventories which were physically taken by or under the supervision of outside experts. One of the most serious cases I remember was that of an automobile company which had included in its inventory a large amount of parts which when assembled would not produce a marketable automobile. The inventory in this case was checked by the staff of another automobile concern which, as I recall it, gave a clean bill of health in regard to the usability of the material. If such an overstatement could take place in an inventory checked by independent experts in the same line of business, how could an accountant be expected to discover it?

Before leaving this subject, I do not wish you for one moment to think that I am endeavoring to minimize the responsibility of the accountant with regard to the inventory item. There is a great deal of work that he can do to assure himself that the inventory is correct from every viewpoint, and if he does not use every reasonable precaution he can properly be accused of negligence.

The outline of inventory verification in the federal reserve bulletin is representative of the best practice of inventory verification by accountants at the present time.

Another point of difference between the banker and the accountant arises in the form in which the statement of profit and loss is presented to the banker. In a balance-sheet audit the accountant, of course, verifies the profit-and-loss account for the period under review in the manner outlined in the federal reserve programme, and in that programme is presented a standard form of profit-and-loss account. In accounts which are prepared primarily for presentation to the stockholders and are available to the public at large, it frequently happens that clients take the position that too much information is presented in this form of statement and that this information may be used to their detriment by competitors. It is therefore customary in statements prepared for wide circulation, to give only a very condensed statement of profit and loss. Where such a statement is submitted to a bank credit man for credit purposes, in this case also he should ask his customers for a more detailed statement. The accountant, of course, can not give it without his client's per-

mission. It might be well, however, to say that even in a condensed statement of profit and loss extraordinary profits which do not arise from the year's operations should be shown as separate items, or it should be indicated in the statement that such extraordinary items have been included in the profits.

In the time at my disposal it is, of course, impossible to cover the ground completely, but I have endeavored to give you some idea of the way in which our committee is functioning and of the questions between the two committees with regard to which we are trying to find common ground.

In concluding, I may say that while I am in hearty agreement with the adoption of the minimum standard of verification of balance-sheets for credit purposes, such as that outlined in the federal reserve bulletin, I am strongly opposed to too much standardization in the accountant's work. Standardization carried to the extreme would leave no room for the exercise of initiative and judgment by the trained professional accountant in carrying out his work, and the business community, including the bankers, would be the losers.

I would like to place on record my appreciation of the spirit in which the accountants have been met by the bank credit men since the present movement for closer coöperation between the accountants and credit men was inaugurated. I have derived a great deal of pleasure and profit from my contacts with the bankers. The Robert Morris Associates committee on coöperation with public accountants and its chairman, Mr. Whitney, have always met us in the fairest possible way.