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THE title assigned to me for discussion violates the first principle that should apply to any type of accounting reports to the public. It is ambiguous. It might refer to financial statements, to accountant's certificates, or to both. I shall assume that either is acceptable and touch upon both, placing the greatest emphasis upon the certificate. (Incidentally, when everyone understands what is meant by "the accountant's certificate," why should there be so much effort to change its name to something more ambiguous?)

Financial statements are drafted for a wide variety of purposes, but the major purpose for publishing corporate reports is to furnish information to holders of the company's securities who are not sufficiently close to the management to be kept properly informed through more intimate channels. It is the contents of statements of this kind that have attracted most of the attention in recent years and it is the accountants' certificates accompanying such statements that are to be dealt with for the most part in this discussion.

Viewed in their proper light, financial statements submitted to stockholders are reports to the owners of the enterprise, and if this viewpoint is kept in mind many of the problems of determining whether information should be included or excluded will be less difficult to settle. This does not mean that it is always easy for the auditor to make his decisions, but it does give him a wholesome and effective guide to determining his own policy if the management does not make disclosures that seem to be important. We cannot superimpose our ideas as to the content of the report upon the management, but we can and should refuse to certify a set of financial statements if they do not disclose the information that must be disclosed to prevent them from being misleading. In some cases such a lack of disclosure may be offset by the accountant in his certificate, though usually any information that the client will print as part of the accountant's certificate could be, by a little persuasion, incorporated in the statements proper or in footnotes thereto. I am not saying that matters to which the accountant takes exception may usually be changed by a little persuasion, though sometimes even that is more true than we realize.

Incidentally, in this respect, the public does not wish to be and should not be left in doubt as to whether a comment by the auditor is an explanation or an exception. The reader of a certificate is entitled to know what it is to which the accountant takes exception and he should be told in terms that clearly convey that knowledge. A comment, for example, to the effect that depreciation has not been taken on certain types of assets means nothing to the layman as a general rule unless the certificate states whether or not it should have been taken to conform with sound accounting practice.

The investing public wants sufficient information in the accounting statements to make possible a reasonable analysis of the company's financial accomplishments upon which to make a judgment as to the possible future course of the enterprise. Securities do not sell and investment judgments are

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not made on the basis of what has happened in the past except as those events throw light upon what may happen in the future. That being the case, it is essential that the public be furnished with reasonable information about the past, under known economic conditions, so that those who are qualified may make informed judgments with respect to the future. Probably no great percentage of those who read financial statements can make an intelligent forecast irrespective of how complete the information may be, but there are enough who can and they have a sufficient stake in corporate securities so that the information should be published.

Just what particular information ought to be made available is material for a full day's discussion in itself. Accordingly, I shall take no time to discuss that phase of the subject except to state that any unusual items important enough to distort comparisons materially should be sufficiently clearly disclosed to make it possible to give due weight to them; that any significant changes in accounting principles or procedures should not only be disclosed, but their effect should be shown; that any significant departures from generally accepted principles or procedures should be fully stated, together with the means of appraising their effect upon the statements; that statements should be so drawn that significant matters are not concealed in large unexplained items; that significant classifications of items are not concealed by combination with others; and that descriptive titles are understandable to anyone with normal intelligence who is accustomed to reading financial statements.

The standard certificate promulgated by the American Institute in 1934 (which I shall call the old form) recommended that we say that the statements "fairly present in accordance with accepted principles of accounting consistently maintained by the X.Y.Z. Company . . . its position and the results of its operations. . . ." Under the form which was adopted by the council on May 9th of this year (which I shall call the new form) we are advised to certify that the statements "present fairly the position of the . . . company . . . and the results of its operations. . . ." May we say that statements "fairly present" or "present fairly" the position of a company or the results of its operations if the information they contain is not sufficiently comprehensive for the investor to make reasonable use of it for his purposes?

There has been considerable discussion as to whether it is the client's or the auditor's statements that are certified. A prominent member of the Institute's committee on auditing procedure recently stated that of a substantial number of accountants questioned on this point, sixty per cent thought the statements were the accountant's and only forty per cent thought the statements were those of the client. Whatever the answer to this may be in statements prepared for the numerous other purposes, when statements are presented to the public there can be only one answer, i.e., they are the statements of the client. The accountant may in fact prepare them for the client, but when they are presented to the public they become the representation of the client. Fine technicalities do not sit well with the average person, and you may be sure Mr. John Q. Public would not stand very long for management's evasion of responsibility on the grounds that the published statements are the auditor's. A corporation has a definite responsibility for the statements it presents and it has no right, in my opinion, to publish them unless it presents them as its own.

Any conception of the statements as being the representations of the auditor would preclude any qualifications by the accountant in his certificate, just as a client, in my opinion, is precluded from any qualifying statements in the footnotes. To present footnotes that are contradictory to the financial statements is entirely out of order, since both are the presentations of the same person. It is not out of order for the accountant's certificate to contradict the statements. As the reviewer, he may be expected to differ with the client. If they were his own he should have no differences with himself.

Probably most of the so-called public would like to see a certificate reading somewhat as follows: "We hereby certify that the attached balance-sheet and related statements of surplus and income of the A. B. C. Corporation are correct. (signed) X. Y. Z. Co., C.P.A's." However, I would expect the well informed person to be quite exercised over any such wording. The accountant should believe that the financial statements are a fair presentation of the condition of the client and the results of its operations, but any representation by him that they are correct would be adequate grounds for questioning his qualifications. It is impossible for a statement covering any period less than the entire life of a corporation to be correct. The informed person would like to know how the accountant could be so sure about depreciation, contingent liabilities, the carrying value of assets, the collectibility of accounts receivable, the accuracy of the amortization of deferred charges, and a host of other matters.

Nevertheless there is a desire on the part of the public for a concise assurance by the auditor, which he can satisfy. No one can be sure from an auditor's certificate that an adequate audit has been made. The public must depend upon the integrity and the professional ability of the accountant whose name is signed to the certificate for its assurance that a proper job has been done. I challenge any of you to ascertain from any long form of certificate you ever saw that a proper audit was made. In some cases you may be reasonably sure that a proper audit has not been made, but the affirmative finding is impossible. Why, then, attempt to describe the scope of the audit to the prospective reader of the financial statements?

This plea for simplicity and brevity of the certificate with respect to the scope of the audit probably will not be concurred in by bankers and credit men, many of whom want a very extensive report. They would like to have the accountant state in great detail what he has done. Possibly they can make intelligent use of such information, but I have my doubts. At any rate, I have no quarrel with them and will coöperate gladly. They are in a position to demand what they want of the client. Let them do so and get the kind of report they wish, but let us not confuse the public with it. In this respect, my views differ also from those held by several recent writers and speakers and at least one member of the Securities and Exchange Commission, who have advocated an expansion of the description of the scope of the audit considerably beyond even that recommended by the old form of certificate. These persons assume that, with a more comprehensive statement of the scope of the audit, the investor will know better what has been done and the Commission will know whether a reasonably adequate audit has been made. I do not believe either is true. Moreover, I think there is always a tendency for the reader to be uneasy when an accountant goes into great detail with respect to the scope of his audit. There is always a suspicion that the recital may be an attempt by the accountant to free himself from liability for failure to do all he should, believing that any misrepresentation that could not be detected reasonably by the procedures he describes cannot be held against him.

As I have said, it is impossible for anyone to determine by reading the description of the scope of an audit that some procedures which are important to the particular case have not been omitted. The steps that must be taken in making an audit are determined by the methods followed by the client in keeping its accounts, the extent to which the work is subject to internal audit or check, the number of employees handling accounting and financial matters, the personalities of the management and employees and their general actions and attitudes, the opportunities for fraud, the incentives for misrepresentation, and a host of other items too numerous to mention and so subtle in their influence that they defy description. How, then, can any certificate recital of what has been done disclose whether or not everything has been done that should have been done?

For these reasons, I think the Institute committee took a very desirable step when it provided in the new form of certificate that the investor should be told that the accountant has "reviewed the system of internal control and the accounting procedures of the company and . . . examined or tested accounting records . . . and other supporting evidence, by methods and to the extent . . . deemed appropriate." It seems to me that the words "by methods and to the extent . . . deemed appropriate" are very important and highly significant. They say, "You must trust me to do a good job as an accountant. No detailed recital that I might make of the auditing procedures followed would tell you enough to make it worth your while to read them. If you cannot trust me, you had best not depend upon my certificate; but if you can bring yourself to the frame of mind where you believe I will do what an honest, capable, and independent public accountant should do, then you may rely upon it."

In adopting the wording of the new certificate, the committee discarded that part of the old one which said that the accountant had "obtained information and explanations from officers and employees of the company" and that he "did not make a detailed audit of the transactions." It seems to be assumed that the public will take it for granted that the accountant would not fail to obtain information and explanations from the officers and employees of the company if that were necessary to a proper audit. That seems to me to be a reasonable assumption. Possibly it may also be assumed that the public will understand that he does not make a detailed audit, but I am disposed to be highly skeptical as to that. Prior to the rather general adoption of the standard form of certificate promulgated in 1934, I think a very large proportion of the persons reading published financial statements were of the opinion that the certifying accountant usually made a detailed audit. I think there still is, unfortunately, a widely held opinion among laymen that the auditor reviews every transaction and determines that it has been properly accounted for and that his examination is of such a nature that, if done properly, it would be sure to detect any falsification of an entry or any defalcation. If the words "but we did not make a detailed audit of the transactions" are omitted from the certificate, I very much fear that a large part of the public will assume that we do make a detailed audit. I should much prefer to be able to omit this negative comment from the certificate, but I believe it is dangerous to do so until after there has been a very comprehensive program of public education.

It is argued that the public, through our old form of standard certificate and through the widespread dissemination of the bulletin *Examination of Financial Statements by Independent Public Accountants*, knows that our audits consist largely of testing, sampling, and reviewing of practices and not of the detailed auditing of all transactions. I should be glad to believe that is so, but I do not. Moreover, it seems logical to believe that those accustomed to reading our certificates, most of whom never heard of the bulletin, will believe that when we drop our statement about not making detailed audits it must mean we have made one, particularly in view of the public nature of the agitation out of which the report of the committee has grown.

Another place where I fear the committee, in taking a step toward simplification, went too far is in that part which states that the financial statements "present fairly the position of the . . . company . . . and the results of its operations. . . ." It seems to me this has an undesirable connotation that the statements, as submitted, fairly present the position of the company and the results of its operations, without any "ifs," "ands," or "wherefores"; that is, the financial statements appear to stand on their own feet; they do not, as is understood from the old certificate, fairly present in accordance with generally accepted accounting principles; they present fairly. When separated from generally accepted accounting principles, is it proper to say that a balance sheet presents fairly the position of a company? That seems pretty broad in view of the many things that are stated in accordance with accounting custom and not upon the basis of any abstract concept of fairness. How about buildings at cost with fair value substantially below, or inventories at cost with fair value greatly above, or past advertising carried as a deferred charge, or a lot of other things such as any accountant could mention? It is argued that the part of the certificate immediately following, which says that the statements "conform to generally accepted accounting principles," is to be read into the comment regarding the fairness of the presentation. I doubt whether the public will read it that way.

In the changed wording regarding the consistency of the basis of accounting with that followed during the preceding year, it seems to me the committee has improved the certificate significantly. The new form says the statements "conform to generally accepted accounting principles applied on a basis consistent with the preceding year." The old form which read "in accordance with accepted principles of accounting consistently maintained . . . during the year under review" was ambiguous to the layman and even accountants misinterpreted it. It was often used or interpreted to be merely an assurance that the procedures followed during the year were consistent. To most people it conveyed no assurance that they were consistent with the preceding year.

The report of the committee did not confine itself to proposing a new form of standard certificate. It also made certain recommendations regarding the audit of inventories and accounts receivable which almost preclude the acceptance of the certificate it proposed. By the action of its council in adopting the recommendation of the committee, the Institute publicly proclaimed that where inventories are a material factor the public accountant should either make or observe the making of physical tests by count, weight, or measure to satisfy himself that the inventories have been taken properly. If he does not do so, even though it is impracticable or unreasonable for him to do so, "he shall make suitable explanation or exception" in his certificate.

While I believe an auditor should make reasonable test inspections of inventories, wherever practicable, his ability actually to verify quantities and condition by physical inspection is subject to such important limitations that I feel the public will be misled if it is encouraged to attach undue significance to what he does along that line. He should do it, where practicable and reasonable, as a further support of his customary accounting tests of the inventory. Where it is impracticable or unreasonable to make such tests, it is often possible to supplement the inventory examination with other procedures that, to a considerable extent, make up for such a lack.

If statements are to be qualified when no physical tests are made, an unfair cloud will be thrown on the client in cases where such tests would not be practicable or reasonable, and there is serious danger that it will inspire a false confidence in the accuracy of the inventories in cases where no qualification appears. The accountant may be able to avoid any unfair inferences regarding the client, when he has to qualify, by expanding his comments to explain why the omitted procedures were not followed, but the misleading of public confidence, where no explanation or exception is included, is not prevented so easily. Possibly it will be necessary to expand the certificate in each instance in a way that will warn the reader of the limited reliance that may be placed upon the physical tests made by the auditor.

There is in this, however, a more serious problem. The committee says that "hereafter, where an independent certified public accountant has not made, or observed the making of, physical tests by count, weight, or measurement, either because such tests in his opinion are not practicable or reasonable, or because he has departed from normal auditing procedure, he shall make suitable explanation or exception in reporting on the financial statements of a concern over his signature." Apparently the committee overlooked the possibility of cases where such tests, while practicable and reasonable, may nevertheless be unnecessary. As I have just indicated, it seems to me that where such tests are not practicable or reasonable, there is no sense in commenting on them because accountants presumably do not do things that are impracticable or unreasonable. On the other hand, if his failure to make such tests was "because he has departed from normal auditing procedure," is he entitled to certify to the statements at all? An accountant may differ with and take exceptions to positions that the client has taken in its statements; he may also believe that the client has not disclosed certain facts sufficiently and may insert additional information in his certificate so that the statements, when coupled with his certificate, may not be misleading; but if he has not made the kind of an audit that he thinks would be required normally, it seems to me he has no right to attach his name to the certificate.

The case against requiring circularization of accounts receivable or qualification in the certificate is not nearly so strong. However, a substantial part of what I have said regarding the committee's pronouncement on inventories applies, though to a somewhat lesser extent, to the pronouncement regarding receivables.

After all, just what difference is there between the discretion necessary to determine when accounts should be circularized and inventories physically tested and that necessary to determine the extent of the examination to be made of all the other things that involve judgments as to procedures to be followed in the individual case? Is this a step toward attempting to lay down the detailed auditing procedures that are to be followed? If so, it is a serious mistake. Whether it is or whether it is not, I still think it is a mistake because it is a step in that direction. There is no way to codify the professional skill, judgment, intelligence, alertness, and instinct, or the integrity that mark the good auditor. It is impossible to blaze a trail for a hunter to follow when he is pursuing a deer. His success will depend upon his ability to leave the trail, to avoid the briars and swamps, to guess the motives of the deer, to adapt himself to the direction of the wind, etc. So it is with the auditor. He must be quick to see the pattern formed by apparently unrelated facts, to detect efforts to throw him off the trail, to recognize pretense and deceitfulness, to detect motives for unusual procedures, and a host of other matters, most of them obscure or subtle in their significance. Judgment, character, and intelligence cannot be codified, but they are the heart of auditing.

I realize that public confidence in the accounting profession has been somewhat shaken by some recent unfortunate events, but that is all the more reason why we should be extremely careful not to lead the public, either by our words or by our actions, to think that we do things to protect the investor which we know we do not do and cannot do.