

“ACCOUNTANTS’ CERTIFICATES”

ADDRESS

of

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BEFORE

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and

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Sound and informative accounting statements are basic under each of the acts* administered by the Securities and Exchange Commission; therefore, the part played by the accountant is extremely important, and much dependence is placed upon the results of this work.

Many accountants have expressed the belief that the Securities and Exchange Commission is in a position to make substantial contributions in the direction of more uniform accounting practices and more general acceptance of sound accounting procedures. When we note the number of occasions writers on accounting and financial subjects find for referring to the attitude of the Securities and Exchange Commission with respect to accounting matters, we cannot fail to be impressed by the seriousness of the commission's responsibilities. This is a direct challenge, but the commission cannot hope to achieve the desired results unless the members of the profession and the commission work together in the formulation and execution of sound policies.

A thorough discussion of the accounting problems confronting the commission would include a consideration of the historical background giving rise to the passage of the various acts; the provisions of the acts relating to financial statements of registrants; the forms prescribed and the rules and regulations promulgated by the commission; the controversial questions regarding accounting principles followed in the preparation of financial statements by individual registrants; and the policies adopted by the commission in approaching the solution of such problems. However, from this virtually unlimited field, I have selected for discussion the requirements of the commission relating to the certification of financial statements by independent public accountants.

THE STANDARD FORM OF REPORT

During recent years a great deal of attention has been given to accountants' certificates. As all of you undoubtedly know, the correspondence between the American Institute of Accountants and the committee on stock list of the New York Stock Exchange, published on January 21, 1934, as a pamphlet entitled *Audits of Corporate Accounts*, contained a suggested form and termed it an "accountants' report." While the general adoption of this form was a notable step in the improvement of accountants' certificates, questions relating to them nevertheless have continued to arise, and the commission, as well as the Institute, has continuously endeavored to bring about the improvement of accounting practices in this respect.

Early in 1937, I corresponded with representatives of a number of accounting firms for the purpose of obtaining their suggestions for the improvement of our requirements relating to accountants' certificates, and these suggestions are now being carefully considered. At the last convention of the American Institute a number of prominent practitioners participated in a round-table discussion of the Institute's form and I understand that, as a result, serious consideration is being given to an amended recommendation.

* Securities act of 1933, securities-exchange act of 1934, and public-utility act of 1935.

The form suggested by the American Institute has had considerable influence on the commission's requirements. The first rule that we prescribed with respect to certificates provided that:

“Any certificate by an independent certified, or public accountant with respect to any part of the registration statement, any papers or documents used in connection therewith, shall be dated and shall state that such accountant or other expert has, after reasonable investigation, reasonable grounds to believe, and does believe, at the time of the date of such certificate, that the statements therein are true and that there is no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, except as specifically noted.”

Some time after the American Institute suggested its form of “accountants’ report,” this rule was discarded and a rule substantially the same as our present one was adopted in its place. The first sentence of our present rule provides that:

“The certificate of the accountant or accountants shall be dated, shall be reasonably comprehensive as to the scope of the audit made and shall state clearly the opinion of the accountant or accountants in respect of the financial statements and the accounting principles and procedures followed by, the person or persons whose statements are furnished.”

This provision in effect calls for a certificate similar to the American Institute's suggested form of “accountants’ report,” inasmuch as that form prescribes a statement as to the scope of the audit made and an expression of the accountant's opinion of the accompanying financial statements and of the principles of accounting followed by the company. The Institute's form contains one very important requirement not specifically referred to in the commission's rule, i.e., that the accountant shall state whether accepted principles of accounting have been consistently maintained by the company during the period under review. However, we have interpreted that portion of our rule requiring comment with respect to accounting principles and procedures to infer that it is necessary to comment on whether or not these principles and procedures have been consistently maintained. Some of the certificates filed with the commission do not contain a reasonably comprehensive statement as to the scope of the audit made; others fail to give the accountant's opinion as to the accounting principles and procedures followed by the registrant; many others indicate a misunderstanding of the meaning of such terms as “consistently maintained by the company during the period under review,” and “accounting principles and procedures”; and still others indicate differences of opinion regarding the function of certificates.

CONSISTENCY IN ACCOUNTING

What does the term “consistently maintained by the company during the year under review” mean? Note 5 published in connection with the Institute's suggested form of certificate explains the phrase in this manner:

“This certificate is appropriate only if the accounting for the year is *consistent in basis with that for the preceding year*. If there has been any material change, either in accounting

principles or in the manner of their application, the nature of the change should be indicated.” [Italics mine.] Yet, it is not uncommon to hear accountants argue that, if the company was consistent in its accounting throughout the current year, they are not obligated to mention that the principles followed during the year were inconsistent with those followed during the preceding year. In my opinion, failure on the part of the certifying accountant to point out such inconsistencies, if material, and to furnish sufficient basic information to make comparisons possible constitutes negligence and makes the accountant a party to misrepresentation.

In the March, 1937, issue of *The Accounting Review*, I pointed out examples of the wide variety of opinion among accountants as to what constitutes “accepted principles of accounting.” A number of persons have argued that there is no conflict with respect to accounting principles; that they are confined to a few fundamental concepts, and that these are axiomatic.

Whether or not this is correct, to say in a certificate that generally accepted accounting principles have been consistently maintained, when the matters to which reference is thereby made are those fundamental principles universally accepted by all accountants, is to disregard completely and fail entirely to comment upon the only matters with respect to which inconsistent policies could have been followed. So far as the commission is concerned, it does not matter what the definition of the word “principle” may be. Its rules specify that the “accounting principles and procedures” followed by the registrant shall be commented upon. What is important to the reader of the financial statements in this respect is whether the company has been sufficiently consistent in the keeping of its accounts that the statements of one period are comparable with the statements of another, or whether they contain differences that may be misleading.

It is immaterial whether a change in the rate of depreciation or a change in the policy of amortizing debt discount and expense should be considered a change in principle or merely a procedural change. If the changes will materially affect comparisons, they must be clearly revealed in order that the statements may not be misleading. Moreover, if the accountant does not comment upon such changes, he is remiss in his duty.

To what extent is it proper for an accountant to certify that the financial statements of a company correctly reflect its condition and the results of its operations in accordance with generally accepted accounting principles within a particular industry – for example, “within the public-utility industry?” or “within the nonferrous-metals industry?” or “within the meat-packing industry?”

Accountants and registrants have often objected to any expansion of this expression, insisting that there are accepted accounting principles peculiar to a given industry and that the statements are properly drawn if prepared in accordance with such principles. Our attitude, on the contrary, is that accounting principles followed in a particular industry need explaining if they differ from principles generally accepted throughout business as a whole. Accordingly, when such conditions have existed, we have asked the accountant to state wherein the principles of accounting followed by the particular registrant differed from generally accepted principles, and to express his opinion with respect to the propriety of the procedures followed. Thus, an accountant who certified to the statements of a public utility that deferred the writing off of

abandoned property pursuant to the order of a state public-utility commission and who stated that the registrant had followed generally accepted principles of accounting in the public-utility industry was requested to point out wherein this was a departure from generally accepted accounting principles, and to express his opinion with respect to the propriety thereof.

Because of the lack of agreement among accountants with respect to important accounting practices, it has been difficult for the commission to determine what position it should take with respect to many statements involving controversial questions. A great many questions presented to us must be settled immediately. In some cases where highly thought of practitioners have followed contrary procedures, we hesitate to take a position in favor of what we believe to be the best practice, when there is no time for extensive research and consultation with leaders in the field. In numerous instances, when we believed that the methods of accounting followed by the registrant were improper, we have nevertheless accepted complete disclosure of the questionable matters, instead of insisting upon a revision of accounting statements. Of course, where there has been a violation of an unquestionably-accepted accounting principle, we have insisted that the statements be changed.

FOOTNOTES

Often, the procedures followed by a registrant are such that voluminous notes must be attached to the statements to make them not misleading. Apropos of this, in an issue of *The Journal of Accountancy** about a year ago, a prominent accountant made the statement that “while explanatory footnotes are sometimes necessary, an accountant has not lived up to his full professional obligation if he accepts an unsatisfactory method, explained in a footnote, in any case in which by the exercise of courage and persuasion he might have brought about the adoption of a more satisfactory method which would have rendered the footnote unnecessary.” Certainly the commission would prefer that financial statements be so prepared as to eliminate the necessity for extensive footnotes.

Often registrants and their accountants and, at times, members of our own staff appear to be confused by the question, “where shall explanations and exceptions be stated?” The answer depends upon the answer to another question which occasionally arises, i.e., “are the certified statements contained in a company’s annual report or as filed with the commission the statements of the certifying accountant or of the company?”

Accountants generally consider that statements filed with us are those of the registrant. Since the statements are drawn up from the books of the company and are presented by the company in its annual report or in a registration statement, this seems to be a logical view. The footnotes to the financial statements are pretty generally recognized as being part of the financial statements to which they are attached.

If, then, the statements and the footnotes are those of the company and the certificate is that of the independent accountant, it seems clear that the footnotes should contain the explanatory material, but not the qualifications and exceptions. The company cannot take

* January 1937 p. 66 Letter to Editor by George O. May.

exception to its own presentation. It would be wholly improper for a profit-and-loss statement to contain a footnote stating that the depreciation taken in the statement is insufficient. If the company deems the depreciation to be insufficient when it prepares the footnotes, it must also be considered insufficient for the purpose of the profit-and-loss statement. Conversely, anything that is purely explanatory in nature and useful only to interpret correctly items in the body of the financial statements belongs in the footnotes with a reference thereto in the statement proper.

The accountant's certificate, on the other hand, is his expression of opinion with respect to the company's accounting policies, its statements, and the related footnotes. If he is unable to convince the company that it should change the statements to conform with his opinions, he must, if he does not withdraw from the case, qualify his certificate by stating his objections and specifying his exceptions. The certificate is also the proper place for calling attention to unusual or controversial matters that call for special mention by the accountant.

Of course, the accountant is not without responsibility for the manner in which the statements are drawn, even though they are the statements of the company. While, theoretically and, possibly in some cases, practically, the internal staff of the registrant may prepare the financial statements, in a very large proportion of an accountant's engagements, it is my understanding that he prepares the statements himself and has a significant influence upon their final form. Many of the unsatisfactory items now appearing in financial statements would be corrected if, at every opportunity, the accountant conscientiously urged a change in policy and a correction of the objectionable procedures.

EXCEPTIONS

"Subject to the foregoing" is a phrase commonly found in the last paragraph of a certificate with reference to preceding paragraphs. What is the meaning of this expression? Does it voice an exception or does it not? Some accountants who use the term say, "No, we are not taking exception; we are merely calling attention to the fact that the foregoing comments must be read in order to get an intelligent picture of the financial condition of the company or the results of its operations; they are explanatory in nature and not qualifications."

Other accountants say, "Most assuredly we intend to take exception. When we have stated a practice followed by the client and then say 'subject to the foregoing,' we mean to say that our certificate is qualified by the matters previously recited." If accountants cannot agree among themselves as to the meaning of this expression, how can investors be sure of the meaning intended? If the accountant has recited matters to which he takes exception, he should specifically so state. If he does not take exception, his certificate should clearly show that he does not. The investor has enough difficulty interpreting the data without trying to guess what the accountant means by his language.

Another point that has come up in connection with accountants' certificates is the responsibility of the accountant for the depreciation provision and the accumulated reserve. It is generally recognized that it is not a part of the accountant's duty to assume responsibility for the depreciation charges and reserves, other than to determine that they are based upon a reasonable policy, consistently maintained. An accountant who certifies to financial statements without any

comment with respect to depreciation is generally considered to be saying that, in the course of his examination and the making of the usual checks and verifications incident thereto, he has not observed anything to indicate that the depreciation provisions of the company are not within reasonable limits. If an accountant, in the course of his examination, learns facts that cause him to believe that the company's depreciation provisions are unreasonable, it seems to me he should so state in his certificate. We have noted, however, that in some instances accountants have stated that they take no responsibility for the adequacy of provisions for depreciation or the accumulated reserve. I doubt whether it is proper for an accountant to avoid responsibility in this manner.

An accountant's comments with respect to the registrant's title to property or its freedom from mortgage often raise a similar question. For example, we have had certificates reading somewhat as follows:

"No inspection was made of the public records to verify the company's ownership of its property, the liens against such property, or the status of real-estate taxes. We have not undertaken to pass upon and assume no responsibility for the legal or equitable title of (the company's property). . ." We do not believe the accountant should be permitted to avoid the ordinary responsibilities of an auditor by disclaiming them in his certificate. Our rules provide that there shall be no omission from the audit "of any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit."

Generally an auditor is not required to make a specific study of the public records to verify the company's ownership of its property or to obtain legal opinion as to such ownership, provided the usual indicia of ownership appear in the accounts and nothing is revealed by the audit to indicate lack of ownership.

If the auditor finds and examines deeds showing evidence of having been recorded; if tax payments, special assessments, maintenance and repair charges, etc., properly supported, relating to such property are found to be reflected in the accounts; if rentals received from the property are recorded; if no rental payments are shown that might indicate lack of ownership; if no cash receipts from unentered mortgages are revealed and no payments of principal or interest on unentered mortgages are found; and if all similar lines of examination customarily followed in the normal audit reveal nothing to create suspicion as to the ownership of the property – the accountant ordinarily is not expected to make a search of public records as to title or liens.

If, on the other hand, the audit reveals something that leads the accountant to suspect that the property is not owned in fee or that existing liens or mortgages against the property have not been recorded on the books, I think he is bound to make such investigation of the public records or get such opinion from attorneys as will convince him that the facts are properly recorded.

It occurs to me that, in the statement quoted above, the accountants are making a reservation with regard to the ownership of the property that is out of the ordinary and leads to the suspicion that they may have had reasons to believe that the titles were not entirely clear, or that mortgages against the property were not reflected in the accounts. If a qualification of this kind is made in an accountant's certificate, it seems to me the certificate should further state that

the audit had revealed nothing to indicate that the books do not properly reflect the status of the property and all related liens and mortgages.

Closely related to the question of the accountant's certificate is the general question of accounting principles versus permissive state law. I think most of you would agree that the permission of a practice by a state law does not make it good accounting. However, there are some who take the position that, because a procedure is permitted by a state law, the accountant is in no position to criticize it. If you grant that a procedure does not become good accounting just because it is permitted by the state law, it must follow that, when generally accepted accounting principles have been violated, the accountant is required to take cognizance of such violations and comment regarding them, even though the procedure followed by the company has met the legal requirements of the state.

For example, a certain investment trust is authorized by its charter to treat as income the net cash proceeds received from the sales of stock dividends and rights arising out of its investments. The company has followed this procedure in its accounts, and the company's attorneys state that it is legal. Does this permission of the law make the practice good accounting? I think not. Moreover, I think the accountant would have been negligent if he had not pointed out this violation of accepted accounting principles and expressed his opinion with respect to it.

INTERNAL CHECK AND CONTROL

While most of the questions relating to accountants' certificates arise under the first provision of the rule, some questions arise under the other provisions, as well. The second part of the rule provides that:

“In certifying to the financial statements, independent public or independent certified public accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. In such case the independent accountant shall review the accounting procedures followed by the registrant and its subsidiaries and by appropriate measures shall satisfy themselves that such accounting procedures are in fact being followed.”

This provision differs somewhat from the pronouncement of the American Institute in its bulletin *Examination of Financial Statements* where (on page 8) it is stated that:

“An important factor to be considered by an accountant in formulating his program is the nature and extent of the internal check and control in the organization under examination. The more extensive a company's system of accounting and internal control the less extensive will be the detailed checking necessary.”

The commission's rule refers only to *internal audit*, as distinguished from the broader term *internal check and control*, and consequently it has been criticized as being too restrictive. It is pointed out that the fact that a specific reference is made to an internal system of audit maintained by the registrant may leave the impression that no dependence should be placed upon

internal check and control and that, inasmuch as dependence actually is placed upon both internal audit and internal check and control, both should be specifically mentioned, or both should be omitted from the rule. Possibly this criticism has merit. It is my understanding that the sentence about giving due weight to an internal system of audit was incorporated in the rule at the suggestion of the public accountants. It is not an affirmative requirement and should not be taken to infer that reasonable weight may not be given to the more general methods of internal check and control.

The third part of the rule reads:

“Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit.”

We have been told that this provision does not convey any definite meaning. According to my understanding, it means that the independent accountant shall not omit any audit procedure necessary to present a comprehensive and dependable financial statement.

The accounting profession has certain well-established requirements for a general periodic audit. The Institute, in its bulletin entitled *Examination of Financial Statements*, has laid down a program which, where applicable, must surely be recognized by the profession as a guide in determining the extent to which an audit of this kind must go. Recognized authorities have written extensively on the subject; it is part of an accountant's training and education.

The fourth and last part of the rule provides that:

“The certificate of the accountant or accountants shall be applicable to the matter in the registration statement proper to which a reference is required in the financial statements.” There seems to be some doubt among accountants as to the meaning of this sentence. This provision relates to matters required by the registration forms which are not a part of, but are required to be referred to in, the financial statements; e.g., in form A-2 the registrant is required to furnish schedules setting forth certain information with respect to each issue of authorized funded debt and for each class of authorized capital stock, as items 9A and 10A, respectively, of the registration statement proper. These schedules not only form a part of the registration statement but they also support the balance-sheet, inasmuch as reference must be made to them in that statement, and consequently should be covered by the accountants' certificate.

An interesting question arises where more than one independent accountant or firm of accountants have participated in the verification of financial statements of companies included in a consolidated or combined statement, namely, to what extent and in what manner should the work of accountants other than the principal firm be disclosed? Should the principal accountants be required to accept full responsibility for the work done by other firms? In the event responsibility for the work of other accounting firms is denied, should such other accountants submit their certificates and should their certificates be accompanied by the related financial statements, or, as an alternative, should the principal accountants be required to certify that, for subsidiaries or branches which they have not audited, they have in their possession statements

certified by other independent accountants whom they consider qualified and whose figures they have, after adequate review, accepted for the purpose of the consolidation?

These points are not specifically covered in our rules, nor has the commission adopted a definite policy with respect to them, although a revision of the rule is now under consideration. In the administration of the rule, it has been customary to require that the principal auditor take full responsibility or that the registrant file the certificates of the other accountants.

It has been possible to deal with only a few of the problems that arise in connection with accountants' certificates. The principle that guides us in dealing with these and similar problems is that the accountant should state his opinion clearly and unequivocally with respect to the statements of the registrant and the procedures followed in their preparation. Conscientious effort to observe this principle will solve most of the questions that arise.

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