

# THE AUDITOR AND FINANCIAL REPORTING

*door Prof. A. Goudekot*

## *Introduction*

The choice of topics of the papers to be presented during this congress, as made by the council, must be applauded; they cover an area which is of great importance to auditors everywhere. Accounting, auditing and financial reporting have their own philosophies and problems but they are also interrelated to such an extent that it is appropriate to discuss them together.

The council of this congress has also recognized that these fields can no longer be regarded from a narrow, nationalistic point of view. On the contrary, the fascinating development of the world economy necessitates a broadening of the approach to these various problems. Indeed, it is an international problem, which concerns the members of the profession throughout the world. The congress offers an unique opportunity on the one hand to deal with national postulates on a comparative basis and on the other hand to stimulate the thought that the profession has before it a task in the international area. This can lead to the action needed to arrive at international research on accounting as pointed out by my colleague Kraayenhof <sup>1)</sup> in his address to the American colleagues in San Francisco in 1959.

## *The world economy and the auditor*

I would like to have my reflections proceeded by a few observations to illustrate the significance of this problem in its world wide aspects.

After world war II we observed a spontaneous internationalization of economic relationships both as between investors and enterprises and as between enterprises, but also the countries of the free world increasingly pursue a determined policy to achieve ever expanding economic units. In this field here and there spectacular results can already be noticed. It is important for us to ascertain whether this development creates new problems within the scope of our professional activities and also whether the auditing profession can make a contribution in this field. It is appropriate to go into this further.

To form an opinion in this respect a distinction has to be made between the purpose of accounting, auditing and reporting and the principles applied in achieving that purpose. The latter is concerned with problems which to a greater or lesser extent are continuously being studied in the various countries. Certainly national circumstances, differences in fundamental viewpoint and development have led to widely differing accounting and auditing principles as between the various countries. As far as the ultimate purpose is concerned, I am under the impression that international cooperation directed at uniformity of opinion need not encounter great difficulties. With regard to the means of achieving that purpose many differences must be reconciled to arrive at uniform conceptions. It is my firm conviction, that these differences also can be reconciled if the ideas put forward by my colleague Kraayenhof in his previously mentioned address would be followed. For he advocated international professional consultations

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<sup>1)</sup> International challenges for accounting, J. Kraayenhof.  
Journal of Accountancy - January 1960.

aimed at international uniformity with elimination of rigidity. Undoubtedly Kraayenhof meant that the members of the profession should not strive primarily to convince each other of the correctness of their own views, but rather to reach one common denominator. This definitely need not involve the dogmatic adoption by one of the principles of the other.

To summarize, I would like to emphasize that regarding the relationship between our professional problems and the world economy, that the main problem areas do not change from country to country. That is to say that both nationally and internationally the problems which are important to be discussed were and will continue to be the purposes and principles of accounting, auditing and reporting. However, a supplementary problem arises, that is, how to achieve international agreement on that purpose and those principles. If the profession wants to make a positive contribution internationally on the same level as has been achieved on a national level in many countries, then the achievement of international agreement is a matter of great importance and urgency.

### *Financial reporting in general*

When dealing with the topic „the auditor and financial reporting” it is appropriate first of all to form an opinion regarding the position occupied by financial reporting in the overall field of accounting, auditing and financial reporting. Financial reporting - whether internal or external - aims at satisfying the need for information of those for whom the reporting is intended. Accountants and auditors focus on this objective, each from his own specific functions: that is to say, the first charged with preparing the information leading to a picture of the subject and the second charged with giving an opinion on the acceptability thereof. Therefore the information must be geared to the needs of those for whom it is intended, in which respect not only do contents and presentation play a part but also the time at which the information is given is of great importance. In this context it will therefore be necessary to carefully weigh all these factors so as to achieve an optimum performance of the objective, in which case some requirements must be subordinated to other considerations which are thought to be of even greater importance. This is the case, for example, when weighing the necessary degree of accuracy against the need for speed.

Regarding the requirement that the information must be geared to the needs of the persons for whom it is intended, external reporting has an extra problem as compared to internal reporting. In view of the great differences in expert knowledge of the various groups of interested people due care must be taken that the external reporting takes into consideration the needs of these groups. Technically it will not always be possible to achieve this result in a single report. In that case separate reports must be prepared for the various groups. An example is the annual report to employees which in many cases is a separate and distinct report.

With regard to financial reporting in general I should like to summarize by stating that it is complementary to accounting and auditing as such; after all the report is the visual demonstration of the results of those activities. For the members of the profession it is of paramount importance to realize distinctly that an erroneous conception of reporting may defeat the results achieved by sound accounting and auditing.

### *The auditor and financial reporting: general aspects*

With regard to the audit function a distinction must be made between the advisory and the pure audit function.

As far as the advisory function is concerned, a further distinction can be made between the auditor's advisory activities in general and those for a specific enterprise. I will not go into the details of these advisory activities but will limit myself to observing that in the various countries the profession makes a contribution in its own specific way. With regard to the general advice, in The Netherlands the professional organizations do not issue specific directives or recommendations in this field and this general advice takes place among other things by publication of the results of studies made by committees, appointed by the professional bodies, by the participation of members of the profession in study groups with other organizations and the like. The considerable improvement which can be observed in financial reporting in Holland is due furthermore to an appreciable degree to the recommendations given by the individual auditor to his client. For an auditor to practice his profession properly, as a result of his observations in the course of his audit, he must be in a position to impart to his client the full advantage of his advisory function. Where it concerns information to be published, this is true to an even greater extent. This involves the potential risk of collision of opposing interests, particularly in a country like Holland where in general there is no compulsory auditor's examination and there also are no specific rules and recommendations governing the form and content of the annual accounts. In such situations the auditor has to defend his standpoint more vigorously than in countries where such rules do exist. Consequently the entrepreneur may, at times, reproach the auditor for letting the interests of the business community prevail over those of the company. I feel it of importance to establish that in principle this conflict should not exist but that the auditor must be able to make it clear to the management of the company, that the company itself has an interest in reporting which satisfies the requirements of the business community. In my opinion, it is not debatable that the interests of the business community and those of the company broadly coincide. On the one hand the business community needs a reporting that discloses all essential aspects of the financial position. On the other hand the company is interested in satisfying those needs in order to maintain its position in the capital market and vis-à-vis other interested parties. In this respect auditor and entrepreneur stand side by side: the demands on the auditor in his function as a person trusted by the business community equal the demands on the entrepreneur, if the latter is to maintain his position in the capital market. I consider this an argument of great psychological importance both from the standpoint of the enterprise and that of the business community.

In the preceding part of this paper when discussing „financial reporting in general” I also mentioned internal reporting. It is appropriate to develop further the position of the auditor in his pure auditing function with regard to internal reporting. Undoubtedly the auditor has to include a review of such reporting in the scope of his audit. Without a review of the internal reports, which have been geared to the structure of the organization, the auditor will not have sufficient background for his opinion on the annual accounts, which concern the true reflection of both the financial position and the results of operations. However,

this is only one aspect of the problem. It should be borne in mind that internal reporting is there to supply the information needed by management in order to direct and control the enterprise. Therefore internal reporting encompasses a number of very important management documents. In view of the fact that the auditor also functions as a person trusted by the company's management (which means that he also performs his duties on behalf of management), he would be deficient in the performance of his duties in respect of that management and therefore indirectly also in respect of the business community, if these management documents were not included in the scope of his examination to a substantial extent. The auditor will have to ascertain that the information in the internal reports are in fact responsive to the needs of management: this is expected by management. The auditor will be able to judge the true picture of the annual accounts only if he also takes into account his opinion on the internal reporting.

### *External financial reporting*

In dealing with the field of external financial reporting I have to limit myself to some extent. For our purpose individual reports as issued to official agencies, to a single capital supplier and the like can be excluded from our consideration. As far as reporting to the public is concerned - usually by means of the annual report and the offering prospectus - we may confine ourselves to the annual report, as the problems in both cases differ only in the matter of emphasis.

I consider a limitation appropriate in another respect also. The specific requirements relating to the annual accounts will not be elaborated upon since these have already been discussed extensively by my Dutch colleagues who presented papers on accounting and auditing. In conclusion, within the limited scope of this introduction, a review from a more general point of view appears more appropriate to me.

First of all, therefore, let us focus our attention on the annual accounts and on the annual report of which the annual accounts form a part. The function of the annual report - a composition of information regarding a specific period in the existence of the enterprise, which period is rather arbitrary as it is only marked out by the calendar - is dictated by the needs of those interested in the report. This function is twofold:

- a. accounting by the company's management of its administration during the period under review (retrospective purpose);
- b. supplying information from which interested persons may form a picture of the future of the company (prospective purpose).

In preparing the annual report, care should be taken that both purposes will be satisfied. As the annual report sets forth information on a relatively accidental period in the existence of the company, the approach to it must be dynamic, which means that this instantaneous photograph during the life of the company must be placed in the overall context of the development of the company. Only then can the annual report meet both of the previously mentioned requirements. The interested parties will have the full benefit of the information only if the annual report gives not only an account of the period under review, but also provides comparative material relating to the past and certain basic data for orientation on the future. This is what the investor wants and needs, and the



information can be called appropriate only if it is focused on and geared to the actual development of the enterprise in the past and the expected development in the future. To fulfil that purpose the annual report must meet the following requirements:

- a. the annual report must state the accounting principles on the basis of which the results of operations and financial position have been computed. Only then is it possible for the reader to form an opinion regarding the published figures. This is especially true today in the light of the variety of acceptable, alternative accounting principles. If in due course more uniformity will have been achieved, this requirement will continue to be valid since there will always exist differences in application, evolving from the circumstances of the specific case;
- b. the income account must be presented in such detail that insight on its composition can be achieved and that it is possible to calculate the ratio of income to invested capital. Regarding the composition of the result, it is important to segregate the activities which have led to operating income and to distinguish between operating and other income;
- c. in the balance sheet the assets and liabilities must be set forth in such detail that insight can be gained as to the solvency and liquidity of the enterprise;
- d. contingent claims and liabilities must be disclosed if this is important;
- e. changes in the application of accounting principles and the composition of the figures as compared with those of the previous period must be stated, together with an indication of the effect thereof;
- f. to the extent practicable the figures of previous periods must be given on a basis comparable to those of the period being reported upon;
- g. statistical information relating to previous periods should be presented in a way which integrates the data currently reported upon with the historical development of the enterprise. This brings the dynamic meaning of the information to the fore and relegates the static evaluation of the period to a secondary position. Ratios of importance to the reader must be shown in the annual report;
- h. in cases where balance sheet and income account items cannot be adequately explained within the body of the statements, or where there exists a danger of misunderstanding, separate explanatory notes must be given and the annual accounts must refer to such notes;
- i. management should give its views of the future in such a way and to such an extent as to enable interested parties to form a picture of the future of the company;
- j. the annual accounts together with the explanatory notes must be certified by an auditor.

Before ending this part of my paper, I should like to give some attention to the following points.

With reference to the requirements previously mentioned which should be met by an annual report in order to give an appropriate insight, it is clear that the principles embodied in the report must also be in accord with sound economic principles. In most countries the government or official agencies (among which we may mention the tax authorities) issue general statutory or other more or less

binding rules for reporting. In general, society, financial experts, and certainly the auditors will be interested in the gradual and rational evolution of these rules. To the extent that this is not yet the case, they will have to insist that the annual accounts drawn up in accordance with such rules be supplemented wherever necessary by explanatory notes so that the reader gets the information he needs. As regards the tax rules, it is important to realize that these rules are designed to serve the purpose of an appropriate levying of taxes and it is therefore questionable whether they should have a decisive influence on the preparation of financial statements. In view of the fact that these tax rules are not always in agreement with sound economic principles, I am inclined to exclude tax rules from considerations of sound accounting. In this respect I take the view that the application of economic principles to the financial statements will not lead to higher taxation but only to a shifting in the timing of the tax payments and this leads to the introduction of „deferred taxes“. In the event that this would result unfavourably on the levying of taxes, a procedure will have to be found to eliminate that result.

In order to enhance the reader's insight into the solvency, liquidity and earning capacity of a company, consolidated annual accounts must be published in those cases where the corporate structure requires it. In my opinion the consolidated annual accounts must be considered an essential explanation of the unconsolidated statements. As a consequence, when publishing consolidated statements, the unconsolidated statements should also be published. It also follows that the final figures of both statements, as far as the shareholders' equity and income are concerned, must be the same. After all, an explanatory note can never produce a different result; it can only provide a better insight into this result.

Concluding this part of my paper which was concerned with the purpose of the annual report and the requirements to meet that purpose, it is important to emphasize that the responsibility for the annual report rests squarely on the company's management. The outside auditor has his own responsibility, which we will now review.

### *The outside auditor and the annual accounts*

Taking into consideration the place of the outside auditor with regard to the annual accounts, first of all the starting-point must be determined.

It is the general professional opinion that the auditor's certificate is a part of the financial statements presented by the company. With this certificate are connected professional and legal responsibility and liability.

Before stating my own viewpoint regarding the contents of the certificate I should like to quote from the Journal of Accountancy of August 1961 in which four authors answer the question: „What is wrong with financial reporting?“ The financial columnist, Mr. J. A. Livingston, writes: „Certification statements are ambiguous. One certificate will specify that the certification applies to pages 14 to 16 of an annual report; another, to the income account and balance sheet; a third to statements only. Well, which is it? Does the average reader know what the statements encompasses: the president's report, including his glowing prognostication of the future, and the treasurer's statement about the financial well-being of the company? Is the president's report a true reflection of the company's situation?“

In the part of my paper dealing with external financial reporting I described the annual report as a composition of information related to a period in the existence of the enterprise. This composition of information is - as we have seen - directed to a retrospective and a prospective purpose. The responsibility and the liability of the auditor are limited to those parts of the annual report to which his certificate relates. The statements of Mr. Livingston would seem to give rise to doubt whether the interested parties clearly realize to which part of the annual report the auditor's certificate relates.

Therefore I should like to go further into the question of what the auditor's certificate ought to cover when this certificate is considered within the framework of the function and conception of the annual report and how this coverage is to be included in the general professional opinion regarding the responsibility and liability of the auditor.

In accordance with my conception of the function of the annual report, wherein the complete financial information and its interrelationship are of importance to interested parties, I am inclined to believe that the responsibility of the auditor should cover the complete report - not merely the formal financial statements. As far as the balance sheet, the income statement and the explanatory notes directly related thereto are concerned, it is clear beyond question that the auditor bears the responsibility for his opinion relating to such statements. Regarding the other information in the annual report - particularly that part of the observations focussed on the future - the auditor's responsibility is not clear-cut. It is an essential principle that the auditor can only give an opinion if the work performed by him justifies it. However we must take into account the fact that the auditor follows the evolution of the needs of the business community in order to arrive at the contents of his certificate. This evolution causes the business community to get a more and more dynamic attitude in its observation; it is concerned with the overall information and not only with the annual accounts. It appears to me that the Rules for Professional Activities of the Nederlands Instituut van Accountants (Netherlands Institute of Accountants) give the fundamental solution therefor. Article 14 of those Rules states that the certificate also covers the information in the annual report which serves as an explanation to the document to which the certificate directly relates and also covers the further data given in relation to said document.

The article from the Rules for Professional Activities, quoted above, bears emphatically on the explanations and on the additional data in the document to which the certificate is directly related. In connection with the concept of the annual report as I view it, I am inclined to believe that in spirit this rule embraces all the information related to the functions of the annual report. Taking this as a basis, then the problem as put by Mr. Livingston is solved, in the sense that the auditor's certificate must cover all financial information in the annual report. The responsibility should be clearly marked; the auditor bears full responsibility for the annual accounts and should bear limited responsibility for the other data. In order to shoulder that responsibility he has to do all that can reasonably be expected of him. Then, it becomes important to find out what the substance of that reasonable expectation can - or may - be. This much is certain: except for the personnel in the enterprise itself, the auditor is the most appropriate party to review these other data. After all, in his pure audit function he learns much about

the internal information of the enterprise, he examines the means and techniques with which the information is created, and therefore there is much which he can do to test the other financial data in respect of which he carries this limited responsibility.

The countries which have achieved advanced development of professional practice have succeeded in delineating the responsibility of the auditor in regard to his certificate on the annual accounts. It appears to me that it will also be possible to delineate his limited responsibility in regard to the further financial information in the annual report. This information, together with the annual accounts, give a picture of the financial position and the results of operations of the enterprise for a period which can only be judged appropriately in its proper place in its development. Only when the auditor views the contents of his certificate in that manner, can he serve the business community and the management of the enterprise appropriately. This would be an evolution parallel to the evolution in reporting, in the same way as a parallelism can be observed between the evolution in performance of the auditor's duties and the dynamic development of accounting. As far as the latter subject is concerned, Mr. Jennings in the U.S.A., Mr. McBeath in England and Prof. Groeneveld in The Netherlands, amongst others, have advocated the spreading (= dynamization) of audit operations. The discussion on the paper presented by Prof. Groeneveld provided me, at the time, with the opportunity to raise the question as to whether, strictly speaking, it is not intended that instead of an unqualified certificate on a specific annual account (static meaning), the certificate should in substance convey that the auditor, based on his regular examination of principles, organization and performance of the enterprise, certifies that the information given by that enterprise in its report can be considered to meet the requirements (dynamic certificate).

In connection with my observations on the auditor and the annual accounts I should like to make an observation with regard to interim reports, inasmuch as they are subject to procedures which may cause confusion. In these reports it is stated explicitly that they have not been examined by the auditor. In general I consider this not only unnecessary, but even undesirable. The auditor signifies his opinion by means of his signature; when this signature does not appear on the document, no misunderstanding can exist. In my opinion, the announcement „not examined" may even be dangerous: if the enterprise publishes other information which is likewise not examined by the auditor, such information would always have to be qualified in the same manner, and that is not always feasible. Only when confusion could arise, as in the case of a prospectus, containing both audited and unaudited data do I see the justification in clearly labelling the data as audited or unaudited.

### *Final observation*

In my observations I did not always explicitly mention the situation in The Netherlands. The approach of the subject dealt with did not allow for it. As earlier observed, in Holland there is a regular contact between the members of the profession on professional problems, wherein reporting takes an important place. To which extent the points raised by me will become generally accepted professional opinion within the not too distant future, I do not consider to be of



utmost importance. It is important that professional problems remain constantly in the spot-light and that the members of the profession, in their own interest, contribute to their solution on the basis of sound principles. Then the profession will be kept dynamic to the benefit of both the national as well as the world economy.

In the session on Monday 24th of September the paper was not read in full but only a summary was given, to which was added an extensive discussion of some important parts of the paper in the following way:

### *The purposes of accounting, auditing, financial reporting*

In my paper I have pointed out that uniformity of opinion on the purposes of accounting, auditing and financial reporting can be attained without great difficulties. You will agree that to discuss successfully „how”, „who” and „when” we should necessarily agree on „why”. If I am right that uniformity of opinion on the purposes („why”) can rather easily be attained, then we have a sound basis to discuss the means for achieving (= „how”, „who” and „when”) these purposes.

Briefly outlining these purposes, I would like to say that in my country accounting is described as the function in the enterprise which collects and elaborates data in order to create the information needed by management to direct and control the enterprise and to render account.

Auditing is the function which has to give opinion on the acceptability of the information created and the account rendered by the company.

Financial reporting is the means of communicating between the function which creates the information and those for whom the information is intended.

I believe these descriptions of purposes to be an acceptable startingpoint from which uniformity of opinion regarding the purposes may be achieved.

### *The auditor and internal financial reporting*

The subject of my paper, namely „the auditor and financial reporting” has been chosen to enable me, among other things, to deal with internal financial reporting.

I am of the opinion that the auditing profession must develop in accordance with the development in the fields with which it is connected. In this respect I think of the interesting book of Peter Drucker „The landmarks of tomorrow” where, dealing with innovation, he mentions three risks, namely the risks involved in challenge, failure and success. The latter, the risk involved in success, is important for our subject. This risk, Peter Drucker says, consists in the possibility that fields connected with the field where the innovation has succeeded do not follow its development. We in our profession must take care, while maintaining the basic fundamentals of the profession, that we do keep pace with the rapid development of management, organization and accounting. The ever growing importance of information for management and the fact that the auditor performs his duties also in behalf of management makes it necessary that internal reporting be included in the scope of the auditor’s judgement.

### *The responsibility of the auditor and the annual report*

With regard to the function of the annual report we observe an innovation as well. More and more the annual report is used not in the first place for rendering

account, the retrospective function as I called it in my paper, but to enable shareholders and others to take decisions (the prospective function). I am of the opinion that this development has a decisive influence on the annual report. Consequently I believe the annual report has to be considered as an entirety of closely related parts. Management report, management's view on the future and annual accounts should be judged in their interrelation, because only together they give the full picture. This happens the more because the importance of the interested parties is continuously changing. Shareholders' decisions ever more depend on the advices of investment experts. The approach of these experts being professionally, management has to fulfil their requirements in behalf of the position of the company on the capital market.

In view of this development and with reference to the necessity mentioned before of keeping pace with developments in related fields, I have come to the conclusion that the auditor has a responsibility in connection with the annual report as a whole. In my paper I have pointed out that I see a difference between the responsibility for the annual accounts and the responsibility with regard to the other parts of the annual report. The auditor has to accept such responsibility as a consequence of considering the annual report as an entirety; he should not exclude from his responsibility those parts of the annual report which are essential for the total picture.

To what I have said on this subject in my paper I like to add the following:

I am not thinking of the same level of auditor's responsibility for each part of the annual report. It is not easy to describe responsibility in general and even more difficult to formulate a limited responsibility. However, when we bear in mind that everything beyond the range of the auditor's professional knowledge has to be excluded from his responsibility and furthermore that nobody expects the auditor to give an opinion on the correctness of an information if the nature of the information does not enable him to do so, then, I believe, we may be optimistic that we will succeed in formulating that responsibility. For the business community I consider it to be very important that the auditor includes the whole annual report in his audit. As to the contents of the annual report other than the annual accounts there are, in my opinion, different possibilities, depending on the nature of the relative parts of the information:

- the auditor can convince himself of the correctness of the relative parts of the information;
- he can observe these parts to such an extent as to come to a conclusion on the acceptability of the information in question within the purpose for which it was included in the report;
- he can ascertain whether an opinion expressed by management is based on acceptable data.

Mr. President, Ladies and Gentlemen, once more I want to stress that I had not the intention to make any proposals on accounting principles, auditing standards or procedures. I only wanted to keep this very important professional problem in the spotlight. Where could that better be done than on an international congress.

I thank you for your attention.