

# WORKING WITH THE PUBLIC ACCOUNTANT



**A GUIDE FOR MANAGERS  
AT ALL LEVELS**

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**Adolph G. Lurie**

# *Working with Public Accountant*

A Guide for Managers at All Levels

ADOLPH G. LURIE

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# *Foreword*

Much has been written on corporate management and on corporate financial management. Likewise, much has been written on accounting and auditing and on professional practice by a firm of certified public accountants. In fact, some may say there is a plethora of material on all these subjects. Such is not the case, however, when it comes to the subject of what the corporate manager or financial executive should know about the professional accountant and what he or she does.

By the very nature of their work, CPAs must know something about management and how to get along with clients. On the other hand, unless they have had accounting training, corporate executives may know very little about the professional practice of accounting and how best to get along with CPAs.

“Dolph” Lurie is particularly qualified to bridge this gap. I’ve known him for more than twenty-five years and have observed his ability to merge the knowledge gained as a financial executive with the professional expertise he had gained as a practicing certified public accountant. The merging has been most effective in dealing with his clients, large and small.

Dolph has written a book specifically for the corporate manager, to give him or her a greater appreciation of the work of the CPA, to promote efficiency and economy in an audit engagement, to explain what is meant by generally accepted auditing standards and accounting principles, and to give an insight into what is buried in voluminous audit working papers of which the only outward evidence may be a one-page report and perhaps a

letter of comments on matters that come to the attention of the auditors during their examination of the client's financial statements.

Practical and helpful suggestions are included on minimizing audit costs. For a greater awareness of the scope of practice of the CPA, the author has included discussions on such topics as "Auditing Computer-produced Records," "Going Public," "Multinational Corporations," "Corporate Taxation," and "The CPA as a Consultant."

I am happy that the author has made a contribution to the literature which, in bringing to management a stronger awareness of the work of the CPA, will be of positive benefit both to corporate management and to the professional accountant.

*Louis M. Kessler, CPA*  
Past President, American Institute  
of Certified Public Accountants

# *Preface*

During my years as a public accountant, I had occasion to talk to chief executive officers, chief operating officers, members of boards of directors, chief financial officers, and other executives about management matters. This inevitably led to a discussion about certified public accountants as independent public auditors, the scope of their responsibilities and activities, and the contributions they can make to management. As a result, this book was written and is addressed to such executives and to all other executives who have an interest in accounting, auditing, and financial management. This does not mean that the professional CPA cannot obtain information and knowledge from reading this volume, but the prime target is the accountant's client and the client's executives.

Accounting, auditing, and taxation are fast-moving and fast-changing disciplines. The gathering of the data and the writing of the manuscript have taken more than a year. During this period, the sources for accounting and auditing standards and principles have been turning out new concepts and standards, thus constantly requiring new procedures. It has not been possible to include the latest of these in the text or appendixes, which were completed months before the text was set in type.

Although there had been many changes, new concepts, the settlement of some litigation, and much written material about some of the topics treated in this book, it would be reasonable to state that the basic concepts, management suggestions, and ideas still hold true.

I want to take this opportunity to thank all the people, who are too

numerous to mention by name, for their information and assistance. Not only did I discuss the book with my fellow professionals, but I also talked with persons who are involved in managing all sizes of corporations and consultants in various fields that impinge upon its subject matter. All were interested in what I was doing and in what I had to say, and all were very cooperative. My thanks to all for their help.

I specifically want to thank my former partners in Alexander Grant & Company for their encouragement and assistance. First, my thanks to Bill Mette, our firm's executive partner, who encouraged me throughout the project, opened doors for obtaining information, and provided me with help from many persons in our organization. Particularly, I want to thank Charlie Maurer, who reviewed the entire book for technical matters and gave me much valuable advice; Herb Dooskin, who assisted me in the chapters on computers and consultants; Harold Seiden and Marvin Kaufman, who provided advice and reviewed the chapter on corporate taxation; and Larry Kramer, who furnished material on multinational operations. Considerable thanks must be given to those members of the Alexander Grant typing pool who did all the transcribing, typing, and retyping and corrected errors in their spare time from a busy schedule.

*Adolph G. Lurie, CPA*

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## CHAPTER 1

# *The audit function*

When a proud mother refers to “my son, the doctor,” a more or less clear image comes to mind. However, if she says, “my son, the accountant,” a different conception may occur to each of her listeners. This conception may be partially correct, completely accurate, or entirely erroneous. An accountant can signify different things to different people. Even the business person in contact with accountants in daily activities may not have an accurate understanding of the functions of the professional accountant, the person of interest in this book.

Probably the commonest misconception about professional accountants or certified public accountants (CPAs)<sup>1</sup> is that they have ice water in their veins and computers in their brains, never make a mathematical error, and hover over a set of books checking all transactions to make certain that these are penny-accurate and that no one has been stealing anything from the company. The necessity for executives to deal more directly and more frequently with professional accountants has made them more aware of the capabilities of accountants and of the professional activities in which they are involved on behalf of their clients. Although controllers and financial executives have considerable knowledge of the functions and activities of CPAs, they may not know all the strengths and weaknesses in the relationship to enable them to take full advantage of the capabilities of these professionals. Let us examine the history of auditing and the functions of professional CPAs in relation to each phase of the growth of an enterprise.

### HISTORICAL BACKGROUND OF AUDITING

Auditing as we know it today is a relatively new art. It has grown in an erratic manner, by leaps and bounds under outside influences.

During the nineteenth century investors in the United Kingdom discovered that the industrial revolution in the United States had cre-

<sup>1</sup>See Appendix I-1 for explanations of initials used throughout the book.

ated a good climate for investments. However, absentee ownership caused some concern. To protect these investments and to observe progress, accountants from English accounting firms came to the United States, principally to New York, to perform such auditing as was required by the overseas investors. These accountants either formed new firms or established branches of English firms. In 1896 the first certified public accountancy laws were passed in New York State.

The next major impetus in the development of auditing and the growth of the profession was the enactment of income tax laws following the adoption of the Sixteenth Amendment to the Constitution of the United States in 1913. Meanwhile, corporate growth continued, and the American public became involved in investing in major enterprises. Depending upon management policy, auditors were engaged and annual reports issued without any rules or regulations other than those that certified public accountants could impose upon their clients with assistance from the New York Stock Exchange.

At the request of the Federal Trade Commission, a pamphlet with the title *A Memorandum on Balance Sheet Audits* was prepared in 1917 by the American Institute of Accountants (now the American Institute of Certified Public Accountants; AICPA) and later reissued as *Uniform Accounting: A Tentative Proposal Submitted by the Federal Reserve Board*. It was reissued in 1918 as *Approved Methods for the Preparation of Balance Sheet Statements*. In 1929 an updated version was issued under the auspices of the Federal Reserve Board with the title *Verification of Financial Statements*.

Then came the crash of 1929. Stock prices plummeted on stock exchanges and over the counter. As part of the program of the New Deal, regulations were imposed upon stock exchanges, stockbrokers, stock underwriters, and corporate issuers of marketable securities through the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 and the establishment of the Securities and Exchange Commission (SEC).

The McKesson & Robbins scandal of 1939<sup>2</sup> created a climate for intensifying audits of publicly held corporations. This encouraged the Committee on Auditing Procedures, created by the American Institute of Certified Public Accountants in 1938, to start issuing Accounting Research Bulletins (ARB), establishing accounting principles. As these bulletins became accepted, the Auditing Committee of the AICPA

<sup>2</sup>See Chapter 4.

issued its *Tentative Statement of Auditing Standards* (October 1947), establishing generally accepted auditing standards (GAAS).

As successor to the Auditing Committee, the AICPA created the Accounting Principles Board (APB), which issued opinions from 1959 to 1973. In 1973 the Financial Accounting Standards Board (FASB) was created as an independent body to study accounting principles and issue accounting standards.

## THE ACCOUNTANT AND THE PROPRIETORSHIP

The need for outside accounting services and assistance grows as a business progresses from a small one-person enterprise to a large publicly owned corporation. The owner of a one-person business may hire an accountant merely for the preparation of tax returns, payroll taxes, sales taxes, income taxes, and the like. The records maintained by the proprietorship are frequently minimal, merely enough to provide the necessary information for tax returns and to give the proprietor a broad idea of the progress that has been made. If the bank account has a larger balance at the end than at the beginning of a period, the business is considered profitable. Some proprietorships can be fairly substantial, and complete accounting records may then be desirable as a management tool. Stewardship is not involved, because the business and the proprietor are one. Financial statements are required only for credit purposes and for borrowing from third parties.

## THE ACCOUNTANT AND THE PARTNERSHIP

An accountant is needed to provide records for a partnership so that each partner may have confidence in the financial data, the partners' share of the earnings, and their share in the net worth of the enterprise. It is at this juncture that the CPA begins to perform the important function of examining financial statements. Although the word *examination* is used technically, in many instances the accountant actually prepares the financial statements from the books and records. The financial statements are used not only by members of the partnership for their purposes but also by third parties, such as banks and insurance companies making loans to the enterprise to enhance and continue its growth. Furnishing financial statements to third parties, with the auditors briefly describing the extent of their examination and stating their opinion, is an important function useful to the partnership.

## THE ACCOUNTANT AND THE PRIVATE CORPORATION

For various business, financial, and legal reasons, a corporation may be considered the appropriate form for an enterprise even though the business is owned by one individual or by a small group of partners. The need for a CPA depends to a great extent upon the requirements of the corporation and its owners. Unaudited financial statements may serve them very well, and an auditor may be retained only to prepare tax returns and furnish simple financial data for management purposes.

As a business grows and greater numbers of employees are hired, its operations become more complex and require internal accounting and financial people. The role of the CPA then changes to that of consultant to management and auditor of the financial statements. The audits are performed principally to attest to the fairness of the statements and only incidentally and indirectly to try to unearth errors, fraud, thefts, or defalcations. With further growth the company's loans from banks, insurance companies, and other third parties may increase, and the reputation, capability, character, independence, and quality of the performance of the CPA become more important. There are many local accounting firms that are well known in the community and can operate with a high degree of professionalism, performing audits and issuing opinions which will enhance the reputation of their clients.

## THE ACCOUNTANT AND PUBLIC CORPORATIONS

As a company continues to expand, its need for outside capital increases. For this and other reasons, management may want to go to the public marketplace to obtain funds from unrelated outside investors. Even if new capital is not needed, the establishment of a public market for the company's securities may be desirable for a number of reasons, including the following:

- Stockholders may want to sell some or all of their holdings.
- Cash may be required for estate tax purposes.
- Management may want to make a market for its securities to meet future public issue requirements.
- Mergers and acquisitions may be planned.
- A public corporation may be desirable to entice new, younger management.

If a corporation does become public, it must file financial statements audited by an independent accounting firm with the SEC.

Underwriters often suggest a change of auditors so that a firm's financial statements will be examined by CPAs who are in fact and in appearance independent and can meet the requirements established by the SEC for filings with the Commission. This does not necessarily mean that the auditors who examine the financial statements cannot be a local accounting firm that has handled the corporation's accounts for many years. The important criterion is that the accountants meet the standards of independence established by the SEC and have the capability and experience to satisfy both the underwriters and the SEC.

From the company's point of view it would be highly desirable to retain auditors who have performed satisfactorily in the past because their years of experience and knowledge of the company's business will result in lower costs. On the other hand, underwriters feel that it is easier to market a new issue when financial statements are attested to by a well-known major accounting firm. Individual investors are not generally knowledgeable about auditors. It is only institutional investors, bankers, and underwriters familiar with accounting firms who may express concern or influence the marketability of securities because the name on the accountant's certificate is not known to them or is not well known.

## UNAUDITED VERSUS AUDITED FINANCIAL STATEMENTS

Generally it is management's decision whether or not financial statements should be audited, but circumstances often take the decision out of management's hands. Audited financial statements are required by the SEC and usually by the financial community in dealing with the company on financial matters.

One of the significant points considered by the management of a private company is the additional cost attributed to audited financial statements. An audit is defined in Webster<sup>3</sup> as:

An examination of an account or of accounts by proper officers or persons appointed for that purpose, who compare the charges with vouchers, examine witnesses, and report the results.

<sup>3</sup>With permission. From *Webster's New Twentieth Century Dictionary*, second revised edition; copyright © 1975 by William Collins & World Publishing Co., Inc.



The audit of financial statements by a CPA is spelled out more particularly in the generally accepted auditing standards, which are discussed in Chapter 3. Probably the most important effect of an audit upon management is a feeling of security that the financial statements and records have been examined by a professional, independent, and experienced accounting firm. Through the medium of an audit management can look to an independent outside party and consult with this party on a knowledgeable basis about many matters of business, accounting, and finance. The additional cost is generally small in relation to the value received from an audited financial statement and the availability of the knowledge and experience of this third party. However, it is extremely difficult to measure the intangible nature of these services and their value in dollars and cents.

The subject of audited versus unaudited statements should not be examined from a short-range point of view. A family-owned business that has little need for outside borrowings or is able to satisfy outside lenders with collateral, owner's signatures, or data without the attestation of an independent auditor could reduce expenses by using unaudited financial statements. Many successful small businesses have prospered and had very satisfactory relationships with their accountants by utilizing their abilities even though a complete, full-scale audit has not been performed. Unaudited financial statements can be prepared by a CPA directly from a company's books with a minimum amount of work. The scope of the work is based on an agreement between the company and the CPA, which is usually spelled out in an engagement letter signed by both parties before the commencement of the assignment for preparation of the financial statements. The accounting service can be expanded to include some aspects that might be considered auditing in part but are not sufficient for the accountant to attest to the financial statements and give an unqualified opinion.

From a long-range point of view audited statements may serve useful purposes that are not contemplated in the short-term plans of a company. It is never certain that the company may not go public, and if a public offering is to be made, audited reports are required for a minimum of three years. Sometimes it is almost impossible to prepare retroactively appropriate financial statements for filing with the SEC. The time for going public is when the market is right, and opportunities have often been lost while waiting for the time to meet the rule of furnishing audited financial statements covering three years.

Audited financial statements are valuable if a merger with or sale to