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AN 1870 CORPORATE AUDIT COMMITTEE

Abstract: Board of directors' audit committees are becoming an increasingly popular vehicle for enhancing the objectivity and independence of auditors and overseeing the financial information generating process. This is occurring at a time when directors and auditors are facing criticism and increased litigation due to corporate failures and disclosures of illegal or questionable payments.

This article examines the workings of a corporate audit committee that operated in the mid-nineteenth century. The committee functioned as "auditor" for the company since there was no established public accounting profession in the U.S. at that time. They disentangled the financial affairs of the company and probably directly contributed to the replacement of the President of the company. Although the activities of corporate audit committees have changed or evolved considerably through the years, both the 1870 corporate audit committee and modern corporate audit committees have pursued a common goal of achieving accuracy and completeness in corporate financial reports.

The establishment of corporate audit committees has become increasingly popular in recent years. Both the Securities and Exchange Commission and the American Institute of Certified Public Accountants have recommended that all public companies establish audit committees. They are currently required for all New York Stock Exchange Companies.¹

The books and records of the East Tennessee and Western North Carolina Railroad Company (ET&WNCRR) located at corporate headquarters in Johnson City, Tennessee provided the data for this article. These records disclose the existence of an historical predecessor to modern corporate audit committees that functioned over a century ago. On February 28, 1870, shareholders of the ET&WNCRR appointed a special committee to ". . . inspect the accounts of the offices of the Board of Directors of the company and report at the next meeting." The "offices" referred to in the previous resolution were the offices of the company President and Secretary-Treasurer. This may be one of the earliest documented instances in the United States of an audit committee reporting to the board of directors of a corporation.

BACKGROUND AND ORGANIZATION OF THE COMPANY

The ET&WNCRR was incorporated under an Act of the Tennessee Legislature passed May 24, 1866, ". . .for the purpose of construct-

ing a railroad from the East Tennessee and Virginia Railroad, commencing at either Carter or Johnson Depots on said road, running by way of Elizabethton, Doe River Cove, and Crab Orchard to the North Carolina line, near Cranberry Iron Works."² The company's charter allowed two years to start construction with the provision that the railroad would be completed within five years. The completed line was approximately 34 miles long per reference to an 1883 timetable.³

The first meeting of the stockholders was held on February 17, 1868, in Elizabethton, Tennessee. The stockholders elected a board of directors who unanimously elected Elijah Simerley as President and John W. Cameron as Secretary-Treasurer.

During this period the State of Tennessee was actively encouraging railroad construction through the issuance of state bonds to railroads. The railroads could then sell the state bonds to raise part of the money needed for construction.⁴ On March 26, 1868, the board of directors of ET&WNCRR authorized the President to draw \$150,000 of these bonds⁵ from the State. He was ". . .authorized and instructed to make a special deposit of the bonds drawn as per Resolution No. 2 in some safe bank or banks." He was also ". . .authorized and instructed to sell from time to time or place an amount of the bonds in the hands of the Treasurer of said road (Railroad) sufficient to meet the expenses and liabilities of said company." The board of directors also instructed the Secretary-Treasurer to post a \$10,000 bond. The \$150,000 in bonds was received from the State of Tennessee in April, 1868.

On May 21, 1868, the board of directors authorized the President to draw another \$100,000 of the State of Tennessee bonds. On October 24, 1868, the President reported that he had sold the first bonds with a face value of \$150,000 for \$113,901.07 and deposited the proceeds in the Phoenix National Bank in New York subject to his sight draft.

At the February 15, 1869, annual meeting of the stockholders the President reported on the progress of the railroad construction. He had spent \$92,500 of the \$113,901.07 bond proceeds leaving a balance in his hands of \$21,401.07. "From this amount, however, must be deducted commissions paid for the sale of the bonds as well as some other contingent expenses which will appear in my next annual report." The second bond issue of \$100,000 bonds had been partly sold ". . .but none of this fund has yet been used." E. Simerley was subsequently re-elected President of the railroad. Isaac A. Taylor was elected as new Secretary-Treasurer after defeat-

ing J. W. Cameron for the position⁶ and the bond for that office was raised to \$20,000.

The company minute book mentions little of the activities of the company during the period February, 1869, to February, 1870, other than references which indicated the company was still in the construction phase and apparently having difficulty raising sufficient money to pay its creditors and buy materials, particularly iron, for the railroad construction.

At the February 28, 1870, annual stockholders' meeting the President reported that during his approximately two years of office he had received \$400,000⁷ in bonds from the State of Tennessee of which \$350,000 had been sold for \$224,415.07 and \$50,000 remained unsold. He reported that from these proceeds he had paid \$80,500 to the former Treasurer, John W. Cameron, \$58,920.90 to the current Treasurer, Isaac A. Taylor, and \$34,588.49 to Gredegar Iron Company of Richmond, Virginia for iron and equipment leaving a balance of \$50,441.68 in his hands. At that same meeting the stockholders elected a committee composed of N. G. Taylor, J. G. Smith, J. M. Johnson, A. Jobe, and W. B. Carter “. . .whose duty is to inspect the accounts of the offices of the Board of Directors of the company and report at the next meeting of the board of directors.” No mention is made in the minutes of the discussions held at the shareholders' meeting but one might hypothesize that the state of the company's finances was a major topic. Newspapers in the region had given full coverage in 1869 to the disappearance of George Swepson, President, and Milton Littlefield, another official, of the Western North Carolina Railroad with \$4,000,000 worth of bonds from the company's treasury.⁸ A Commission investigating the activities of Swepson and Littlefield reported that “. . .they operated on the basis of personal charity—particularly to themselves.”⁹ With the publicity given this nearby railroad scandal and their own lack of financial resources it is likely that the directors and shareholders of ET&WNCRR naturally wanted a full accounting of the funds of their company.

WHY WAS AUDIT PERFORMED BY A COMMITTEE REPORTING TO THE BOARD OF DIRECTORS?

In order to understand why a committee as opposed to a professional auditor was appointed to audit the officers of the ET&WNCRR it will be necessary to briefly review significant historical developments of that time period.

According to Boyd, nineteenth century auditing developments followed the construction of railways, the growth of insurance companies, banking companies, and other joint-stock concerns.¹⁰ The railway age apparently came into its own in the 1820's with improvements in locomotives.¹¹ A building spurt began in England which carried across the Atlantic to the U.S. "Work was begun at Baltimore in 1828 upon the Baltimore and Ohio railroad, which was the first important railroad project undertaken in the United States."¹² Railroad investments began to come from abroad, particularly England, during the mid-nineteenth century. The British accounting profession began to develop during this same period and by the 1870-1880 period British accountants were doing significant audit work on investments in the U.S. This gave impetus to the growth of the U.S. public accounting profession which began to develop on a small scale in the 1880's. The size of the U.S. profession is evidenced by reference to the 1888 membership list of the American Association of Public Accountants, the predecessor of the American Institute of CPAs which shows only 26 members at that time.¹³

Thus, it appears that an audit committee reporting to the board of directors was established for two reasons. While some public accounting services may have existed in the U.S. in 1870 they were concentrated in only a few of the larger cities. In addition, the practice of having a select board of citizens audit the accounts of certain public officials had been well established in Great Britain by 1600 A.D.¹⁴ This practice had apparently carried over to the U.S. since references to it dating back to the 1600's can be found for certain American colonies. The shareholders of ET&WNCRR were apparently following accepted business custom of the time in appointing an audit committee to report to the board of directors.

THE AUDIT COMMITTEE'S EXAMINATION

The board of directors met again on August 9, 1870, in Johnson City, Tennessee. ". . .we are anxious to have a report from the President of the financial condition of the company. . ." declared the board of directors. The President was absent due to illness so they adjourned without conducting any business to meet on Saturday, August 13, 1870, ". . .at Hampton near the residence of the President that we may there if possible confer with him, receive his report and transact such business as may be deemed necessary."

At the August 13, 1870, meeting in Doe River Cove near Hampton, the President, E. Simerley, was apparently still sick. The board of directors adjourned without conducting any business, ". . .to meet

again at the call of the President, E. Simerley, as soon as he is able, and the meeting to be notified by the Secretary and Treasurer.”

President Simerley was present at the next meeting of the board of directors on October 13, 1870. Three items of minor business were transacted. Although the details are not provided in the minutes there was apparently some discussion of appointing a new audit committee since a motion was made, seconded, and carried “. . .that the directors have know (sic) right to appoint a new committee to settle with the President.”¹⁵

The board of directors met again on January 7, 1871, “. . .with the President being absent on account of sickness. . .” The board was presented the reports of the audit committee and made them a matter of record by putting them in the minutes. The report on the Secretary-Treasurer’s activities was brief and essentially gave the Secretary-Treasurer an “unqualified opinion” with respect to the funds entrusted to him. A copy of that report is contained in Exhibit I. The report of the President’s activities was much longer, taking approximately three full legal-size pages in the corporate minute book. The essentials of this report were that the President had received \$261,332.17 and had disbursed \$196,742.05 leaving a balance of \$64,590.12 owed to the company. The President, E. Simerley, had claimed two separate expense items totaling \$5,643.28 which the audit committee disallowed since they had been paid by the Treasurer. The committee also disallowed various items totaling \$1,228.27 for which no vouchers had been submitted.¹⁶ The committee commented “Mr. Simerley is no doubt entitled to money due him for expenses but he has furnished your committee with no data by which they could determine the amount. As to his salary as President—your committee leaves that question wholly to your Board.”

The annual shareholders’ meeting was held on February 27, 1871, in Elizabethton, Tennessee. A new board of directors was elected which consisted of approximately the same directors as in the previous year. The board then appointed a new audit committee for an audit of the current year. The old audit committee was retained to complete the previous audit and instructed to try to finish within thirty days. The election for President resulted in John Hughes receiving nine votes and E. Simerley receiving one. E. Simerley was elected as a director, however. J. C. Hardin was re-elected Secretary-Treasurer. The former president had apparently lost the confidence of the shareholders as a result of the audit report.

The board of directors met on March 15, 1871. They voted to allow the former president, E. Simerley, credit for \$4,890 of ex-

penses previously incurred “. . .in going to Nashville and getting certain business through the legislature in reference to said railroad.” After many different motions and ballots the board also voted to allow the former president a salary of \$1,600 per year and \$800 per year to cover expenses. On June 27, 1871, the next board of directors’ meeting, J. C. Hardin was appointed to “. . .wait on the ex-president, E. Simerley, and request him to turn over the assets of said RR Co. . . .”

The board of directors met on July 10, 1871, and heard the final report of the committee auditing the former president. The balance due per their first report was \$64,590.12 and when reduced by the salary and expenses allowed at the March 15, 1871, meeting and various other minor items for which vouchers were found, the former president owed \$49,178.19 plus \$1,920.78 on his stock purchases. However, a review of minutes through the next decade did not reveal any evidence that these funds were received by the ET&WNCRR.

The minutes are rather sparse for the 1871 through 1876 period but Sulzer supplies some of the details:

The railroad defaulted on its indebtedness to the State and on November 15, 1871, the railroad with its attendant rights and franchises was sold to John Hughes and others for \$20,000 in bonds of the State of Tennessee. Subsequently, the purchasers requested the Chancery Court of Carter County to confirm the sale of the properties to A. Pardee and others for the sum of \$25,000. This was confirmed by a decree on February 16, 1876.¹⁷

The 34-mile line railroad was completed by the new owners in 1882 and portions of the track are still in operation today.

SUMMARY AND CONCLUSIONS

Prior to the rise of the auditing profession in the United States, the auditing task was frequently handled by committees such as the audit committee of the East Tennessee and Western North Carolina Railroad. In view of the committee’s lack of accounting background, they performed a needed function in a creditable manner. The disentangling of the financial affairs of the East Tennessee and Western North Carolina Railroad probably directly contributed to the replacement of the President of the company. Due to the lack of records, it is uncertain whether President E.

Simerley ever repaid the amount the committee said he owed the company.

A modern day corporate audit committee performs a different function than did the ET&WNCRR audit committee although a major common goal of each is (was) achieving accuracy and completeness in corporate financial reports. The ET&WNCRR audit committee achieved this goal by functioning as "auditor". Modern day corporate audit committees function as "audit recipients" and oversee the overall audit process which may be performed by both external and internal auditors.

EXHIBIT I

1871 REPORT OF AUDIT COMMITTEE ON AFFAIRS OF SECRETARY-TREASURER

To The President and Directors of The ET&WNCRR Company

Gentlemen,

The committee appointed by the shareholders of your Road at their last meeting to settle with your Treasurer beg leave to report that they have carefully examined his accounts and find that he has received from E. Simerley, President, at various times

Cash to the amt of	\$58,920.90
Cash Rec from Stockholders	134.00
	<u>\$59,054.90</u>

and he has distributed 59,054.90

All of which is respectfully submitted
Errors excepted
January 5, 1871

(Signed)
N. G. Taylor, Chairman
Wm. B. Carter
A. Jobe
Jas. G. Smith

(Source: ET&WNCRR, 1871 Minute Book, p. 48)

FOOTNOTES

- ¹Arthur Andersen & Co., p. 2.
²Sulzer, p. 87.
³Sulzer, p. 84.
⁴Sulzer, p. 87.

⁵These were \$1,000 denomination, 6% coupon bonds maturing on January 1, 1900.

⁶There was apparently more interest in this office after the salary was set at \$300 per year.

⁷The \$400,000 total for the bonds is confirmed by Dykeman who reports, "a total of \$400,000 in state bonds was issued to ET&WNC. . ." (Dykeman, p. 87).

⁸This railroad was unrelated to the ET&WNCRR although both operated in the Tennessee-North Carolina border area.

⁹Dykeman, pp. 154-155.

¹⁰Boyd, p. 92.

¹¹Pollins, p. 334.

¹²Cleveland and Powell, p. 61.

¹³Tansill, p. 9.

¹⁴Boyd, pp. 81-83.

¹⁵This appears to have been a spelling error in the minutes and "no" was intended by the directors rather than "know".

¹⁶Auditors had apparently established early in history their power to disallow questionable items. Boyd reports, "charges were frequently disallowed for reasons which are explained as being insufficiently vouched. Thus, of the sum of six hundred and forty pounds charged in the Chamberlain's accounts of 1337 and 1340 for stores to Lochleven sixty pounds was disallowed, after the vouchers had been called for, as having been already charged in a previous account." (Boyd, p. 76).

¹⁷Sulzer, p. 87.

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