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AMERICAN INSTITUTE OF ACCOUNTANTS

Accounting Auditing Taxes 1953

Complete Text of
Papers Presented at
The 66th Annual Meeting

Presented

by

Touche, Ross, Bailey and Smart

AMERICAN INSTITUTE OF ACCOUNTANTS

Accounting Auditing Taxes 1953

TOUCHE, NIVEN, BAILEY & SMART
DETROIT

Complete Text of
Papers Presented at
The 66th Annual Meeting

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Canada as a challenge to the accounting profession

WALTER J. MACDONALD

Senior partner, Millar, Macdonald & Co., Winnipeg. President, Canadian Institute of Chartered Accountants.

My prime responsibility today is to bring to you the greetings of the 5,400 members of the Canadian Institute of Chartered Accountants, and their good wishes for the success of your annual convention.

On our side, we feel that no annual convention would be complete if we did not have among our guests a representation from your body. Your presidents have done much over the years to foster the friendly relations between the two Institutes. Your John Carey and your Carman Blough are familiar figures to us, welcomed as friends of our executive and more or less intimately linked with us and with our thinking.

We regard your Institute in the light of a big brother. We are impressed with your research into accounting principles. Your bulletins have aided our own research; and, within our limited budget, we are following your example, in similar publications, and with no great divergence from the positions you have adopted in yours. That mutuality of interest and of thought between the two Institutes is a lively and a continuing source of satisfaction to all of us in Canada. We feel that we are marching together with you and are thereby strengthened in the tasks facing us, and you as well.

Turning to the subject I have chosen, I could have discussed with you the work our Institute is doing in recruitment and training of personnel; in research into the professional subjects; in education (and we pride ourselves that our uniform examinations are accepted by our constituent Institutes in all of the ten Provinces); about our work in conjunction with the Canadian Bar Association on taxation; or about cooperation with other accounting bodies. Any one of these subjects would have been interesting and informative. I have chosen, rather, to discuss with you some broader aspects of Canada in relation to our profession. If I have transgressed my terms of reference in so doing, I am sure that—with your customary courtesy to Canadians—you will forgive me.

In this talk I have sought to view Canada through the spectacles of an average member of your great Institute. I should also say at the outset that I come from Winnipeg which, from its geographical position, corresponds in your

country to Chicago. There is a further point of similarity in that much of the the grain trade in both countries is directed from these two cities, and that both are focal points in the railway systems of the continent. (Curiously, the geographical centre of the North American continent is located, not as you might think, south of the 49th parallel but actually close to where I live, some 60 miles north of that boundary in Manitoba).

Looking at Canada from that viewpoint, what I have to say might be biased in terms of the "wide-open spaces." Your objective thinking will counteract that.

WHAT IS CANADA?

From our side of the line we know something of the United States. We read your periodicals. We listen to your radio. We see your movies. We see your television. We know you fairly well, but the the reverse is not the case. To many of you, Canada is a relatively unknown country. Our Canadian periodicals do not have a large United States circulation; your periodicals do give us coverage but usually on the more sensational aspects of our national life. Our radio, operating on a limited budget, does not command an American audience.

We have no native movie industry of any magnitude; your movies of Canadian life, interesting as they are, must be framed largely with an eye to box office appeal south of the line. Our television is yet in its infancy (although we did bring the coronation to you in a minor scoop). Thus, I do not feel presumptious in trying to lay before you a few vital facts about my country, some of which at least will be new to you.

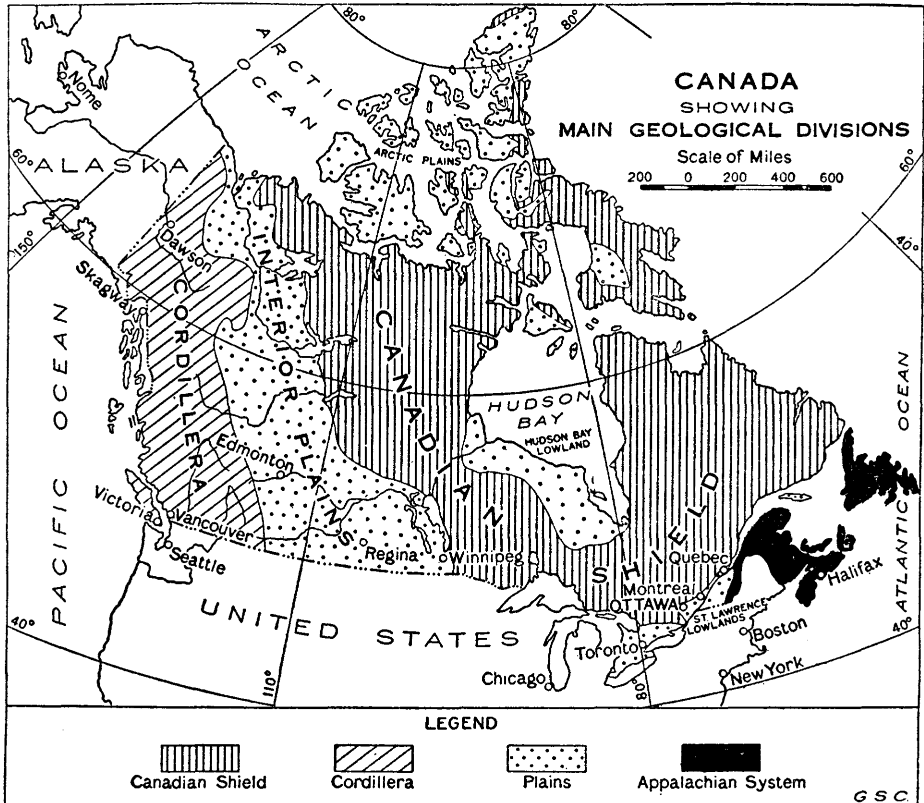
Looking at Canada's surface, there are six distinct areas (see map). The greatest area is that known as the Canadian Shield; the largest Pre-Cambrian area in the world and the oldest rocks on this planet. The Shield is, from the air, half water and half land. The land is, of course, clothed with an overburden, which produces timber of the pulpwood variety. The Shield starts from the east bank of the Mackenzie River basin to wind up covering the whole of Quebec and the coast of Labrador. (Quebec is bigger than Texas.) That is the main geological feature of Canada. It covers one-half of the land.

The second feature is the Rocky Montain area which, compared with the Pre-Cambrian, is limestone rock—relatively young geologically. British Columbia and our Yukon territory are entirely in the Rockies and the terrain is similar to your Rocky Mountain states south of the border. (British Columbia is bigger than Texas.)

The watershed of the interior plains (see map) is just north of Edmonton. Thus, a third area is the Mackenzie River basin. This river flows from just north of Edmonton to the Arctic, some 1,100 air miles. South of the Mackenzie basin and spreading from the foothills of the Rockies in Alberta some 800 air miles to the Manitoba-Ontaria boundary due north of Minneapolis, we have the prairie plains. Their counter-part is in your States of Montana, the Dakotas and Minnesota. This area is a prime source of our agricultural production as it is a main source of yours. The Maritime Provinces, and

Newfoundland, are in the Appalachian region corresponding geologically to your Appalachians.

You will observe that in these five areas we have encompassed a very large part of Canada. What remains is largely a peninsula (including Niagara) centered on Toronto and the relatively narrow cultivated region south of the Pre-Cambrian and bordering on Ottawa, Montreal and Quebec.



Before leaving this surface picture of Canada with you, may I point out that many of you know Quebec City, Montreal, Ottawa, Toronto, Hamilton and Windsor because of the strategic positions they occupy in our financial and production economy (manufacturing produces 30% of our national income). But I do wish to leave the thought with you—and without depreciating the position these Eastern areas hold in your thinking and in ours—that they occupy a very small part of Canada's land surface. And of course we must recognize the Great Lakes and the St. Lawrence, which are the common heritage of our two countries and a gateway to the Atlantic through Canada.

Turning to the production of these different regions, the Shield (igneous rocks) is, of course, the prime source of our base metals—copper, lead, zinc and nickel—our precious metals as well, and now of uranium for atomic power. And Mother Nature has clothed the Pre-Cambrian with the trees we use for paper. Of recent years we have developed and are continuing to

develop our iron mines in the Steep Rock area just north of your Mesabi Range, in the Michipicoten area north of the Sault, in Newfoundland, and now in Labrador (Knob Lake).

From the western slopes of our Rockies we, like you, draw our timber. The counter-parts of our British Columbia forests are in Washington and Oregon. Centered on Trail in British Columbia near your border and at Brittania on the Coast we are producing lead, zinc and copper in quantity, also silver and gold, and we are discovering and developing new sources of lead and zinc, copper and nickel across the whole area of the Rockies. Here again we follow your pattern, your nonferrous mines being principally in the Rockies, from Montana to Arizona.

On the eastern slopes of the Rockies we find bituminous coal and oil, and now reaching far down into the prairies areas we are finding oil, as you do in Oklahoma and Texas. From the prairies we produce, as you do, grain, cattle, agricultural products of every kind, and lignite coal. And in our Atlantic Provinces we are finding new sources of base metals and have always found coal and iron—and timber, much as you do in your Appalachian area south of the border.

You are conversant with our rapidly growing manufacturing industries, and our industrial production received a great impetus from the "know-how" developed in production for World War II.

CANADA GROWS NORTHWARD

In the States in the days of the covered wagon you pushed back the wilderness until you met the settlers who had come by other routes to the Pacific Coast. Correspondingly, we in Canada pushed west, with the Canadian Pacific main line as the backbone of that movement, till we met the colonists who had voyaged around Cape Horn to settle in British Columbia. In the old days in both countries the slogan was "Go west, young man, and grow with the country." The west *has* grown, and I think it is proper to say that in both countries the westward growth is approaching the saturation point.

In Canada we are now looking north and we are pushing our transportation facilities always northward. On both coasts we have northward access by sea. In the far west we have two railroads running north; one from Vancouver to Prince George, the other from Edmonton into the Peace River country. It is inevitable that these two railways will be joined up and that the next step will be a railroad pushing still northward and parallelling the Alaska Highway. That highway, built by you, is a source of pride to us, if only as a symbol of national cooperation, and it is opening up entirely new areas to civilization and to development. The Mackenzie River gives another outlet to the Arctic.

In Manitoba, (1,000 air miles north and west of Chicago) we have recently built 150 miles of rail north of the previous end of steel at Sherridon, to reach the new nickel mine at Lynn Lake. Lynn Lake, and Churchill on the Hudson Bay Railway, are the northernmost points of railway penetration on this continent. Lake Winnipeg gives 300 miles of navigation northward to

Norway House. East of there we have the Northern Ontario Railway running up into James Bay, an offshoot of Hudson Bay. And now we have the 360 mile line to the new iron fields in Labrador which will soon be sending ore to a St. Lawrence port (Sept Isles) for shipment to your mills at seaboard or the Cleveland-Ashtabula-Pittsburgh area.

It is thus in the north that much of our future growth must come. The Pre-Cambrian holds much promise. Presently operating mines are nearly all on its southern fringe, accessible to the prospector and near to railway lines, but air travel and new methods of prospecting are constantly exploring the hinterland and probing farther into its secrets. The Pre-Cambrian area, with its innumerable lakes, forms natural water storage for electric power. On its western and southern borders, we are finding abundant signs of uranium.

The other northern areas are equally promising. The oil at Fort Norman, the untouched tar sands of Athabasca, the asbestos deposits of the north-west and the new base metal finds in the Yukon prove this. And the latest development of aluminum ingot fabrication at Kitimat in northern British Columbia, with its potential 2 million horse-power of electric energy, cannot be lightly passed over.

This picture of Canada productionwise is, of course, drawn with a very broad brush. Of necessity it is incomplete. To restore perspective may I repeat that the geographical centre of this North American continent on which our two nations live and move is near the capital of Manitoba (Winnipeg) some 60 miles north of the 49th parallel.

OUR INTEGRATED ECONOMIES

Apart from these geological similarities, there is a definite interrelationship between your economy and ours.

> Our export grain and yours, particularly the hard wheats of our prairie areas, is deliverable on world markets at prices established in Winnipeg and Chicago—and now once again, after 14 years, quoted on the (Liverpool and Baltic) Exchanges of the United Kingdom.
>
> Our copper and zinc and lead, like yours, is sold basis delivery at your eastern seaboard, at prices determined by the metal exchanges of New York and London.
>
> Your manufactures in many fields have their counterparts in our country, many of them subsidiaries of United States corporations; correspondingly, some of our major industrial companies have counterparts in the United States.
>
> We import your citrus fruits and your early vegetables, your textiles and heavy durables, in *very* substantial volume.
>
> Our lumber moves, inter alia, to your markets.
>
> Your newspapers are printed in large degree on paper that stemmed from Canadian forests.
>
> Our gold goes into your vaults (or has done until recently).

Substantially all of your nickel comes from Canada.
Our uranium goes into your atomic bombs.

Here again I have used broad examples to show the integration of our two economies. You will fill in many gaps in what I have said.

The motto over our House of Commons doorway reads:

"The wholesome sea is at her gates,
Her gates both East and West."

Our Atlantic seaboard is some 3,000 miles from our Pacific shores, and our northern boundaries in the Arctic some 2,400 miles from our Lake Erie Shore. These measurements compare roughly with those of your country. In terms of square miles it is conceded that we are bigger than you are. In population you outnumber us more than 10 to 1. Our population is growing more rapidly than yours. 1946–1952 shows Canada's growth at 17.4 per cent, United States 11 per cent, and our gross national product is now four times what it was in 1939. We are a young country but growing faster than your more mature economy.

Like you, we are a hard-currency country. In national income per capita the average American earns nearly $3 for every $2 that a Canadian earns.

In addition to being a close neighbour, we are your biggest customer. Britain and Argentina run second to us on your customer list (we buy $4 from you for every $1 that they buy). But *we buy more from you than we sell to you*: For every $3 of Canadian products that enter your markets, $4 of U.S. produced goods move into Canada. That pattern has persisted so long as to be almost traditional. Naturally it creates an imbalance we have to rectify by selling more of our product to other countries than we buy of their products.

We are presently plowing back 23 per cent of our national income into capital goods. Our annual savings are sufficient to pay for *all* of our capital development. The investment dollars, which are coming into Canada freely from countries like your own, are offset by Canadian dollars flowing into investments abroad. We are standing even with the world, and we seek no favors from any one.

Add to all that I have outlined the fact that incontestably our two nations are bulwarks of free democracy, free enterprise, and free people in a sea of international turmoil and that in defense against potential invasion we are willy-nilly in the same boat, and I think you will agree that we must each understand the other to the greatest possible degree.

In these modern days, civic, state, national, and international decisions reach down into the affairs of even the smallest business we public accountants may serve. And that is where I see the challenge to our profession in both countries.

A CHALLENGE TO THE PROFESSION

We accountants are fundamentally fact-finders, not case-makers. We cannot state the assets without the compensating liabilities; we cannot state the income without showing all of the concomitant expenditures. In our training we develop a faculty for analysis, and a keen sense of relative values; we

have some capacity for objective thinking and logic in presentation of the facts we find; we pride ourselves on the independence of the opinions we express, and above all we aspire to be intellectually honest and to show integrity of character in our business dealings. Is there not a challenge to bring these attributes to bear on our public policy and our joint position in the international and national fields, at *all* levels of public thinking?

To our profession in Canada I see the challenge to enter more fully than in the past into consultation with our policy-makers so that their decisions may be founded on fact. And thus that Canada may stand right with the world and four-square with your great country, in the path of progess where we have so many common interests. To you as fact-finders for your country I suggest that you study us, our economy, our politics, and our social characteristics, on the basis that our destiny is closely integrated with yours.

If we chartered accountants serving the public on our side, and you certified public accountants on your side each have a full understanding of the facts pro and con, and are listened to on both sides of the border, there should be much less difficulty in arriving at decisions that concern our two nations.

I have spoken of the path of progress, which we both seek to travel. We are both free, independent democratic nations, each standing on a foundation of rugged independence and, undoubtedly, under our democratic system there will be stones discovered on that path. Some little stones can be rolled away easily by one party or the other; some are bigger ones which will require leverage from us both.

Among the little stones that have fallen on the path I could mention the fact that you have a duty on nickel coming into the States whereas, so far as I can find out, not one pound of nickel is produced in your country. Another difficulty lies with some of your labor leaders who come to Canada to recommend parity of our wage rates with yours, but fail to recognize that our income per capita is not on parity with yours. I have already mentioned the 3:2 ratio in that connection. On the Canadian side I have not yet found a valid reason for the much higher prices we pay for household appliances.

Among the bigger stones, we have to recognize the fact that, while our frontiers are undefended on either side (Rush Bagot Treaty) both of our governments have erected tariff walls, each against the other. On our side of the line the claim is made that our country is flooded with your nylons and other textiles, while on your side of the line heavy pressure is being brought to bear to prevent our coarse grains coming into your country.

Recognizing that tariff barriers cannot be rapidly eliminated without dislocation of industry, I submit that, in view of our integrated economies and our mutual position in defense, this is no time to build these walls higher. The joint need should be supplied from the most economical source. Sound cost accounting should have a hearing. The deliberations of the international body that is reviewing the general agreement on trade and tariffs (expiring in 1953) are a matter of vital importance to both our economies and deserve the closest consideration.

In another area, there was no trouble in arranging that your wartime traffic should cross Canadian territory and that the Alaska Highway should be built. Correspondingly, we are happy about the radar screen in our north country and, of course, our joint participation in NATO. We on our side of the line and, I am sure, you on your side, cannot see any over-riding reason against the St. Lawrence Seaway. Undoubtedly there are opponents on both sides. Our inland shippers are concerned about foreign competition; your railways are concerned about the diversion of traffic from their lines, but again I submit that when the debits and credits are added up, our joint national good can best be served by low cost access to and from foreign trade. From my observations, we in Canada are ready to cut sod on the Seaway. Our plans are complete. Make no mistake about Canada's position on the question. We are going ahead.

It is to matters such as these that I suggest we apply our analytical faculty, our sense of relative values and the other capacities we pride ourselves on having developed, in particular the capacity to form an independent opinion. In result, the area of controversy in many of these issues can be eliminated, or at least considerably narrowed down, when all of the facts, financial and economic, are put on the record, the consolidated surplus or deficit is clearly shown and, more important, made known to the public.

You will agree with me that the very best financial statement or factual analysis is useless if it is not transmitted to those whom it may affect, and in that field of publicity our friendship with the press should be cultivated. Among my own valued friendships are those I enjoy with the gentlemen of that fraternity; the stronger in that they were often forged and proven in the heat of controversy.

In conclusion I am suggesting to you that in these days we accountants cannot allow our view to be circumscribed by the narrow confines of the balance sheet. We must lift our sights. It is true that we now accept many responsibilities beyond pure audit. Management seeks our advice on taxes, on methods, on problems of delegation, and such like. But that is all strictly dollar-fee business.

Properly to fulfill our function to the public (using that word in its broadest sense) should we not also think of the service we can perform with or without fee in audit of the facts on which our national divisions are based. And see to it that, with *all* of the debits and credits brought to account, independent opinions are formed and expressed.

Our two Institutes, yours in all the strength of maturity, ours smaller but like our country rapidly coming into adult manhood, through their members, have contact with a fine cross section of thinking men, in both countries.

We seek to set forth this truth in our reports to them on their own affairs. Should we not, if only in the interests of our own security see that they are properly and fully informed on public issues, and certainly in that field the issues with Canada are very close to home.

We in the United States and Canada have not yet seen our cities flattened

like Berlin and Cologne or Birmingham and Coventry (1,200 men, women, and children destroyed in that small town in one night). We face that threat now. In my view our freedom and our lives are at stake. How then can we stand idly by and see tariff doors hysterically opened and closed, on either side of the border, against production which must be stable if our integrated economy is to stand up against a totalitarian state in defence of our common territory. And aside from tariffs there are other issues of like magnitude where we must stand integrated. Our common good must be considered. These things should not be settled by political pressure from small but vocal minorities.

I have spoken of your country and my own—and of those two alone. The hopeful eyes of every civilized country are centred on us—not so much for dollar aid—but for moral support from the example of a common front. I leave that thought with you.

Successful administration of the tax laws

T. COLEMAN ANDREWS

U. S. Commissioner of Internal Revenue. Past president, vice president, and executive committee member, American Institute of Accountants.

I am going to talk about the present, with, I hope, a minimum of reference to the future, except in terms of high hope.

First, I want to thank everyone for the wonderful testimonial dinner that was given for me in Washington on the 19th of March, exactly one month and a half after I took office. When I saw the great crowd of my colleagues of the profession from all over the country that had gathered there in Washington that night, frankly, I could hardly believe my eyes.

I want to tell you that our guests were just as much impressed by that gathering and by the importance of our profession and the solidarity of its membership as I was. That importance and that solidarity, I can assure you, were manifest on every hand, in the eyes, and in the countenances, and in the demeanor of the hundreds of my colleagues who were there.

The news of that meeting spread around Washington pretty fast. There were some forty or fifty members of the Senate and Congress there, and every one of these men, without exception, called me and expressed the very highest compliments of the accounting profession. Frankly, and I hate to admit this, most of those gentlemen didn't realize what a large profession we are, and the high caliber of the people who are in it. I want to say that the conception, the organization, and the carrying out of that meeting was a masterpiece of effective public relations, and you may be certain that it increased enormously the great pride I already had in our profession and its members.

More important than that, however, was the fact that it gave me a new sense of the increased magnitude of the responsibility to the profession I already felt. I think most of you know how great that pride is, and I am sure that I don't have to tell any of you that I pray constantly that I may be vouchsafed so to discharge that responsibility that, when I reach the end of this assignment, my performance will have warranted the confidence so many of you have so generously expressed in me.

Notwithstanding frequent contacts with members of the profession during

the course of my official activities, I have been in a new environment—one that has occasionally not been as friendly as the one I was accustomed to when I was in practice. It is therefore mighty pleasant indeed to join you again in annual meeting. I do not want to give the impression that my job is an habitually unpleasant one, for that would really be misrepresenting it. We have had our troubles, of course, but thus far none of them have been too hot to handle.

The fact is that, on the whole, our experience has thus far been very pleasant and satisfying—primarily because we have enjoyed the uninterrupted confidence and support of Secretary Humphrey and Under Secretary Folsom, but also because the job has been an extremely challenging one.

We have heard a lot about Texas since we have been at this meeting. Perhaps I should say that we have heard a lot, as usual, about Texas. Be that as it may, I think that one of our most pleasant and, I might say, amusing experiences was with a gentleman from Texas who had discovered oil and had grown rich. Contrary to the usual custom of employing new-found riches to influence the achievement of a box seat in Heaven, this Texan decided to go to Washington to find out how the government was organized and how his money was being spent.

He arrived in town one morning, came in unannounced, and introduced himself. He said, "Mr. Andrews, I am up here to find out how this government is run."

"Well," I said, "that is a very laudable purpose. I'm delighted to see you, and I hope you will learn a lot. Have you been anywhere else but here?"

"Oh, yes," he said, "I've been here several days now. I've been over to the Department of the Interior and over to the Department of Agriculture," and he named several others. "I decided that I would wait to come to see you last because, after all, you deal in something that is pretty important to me." In the course of my discussion with him, I found out he wasn't kidding.

By his own admission, he had been a tenant farmer a few years ago, and he had lived in a little one-room shack down there on somebody's cotton farm. (I never knew there was something that small in Texas, until he told me.) He had only one chair in the house, he said, and not even a bed to sleep on. Then some oil companies came through there one day and started pecking around and digging, and before he knew it they brought in a gusher on his place, and pretty soon another one, and another one, and the next thing he knew, he was a tremendously rich man. I learned later that his income was now $100,000 a week. I am told that that isn't very much, as incomes go in Texas, but I, having come from a poor but proud state, was greatly impressed by it.

I learned, too, that he had acquired several private airplanes since he had become affluent, that he had chauffeurs and footmen for several cars, that he had sent one of these cars and chauffeurs ahead to Washington to see that he had proper transportation, and under the right sort of circumstances. Then he got into one of his planes and flew on up to Washington.

I shall never forget what the gentleman said to me as he walked out of my office: "Oh, by the way, Mr. Andrews, I haven't asked you how much money you have collected."

I said, "Oh, somewhere between sixty-five and seventy billion dollars a year."

He scratched his head a little bit and looked around and said, "That's a lot of money, ain't it?

I said, "Yes, that is more money than I can imagine."

He thought for a moment more and, as he went out the door, he said, sort of under his breath, "It's a good thing we don't get all the government we pay for, ain't it?"

Today, I want to tell about some of the things we are doing that, I believe, will be of particular interest to you and your clients. I cannot tell you the whole story because, if I did, you would be here all day. So I will limit myself to a few of the more important aspects and some of the minor things that, with your cooperation, may become major accomplishments for us.

First, let me say that I wasn't merely expressing a pious hope when I announced right after I took office that the new administration would take a fairer attitude toward the nation's taxpayers. The longer I stay in Washington, the more I am convinced that there has been an acute need for improvement in this respect. What is more important, we have already plenty of evidence to prove that a reasonable attitude toward taxpayers pays off richly.

What is our policy in this regard? It is simply this: First, we are in business to help the taxpayers, not to boss them around as though they were our servants. So I said to our people, "Let's get in there and help them and stop acting like a bunch of commissars. The people have done us the honor of employing us to help them determine what taxes their representatives in Congress have said they shall pay and you don't help people by snarling at them and attempting to browbeat them."

Second, our job is, of course, to collect taxes; but it is also our job to be helpful, reasonable, and just. We should not allow spendthrift empire builders to make imperial Shylocks of us. Balancing the budget is not up to us. We merely collect the money; and, if the budget can't be balanced by ordinary processes, it certainly is not to be balanced by the process of getting every feather we can pluck out of the goose, by whatever means we can contrive.

Third, our over-all objective is less litigation and more negotiation. We have been emphasizing these policies and objectives to the Service's personnel almost daily, and I can assure you that it is beginning to seep in and pay off. Of course, we don't want our people to have cold hands, but neither do we want them to have cold hearts.

This problem of getting a proper attitude on the part of our revenue people toward taxpayers is a very difficult one. You don't change people's habits overnight. Every now and then somebody complains bitterly to me that he has had an unsatisfactory experience with our people, and his tone is one of reproof. He is saying to me, in effect, "Why don't you do some-

thing about it?" In fact, I am trying to do something about it. We have traveled thousands of miles; we have talked to thousands of our own people, and to thousands of taxpayers; and we always try to impress upon our people the kind of attitude we want them to take. I am glad to be able to tell you that for every one person who says, "Why don't you do something about it?" there are about a hundred who are telling us that they notice the difference.

Of course, we don't expect our people to take insults from anybody. They don't have to. All they have to do is to be sure that they are gracious and just themselves in dealing with taxpayers. The taxpayer, of course, owes the same obligation of reasonableness and courtesy to our people that our people owe to the taxpayer. I think we are making progress in getting a better attitude on the part of our people.

Let's talk about decentralization a bit—what it means to the taxpayer and to the tax practitioners, and what it means to our people in the Internal Revenue Service. But first, let me tell you what the purpose of decentralization is and why we went into it. The purpose of decentralization is to encourage administrative settlements and reduce litigation. That is its primary purpose. Again we want to reduce the formal contest as much as we can, not because I am an accountant, but rather because we were concerned, and are still concerned, about the fact that the Tax Court, when we took office, was confronted with an intolerable backlog of unsettled cases, and that the same was true at the appellate level in our own shop. We soon would have reached an impasse, and it might have seriously effected our whole administration of the tax law.

The fundamental purpose of decentralization is to enable taxpayers to settle their differences with us on their own ballgrounds and across the table, in a spirit of compromise in which each party is willing to give up those things that he can't sustain, to the end that there might be agreement on more positive things.

The same is true in a dispute between business people. We recognize the fact that there has to be litigation of some disputes, and we try to take a reasonable attitude toward it. We do think, however, that the government in dealing with its citizens can very well take the same kind of attitude that those citizens take among themselves in their transactions with each other; for what is government but the people themselves. I don't think that is an unreasonable attitude.

Of course, most of you realize that decentralization was inherent in the whole program of reorganization adopted by Congress last year—a program, incidentally, that, as far as we are concerned, was merely a blueprint we took over. It had not been implemented.

Throughout the country, there were regional offices and chain setups, where the people in charge didn't even know what they were supposed to do. That isn't a criticism of my predecessors. The fact is that they were given a time limit for the institution of the reorganization; a time limit that was so utterly close that there was no chance in the world to make the reorganization effec-

tive before the filing season of this present year came around, consequently we had to get through the filing season before we could begin to make this thing work.

One of the first things we decided was that 17 districts were entirely too many to have. They were then called districts; now they are regions. So we cut it down, as you all know, to nine, and we chose nine gentlemen who have distinguished themselves in the Revenue Service to head those districts.

It is men like Mr. Ernest Wright, the Regional Commissioner for the Chicago area, whose entire lives have been spent in the service of their country, who make me proud to be a part of the Internal Revenue organization.

Now, what are some of the criticisms of the decentralization, and what are my answers to them? There are three principal criticisms. Number one is that the people in the field are not capable of assuming the enormous delegations of authority we had to make in order to carry out this decentralization and make it function. Number two is that we have opened a door for corruption on a much wider scale than ever before by giving great discretion to 64 district directors; whereas heretofore most of that discretion had been retained in Washington. The third one we might mention is that there will be no uniformity of rulings and no uniformity of decisions.

Let's discuss these very briefly. As to competence, I look at it this way: Some of the highest rated and highest paid people we have in the field (over 50,000 of the 54,000 employees of the Service are in the field) are the people who are out on the front line of operation, whose entire lives have been spent in that activity. Is it reasonable to suppose that these people are not competent of doing their job? I don't think it is, and I say to you very frankly if that were a valid criticism of the decentralization, then I should have recommended to the Secretary of the Treasury long ago that we wipe out the organization from top to bottom and start all over again.

What about corruption? The fact of the matter is, as all of you know, that there has not been any widespread corruption in the Internal Revenue Service. There have been people in it who have been guilty of some pretty serious indiscretions, yes, but you can count those people on the fingers of your two hands. I do not think that that number of people among 54,000 makes the entire organization corrupt any more than that one bad apple spoils a barrel. Sure, it creates a smell, but it doesn't destroy the rest of the fruit.

In addition, I have never known any organization that was any more corrupt at the bottom than it was at the top. In other words, if those presently in charge of the Internal Revenue Service at Washington are honest and forthright and fair and just in their dealings with taxpayers, I think that everybody else is going to be, right on down the line. To turn it around, I think that the minute we in charge of the Service in Washington prove unfaithful to our trust, and the people down the line know it (and they would find it out before anybody else), we will hear about it. If we in Washington, the Regional Commissioners, and Directors and their staffs give a proper demonstration of integrity and competence, we can expect the same from the people down the line.

As to uniformity of decisions, I think that most of you know that uniformity is a myth anyhow. We know that the Tax Court, which is a single court, has made contrary rulings in similar situations. There is no criticism of the Tax Court. We know that the District Courts have made rulings contrary to each other, and I suspect that those things will continue to happen. We think, however, that we have better control of the situation than the courts, because we have an administrative obligation to seek uniformity as far as it is possible to attain it. I can assure you without going into details that we have not just dumped this thing in the laps of the people in the field and said, "Here it is; it is your baby; go ahead with it." Instead, we have drawn upon our experience as accountants and auditors to install those principles and procedures of internal check and control which will enable us to obtain the highest degree of integrity and competence throughout the organization, and as great a degree of uniformity of decision as is possible to achieve.

I want to point out what we have done to assure the taxpayer a possible opportunity to settle his difference across the table with us. We have set up, as you know, the group-chief conference. Frankly, I don't know whether the group-chief conference is right or wrong; none of us are sure of that yet. A rather strange thing about it is that it seems to work wonderfully in some places and not at all in others. We have to find out why it doesn't work in those places. I can tell you that the policy of the present administration is that nothing we decide to do is sacred in our sight, and that no procedure we may follow is good one minute after we discover a better way to do it.

Next, I should like to tell a little bit about rulings, which are, of course, important to you. This relates, to some extent, to the question of uniformity. Uniformity involves, first of all, the pattern by which all of our field people act under the laws passed by Congress. This pattern has not been decentralized. Then you have the rulings, which have not been decentralized either.

So those fundamental stones in the foundation pattern of applying the law to given situations all emanate from Washington, and will be of course, under the same control as they have been under before. But we are also going to issue more rulings; we already are doing it. As of September 30, we had issued 207 rulings as against 86 for all of last year, and we expect to issue this year more than four times as many rulings as we issued in 1952.

As many of you have observed, these rulings will be more clearly stated, and what is more important, we will get them out faster. Believe it or not, while the general average seems to be 26 days between receipt of request for a ruling and the issuance of a ruling, which is a lot less than it had been, we often get them out in 24 hours. Of course, the more complex the ruling, the longer it takes to get it out, but I can tell you that under the very able direction of Assistant Commissioner Norman Sugarman, the Technical Rulings Division is not dragging its feet. It is doing a wonderful job, and I am delighted to have this opportunity to commend Mr. Sugarman publicly for the very excellent job he is doing.

The purpose of our whole rulings program is to have greater publication. There will be no more of the sort of thing we saw in the past, such as the

granting of the deduction of campaign contributions in the guise of bad debts, based on rulings that were never published. This administration is not going to engage in that kind of skulduggery. It is going to publish every ruling we make, except those rulings where the same facts and the same application of law have been published over and over and over again.

I have said that we are striving for simplicity in everything else, even our correspondence. It has been a rather strange revelation to me to receive from a number of people letters telling me that for the first time in their lives they have gotten letters or rulings from the Revenue Service that they could understand. Perhaps some are going out that are not so understandable, but I usually tell Mr. Sugarman when they come up to me, "Norman, make them so I can understand them, because if I can get it, I am sure almost everybody can." I think we have achieved that goal generally, but we still have a long way to go.

We are trying to get all the stilted language out so that you will understand what we are trying to say. We are trying to be responsive to your inquiries. We are trying to make you feel, "Well, these fellows are really human beings; they are just like us, they fight with their wives and they probably get divorces and they do all the things that we do. By gosh, one of these fellows may be our neighbor, who knows?" That is what we want to do.

We want to remove the Revenue Agent and Revenue people from that category of mysterious people who oppress the taxpayers, and I think we can accomplish that largely without ever looking taxpayers in the face by just being attentive to what we say and do.

Of course we are trying to avoid being unnecessarily technical, but I hope that you people will not be led into the error of unduly literal interpretation of what we say in some of these rulings. Please don't misunderstand our simplicity. Don't take us too literally. Let's apply the thing on a reasonable basis.

Finally, I want to mention Circular 230, which, as you know, says who may practice before the Treasury Department, and under what conditions they may practice. This circular is now in the course of revision. There are many who undoubtedly regard this current revision of our rules of practice as just a routine matter, but I want to assure you that, in the final analysis, the very success of our tax system of the vonluntary compliance type depends largely upon how broad a participation in the taxpayer-assistance program by persons outside the Service is permitted.

It is a well-established fact of tax administration that compliance with any law depends in large measure upon the public's understanding of the laws and the application to them individually. Meetings such as this afford us the opportunity to show how the laws are applied, to whom they are applied, and in what degree they are applied, but that isn't the whole answer. I think that President Eisenhower indicated the balance of it in a recent speech when he said, and I quote him, "We believe that in judging his own daily welfare, each citizen, however humble, has greater wisdom than any government however great."

This philosophy, when applied to the job that the Internal Revenue Service has to do, means simply that we must allow the taxpayers in choosing who shall represent them in the discussion and settlement of their disputes with us, the broadest possible latitude consistent with sound administrative practices.

I also think that it bars as unthinkable and utterly unworkable the suggestion that anyone save ourselves be permitted to say who may practice before us.

In addition to the basic reasons for allowing taxpayers a wide choice in this matter, there is a very serious immediate reason in our personnel situation. Before I explain that situation, however, let me give you some simple but significant data. In 1939, the total number of tax returns filed in this country was 17,700,000, of which about 10,000,000 were returns other than income-tax returns. Today, there are 93,200,000, of which 60,400,000 are income-tax returns. In 1943, as most of you will recall, our tax base was broadened to bring about this result.

In 1939, the population of our country was 131,000,000. Today it is 29,000,000 greater, or 160,000,000. Bear in mind that that is better than 20 per cent increase.

In 1939, there were 45,750,000 employed persons in this country. Today there are 62,300,000, an increase of nearly 20,000,000. Therefore, what do we face in the Internal Revenue Service? We have had an almost tenfold increase in workload since 1939, with the largest increase in the number of returns filed in the income-tax field, where our principal problem lies. In that period of time we have gone through the greatest war the world has ever known, and since 1946 we have been confronted with serious personnel shortages.

When the Korean War broke out the personnel situation became acute again. Employment today is at the highest level (with some slight recent downward trend) it has ever been at in the history of the country; and, in that situation, the Internal Revenue Service has had to defer or abandon many desirable techniques of tax administration, the net result of which is potentially disastrous. What has happened to us is simply this: As of this moment, we are 1200 Revenue Agents short of what is provided for in our budget, and we are not finding it easy to make up that shortage. We must look forward to a normal attrition of about a thousand agents a year. I am referring to agents, not because they are the only problem we have, but merely because we look upon the Revenue Agent as the backbone of our system of enforcement, at least I do, although I am not sure that everybody else does.

We, therefore, are a long way from having all the people that we need to enforce the Revenue laws. Now, don't let me be misunderstood on that. I am not saying that the Congress has acted, toward us, in any penurious manner; quite the contrary. The Congress indicated to us last year, after approving our budget as presented for the first time in the history of the Revenue Service, as far as we know, that if we needed more men, to let them know, and

they would give them to us. So we are not in any trouble with Congress. We have the finest possible relationship with Congress and the greatest cooperation that anybody could hope for.

Our problem rather is how many can we get and how fast can we assimilate them? We have an organization which normally is a stable organization, because you are going to have taxes like you are going to have death, and, therefore, you do not have the turnover in our department that you do in other departments of government. In one of the important cities in the Middle West, 70 per cent of our top personnel are retiring within the next five years, and a situation almost as bad is to be found in many of our offices.

Therefore, it is absolutely imperative that we do two things: First, provide for a steady increase in the number of our personnel until we get to that point where further additions would not bring in a greater sum than we spend for them, and I can tell you we are a very, very long way from that point. In addition to that we must have just as many people as we can possibly get to help in the administration of the tax law from the outside. The taxpayer must, therefore, be allowed to have all the help that he thinks he requires in accordance with the dictum laid down by President Eisenhower.

The Chinese symbol for disaster is made up of two characters, I am told, one of which is the character meaning crisis; the other the character meaning opportunity. I don't hesitate to state, that we face a crisis, personnelwise, in the Revenue Service, but I also can assure you that we are of that mold and of that frame of mind that we recognize the opportunity and that we intend to seize it. We have a plan for meeting this situation that, in my opinion, will work and will not only give us all the people we need, but will also give us a very much better Revenue Service, a real, true career service.

Only recently Chairman Young of the Civil Service Commission complimented us on this policy of ours, and told a group of government employees that the policies of the Internal Revenue Service will assure, for the first time, one of the great career services of the government.

So, my friends, it all boils down to at least two basic principles: One, successful tax administration cannot be achieved in an atmosphere of mystery as to what the tax laws are all about, who they apply to, and to what extent in each individual case they do apply; and just as it takes all kinds of people to make a world, so also it takes all kinds of people to make a tax system work, especially one as complicated and as varied as ours.

One other thing I would like to mention about Circular 230 is that I frequently have been asked what my attitude is with regard to the publication of disbarment practice. My own feeling is that the taxpayers of America have as much right to know who is disqualified from practice as those who are qualified have the right to publicize that fact. As far as I am concerned, whenever anyone loses his right to practice for cause, it is going to be published. We want the world to know that we are running the Revenue Service on an honest basis, and who the shysters are, if any.

Let me say this to you in conclusion: The question of successful administration of the tax laws of this or any other country boils down to one very

simple thing, and that is the question of whether the taxpayer complies willingly and forthrightly, or whether he seeks to evade. Now, I think most of you know that in several countries of the world artfulness and evasion are being more greatly admired than willingness and compliance, and I think all of you know what condition those countries are in. The president of one of these nations said recently that over 90 per cent of all the people in that country subject to income taxes were evading them.

Let me point out that there isn't going to be any Marshall Plan for the United States of America if and when it falls upon hard times. One of the best ways I know to keep it from falling upon hard times is that the administration of the tax laws of the country be such that will inspire integrity on the part of those who administer that law, and integrity on the part of the citizens who must comply with it.

I think, very deep down in my heart, that we can draw all the pretty pictures of organization we want, we can write all the fine-sounding procedures for the guidance of our people we want, but that, unless we achieve the situation under which the taxpayer of this country continues to come forward and say voluntarily, "This is my income and this is what I owe you;" unless we can preserve that philosophy of tax compliance in this country, then the time will come when the fiscal system of our country will collapse and carry down with it into the rubble of disgrace everything that you and I hold dear. As the Commissioner of Internal Revenue of the United States, I am dedicated to the attainment of that kind of tax administration.

Learning to live with a flexible monetary policy

MEYER KESTNBAUM

Chairman, Committee for Economic Development. President, Hart, Schaffner & Marx, Chicago. Has served as arbitrator on War Labor Boards.

There is no need for me to remind this group that we live in a troubled world. Nor is it necessary for me to point out to practical men that to a large degree the problems of the world are essentially economic problems. Without attempting to prove something that seems obvious I should like to submit the proposition that one of the most important challenges facing us today is the maintenance of a reasonable degree of stability in the American economy. I need not labor the importance of economic stability. We have lived, in less than twenty-five years, through a terrible depression and a serious inflation. During the depression we saw the great productive capacity of the American economy, the marvel of history, lying idle because we had not mastered the problem of keeping that capacity continually engaged in satisfying the real wants of our population. There was physical suffering for some, frustration for many, and for still more loss of confidence in themselves and in their society.

In more recent years we have lived with rapid inflation, striving to keep our personal, business, and national affairs afloat on a raging flood of rising prices. Probably no one is better aware than are the accountants of what it means to try to operate an economic system with a standard of value declining in significance at an unpredictable rate.

As we have become more concerned with our relations to the rest of the world, we have come to recognize that economic stability here is not only important to us at home. It is also an essential condition for the economic health of the non-Communist world and thereby for its solidarity, security, and freedom. The economies of most of our friends are precariously balanced. They cannot adapt themselves effectively to the alternating withdrawal and reappearance of the gigantic American economy as a buyer and seller in world markets.

There is a strong determination in all sectors of the American economy to achieve greater stability than we have achieved in the past. Without this deter-

mination little could be done. But determination by itself is not enough. Our problem is one of means, and of wisdom in the use of means.

There are, in my opinion, available means, in the policies of government and in the voluntary action of business, labor, and consumers, to achieve not perfect stability but the essential goal of reasonable stability. The means are adequate, if we use them wisely. It would be rash to assert that we are now prepared to use the available means with the necessary wisdom. We have learned many things, but there is still much to learn. What we have learned has come largely from hard experience and mistakes, and this is probably how we shall learn in the future. But we cannot afford to make very many mistakes. We now face a real test of our ability to analyze our experience and extract from it the lessons it holds for the future—without making too many mistakes in the process.

I should like to discuss our recent experience with one of the instruments we must use to promote economic stability—monetary policy. In selecting this one instrument for discussion I do not mean to elevate it above its true proportions in relations to other measures. Monetary policy alone cannot provide stability. But it can make a major contribution to that goal and, if badly used, it can certainly create instability. This has been a year of dramatic events and unusually active discussion in the field of monetary policy, and in the closely related field of debt management. It is worthwhile to consider this experience and see what we can learn from it.

RECENT EXPERIENCE WITH MONETARY POLICY

In the years from the end of the war to the spring of 1951 monetary policy was primarily, and with small exceptions, devoted to one purpose—to keeping the yields on government securities low and stable. At the beginning of the period there were some who thought that monetary policy could not succeed in this purpose. They doubted the ability of the monetary authorities to keep interest rates low when all the natural forces of the market were working to raise interest rates. But the Federal Reserve's capacity to buy government securities, with the newly created reserve money, and to expand the capacity of the banks to make loans in the process, with practically limitless. We saw that, if the Federal Reserve was willing to use this power primarily to keep interest rates down, it could do so.

We also saw, however, that in the circumstances such a policy could succeed in keeping interest rates low only at the cost of permitting and contributing to a vast inflation, which weighed very heavily on a large portion of our population. The demands of businesses and consumers for plant, equipment, inventories, housing, automobiles, and goods in general were much larger than the economy could satisfy. The impact of these demands upon the market could not fail to raise prices. If we could have made credit less easy to get, if we could have restricted the public's supply of money, we could have held some of these demands back—still allowing them to be satisfied up to the maximum of our productive capacity, but at least reducing the inflation. As long as the great power of the monetary authority was used to keep interest rates down,

however, there was little opportunity to tighten credit to private borrowers.

As the postwar inflation proceeded, there was increasing recognition that this was a perversion of monetary policy, involving a sacrifice of the primary objective, economic stability, to a secondary objective, stability of interest rates at low levels. Considering the complexity of the issues, public understanding of this grew surprisingly, especially when rapid inflation resumed after Korea.

Finally, in March 1951, the Treasury and the Federal Reserve agreed upon a change of policy. The new policy was embodied in the now-famous accord. The essence of the accord was that in the future the powers of the Federal Reserve would be used primarily with a view to promoting economic stability.

This amounted to a declaration of intent to inaugurate a flexible monetary policy—one in which the direction and intensity of the Federal Reserve's action would be adapted to the changing economic situation; restraining the economy when demands tended to be excessive, and stimulating it when demands tended to be deficient. But this declaration of intent, which freed the Federal Reserve to pursue a flexible policy, did not by itself give us such a policy. A flexible monetary policy has to be managed, and the declaration of intent did not tell the Federal Reserve or the public how it was to be managed.

To manage a flexible monetary policy is much more difficult than to operate a policy of stabilizing the prices of government securities. In the latter case it is only necessary for the Federal Reserve to stand ready to buy government securities from all comers at a fixed price. The Federal Reserve knows what to do and the private market knows what the Federal Reserve will do. But to manage a flexible monetary policy it is necessary first of all to have a continuous and accurate appraisal of the economic situation and its trends. It is then necessary to decide the direction and degree of monetary influence that is appropriate to the economic prospects and consistent with nonmonetary measures that may be taken. Finally, it is necessary to decide how much Federal Reserve action of any particular type is needed to yield the desired net influence. The chain from action to influence is indirect and heavily dependent upon unpredictable psychological factors. Thus the accord, while a long step forward in the recognition of important objectives, opened up hard problems of monetary management.

Similarly, the accord opened up new and important problems of debt management. So long as the Federal Reserve stood by to support the price of government bonds the Treasury had an assured market at a known rate of interest. But without this support both the Treasury and holders of government securities faced uncertainty. Moreover, once support was withdrawn and prices became uncertain, the difference between a long-term security and a short-term security became greater and the effects of the decision to issue one rather than the other became more serious.

The immediate effect of the accord policy and the dropping of the peg on government securities was an increase of interest rates, as had been expected. For a time holders of government securities who wanted to sell couldn't find buyers. The effect of the drop in government bonds was serious. Insurance companies and other lending institutions facing losses on these bonds were

compelled to re-examine their lending policies. The practical effects of this change in direction were felt throughout the economy. The shock was not serious, however, and was soon passed over. This was partly due to the facts that the Federal Reserve cushioned the decline and that dealers and investors cooperated in avoiding speculative selling of securities. Also the transition from rigid support of the government-bond market to a flexible policy came at a propitious time. The initial surge of post-Korean inflation had just begun to abate. Consumers were saving more and businesses were less anxious to build up inventories. The pressure toward higher interest rates was receding.

After their initial increase in the spring of 1951, interest rates declined, although not back to the support levels, and then began a rise that continued at a very gradual rate until the end of 1952. Price controls were still in effect but, in general, prices did not seem to be pushing hard against the ceilings. This combination of relatively stable prices and relatively stable interest rates meant that the demand for credit was not very much larger than could be satisfied without inflationary monetary expansion. There were several reasons for this. During most of the period up to the end of 1952 the Federal budget was in balance on a cash basis, aside from seasonal factors. Housing credit and consumers' credit were under special controls. The demand for additional credit to finance additional inventories was moderate; inventories were already quite high in many lines in the spring of 1951, and in 1952 the steel strike kept many businesses from building up or even maintaining their inventories.

This does not mean that monetary policy was making no contribution to the control of inflation. The supply of credit was being restrained, as is indicated by the rise of interest rates, however gradual. Moreover, the restraint on the supply of credit was not fully measured by the rise of interest rates. To some extent credit simply became harder to get, even though lenders did not raise interest rates.

Perhaps this is a good place to point out the effectiveness of the indirect controls that are involved in monetary and fiscal policy as against the direct controls of wages and prices. It is worth noting also that the indirect restraints were effective despite a continuous expansion of bank reserves, bank loans and investments, and the supply of money. In an economy characterized by a growing population and increasing productivity, some growth of the money supply is generally consistent with stability. Under these conditions inflationary tendencies can be restrained by holding back the rate of growth on the side of money. It is not necessary and usually not desirable to effect an absolute decline in the money supply.

Up to this point, to the end of 1952, the new flexible monetary policy was a clear success. We had, partly because of it, achieved a fair measure of economic stability without any great rise of interest rates. Little criticism of the policy was heard. Even those most skeptical of its contribution to stability could not claim that it had done any serious damage.

But the flexible monetary policy had not yet faced a real test. That test did not come until 1953. By the beginning of this year the situation with which monetary policy had to deal was changing markedly. Defense expenditures and

private plant and equipment expenditures were rising towards what was to be their peak, at least temporarily. We were running into the first cash budget deficit of the Korean defense program. Selective controls on housing credit and consumers' credit were abolished. With the end of the steel strike many businesses found it possible to build up inventories and were willing to borrow to do so. Price and wage controls were about to expire and there was some fear —how long ago this seems—that many prices would be raised when that happened.

Thus the demand for credit was rising. If the Federal Reserve maintained its restrictive policy the gradual rise of interest rates would be accelerated. But if the Federal Reserve relaxed its restraints there was a real danger of inflation.

The situation was enormously complicated by the uncertainty of the economic outlook. There were many forecasts, sufficiently well grounded so that they could not be easily dismissed, of a recession coming toward the end of 1953 or the first part of 1954. This created a number of possibilities for monetary policy. If monetary restraints were relaxed and one last spurt of inflation permitted, the subsequent recession might be made worse. On the other hand, a restrictive policy might hold back some investment demands in the first part of 1953 and leave them to be satisfied in 1954. This would, if the economic forecasts were correct, help minimize both an inflation and a recession.

A policy that was too restrictive, however, might have the effect of precipitating the recession that was feared. In the history of the Federal Reserve there have been a number of cases of anti-inflationary action that were so quickly followed by a downturn as to create the suspicion that the Federal Reserve was responsible. There was a real danger early in 1953 that there was no policy that was "just right." The degree of restriction that seemed necessary if we were to prevent further inflation early in 1953 might have seemed too much later on. The process of restraining expenditures to a level that could be regarded as noninflationary might so discourage commitments to future investment and housing as to intensify a later recession. Furthermore, a policy of restraint that seemed just right for the current situation might prove incapable of being reversed completely when the economic situation changed.

One other element in the early-1953 picture should be noted. A continually large portion of the government debt was in the form of short-term securities. There had been considerable hesitancy about attempting to issue long-term obligations: in fact, since the beginning of 1946 the Treasury had issued no marketable security with a longer maturity than seven and one-half years. Most of the issues had been very much shorter. It was known that the Treasury officials of the Eisenhower administration wanted to reverse that trend. This might be considered another factor making for higher interest rates.

Against this background, the Federal Reserve continued its restrictive policy. In fact, there is some evidence that the policy became more restrictive early in 1953 than it had been previously. In the first half of 1952, member-bank reserves were on the average about $700 million higher than in the first half of 1951. But in the first half of 1953 bank reserves averaged only $100 million

more than in the first half of 1952. In March and April, 1953, bank reserves were actually lower than they had been a year earlier. As a result of this retardation in the rate of growth of bank reserves, the rate of growth of bank loans and investments and of the money supply were also slowed down.

The combination of monetary restriction and increasing demands for credit boosted interest rates substantially. The yield of Treasury bills in November 1952 was only 12 points higher than in December 1951; by May it had increased another 34 points. The yield on Treasury 3 to 5 year issues rose 16 points from December 1951 to November 1952; thereafter it rose sharply, gaining 67 points by June 1953. Long-term United States government bonds were yielding 2.71 per cent in November 1952, as compared with 2.70 per cent in December 1951; by May the yield had risen to 3.09 per cent. The course of private interest rates was similar.

In April, the Treasury announced the offering of a 30-year bond paying 3¼ per cent interest—the longest term and highest coupon in many years. Interest rates had been rising rapidly before this, but the announcement was followed by a further acceleration in the rate or rise, particularly in the market for long-term funds. Although the 3¼ per cent bonds were oversubscribed they were selling at a discount soon after issuance.

As money grew tighter and interest rates increased, particularly after the 3¼ per cent bond issue, there was mounting criticism of the policy. This criticism was of three kinds:

First, there was criticism based simply on the fact that interest rates were rising, with the implicit assumption that an increase of interest rates is always a bad thing.

Second, there was criticism of the size and timing of the operation, on the ground that it would hasten or intensify a recession.

Third, there was criticism of the methods used, on the ground that they had unintended and undesired effects.

The simple view that a rise of interest rates is always a bad thing results, I believe, from looking at interest rates as mainly a means of dividing income between borrowers and lenders. In this picture the borrowers are usually conceived of as veterans who need houses, farmers, small businessmen, etc. and the lenders are conceived of as hard-hearted bankers. Of course, this is an entirely erroneous view of who the borrowers and lenders really are. We find both creditors and debtors at every income group and in every walk of life. The great lenders, the banks, insurance companies and other financial institutions are intermediaries that lend the funds of millions of small savers to borrowers of every description.

The important national concern with interest rates is not in the distribution of interest burdens but is in the stabilization of the economy. A monetary policy that will restrain inflation is well worth its cost in higher interest rates, if indeed that is a cost at all. This does not mean that a stabilizing monetary policy always requires high or rising interest rates. But a stabilizing policy will be completely hamstrung if it is limited by the requirement that interest rates can never be allowed to rise. This was the lesson of the years before the

Treasury–Federal Reserve accord. It is amazing that so many people should have forgotten it so soon.

There is another element in the situation that has generally been overlooked. The banks decided to increase their rate on prime loans by one-quarter of one per cent at a time that coincided with the Treasury issue. This may or may not have been wise—there are arguments on both sides—but there is no doubt that this action on the part of the banks had an important impact on the attitude of the business and financial community toward interest rates and on the market price of bonds.

In general, the critics of higher interest rates, as such, usually assume that the Treasury was responsible for the increase. This view is also taken by many of the financial writers. The Treasury is said to make money tight and raise interest rates by raising the rates it pays on its own newly issued securities. On the other hand, in an attempt to absolve the Treasury of responsibility it is sometimes described as playing an entirely passive role, meeting the market rates of interest but not influencing them. And this raises the further question whether it is a "free" market or a market dominated by the Federal Reserve that influences rates.

It is clear that the Treasury does not determine the rates on its own securities but only estimates the rates that will be necessary to make the securities saleable in the market. At the same time, the Treasury is an important influence in the market both for its own securities and other securities. It influences the market not by the interest rates on its issues, which it does not determine, but by the amount, maturity, and other features of its issues, which it does determine. For example, if the Treasury decides to issue a 30-year bond it will have to pay the market rate of interest for such a bond. But the rate it will have to pay if it is issuing $5 billion of such bonds may not be the same if it is issuing $1 billion. Also, the effect on interest rates will vary depending on whether the Treasury offers $1 billion of 30-year bonds or whether it issues $1 billion of 90-day bills, although in each case it prices the securities to meet the market.

The Treasury's decision to move in the direction of funding the debt was an influence toward higher interest rates. More obviously and more importantly, the Federal Reserve's restrictive policy tended to raise interest rates, even though this was not the main objective of their policy. The defense of the Federal Reserve and the Treasury against their critics is not to disclaim responsibility for the higher interest rates but to point out that the higher interest rates were the proper and inevitable consequence of policies the national welfare required.

More sophisticated critics did not start from the premise that higher interest rates are prima facie evidence of error, if not of sin. Instead they accepted the principles of a flexible monetary policy, involving rising interest rates at certain times, and argued that in the particular circumstances which obtained in the Spring of 1953 the policy was too restrictive. This difference of opinion resulted from a difference of opinion about the economic situation and outlook. This difference will probably never be resolved, and I shall certainly not attempt to resolve it. If we have a recession within the next six or twelve months,

those who considered the policy too tight will claim support from the facts. On the other hand, if we do not have anything more than a moderate decline within this period, the policy will seem to many to have been vindicated. Neither conclusion is necessarily correct. The important question is whether the action taken represented a reasonable application of generally sound principles to the situation as it could be ascertained at the time. We are dealing with possibilities and probabilities, not with certainties, it is impossible to avoid a certain percentage of error. The results in any particular case would not prove that the policy was correct or incorrect because there are too many imponderables, but persistent success or failure would be significant.

In criticizing the actions of the monetary authority we must recognize that there is rarely full agreement about the future of the economy even among well-informed people. The monetary authorities are charged with an exceedingly difficult and delicate task, and they must have some margin of tolerance if they are to execute it well. It is impossible in a complicated situation to make everyone happy and continual second-guessing does not help. The monetary authority must proceed judiciously, but it must not be too timid to act and it must not be inhibited either by fear of criticism on the part of those who are adversely affected or by the fear that its careful appraisal of the trend of the economy may later turn out to be incorrect.

The unreliability of economic forecasting being what it is, our chief safeguard against undesirable effects of monetary policy must be flexibility—the capacity to change promptly in response to economic changes as they become apparent. One of the most encouraging developments of the past year was the fact that the Federal Reserve shifted quickly from a policy of restriction to a policy of monetary ease, without being forced to do so by an acute economic decline. There is a tendency in some quarters to regard this shift as a confession of previous error, but this is not necessarily a correct interpretation. The essence of a flexible policy is that policy should change in degree and direction as conditions or our understanding of conditions change. The important thing is that neither inertia nor dogmatism should stand in the way of prompt changes.

One perplexing question in this connection is whether the effects of a policy of tight money can be reversed, even if the policy itself is reversed. Once money gets tight and interest rates high, it may be difficult to get rates down again, because lenders regard the higher rates as normal and are unwilling to commit their funds for less. Something like this happened in the thirties, when long-term interest rates declined only slowly despite the existence of large excess reserves. But this year an easing of monetary policy was followed rather promptly by an easing of credit conditions and a decline of interest rates. For example, in four months the yield on the longest Treasury bond has declined from 3.32 per cent to 3.11 per cent. In part this prompt reaction was due to the fact that the period of monetary tightness had been so short. But it probably also reflects increased awareness of the power of the Federal Reserve to get interests rates down if it sets out to do so.

There is one aspect of the monetary experience of this spring that should be,

in my opinion, a cause for concern. This is the vigorous and unstable reaction of the market to the actions and statements of the money and debt authorities. I think it is rather unlikely that the Federal Reserve expected interest rates to rise as fast as they did or that the Treasury expected the 3¼ per cent bond to sell at a discount so soon after issuance.

This exaggerated sensitivity of the market, which does not seem warranted, creates a difficult situation for flexible monetary policy. It makes it hard to proceed gradually, in small steps, feeling one's way as to degree and even as to direction. There is always the danger of a severe reaction to a small step.

The sensitivity of the market was due in part to the manner in which the policy was executed and described by the authorities. For example, it appears that too large a proportion of the 3¼ per cent bond was allocated to subscribers who were likely to sell at the first opportunity. Probably more important was the failure of the money and debt authorities to communicate to the public an accurate sense of what they were trying to do. It was not that the authorities didn't talk enough. There was a tendency to describe very limited actions in universal language that suggested the advent of some totally new permanent policy. When the Federal Reserve talked about credit restriction it conveyed, or at least did not correct, the impression that the Federal Reserve was going to stay out of the market indefinitely. And when the Treasury talked about funding the debt the market got the impression that massive operations were to be carried through no matter what. More realistic explanation of policy would make the market less sensitive and safer for flexible monetary policy.

To a large degree the volatility of the market resulted from our lack of experience with flexible policy. For so many years our monetary and debt policies were all one way. We have to get used to the ideas of moderation, adaptation, and reversibility that are the essence of the new policy.

Not only in monetary policy but also in all other government policy to promote stability, better communication between the government and the public is essential to success. If the public, including especially the business community, has confidence in a government stabilization program, the battle is half won. For in that case the public will behave in a stabilizing manner: it will not be betting on instability and thereby aggravating instability.

Of course, sturdy confidence cannot be created by talk alone, by saying that every day in every way we are becoming more and more stable. Confidence, if it is to persist, must be deserved. But there is a real basis for confidence now and there could be an even stronger basis for confidence. This is not the economy of 1929. Our banks and other financial institutions are incomparably sounder. The financial position of businesses and home owners is much better. We have important built-in stabilizers in our tax system, our unemployment compensation system and our farm price support program. We have an Employment Act, important both as a symbol of intent and as mechanism for focussing attention on the stability problem.

We can and should go further, both in developing plans for maintaining stability and in making those plans known. There are many instruments

that can be used, and probably will be used. But we need systematic and coordinated plans for their use, and greater public understanding of these plans.

The responsibility for the maintenance of confidence runs both ways. The government must act and plan in a way that deserves confidence. The public, including the business and financial community, also has a responsibility to show confidence when it is deserved.

Monetary policy is an especially appropriate instrument for achieving stability in our society. Ours is a money economy in many senses. We value our activity and possessions in money, exchange through money, hold money as an asset, and we mobilize our savings for investment in large part through money. Control of the supply of money, affecting the cost and availability of credit and indirectly the value of money, exerts a pervasive influence throughout the whole economy. At the same time this influence can be exerted and managed without that detailed central control over the transactions of the individual person and business that is the end of freedom. The alternatives to wise and vigorous monetary policy will be not only less effective, but also less consistent with the operation of a free society.

A serious danger in our recent experience with flexible monetary policy is that the public and the authorities may become over-impressed with the difficulties and retreat from the whole project. This would be a serious setback. Whether the recent administration of the policy was wise or not, whether we have achieved stability or whether we face some degree of recession, we must not abandon our efforts to master the techniques of a monetary policy that is flexible and adaptable. We must learn to live with such a policy, we must tolerate its costs and its errors, and we must learn to manage it better. This requires clearer statements of objectives on the part of those who are carrying out this policy. In a democratic society, which is based on individual freedom of action, it also requires a large degree of understanding and cooperation on the part of our people, and in this area the business and financial community has a special responsibility. We cannot afford to be fearful and we must not be so preoccupied with our problems as to lose faith in ourselves or in our leadership, or in the power of our economy.

Plans and purposes of the Small Business Administration

WILLLIAM D. MITCHELL

Administrator, Small Business Administration. Member of the bar, District of Columbia, U.S. Supreme Court, and Utah.

It is a pleasure for me to meet here with you for a very particular reason. I am always glad of an opportunity to discuss the problems of small business and the plans and purposes of the Small Business Administration with a representative group of businessmen. But the particular reason why I am grateful to have this opportunity of speaking to you is that your organization is exceptionally close to the kinds of problems with which I am concerned as Administrator of SBA.

In fact, I don't know of any single group of people who know more about the over-all problems of small businessmen than certified public accountants. In your professional work you necessarily come to grips with most of the problems that confront small business. Thus, you have a broad familiarity with them and a special insight into them.

It follows, of course, that you have a sympathetic interest in all worthwhile endeavors to improve the lot of small businessmen and make their position in our economy more secure.

We in the Small Business Administration are well aware of the knowledge public accountants have of small business problems and of the services they perform for small firms. Indeed, one of our Small Business Management booklets deals specifically with what the members of your profession can do to help small businessmen.

If there are any of you who don't already know about it, the booklet is entitled *Public Accounting Services for Small Manufacturers.* It was written by one of your speakers at this session, Robert S. Witschey, who, of course, is a member of the American Institute of Accountants. The booklet describes many of the ways in which public accountants can help to improve the efficiency of a small concern. That is the object of your services to small firms, just as it is ours—to improve the efficiency of their business operations.

Therefore, in speaking here I feel that I am not only among friends but also among people who share the Small Business Administration's interest in serving the small-business community. As public accountants you are

especially concerned with the financial operations of your small business clients. I am sure, then, the subject you will be most interested in having me discuss is SBA's financial-assistance program. I know that in many instances you accountants will have the responsibility for helping applicants for SBA loans to fill out the application forms properly and to provide guidance for your clients in handling their financial affairs to the best advantage.

As you know, SBA is a new agency established by the Congress in the Small Business Act of 1953. This is only the third month of its existence. We are even newer than *that* in our activities in the lending field, because we did not assume *that* responsibility until September 29, less than a month ago. It was on that date that the small business and disaster loan functions formerly exercised by the Reconstruction Finance Corporation passed to SBA, in accordance with the provisions of the Act.

SBA has other responsibilities, of course, besides that of giving financial assistance to small firms. We are concerned also with helping small business to obtain a fair share of Government contracts and other business; with providing assistance in solving managerial and technical problems; and with giving aid in meeting requirements for materials and equipment. SBA has programs in operation to serve small firms in all these fields.

Our financial assistance program, however, now imposes greatly increased responsibilities upon SBA. This is true not only for the reason that the former RFC lending functions previously mentioned have been transferred to SBA but also because we have embarked upon a new policy of developing a broader base of private capital and credit for small concerns.

Before taking over our new lending functions just three weeks ago, we in SBA devoted about two months to preparation for the task. After thorough and intensive consideration the SBA Loan Policy Board adopted a loan policy statement which we believe represents a sound, businesslike approach to our lending activities.

The Loan Policy Board was created by the Small Business Act of 1953 to guide SBA's lending operations. The Board consists of Secretary of the Treasury George M. Humphrey, Secretary of Commerce Sinclair Weeks, and myself as Administrator of SBA, as Chairman. The Board will maintain a constant watch on our lending activities and will be ready at all times to adjust our loan policies to meet conditions most effectively. I am very happy to have the counsel of such able and broadly experienced businessmen as Secretary Humphrey and Secretary Weeks.

The loan policy statement calls for giving *preference* to granting financial assistance that will "assist, expedite, increase or maintain the production necessary to meet military, defense or essential civilian requirements." This provision does *not* rule out loans for other purposes, but gives preference, in short, to financial assistance for defense or essential civilian production.

Because of the continuing urgency of the mobilization program, I think it is a safe assumption that SBA loans will be almost wholly confined to defense and essential civilian purposes in the current fiscal year, at least. Even so, this field affords considerable latitude for financial assistance.

Moreover, loans made in furtherance of defense and essential civilian production will indirectly benefit other lines of small business, such as wholesaling, retailing, and the service industries. Since defense and essential civilian production is *basic* in our economy, assistance given to small producers will result in a flow of indirect benefits all along the line.

The Act itself provides that SBA can make loans *only* when the financial assistance sought is not otherwise available on reasonable terms. In keeping with that requirement of the law, our loan policy statement lays down certain criteria for determining whether financial assistance is otherwise available. Boiled down, these requirements mean that a small firm can qualify for an SBA loan *only* after it has exhausted the possibilities of obtaining the amount sought from a bank or other private source of capital or credit.

Naturally, the applicant must also qualify on the basis of sound loan value. Our legislative act and our policy statement emphasize that all loans made must be of such sound value, or so secured, as reasonably to assure repayment. This provision, however, *does* constitute a liberalization of the policy which prevailed in RFC loans. RFC required tangible collateral as security for loans. While SBA also is interested in having tangible collateral to the greatest possible extent, it may take into account other factors besides this in judging the soundness of a loan. These factors include the character of the man or the men behind the firm involved, the ability of the management, the credit history of the company, and the purpose for which the loan is sought.

Now, some of you may wonder how our standards of sound loan value differ from the prudent business requirements for bank loans. If a loan application is turned down by a bank and the applicant then goes to SBA —which is the only way he could gain our consideration—on what basis, you may ask, could we judge the loan to be a sound one?

I have indicated some of the bases on which we might consider the loan but which banks often *cannot* take into account. Let us remember, though, that to say a loan is nonbankable is not necessarily the same thing as saying it would not be a sound loan. For banks must be governed by legal and other restrictions, and by considerations growing out of the fiduciary nature of their operation.

Often such restrictions and considerations preclude a bank from making a loan even though it may have no question concerning the character of the applicant or his ability to repay. This is especially true of *long-term* loans. Usually banks can meet the *short-term* financial needs of small concerns where the loan requirements are legitimate. Moreover, as we all know, one bank sometimes can and will make a loan that another bank, for one reason or another, will decline to make.

Our policy statement provides that the financial assistance applied for shall be deemed to be otherwise available on reasonable terms unless it is satisfactorily demonstrated that proof of refusal of the required amount has been obtained from: (*a*) the applicant's bank account, and (*b*) a competing bank in the same area; and (*c*) if the amount of the loan applied for is in

excess of the legal lending limit of the applicant's bank or in excess of the amount that the bank normally lends to any one borrower, then a refusal from a corresponding bank, or from any other lending institution whose lending capacity is adequate to cover the loan applied for.

At any rate, there is undoubtedly a considerable degree of latitude in which loans of reasonably sound value, for legitimate purposes, may be made by SBA which banks would not be in a position to handle. I assure you that SBA firmly intends to carry out this policy of sound loans with a view to conserving the funds that have been provided by the American taxpayers.

The amount the Congress provided for SBA loans in the current fiscal year is $55,000,000 as a revolving fund. Out of this, $5,000,000 or more will be set aside to meet disaster loans. Thus, in a round figure, SBA has approximately $50,000,000 for the current fiscal year to meet the legitimate requirements of small concerns for Government financing.

In the light of previous experience, $50,000,000 seems to me to be a realistic amount for this purpose. I base this opinion on the fact that in one year and seven months the Reconstruction Finance Corporation made small business loans totaling something more than $51,000,000 on the recommendation of the former Small Defense Plants Administration. If a little more than $51,000,000 met the needs of Government loans to small firms over a period of more than a year and a half—and at a time when the mobilization program was reaching its height—then I feel that approximately $50,000,000 will serve adequately for the rest of this fiscal year, which has barely more than nine months remaining.

The law limits SBA loans to $150,000 to any individual small firm. This also seems to me to be a realistic figure, since the average size loans made to small concerns in the SDPA-RFC program was about $126,000, although there was no such legal limitation on the amount of loans. A few of those loans, in fact, went as high as $1,000,000 or more, and many were between half a million and a million dollars, although eventually an administrative limit of $300,000 was set. Most of the loans, however, were small enough to bring the average down to about $126,000. So I feel that the present legal limitation of $150,000 will permit SBA to meet the legitimate needs of small firms for Government financial assistance quite satisfactorily.

Our lending activities, however, constitute only a part of SBA's financial assistance program. Our aim is to stimulate and encourage loans to small concerns by banks and other private lending institutions and to use SBA funds as supplemental financing to the greatest possible extent. Thus we will be able to give "leverage" to our $50,000,000 and multiply many times its effectiveness.

SBA has no desire to compete with banks or other private sources of credit, but on the contrary is determined to do everything it can to help small business fulfill its financial requirements from private capital. SBA will not make a direct loan to a small firm unless it is shown that participation by a bank or other lending institution is not available. Congress has

spelled that out for us. We have two forms of participation loans—*immediate* and *deferred.*

In an *immediate* participation, a bank or other lending institution originates the loan and SBA takes a portion of it. In a *deferred* participation, a bank or other lending institution originates the loan and provides the entire amount, with an agreement that SBA will purchase a specified part of the loan later, on demand, if the lending institution wants it to do so.

Not only will SBA make no *direct* loan if a *participation* loan can be arranged; it will enter no *immediate* participation if a *deferred* participation is available. So, *if* SBA is going to make a loan at all, the statutory order of preference is this: (*1*) for a *deferred* participation loan; (*2*) for an *immediate* participation loan; and, last of all, (*3*) a *direct* loan. Thus, you see, our major effort is directed toward providing the greatest possible amount of private financing for small business.

In addition to stimulation of more private financing in this way, SBA has embarked on a program to encourage the formation of state and local reservoirs of private capital to broaden the base of financial assistance to small business. Such private credit reservoirs are already in existence in a number of states and communities, notably in New England. In the six New England states these reservoirs have taken the form of state-wide development credit corporations. In these credit corporations, banks and other lending institutions, and other civic-minded individuals and companies within the state participate on a spread-the-risk basis.

We in SBA feel that every state in the country should have such a reservoir of private capital and credit to help finance small business and we are actively encouraging the adoption of this plan in other states. The idea is catching on with enthusiasm across the country. Basically, we believe that this is the *right* way to do the job—to encourage states and localities to solve their own economic problems, with federal participation but *not domination.* That is the traditional American way of doing things. It has always worked, and we know it will continue to work, with adaptation to new conditions as they arise. SBA will participate with state and local credit corporations, as with banks and other lending institutions, in meeting the financial requirements of small firms.

Now I want to explain the interest rates set by our Loan Policy Board on SBA loans. On deferred participation loans in which banks or other lending institutions originate the loan and SBA obligates itself to assume a part of the amount, on demand, the interest rate will be fixed by the participating bank or other institution, with a minimum rate of not less than five per cent annually on the portion of the loan which SBA is obligated to purchase. This compares with the former RFC charge of a fixed rate of five per cent on loans of this type.

On those loans in which there is a commitment for a deferred participation by SBA, with the bank advancing the full amount immediately and SBA obligating itself to assume a portion of the loan, on demand, a charge is made to the bank to offset the lack of income from the segregated funds.

In such cases, of course, the government fund must be segregated without income in anticipation of a demand for the portion of the loan which SBA is obligated to purchase.

Charges of this type will be on a sliding scale depending upon the percentage of the loan which SBA is obligated to purchase. On loans in which the SBA obligation is up to 50 per cent, the charge is 1 per cent annually on the portion SBA is obligated to purchase; from 50 to 75 per cent, the charge is 1½ per cent; over 75 per cent, and not greater than 90 per cent, the charge is 2 per cent. Under the law, SBA cannot assume more than 90 per cent of any participation loan.

This sliding-scale policy will result in a smaller charge on banks and other lending institutions on participation loans than was formerly charged by RFC, which had a flat 2 per cent charge on the obligated portion of such loans. This sliding-scale policy should result in more participation loans by banks and other lending institutions, and thus make more private financing available for the encouragement and development of small business enterprises.

On *immediate* participation loans, in which banks or other lending institutions originate the loan and SBA assumes a part of the amount at once, the interest rate will be fixed by the participating bank or other institution, with a minimum rate of not less than five per cent annually on the portion of the loan which SBA purchases. The RFC charge was a fixed rate of five per cent on its portion of loans of this type.

On *direct* loans by SBA, the interest charge will be six per cent annually, an increase from the five per cent rate charged by RFC. We believe this rate is commensurate with average private lending rates, in general. And the Loan Policy Board believes that public funds should *not* be used on this type of sound but unbankable loan without a commensurate rate to protect the public interest.

The policy on the interest to be charged on disaster loans made by SBA is unchanged from that of RFC. The rates for disaster loans are three per cent on those made for home construction or repair, and five per cent for business disaster loans. SBA is not authorized to make disaster loans for a period exceeding ten years except in the case of home loans.

The period of SBA loans to small firms including renewals or extensions may not exceed ten years, except that any loan made for the purpose of constructing industrial facilities may have a maturity of ten years plus the estimated time required to complete construction. It will be SBA's policy, however, to restrict the maturity of each loan to a minimum consistent with sound business practices.

I have gone into detail about our financial-assistance program because I believe that this is the aspect of SBA operations in which public accountants are most immediately interested. You are, I am sure, generally familiar with our other programs which I have mentioned. I shall only add that these programs—in contract procurement, materials and equipment, management and technical aids, etc.—are continuing to go forward.

Through these various programs we hope to strengthen small business

throughout the nation, and thereby strengthen the whole national economy. For small business, as I know you will agree, is a bulwark of our entire system of free, competitive enterprise.

This country is engaged in a serious, deadly struggle against Communism on a world-wide scale. We are combating Communism on all fronts. On the American front, one of the most effective ways of showing up Communism is to make our own free-enterprise system work better and better. It is by no means perfect, but I want to tell you right here and now that progress in physical and material well-being and in preservation of individual liberties, under law and under God, has been greater in the one hundred and seventy-seven years since the birth of this Nation than in the past thousands of years of recorded time!

We HAVE got an American way of life—a way that is the wonder and inspiration of freedom-loving people everywhere. It IS something new under the sun!

We have made it that way and kept it that way through an economic system under which young men can grow up and expect to find jobs, to build businesses of their own, to expand, to live well, to provide a nest egg for retirement, and to help their children get a start in life. These are the very wellsprings of human endeavor. We have got to keep those wellsprings free and open and brimming with life and hope, through good times and bad, through war and peace, through inflation, deflation, reflation—what have you!

But we cannot hope to make our enterprise system work better without making the climate favorable to the success of the small business man. Because he is the bone and sinew of the body economic of this country. If small business is not healthy, then the times are indeed out of joint. If we do not have a vigorous, adaptable, resourceful Commonwealth of Small Business, then we do not have a broad and sound base for our world-wide stand as the protector of civilization itself.

Realizing all this, one of the things the Eisenhower Administration has done is to set up the Small Business Administration—the only new, independent agency to be established for the exclusive aid of any group since President Eisenhower was inaugurated.

I pledge this new agency to do all within its power to fight the battle of the small business man because by so doing, we fight the battle for a greater America and the battle for a strong economic base against world-wide, aggressive, Godless Communism!

Personnel problems of the local practitioner

ROBERT E. WITSCHEY

Senior Partner, Robert E. Witschey & Co., Charleston, W. Va. Former chairman, advisory committee of local practitioners.

This discussion might well begin with a few words about competition. CPAs hear a great deal about competition and its importance to the development of a strong, growing economy. We recognize that success in competitive effort, bringing as it does both inward satisfactions and material rewards, provides the incentive that makes people want to progress.

Competition demands continuous striving for a more efficient and more acceptable product at a reasonable price. It requires also that the public know about the product. These general statements are equally true whether we are dealing with television, adding machines, or accounting services. I should like to discuss them briefly in terms of public accounting.

What we have to offer is service. It is our product. We must face competition, but there is no room for competition in the price field. Competitive bidding is precluded by our rules of professional conduct as unbecoming, and in the long run harmful, to both the accountant and his client; but were it no so, it would still be shortsighted. Our rates are just about as low as they can be and still permit a fair remuneration to persons with the ability and character necessary to provide the high-quality services that will assure public acceptance. We must, therefore, constantly strive to improve the quality of our product—our services. We must seek greater efficiency in rendering those services, and we must increase their value to the user. Such efforts constitute competition—competition in quality but *not* in price.

That brings us to what is really our basic problem: "How can the quality of our services be improved?" The strength of a profession and the quality of the services it provides are dependent upon the competence, the character, and the professional attitude of those who are engaged in it. In order to assure continued improvement in quality of service, the answers to three basic questions must be found. They are: (*1*) What can we do to assure

a continuous and adequate influx of able young people into the profession—the kind of people whose professional stature will develop in an orderly way within reasonable time limits? (*2*) How can we best train these people and help them develop and progress after they have joined our organization? (*3*) How can we best utilize these people on our staffs to provide our clients with the highest quality accounting service?

Within the framework of these three basic questions are scores of others concerning details of achieving the major solutions. Obviously, the latter cannot all be raised and answered in this paper, although the general problems concern the profession as a whole, and the answers must be provided by our joint efforts. Let us consider the first: "What are we as a profession doing to assure an influx of able men into public accounting?"

In the spring of 1952, council consolidated all existing committees dealing with accounting-personnel matters by the appointment of one enlarged committee on accounting personnel under the chairmanship of Mr. Samuel Broad. This committee has been very active, and the objectives that it has set out to achieve, as outlined in its reports to council, are: (*1*) expansion of the knowledge of the accounting profession among high school principals and guidance personnel in secondary schools and colleges; (*2*) development of methods for directing college students into professional accounting; (*3*) developing of internship programs; (*4*) improvement in the training and professional interest of noncertified junior staff men and of the accounting majors in college; and (*5*) continuation and broadening of the testing program.

Much work has already been done to accomplish these objectives. The committee is surveying the effectiveness of the personnel-testing program and is undertaking the production of articles on the program as well as the development of new tests. They have encouraged the Kuder Preference Record to obtain a "profile" of the ideal embryonic CPA to be used in Kuder's interpretation manuals, which are widely used in high schools by guidance personnel.

The committee has completed a pamphlet entitled *Professional Help Wanted* that is, I believe, already in the printer's hands. This pamphlet will be distributed to high school and first-year college students, including distribution at meetings at which CPAs may address classes. They are also working on what is expected to be about a 24-page pamphlet dealing with the accounting profession in considerably more detail. This pamphlet, while still in the preliminary stage, is intended to replace the two earlier pamphlets, *A Career in Public Accounting* and *The CPA Examination—Gateway to a Profession.*

The problem of improvement in education and training is being brought under scrutiny, with particular attention to such matters as junior societies, internship programs, and coöperative staff-training programs. Consideration is being given to the possibility of a program that would provide teachers with practical experience in public accounting firms.

In the matter of communication with students, "Personnel Project Pack-

ages" have already been sent to state society presidents, education committee chairmen, public relations committee chairmen, and executive secretaries of all of the state societies. Among other things, this package includes two of the career booklets published by the American Institute, the first chapter of the *CPA Handbook*, pattern speeches for high school audiences, and the United States Department of Labor Bulletin entitled *Employment Outlook in Accounting.*

Perhaps the most ambitious project to be undertaken by the committee on accounting personnel is a moving picture to be shown to appropriate groups of students, and, where possible, to such organizations as parent-teachers associations, service organizations, and other similarly interested groups. It is believed that this project can do far more toward educating young men as to the true nature of the accounting profession than any number of articles on the subject. I understand that the movie will be completed early this winter.

As a final note to this matter of acquiring personnel, I should like to inject one other thought that may be worthy of consideration. In other professions, the student has some idea as to just what kind of professional future may be ahead for him. In law for example, he can, while yet a student, make an intelligent analysis of advantages and disadvantages of practice in a large firm of corporation lawyers, practice in a small town, criminal law practice, or other types of legal practice. The point is that he has been provided with information as to the various possibilities and has therefore an opportunity to make a well-thought-out decision. The same should also be true in our profession. There are differences in the conditions under which the practices of large CPA firms and local firms are carried on. Both have advantages and disadvantages of which the student should be made aware so that he can make a decision as to the kind of office in which he would like to be employed. This situation has been recognized by the committee on accounting personnel and they plan to seek information as to what are generally considered to be the advantages accruing to the junior accountant who obtains his initial employment with a small rather than a large firm and vice versa.

As a closing note to the discussion of matters pertaining to accounting education, I suggest a careful reading of a comprehensive discussion of the subject contained in a volume to be published soon.[1]

We come now to the second major personnel problem: "How can we best train young staff men?" This is, perhaps, the most difficult of solution of all personnel problems in a small office. In the past, a substantial part of the work in many small offices was that of supervisory record keeping. In such an office, obtaining and training personnel was no great problem. A competent bookkeeper would suffice. But local practitioners have become aware of the fact that competent bookkeeping techniques applied to our clients' affairs provide only a minor part of the service clients need. Their problems are as complex, in many respects, as those of large enterprises. I think it is a fair statement to say that the small client looks to his CPA

for solutions to more different *kinds* of problems than is true of a large business where many of the answers are provided internally.

This is not to belittle the importance of supervisory record keeping in small offices. Even if we did not wish to have any part of it, we could not escape a certain amount of such work. It is a necessary part of our service to many small clients. If the local practitioner hopes to grow in stature, he must make a decision to keep pace with his profession and maintain its standards, so that he will be able to perform competently those things which will best serve his clients. It is obvious that such growth will depend on just how well staff men are trained. The lack of sufficient personnel can, in the final analysis, be overcome by a judicious selection of clients, but there is no alternate method of overcoming the handicap of a poorly trained staff.

This problem of training staff men is particularly acute in small offices, and several reasons for it can be advanced.

The small CPA office has not yet even approached a plan of training that would compare with the in-training programs of the national CPA firms, And don't have any misconceptions about it—such training programs provide a young man with a great deal of knowledge that is immediately usable in a small office. I have had experience both with those trained in large and with those trained in small firms, while I have trained others myself. I cannot help but wish that each new man I employ in the future could have at least two years training with a large firm.

The problem of training in a small office is made more difficult by the fact that our engagements are, for the most part, "one-man" engagements. The work load would ideally be divided by degrees of skill and experience; *i.e.*, junior work for juniors, more advanced work for semi-seniors and so on up the ladder, with the staff man moving upward in an orderly fashion as his judgment feeds and grows on experience. In a small office the division of work is most often by clients rather than by grades of work. The result is that, while we are likely to train the staff man in the specific problems of specific clients, we fail to provide him with the broad background of experience so vitally necessary if he is to become fully mature. A further result is that a trained staff man may sometimes be doing junior grade work while a junior is idle.

It is generally recognized that the local CPA deals usually with clients whose ability to pay for accounting services is limited, just as their ability to pay for advertising or other items is limited. In many such situations, the client cannot afford all of the accounting services he really needs. The local CPA must, therefore, make a careful analysis of the most important things to do and do them promptly. It has been my experience that there is usually very little productive work on such a job that can be entrusted to a beginning junior. The young staff man is actually little more than an observer. It is good for him to observe, but we must remember that this new staff man may represent a 10, 15, or 20 per cent increase in staff size of a small office, so that his training can be costly in relation to the total payroll.

Another difficulty of training men in a small office is that of finding time

to do it. For most of us the task of finding just one extra hour in the working day is a major operation for several reasons: (*1*) Because our clients are usually small, we must carry a larger numerical load of clients per man. This, in itself, multiplies the problems of administration and office procedures. (*2*) We cannot go in for much specialization in a small office. Every staff member must acquire a sound knowledge of many things—auditing, cost accounting, income taxes, budgeting, and others. This requires that a substantial amount of our time be devoted to reading on many subjects. (*3*) Local practitioners do not, as a rule, have a business. They have only their independence. That means that, no matter what else they have to do, they must still spend a substantial part of each day on productive work.

The problem of training men in small offices can be solved, and the profession continues its efforts towards better solutions. The committee on accounting personnel, previously mentioned, has under review several projects designed to assist in training staff men.

One of these is a study of internship programs. This is a long-range endeavor, but I am confident that, as the development of internship programs progresses, ways will be found to make them practicable for small offices.

Another method of approaching the staff-training problem is through the formation of junior societies. While the idea of junior societies is not new and has actually been tried in several states, the subject needs much more study. The general idea is to form a society under the sponsorship of the state CPA organization with general guidance by the American Institute. Membership might well include college senior accounting majors as well as the young, noncertified staff men in the employ of public accounting firms. A good deal of material is available, and the project could be significant.

A third proposal for the alleviation of staff-training problems in small offices is that of establishing coöperative staff-training programs. Most of the large accounting firms have elaborate staff-training programs that have taken years to develop. Obviously, small firms are not equipped nor have they the time to provide such comprehensive programs. It is thought, however, that groups of local practitioners and small firms in specific areas could pool their resources and efforts to make available to their younger men the advantages of a well-organized staff-training program. The mechanics and much of the course material could be provided by the Institute. Such a program, tailored as it would be to the peculiar requirements of small office practice, would do much to help provide adequate training.

Until such programs have been established, the best method for training staff members will be a combination of on-the-job training with supervised individual study. In spite of the many obstacles there must be a tutor-student relationship between the principal and the new staff men. In our office a new man is given a two week get-acquainted-period, devoting most of his time to selected reading that includes several of the Institute research bulletins, to which have now been added Chapters 1 and 5 of the *CPA Handbook.*

After this period he will be sent with an experienced CPA on an engage-

ment. Beforehand, however, he is given an opportunity to review the previous year's file. On the job, the young man will be given routine tasks to perform. Frequently, time limitations do not permit much explanation to him of just what his work means or how it will fit into the total picture. This practice of itself does not provide much training. At the end of each day, however, the senior will go over the day's work with the junior and try to point out the importance of the particular task and how it fits into some specific part of the engagement. Then, when the job is ready to be "pulled together," the junior sits as an observer, with the senior making explanations as he works. Selected reading still continues. Obviously, this program has weaknesses but, at the moment, it is the best I have. Before leaving this particular subject, I recommend a careful reading of Chapter 9 of the *CPA Handbook.*[2]

We pass now to the third major personnel problem of the small office: "How best can we utilize our staff to provide the highest quality service most efficiently?"

Before getting to specific problems of staff utilization, I should like to devote a little time to our seasonal problem. This situation, peculiar among professions, has long been with us, making it difficult to provide for staff utilization in an orderly way. Each year accounting firms have been confronted with a mid-year and an end-of-the-year peak. In between are those periods of severe recession from the normal tempo. During rush periods, our regular personnel must work long hours under pressures and strains that might endanger the quality of work. In addition, it is frequently necessary to employ temporary personnel. These people are usually unacquainted with the policies and practices of the firms employing them, and are probably neither as well qualified nor as experienced as the permanent personnel.

There is the other and equally disturbing extreme, the slack season when it may be necessary to release a trained and skilled staff member. Mr. A. Stanley Harmon, writing in Chapter 10 of the *CPA Handbook,*[3] points out that the profession is not only aware of the problem but has made substantial strides toward its solution.

During the preparation of the *Handbook* the American Institute made a survey of peak-load conditions. Mr. Harmon reports that almost 70 per cent of the small and medium-sized firms find the semi-annual concentrations of business constituting a major problem for them. Four specific solutions offered by many firms were: (*1*) Induce clients to adopt their natural business year; (*2*) increase interim work; (*3*) make quarterly or semi-annual audits; and (*4*) make monthly examinations.

A discussion of the natural business year is not properly a part of our subject, and I pass it by with just three comments: (*1*)Adoption of a natural business year by a client helps spread the work load, which in turn means increased efficiency in staff utilization. (*2*) Local practitioners have probably not done enough to encourage the natural business year. (*3*) Forty accountants in one area, through their own efforts, were able to get 147 companies to change to a natural fiscal year.[4]

Accepting the premise that spreading the work load will aid materially in more effective utilization of staff time, what are other measures that will accomplish this spread? First of all, a careful analysis should be made of the services now performed for each client. Incidentally, a corollary benefit of such an analysis is that it indicates whether or not all the things that need doing for a client are being done. That seems important, now that the profession is giving so much thought to more intensive service for small clients. Once a schedule has been prepared, each client's record is analyzed to determine what parts of the service now being rendered can be performed in anticipated slack months. Such matters as testing inventories, confirming receivables, preliminary work on many schedules, and others can frequently be performed prior to the year end. More and more, local practitioners are coming to this kind of procedure to relieve peak-load periods.

To supplement this general allocation of client's work, there still remains the need for specifically scheduling each engagement for time allocation and for control of procedures. Many small offices have been lax in establishing estimated time requirements for performance of each engagement. The same appears to be true of engagement programs. Familiarity with a client's needs may sometime cause the CPA to short-cut audit programs. Many local practitioners hold to the firm conviction that no audit can be performed thoroughly and efficiently within reasonable time limits without a carefully worked out program, with as rigid adherence to it as can be practically achieved.

Another method for more effective utilization of personnel is to make the fullest possible use of the client's record-keeping staff. From my discussions with many local practitioners, I reach the conclusion that as a group we are doing too much detail work in many of our engagements. Large CPA firms follow the practice of making the client's staff responsible for the preparation of many schedules. It takes only a little effort on the part of the CPA to get the cooperation of the client's bookkeepers. The accountant should encourage the client's staff to prepare trial balances, schedules of receivables properly aged, schedules of payables, depreciation schedules, and others. The staff man can then devote his time to the higher-level parts of the engagement for which he is trained. In a small office, the saving of one or two days on an engagement is of tremendous importance.

It was noted earlier that the work load in small offices is frequently allocated by jobs to the different staff men. The result may be that the start of an engagement for a particular client may be delayed for the simple reason that the staff man who has been doing the work in the past is otherwise occupied, while at the time time another staff man may be idle. To achieve the most efficient utilization of manpower, it is essential that clients be rotated among the staff men. Rotation is also beneficial to members of the accounting staff in giving them broader and more varied experience. This practice not only assures a better maintenance of work schedules, but also helps alleviate the condition of one accountant being too busy while another is idle.

The growing interest in bank audits by CPAs indicates a possible additional way of filling in slack seasons. There is a difference of opinion among accountants as to the minimum scope of such engagements, but many of them—including smaller firms—are becoming interested. The American Institute has prepared a case study on the bank audit programs in three states. Such studies are certain to provide assistance to CPA firms in their efforts to reduce slack seasons as well as to improve relations with one of the profession's key groups.

Even with the best of planning, there will be periods when the accountant will be hard pressed to find productive assignments for staff members. The time need not be wasted, however. This is a good time to arrange vacations. Those files which have been getting cluttered up can be worked on, or the staff man can prepare for the forthcoming CPA examinations. Many local firms use this time for intensive training programs. And last, but by no means least, the slack period is an excellent time for staff men to catch up on the selected reading program.

The most efficient utilization of personnel will, in the final analysis, depend on more extensive adoption of the natural business year, further extension of interim work, more careful planning of engagement schedules, more intensive preparation of specific engagement programs, and rotation of accounting staff members.

It is recognized that many more questions have been raised in this paper than have been answered. No matter how serious our problems of personnel may be, they are the problems of all of us. I am certain that there is enough interest within the profession to assure eventual solutions through our combined efforts.

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Office problems of the local practitioner

WINSTON BROOKE

Individual practitioner, Anniston, Ala. Member, Institute's advisory committee of local practitioners.

I shall endeavor to approach the office problems of the local practitioner in three steps: (*1*) the problems that are foremost in his mind when he sets out to establish a practice; (*2*) the problems that will trouble him most after his practice is underway and when he wishes to solidify it; and (*3*) the hurdles he must clear when he decides to provide for a continuity of his practice after retirement and death.

Since most of us have established ourselves to at least some extent, I want to mention only some of the problems with which the beginning practitioner is confronted. After he has come to the decision that his education and experience qualify him for the venture that lies ahead, the first problem the would-be practitioner encounters is, "Where shall I establish my practice?"

Let's assume that our neophyte is employed on the staff of a well-established and well-regarded firm in one of the larger cities of the nation—a city in which there are perhaps 20 CPA offices. Should he attempt to establish himself in the same city, or should he look for open territory? Should he attempt to confine himself from the very beginning to high-level audit, tax, and systems work, or should he encourage monthly service assignments? These questions are not easy to answer. The answers depend first of all on the personality and desires of the individual, and also on his social and business contacts. And one of the factors that certainly should not be overlooked is the matter of his financial resources.

It is a very strong belief on my part that one of the things that plagues our profession most is the lack of financial resources inherent in our profession. I do not speak of the average earnings as compared with other professions, but of the financial background from which we come. For the most part, the average local practitioner is a self-made man. Occasionally there will be one who inherited, or was given a goodly sum of money at the beginning of his career, but this is rare. This situation is not so pronounced with law and medicine. Quite often the sons of wealthy people enter these pro-

fessions, but rarely does the son of a wealthy family hang out his shingle and enter the practice of public accounting. I hope that this distressing condition will be greatly abated by the time our sons are ready to enter the field.

There are excellent rewards awaiting those intrepid souls who will enter the field as individual practitioners, and I encourage all young CPAs to consider it. There is plenty of open territory, even in the cities with numerous established offices. Because I am more familiar with Birmingham than with any other middle-sized city, I shall discuss briefly its potential and assume that it is typical. As is usual, there are several business communities that form a part of Birmingham, and there are several incorporated cities adjacent to it —East Lake, Five Points, Central Park, Fairfield, Ensley, Bessemer, North Birmingham, and many more. There is not a single practicing CPA in any of the business suburbs I have mentioned, though any one of them could and would provide a very good opportunity to establish a practice. Let the would-be neophyte look carefully at the suburb that has a good business area, a fair-sized bank or branch, and a couple of community service organizations formed of businessmen. The same is certainly true of the smaller cities, say 5,000 and up in population. Actually, I think it might be easier to begin a practice in a small city or in a suburb than it would be to open in the midst of a metropolitan area. It is easy to become buried on the 17th floor of a modern office building.

Once a practice is underway, the problem of solidifying the practice comes to the forefront. By solidifying, I refer to the desire of the average practitioner to enter into a long climb of gaining the complete respect of the existing clients, experiencing a respectable growth in the size and scope of his practice, and holding the costs of operating an office to a minimum consistent with good quality of output. These desires and objectives are not necessarily stated in the order of importance, and they are so closely interrelated that I doubt that one outranks the other.

Let me begin with the matter of holding the costs of operation to a minimum, because it can be accomplished with a minimum outlay of cash. How do we do it? By practicing what we preach. As soon as he has time to think about it (and the sooner the better) the local practitioner should devise a good accounting system for himself. And I mean an accounting system, not a bookkeeping system. This system should produce: (*1*) monthly financial statements, including at least a balance sheet and P & L; (*2*) a monthly analysis of the over-all efficiency of the organization as compared with either (*a*) past experience, (*b*) a budget, or (*c*) a standard; and (*3*) an analysis of the relative efficiency with which each assignment is handled. Almost anyone can walk through the woods and point out the bent or defective trees, but it takes a real woodsman to evaluate the forest. So it is with a business organization. Almost anyone can sit in an office and point out the mistakes of the day, but it takes a real accounting system to bring out the over-all picture.

Let me say right now that I advocate unequivocally the accrual basis of accounting rather than the cash basis, and let me say further that you will have to do your own research as to the income-tax consequence of your ac-

counting policies. I want to remind you, however, that many a tax-minimization device produces unsatisfactory results when compared with profits lost through the ensuing lack of sound business policy.

Such an accounting system as I advocate should not be a burden to you. Even if it were a little burdensome, you should bear it so as to better understand some of the problems being encountered by your clients. But it shouldn't be a burden. After all, if you are as good an accountant as your best clients think you are, shouldn't you have the capability to design a smooth-working system that can be kept by your secretary?

In your efforts to achieve greater efficiency in your organization, I would suggest that you examine your auditing techniques next. First of all, is your staff really well trained in the use of the office machinery they have to handle? Most adding machine companies suggest methods of using their machines, and if you will follow their suggestions the chances are that you will get better production. And are you reasonably well equipped with adding machines and calculators? Do you take your own with you when practicable, or do you always depend on the use of the client's machines? At the per diem rates we are forced to charge, it does not take a great deal of time saving to pay for a good adding machine or calculator.

In this regard, let me pass along a tip to you. In Alabama and perhaps throughout the nation, the competition in the office machinery field is becoming quite keen and the competitive makes are vying for sales. On their own initiative, some dealers are offering rental arrangements with unusually liberal application of paid rentals toward the purchase price of a new machine. Such an arrangement has decided advantages from a standpoint of the financial management of your practice.

Also in connection with your auditing techniques would be the development of your working papers. There are good opportunities for cost reduction here. In almost every assignment you will have bank reconciliations. Why not develop a basic form that, with on-the-job modifications, can be used as a uniform procedure, and then have that form duplicated? To the extent that they are used, the same is true of working papers covering cash counts, ageing of accounts receivable, inventory test checks, analyses of fixed assets and reserves, and so on. Regardless of what your basic policy is with respect to audit programs, your development of these working papers from assignment to assignment will tend to follow a pattern that has but minor variations. To the extent that the pattern is there, you can use uniform or basic working papers with no loss in the level of your auditing standards. In fact, you might well raise your standards because increased efficiency will give you time for broader coverage or experimentation with new techniques.

In this connection, I urge and implore you to acquire a duplicator of established quality. There are four basic types of duplicating machines practical for a small office, and each has its advantages and disadvantages. Without going into detail on the subject, I do want to suggest that you demand a high degree of registration in the machine you purchase, for otherwise you will find it impractical to run columnar sheets through the machine. If low

cost is essential, you might well choose a second-hand machine of reputable manufacture with a guarantee by your local equipment dealer, rather than a new machine of questionable quality.

You will find many uses for such a duplicator besides the development of uniform working papers. Many of your own internal forms can be produced on the machine—perhaps even your own letterheads and billheads, although these can usually be bought through the normal channels in large quantities at lower costs that you can reproduce them yourself. For your clients, you can develop forms that are used in small quantities. They will be most appreciative of pro forma standard monthly journal entries, bank reconciliations, trial balances, and even financial statements in blank form. You will find these to be great aids in raising the level of your clients' accounting procedures.

I mentioned earlier that one of the ills plaguing our profession is the inherent lack of financial resources. Very few of us have the funds available to equip our offices as we would like to. Most of us have to equip our offices from earnings ploughed back into expansion—retained earnings as the committee on terminology calls them. This situation suggests the problem of what to buy first. In the practitioner's office are necessarily two types of equipment: (1) the equipment that produces his work, such as desks, adding machines, and the like; and (2) the equipment that completes his work, such as typewriters, duplicators, report binding devices, etc. When funds are available for expansion of equipment, I would suggest that you lean toward the finishing equipment, rather than the production equipment. By and large, our clients can understand the quality of the physical appearance of our reports. They know whether or not the typing is good, and they can appreciate care in the assembly of a report. They have a much greater concern for these items than they do for the relative quality of your old adding machines or old desks.

You might examine the make-up of your reports. Most of the clients whom we local practitioners serve are the smaller businesses, and our reports have a considerably greater significance for management than they do for absentee ownership. Most local practitioners' reports are designed with too little concern for this situation. Management is mentioned only in passing if at all. Give some thought to preparing a report of management and letting the auditor's report be a necessary and complementary part thereof. Such a report might look like this.

First of all, the cover should emphasize the company's name and identity and, if possible, reflect the decor of its line of business. The auditor's name, if mentioned at all, should be subdued. Did you ever see the auditor's name on the cover of the annual report of a nationwide corporation? No, because the report is a report of management. If you can, design the cover individually for the client, and let the basic cover design be his and his alone. Let it be recognizable as the client's report. This will give him a pride of ownership that will inure to your benefit.

Secondly, on the inside of the report and near the front, show some basic information about the client. If it is a corporation, show the names and titles

of the officers and perhaps the names of the directors. Give the address of the main part of the enterprise—the plant, the showroom, or the executive offices. If the client retains attorneys, list them as general counsel, after of course, having obtained both the attorneys' and client's approval. The identity of the general counsel is pertinent information, and it has been my experience that the attorneys appreciate this little bit of recognition.

Next, let your report—or should I say the company's report—give a commentary on operations for the year, and on the financial condition of the enterprise. Show some condensed comparisons, a statement of application of funds, and operating and financial ratios. Comment on facts beyond debate, but here a word of caution. Be careful to avoid statements of opinion and statements that could be—not might be, but could be—contested. Avoid inferences of all sorts.

After this put in the auditor's certificate—and I for one prefer the auditors' certificate to the letter of transmittal—and then the usual financial statements and schedules. You will notice that I have indicated that the organizational structure and commentary parts of the report should come before the auditors' certificate. I suggest this because there may be items in the commentary to which you do not wish your certificate to apply. You might wish to insert unit averages, such as plant investment per employee and the like, which are based on matters you did not examine. A careful reading of your certificate would show of course that you are not certifying to these items, but placing them before the certificate will assist the reader in understanding this.

I would also suggest that you consider dropping two policies that are apparently dear to the hearts of most practitioners, namely the use of name stationery for reports of this type, and the use of any fancy binding devices, which are supposed to afford the auditor security against forgery or substitution of parts of his report. If you adopt the theme of writing the report of management—which report includes the certificate of the company's auditors—you must put all except the auditors' certificate on plain paper. The auditors' cerificate, of course, should be on your official stationery. And let's get away from the idea of putting our reports in a burglar-proof binding. In the first place, it cannot be done, and in the second place our clients are 99 per cent honest and it is high time that we recognized it.

Quite often we find ourselves filling more than one function in our relations with clients. To some extent, in almost every assignment we local practitioners have, we will perform some of the functions of the comptroller of a big business. Developing an annual report such as I have described is one of the ways in which we can serve our clients better. It will give a positive force and effect to the year-end work. It will serve our basic function better because, rather than worrying over the bill for a necessary nuisance, our client will look forward to the annual report with an expectancy of pride.

In dealing with your clients, you should be constantly alert to improve the client's own salaried staff and his internal procedures with regard to daily accounting routine. For instance, if you have a monthly service assignment

for a client who has a salaried accounting staff, you should endeavor to teach his staff to take over. At first glance, this might seem to be a policy of killing the goose that laid the golden egg, but it isn't. By getting the client's staff to do the routine work, you are freed for the high-level work—which of course usually justifies a higher fee for the time spent. This high-level work might bring to light economic opportunities for your client that will enable him to expand his operations and thus produce new assignments for you. In any case, you are better off with a smaller dollar fee but a higher per diem rate. And your client is better off because he saves in actual dollar outlay but gets more policy-level talent for his money.

Bear in mind that, as a certified public accountant, you have two things to offer to the business public. You have an unimpeachable integrity to offer. You are an exponent of a high quality of business management. Anytime you adopt policies contrary to these two maxims, you are defeating the purpose of the profession and hurting your own economic welfare. You must realize that there is an economic good inherent in our profession and that your best chance for success lies in pursuing that ideal. If you do, you will find that your practice will be based on solid ground.

Having gotten to solid ground, your next objective should be to provide for a continuity of your practice in the event you are disabled, or in the event of your unexpected death. If you aspire to this long-range objective, you must put your practice on solid ground first. It will pay you to do so. I made a summary of the classified ads in THE JOURNAL OF ACCOUNTANCY which offered practices for sale and computed the value of the practice compared with annual fees. For the past three years, it appears that practices have been offered for sale at about 80 per cent of annual fees. This price is little more than goodwill, because these ads specified a price plus equipment. Therefore, if you build your practice on solid ground, you are building a hidden economic asset, which someday might become very important. On the other hand, if your practice is built on the shifting sands, I seriously doubt whether you or your widow could get anywhere near 80 per cent of a year's fees for it.

If you want to provide for continuity of your practice, you must realize that neither you nor anyone else on your staff can be the indispensable man. Your practice must be built on policy rather than personality, and you must constantly urge your staff men to broaden their capabilities. If you worry about having a staff man leave you and take a lot of your clients with him, then rotate your men on the jobs, or alternate with them yourself. The thought of tying up staff men with restrictive employment contracts impresses me as being a negativistic attitude and economically unsound. In the long run, you'll be better off if you base your policies on positive forces.

Of course, if your practice is based on solid ground, and if you have developed your policies and your personnel to the point where your absence will be least felt, you have done a great deal toward established continuity of the practice. Bear in mind that this is what your clients want. They want to feel that they have a service they can depend on, not only for the correct

answers, but for constant and continuous availability. If you are removed from the picture, their greatest desire will be to have your practice continue as always, and with the least interruption. They do not wish to cast about for a replacement and go through the uncertainties of courtship and marriage with another accounting-service organization. They would much prefer to continue with your office, provided of course, a well-chosen successor takes over.

If you have developed younger partners, the problem is pretty well solved. All the staff can move up a notch, and the replacement can be brought in at the bottom without a great deal of trouble. But suppose this state of affairs has not been accomplished for some good reason or the other. Then what can you do to provide for continuity?

At the present time, the Advisory Committee of Local Practitioners has a sub-committee under the chairmanship of Theodore N. Perry of Illinois working on this problem with a view to determining what, if anything, the Institute can do. I am anxiously awaiting Chairman Perry's report because of something of a personal interest in the matter. Meanwhile, I can suggest to you only that you designate some practitioner whom the widow can call in for advice and counsel on disposition of your practice in the event of your sudden death. It will be both wise and fair to all concerned for you to select a friend who should have no conflicting emotions.

I have indicated to you in so many words that the local practitioner is beset with many troubles throughout his life as a practicing CPA, and so he is. This may cause you to wonder if perhaps there isn't a panacea for his ills. There may or may not be. I do not know. If there is, it must lie in the realization that the local practitioner is an integral part of our American economic system, that he is rewarded for playing this vital role, and that he must constantly review all his policies to measure their contribution to our nation's economic welfare. He must justify his economic existence. He must seek to have every fee paid him made an investment in a better economic future for his circle of clients. He must constantly strive to have all his assignments produce economic good. In short, he must accentuate the positive.

Direct costing and its implications in financial reporting

ROGER WELLINGTON

Partner, Scovell, Wellington & Co., New York.

The primary objective of the direct-costing plan is to provide the members of management regularly with information about the relationships in their business between costs, volume, and profits. To achieve this, manufacturing and other costs and expenses are carefully segregated between "direct costs" (those which vary directly with volume of production) and "period costs" (those which continue for an accounting period merely because the company is in business). Direct costs normally include direct material, direct labor, and items of expense that are directly related to production volume, such as some portions of electric power, process steam, supplies, and indirect labor. These costs are considered to be the costs of products made. All other indirect costs of production and the fixed costs are considered to be the costs of being in business, having facilities available and being ready to produce. As such, all these so-called fixed costs are considered to be incurred or accrue through passage of time, regardless of actual production volume, and are treated as costs of the period, not as costs of goods produced. In direct costing only the direct costs are charged to inventories and to cost of sales. All period costs are charged to profit and loss in the period in which they are incurred or accrued. In statements of operations, direct costs are deducted from sales revenue to show marginal income or "net contribution" toward period costs and profits.

As a result of this approach to cost, the management of a company using direct costing is furnished with periodic income and cost statements in which costs that vary with volume are distinguished from fixed costs. In making decisions on many questions faced in business operations, such information concerning marginal costs is essential. Direct costing provides this information directly from the regular accounts and eliminates the need to develop it by supplementary statistical compilations and analyses. It makes it easier to weigh the immediate effects of alternative courses of action, to choose realistic objectives, and to make decisions on a practical basis.

More specifically, costs developed in accordance with direct costing principles are useful to management in the following ways:

(*1*) The behavior of costs and profits under various levels of business activity is developed and, therefore, the effect of changing volume on costs and profits is shown.

(*2*) Variable costs may be expressed clearly and controlled in terms of units of product or quantity of production, while fixed costs are expressed in terms of time. The confusion that arises from trying to combine both types in one set of unit costs is avoided.

(*3*) It is much easier to estimate the probable results in terms of cost and profit when the most advantageous course of action is chosen from a range of alternatives. The effect of resulting changes in volume on costs and income is an element in most managerial decisions, and managerial thinking often follows the marginal-cost approach.

(*4*) Cost data are readily available in an easily obtainable and understandable form, appropriate for budgeting and planning. The total amount of fixed cost that must be covered is clearly shown. The effect on profit of a specific change in sales volume can be calculated in a moment. Since direct costs are essentially cash costs, cash budgeting is simplified.

(*5*) Relative profitability, on a marginal-income basis, of different products or classes of sales is most useful, if not essential, for management to know in order to decide which products to make, which to promote, and at what selling prices or discounts.

(*6*) Once the sales figure is known, operating income can be estimated closely, without knowledge of the level of plant operations or the changes in inventory, which would affect operating income under conventional methods.

(*7*) Direct costing is practical and useful in cost control. It lends itself to use with a well-organized and integrated set of monthly internal operating and cost control reports. Fixed costs should often be considered to be period costs for purposes of short-range current operating decisions, and it is convenient to use statements developed on such a basis covering short periods, particularly for levels of management below the top. The costs that can be controlled by the lower levels of management (*i.e.*, the direct costs) are segregated.

Can conventional cost-accounting methods be useful in the same ways?

The areas of business management in which direct costing is most useful are important areas. Management needs the kind of information direct costing produces. Evidence of this is that the theory and practice of segregation of variable from fixed costs is not new, but was put into practice by some companies at least 40 years ago. Furthermore, the importance of separating direct costs from fixed costs, and the usefulness of the results for controlling operations at the various levels of management have long been advocated by professional cost accountants and management engineers experienced in the development and use of cost accounting.*

* "Proper Distribution of the Expense Burden," A. Hamilton Church, 1908.
"Cost Accounting and Burden Application," Clinton H. Scovell, 1916.

In the thinking and practice of these users and advocates, cost accounting should and did serve two purposes: It provides (*1*) information for the use of management in controlling operations; and (*2*) a proper basis for periodic financial statements. Cost accounting plans developed under this concept have served both purposes well. Basically, such plans are conventional in that all normal costs of production are charged to inventories and cost of sales, but at the same time internal cost statements that clearly differentiate between direct and fixed costs are prepared for operating control. The basic data are available to produce, in the form desired, the same useful information that is the product of direct costing. In addition, figures that provide a sound and generally accepted accounting basis for periodic inventory values and determination of profits are regularly developed.

Dangers and weaknesses of direct costing

In spite of its usefulness as a tool for management, direct costing has its weaknesses and the direct cost approach can lead management toward some real dangers:

(*1*) For many of the needs of management and as a basis for many decisions, it is essential to have full product costs, including properly and individually allocated fixed costs usually based on normal volume. For example, decisions concerning long-range pricing policy, to be sound, must be based on such information. With direct costing in use, full costs must be developed in addition to the figures for the regular financial statements. As proof of this need, companies using direct costing all find it necessary to develop full product costs also.

(*2*) In segregating fixed costs, assumptions will have to be made as to a reasonable level of operations and as to some period of time, since "fixed" costs can be "unfixed" by management decision to a considerable extent with major changes in volume, and almost all costs except material costs have some fixed characteristics over a very short period. On the other hand, over a long enough span of time, all costs tend to become variable.

(*3*) Direct costing oversimplifies the complex relationships between sales income and costs. Many items of cost are incurred in relationship to individual transactions or per day operated and such costs only relate to sales on an average basis. For example, transactions might average to a certain dollar value apiece or to a certain number of units apiece and at the same time production might average so many units per operating day. As a result, changes in the average size of sales orders or production orders could have a marked effect on the relationship between volume and costs. Items of cost such as set up are incurred for changes in production and have the characteristics of fixed costs in relation to each production run rather than in relation to time.

(*4*) The use for operating decisions of statements prepared on a direct-costing basis implicitly assumes that plant and machine capacity and other overhead facilities or personnel are available to implement any decision reached on the basis of the "marginal contribution." In other words, the

effect of additional or permanently reduced capacities and the costs thereof has to be considered and developed before decisions can be reached. The conventional method of costing gives a clearer picture of what the results might be if major changes in capacity are contemplated than does a direct-cost income statement.

(*5*) The usefulness of direct costing is primarily in application internally to short periods and for purposes of current operating decisions. Its application and usefulness for long-range thinking, planning, and decisions is much more limited.

(*6*) Most successful companies have found, in the long run, that an exclusively or primarily marginal cost and income approach to their problems is not safe or healthy. There is great danger that the need to recover fixed costs actually incurred will be disregarded, and, with direct costing for internal reporting, top management will have to be constantly on the alert to protect against this danger. The danger is greatest in the smaller company where direct costing is used, particularly in the thinking of its sales department, since many such companies would not make the additional effort to develop carefully product costs that are complete.

The purported disadvantages of conventional cost-accounting methods

Many indictments of conventional cost-accounting methods have been made in writings of the proponents of direct costing, who believe that the conventional approach to costing is deficient in the following respects:

(*1*) Fixed and variable production costs are merged in charges to the same expense accounts and inventory accounts, and therefore the accounts give no clear picture of the relationships between volume and costs. Hence, management does not have, from its financial statements without supplementary analysis, a sound basis for decisions that will affect volume of production. The usual "gross profit" figures do not show marginal nor out-of-pocket costs.

(*2*) Conventional methods and presentations are not clearly understood by management, and confusion results from trying to compare the operating results of one period with another. Management does not understand "over-absorbed burden" nor "under-absorbed burden," nor the effect of carrying forward in inventory values a portion of fixed charges. The proponents of direct costing believe that most members of management consider profits to be realized in relation to sales only, without reference to production activity.

(*3*) The "normal" volume of production on which burden rates may be based is at best an estimate that depends upon assumptions. The rates at which fixed costs are charged to product costs are affected by the volume chosen and therefore product costs themselves are affected.

(*4*) The values applied to inventories of work in process and finished goods include a proportion of fixed charges. Increases or decreases in these inventories cause a greater or lesser proportion of the fixed charges to be treated as assets and deferred to subsequent periods. Therefore, when the

level of production is different from the level of sales, profits are not proportionate to sales but are also affected by the level of production.

(*5*) With conventional methods and fluctuating volume of business (where production volume and sales volume are varying from period to period but not varying similarly at the same time), periods of higher sales may show lower profits and vice versa. Such results are due to differences in the rate of absorption of fixed charges in product costs. The proponents of direct costing believe that such results are not logical and that management does not think them realistic. Conventional methods are not well adapted, therefore, for measuring results of operations over short periods of time, as an approach to computing unit product costs, nor for providing cost information for current operating decisions.

These criticisms of conventional costing methods can be reduced to five important points:

(*1*) Conventional methods do not segregate fixed from variable costs and therefore do not show the relationship between costs and volume nor what will be the effect of changes in volume.

(*2*) Management does not understand the conventional "absorption" costing methods nor the customary presentation of operating results or unit product costs.

(*3*) Product costs that include fixed charges must, of necessity, be based partially on estimates or assumptions, at least as to useful life of fixed assets and frequently as to a "normal" rate of productive activity.

(*4*) Fixed charges are period costs—not costs of products made.

(*5*) Fixed charges should be absorbed, in the sense of being realized, only as sales are made and in no part through production activity. Therefore, there is no justification for including fixed charges in inventory values.

It is all too easy to "prove" that the results of conventional methods are poor by citing the unsatisfactory results commonly seen. Studies of such cases will show, however, that the unsatisfactory results are due to incomplete application of sound methods, compromises made to save clerical work, and generally incomplete factual information on which the figures can be based. Such weaknesses are not inherent in the conventional theory nor methods themselves; they are weaknesses in particular sets of figures or in particular organizations and their managements. The proper comparison to make is between direct costing, properly and thoroughly applied, and conventional cost accounting, properly and thoroughly applied.

I am reminded of the results that are often seen when a company is surveyed by one of the office-equipment manufacturers' sales engineers to determine potential savings through use of their mechanical equipment. Comparison is shown between methods as they are and revised methods using the mechanical equipment. When such a comparison is carefully analyzed, and the present methods are studied and reorganized to get maximum efficiency, as would also be necessary in order to use the mechanical equipment, a large portion of the prospective savings has often already been accomplished without the mechanical equipment. Similarly, the installation

of direct costing requires that much be known about the behavior of costs. This knowledge is most useful, but can be available under any good cost-accounting system.

With this approach in mind, let us consider these five points and their bearing on the pros and cons of direct *vs.* conventional costing.

Point 1. Conventional costing methods do not *require* segregation of fixed from variable costs, as does direct costing. Many managements and accounting systems make only such segregations as are customary or are found convenient. However, most alert managements with well-designed conventional accounting systems have made and do make complete segregation of detailed items of cost and expenses into fixed and variable categories and maintain records thereof, so that statements showing direct or marginal costs are prepared and are used. This primary objective of direct costing can be and is achieved under conventional methods, although the regular financial statements are not prepared on a direct-cost basis. Statements showing direct costs are prepared for internal use separately from the financial statements. While managements should know their direct costs, "direct costing" is not required in order to accomplish this. Therefore, this is not a valid criticism of conventional costing methods as such, but rather a criticism (and a sound one) that many companies do not make such a segregation or do not make use of the results.

Point 2. Lack of management understanding is a most serious deficiency, if true and if inherent in conventional costing methods. No matter what the method of development, financial operating statements cannot be used intelligently by management as a basis for judgment and decisions without full understanding of what the figures mean and on what principles and assumptions they are based.

Let us define what we mean by "management." If we mean all members of an organization above the position of supervisor, the criticism is undoubtedly valid as to a large proportion of management. If we mean only the top-management people who normally use financial statements as a basis for judgment and long-range decisions, any such blanket criticism of conventional methods is not justified. Lack of understanding at this level would lead to the conclusion that management is at fault rather than the methods. Naturally, if top management becomes "sold" on direct costing and enthusiastic about it, all levels of management are going to be thoroughly indoctrinated, but the same amount of enthusiasm would probably engender a like amount of indoctrination in other methods.

Direct costing is simpler and easier to explain to a production man or a salesman with little or no knowledge of accounting than is the concept of normal burden rates. A financial operating statement shows the sales figure and the period of time covered. No other data are needed to understand what the apparent relationships are: direct costs of products sold were at a certain ratio to sales; so many dollars of fixed costs were incurred for the period.

The "horrible" examples the proponents of direct costing like to cite of

the poor cost accountant who is saddled with a conventional costing system and trying to explain to an executive why profits are down when sales are up could be countered with equally "horrible" potential examples under direct costing of trying to explain why the company is losing money when producing at capacity to fill firm sales orders for later shipment.

Perhaps the key to lack of management understanding of cost accounting lies in the mental processes or approach of many executives or managers who use reports or figures for control. When presented with an operating statement, they have pre-conceived ideas, based on experience, knowledge of the situation, and some rough mental calculations, of what the results should be. If the statement results do not approximate their mental answers something must be wrong. If on further inspection no serious error in their own mental calculations is found, then the statement results are suspect. If the executive's approach does not parallel that of the cost accounting but he still considers his to be basically correct, no amount of explaining is going to satisfy him that the statements produced by the cost accounting system are right. Too many nonaccounting executives do not realize that different presentations of costs are necessary for different purposes.

It appears to be true that many members of management do not understand well enough the cost accounting used in their companies, and that it is easier to grasp the apparently simple relationships shown by direct costing than the more complex relationships of conventional costing. The complex relationships are really there, however, and ignoring them by the direct costing approach will not result in a better informed management.

Point 3. Writers advocating direct costing have made much of the uncertainty in conventional costing resulting from the use of estimates and assumptions. Such criticisms are not pertinent because cost accounting by any method includes estimates and assumptions, necessitated by the nature of the situations dealt with and often by lack of available facts. Furthermore, direct costing involves its own set of assumptions and estimates as to which costs will vary directly with production and within what period the "fixed" costs will remain fixed. Also, there is a basic assumption that costs are related only to production volume or to time. Depreciation, normally assumed to accrue with the passage of time, may actually in some part be incurred because of the wear and tear of productive activity. Direct labor, normally treated as a direct cost, in actual practice often tends to be related to time over short periods.

Point 4. We may all accept as a fact that fixed charges are not, in general, affected by reasonable changes in current volume of production or are not dependent thereon. Can we accept the further conclusion that, therefore, fixed charges are not part of costs of products made? Such a concept seems to be completely at variance with:

(*1*) Common sense. Consider what would happen when a completely manual operation in the manufacture of a series of products becomes completely mechanized. Is it reasonable that the cost of these products then ceases to include any cost for this operation? Or consider the completely

automatic "factory of the future." Will products from such plants cost no more than the material used? Or think of the situation where a company has the option to make or buy a product or a component. The "cost" and the inventory value will differ much more under direct costing than with conventional costing.

(2) Concepts of the public and of governmental bodies as to what cost is or what it includes.

(3) Usual business practice and generally accepted accounting principles, as stated in Accounting Research Bulletin Number 43, Chapter 4:

> "A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues.
>
> "As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location."

(4) Any requirement for valuation for outside purposes, such as insurance or sale of the business.

Of course, fixed charges are incurred or accrued with the passage of time, and they do represent costs of being in business and having facilities available for production. They are also, and at the same time, costs of production when the business or facilities are put to productive use. It is this dual nature that causes our difficulties, and costs based on the assumption that this dual nature does not exist are incomplete.

The approach of not charging fixed costs to product costs is a step away from the process of matching revenues against the costs that were incurred to produce the revenues. This is an accepted basic concept of accounting for periodic income. While it is customary practice not to match selling administrative expenses against the revenues resulting from these expenditures, this is done not because of any lack of acceptance of the theory, but because it is believed impractical to ascertain the relationship between these expenses and the revenues from any particular sale or period and hence to attempt a process of matching, or to develop reasonable justification for deferring part of these costs to future periods.

Point 5. For many companies it does not seem reasonable to consider that all the fixed charges incurred each period should be charged or absorbed only against the sales made during that period. For companies that do not produce for stock but only to order, direct costing would produce most illogical results: loss of fixed overhead during the period of production and a corresponding increase in profit in the period of sale. Companies that produce fairly steadily but have peak selling seasons would show widely varying monthly profits during the course of a normal business year. The level of production does affect profits, and most businessmen consider that it affects unit costs in the long run. This being so, it seems more logical and more in keeping with the economic facts to recognize this effect in the income statement than to exclude it.

Direct costing for external financial reporting

The external financial statements being considered are the balance sheet and income statement in the form presented in audited reports and in company statements accompanied by an opinion by independent certified public accountants.

In the balance sheet, the change resulting from the use of direct costing would be to reduce the valuation of inventory of work in process and finished goods. The comment has been made that, because inventory stated in this way would be shown at a value equivalent to an approximate cash cost to replace, this fact would be useful to readers of the balance sheet. Whatever benefit the reader might gain would not be available if LIFO is used for costs of materials. The reduction in net current assets from carrying inventories at direct cost might cause difficulties to arise under terms of any existing loan or preferred stock indentures, or the change in method itself might violate the terms of such agreements.

The principal changes occur in the income statement. From net sales will be deducted the direct manufacturing cost of goods sold and also items that are "direct" selling costs, such as commissions or royalties. The resulting figure is intended to represent the net "contribution" towards period costs and profits ("merchandising margin" or marginal income). Then the period costs, including the fixed manufacturing costs, will be listed, and deducted in total. The net result is "net operating income." The amount of net operating income would differ from that in conventional statements to the extent that the amount of items classified as "fixed costs," which would be included in inventory values under conventional methods, differs as between the beginning and ending inventories.

In connection with the preparation and use of external financial statements on a direct-costing basis, certain difficulties and problems have been encountered or can be foreseen:

(*1*) The direct-costing plan produces financial statements in which inventories are not stated at cost, but at a value below cost. Such statements do not in many circumstances give a fair measure of periodic income and are not in accordance with sound and generally accepted principles of accounting.

(*2*) Financial statements on the direct-costing basis can mislead the reader seriously because of their apparent simplicity, and they tend to lack all-purpose usefulness. The kind of data from direct costing that are most useful internally are seldom presented in external financial reports. For example, statements of marginal income by products are considered by many to be the most useful statements produced by direct costing, and yet these are seldom given to outsiders.

(*3*) Many companies would object to disclosing to competitors, in external financial statements, their ratio of direct costs to sales.

(*4*) In practice, segregation of "period" from "direct" costs is difficult and involves the use of assumptions and estimates. The practicability of measur-

ing and relating costs to activities and products in a particular set of circumstances will influence markedly the basis on which direct costs are actually segregated. If one company is willing to, or is accustomed to record certain facts relative to products and another company is not, the former will show items as "direct" costs which the second shows as "period" costs. Such lack of comparability in costs would not be as marked with conventional methods.

(*5*) If financial statements were changed to a direct-costing basis, it would be most important to make clear disclosure of the fact of change of method. Otherwise misleading comparisons might be made, both with the past and with competitive companies. The amount of applicable "period costs" which had been excluded from inventories should be disclosed in each statement.

(*6*) Change-over from conventional to direct costing raises problems: (*a*) If external financial statements are continued on the former basis, methods of adjusting inventory values from direct cost to that basis must be developed and applied. (*b*) Some method must be found to handle or dispose of that portion of inventory value at the date of change-over by which the former cost basis exceeds the direct cost basis. (*c*) The change to a variable cost basis from "full" costs for inventory valuation probably will not be acceptable to taxing authorities.

The committee on research of the National Association of Cost Accountants, from their interviews with companies that had changed to use of direct costing, found that these companies had met the problem of disposing of the "period" cost component of their inventory at the date of change-over in various ways, for example:

(*1*) Fixed items of cost were dropped from product cost a few at a time over a period of years.

(*2*) The fixed-cost component, where substantial in relation to profit, was amortized over a period of years.

(*3*) Because previous methods of inventory valuation were somewhat arbitrary and below total cost, the general reclassification of cost accounts made at that time produced no substantial net change in inventory value.

(*4*) Annual inventory and profit figures are adjusted each year to the conventional cost basis by adding or subtracting an amount representing the net change during the year in the fixed or "period cost" component of inventory value. In Research Series Number 23, *Direct Costing*, the Committee on Research of the NACA cites various examples of how companies in practice make such annual adjustments of their direct cost figures.

There are a number of possible and reasonable ways of adjusting year-end direct-cost inventory values to the conventional basis, which includes a fair proportion of fixed manufacturing costs. The problem is one of determining what portion of the year's fixed manufacturing overhead is properly allocable to the quantity of work in process and finished goods on hand as at the balance-sheet date.

Where a company customarily develops "full" product costs in addition to direct costs, valuation of the inventories to include a fair proportion of

fixed charges presents no difficulties. If no full product costs have been developed (which is an unsound and dangerous position), calculations will have to be made on the basis of reasonable assumptions. In some cases it may be logical to adjust the inventories as a whole, but such treatment would not recognize what may be marked differences in the proportion of fixed charges properly allocable to individual product groups or portions of the inventory. At least one company considers that the fixed-cost component of inventory remains constant in amount until there are permanent changes in production capacity or in the nature of the business. Such treatment is merely an expedient, and will not properly reflect periodic income.

All too many observers of financial statements look only at the net-income figure. While the probable differences in that figure resulting from the use of direct costing may affect the opinions of such casual observers, what concerns us more is the effect on careful students of the financial statements such as creditors, bankers, financial analysts, and investors. Change to direct costs for financial reporting will affect these groups in the following ways:

(*1*) During a transition stage, when some companies were using direct costs and other comparable companies were not, there would be a good deal of confusion. There are more than enough differences of this sort between companies to worry about now, such as use of LIFO, accelerated depreciation, or no depreciation on fully depreciated facilities still in use.

(*2*) Comparisons over periods of time and between companies would be more complicated and difficult to make. Considerable education and publicity would be needed before there was a general understanding of the implications of direct costing.

(*3*) The facts disclosed by the direct-cost income statement could be of assistance in the analysis and understanding of an individual company, its internal characteristics and as a help in judging the probable immediate and near term effect on its profits from future changes or courses of action. For this kind of external use, the direct-cost approach could be helpful as information supplementary to the conventional income statement.

We shall consider briefly how the use of direct costing in external financial statements will affect the independent certified public accountant. He will have to satisfy himself that the direct-costing presentation presents fairly the net income and results of operations for the period; that it seems to be suitable for the business, and does not tend to produce unreasonable nor misleading results.

He must form an opinion on the propriety of the segregation as between "direct" and "period" costs. This segregation is basically important in a direct-cost income statement, but he will find it difficult to justify an opinion thereon. Changes in the way the business is operated, management decisions, contractual agreements, and increased mechanization, all may affect the behavior of costs and the determination of which costs are fixed and for what periods, and which costs are variable. There is not, at present, any set of accepted principles by which independent accountants can be guided in forming an opinion concerning the reasonableness of the assumptions or de-

cisions made as to which costs are "direct" and which "period." Without extensive additional work, the independent accountant will have to rely in this matter largely upon the opinions and representations of the client's management. Although he now takes responsibility that the cost of goods sold is fairly stated, and we know that there is a great variety of apparently acceptable practices as to what items of cost are to be included in cost of sales, the independent accountant must assume additional responsibility by indicating that in his opinion the direct costs have been fairly segregated from the period costs. This additional responsibility relative to segregation of costs cannot be taken lightly because the direct-costing income statement is a "forward looking" presentation in the sense that it is intended to show what will be the future effect on profits of changes in volume. It implies, and the reader will infer, that the ratio of direct costs to sales and the amount of period costs will remain about the same in the near future and that the reader can expect that predictions he might make as to the future based on these relationships will hold true.

Using direct costing, the management of a client will be afforded a better opportunity than under "full" costing, while operating steadily, to shift profits between one fiscal period and the next by delaying or accelerating shipments and thereby decreasing or increasing the sales of a period. The resulting shift of "contribution margin" will exceed a similarly caused shift of gross profit. It is difficult for the independent accountant to cope with such manipulation.

CONCLUSION

Most of the articles and promotional literature on direct costing treat the problems of cost reporting, as reflected in financial statements, from the point of view of the management and the organization within the company. From this approach, and for internal reporting, direct-costing methods and principles and the related procedures have certain advantages in appropriate circumstances. However, most of these values can be obtained for management from proper application and use of conventional cost methods.

It appears that direct costing is aimed in general at overcoming weaknesses of conventional cost accounting in connection with internal presentation of unit product costs and in showing to management the results of short periods of operation. External financial reporting of manufacturing companies is not concerned with unit product costs nor frequently with detailed statement of periods of less than one year. Because of this distinction, direct costing would not achieve in external financial reports what it is aimed at accomplishing internally. Direct costing does not appear to have any clear advantages in furthering the basic purposes of external financial statements nor will profits be measured as well as by conventional methods.

As independent certified public accountants, we are concerned not merely with the management point of view or the effect on only one company or even on only one industry. We are concerned with whether direct costing should be added to the body of generally accepted accounting principles

in presentation of financial reports to the public. We should be fully aware of the direct-costing method, its advantages and limitations, and be prepared to consider with our clients its adoption for their internal accounting and reporting if we believe, based on full knowledge of each client's situation, its management, and its problems, that direct costing will prove more useful in operating the business.

The management of each company should have the benefit of internal statements that analyze costs and expenses between those that are variable and those that are fixed. Each will have to consider whether it prefers to use direct costing for regular internal accounting and financial reporting, with full costing as supplementary, or whether its cost accounting and reporting will be on the conventional basis with marginal costing supplementary. The conventional basis, properly developed and adequately reported, seems definitely superior for general use.

Direct costing as a multiple-purpose management tool

CHARLES R. FAY

Comptroller, Pittsburgh Plate Glass Company. Member, advisory committee on cost justification to assist Federal Trade Commission.

Within the past few years much has been written and said concerning the advantages or disadvantages of direct costing. This widespread interest in this relatively new accounting technique prompted the National Association of Costs Accountants to undertake an extensive study of direct costing as a phase of its research program. The findings of this study were published in the April 1953, *NACA Bulletin* as Research Series Number 23.

Representing both field interviews with representatives of eighteen companies that were using or were planning to use the direct-costing system and a digest of virtually all the then available published data, this study would prove invaluable.

It is not our purpose to discuss here the subject from the same analytical viewpoint as the NACA study. We are more concerned with pointing up the need for such a technique as a functional tool accounting can furnish management, and with our experience in developing and using such a tool.

In order to understand more fully the subject of direct costing and its relation to present industrial accounting needs, it would be well to delve into the past for a minute or two. In accounting, as with many other subjects, a look into the past may reveal what we can expect of the future.

Just about thirty years ago cost accountants came forward with a new cost system which they called "standard costs." This system was quite an innovation in those days. There were many public accountants who looked with disfavor on the system because it deviated from their then existing concept of how reports should be made to the public. A few smaller companies with progressive managements adopted standard costs as their basic costing and control mechanism in the early 1920's.

It was not until about 1928 or 1929 that large companies began adopting standard costs as a cost-accounting medium. Since then, the standard-cost system has been accepted as the best means of obtaining control of the manu-

facturing operations in the majority of American manufacturing concerns. Today, standard costs is an accepted curricular subject in most accounting courses. This subject, coupled with related budget programs, is presented as the best available tool of management in its quest for cost reductions and control of manufacturing operations.

One of the basic reasons for the acceptance by the profession of the standard-costs system was the fact that American business was growing larger and larger. It is this particular aspect of size that is still the primary reason for further improvements in costs systems. As business ventures continue to grow so does the need for more detailed and significantly better means of reporting the results of manufacturing operations. Even more pressing is the need for pointing out ways and means of obtaining more specific data to use in the development of effective control measures.

Today we are living in a world of electronics, of atomic energy, of aircraft that fly at supersonic speeds. Almost every day we learn of new manufacturing techniques and new production-control devices that, in their fields, are as new as colored television and atomic powered aircraft. It is obvious that, as these new techniques are adapted, management must have production data with which to do effective planning. Speed and efficiency of transmitting information have become of paramount importance. To meet this new need, accounting must again move forward. Yet, in my opinion, accounting has not kept pace for the most part. It has not moved ahead swiftly enough to match the higher tempo of today's living. Cost systems are the only really fluid type of an accounting operation. They are the only part of the accounting concept that can flow and change with the everyday advancement of production and manufacturing techniques. Therefore, it is in this area that we must look for improvement and change.

We need a cost system that can step up both the speed and efficiency with which we give information to our manufacturing and sales executives. We need a system that does not lose, in any way, the benefits we have gained through the use of standard-cost systems and their related budgets for manufacturing operations. It is our belief that the concept of direct costing or basic costing as we have applied it in our operations is the answer to this challenge presented to the accounting profession by the progressive management of today.

Of all cost systems yet devised, it seems that the concept of direct costing is the one that will provide the best material to use in discharging modern industrial accounting's two principal functions: (*1*) maintaining the historical checks and balances; and (*2*) providing the accurate information management needs for operating decisions and planning. At least, the experience of those who have pioneered in this area would indicate this to be true.

The direct-costing system assumes particular importance when analyzed in relation to the various types of cost systems now being used in businesses both large and small. Why some of these systems continue in use without major improvements is a question with varied answers. In many establishments the volume and pace of work makes it literally impossible to analyze

the system that is being used to see whether or not it is actually doing all a cost system should accomplish.

Perhaps the system has been in use for years and no one wishes to disturb the status quo. Again it may be that the management of a business is not interested in undertaking a survey of the cost system because it is uninformed as to the benefits that might accrue. In any event, old age is creeping up on outmoded cost systems and progressive management simply cannot afford to let them get too decrepit.

To understand some of the deficiencies apparent in those cost systems now generally in use, a review is in order. Perhaps the cost system that is simplest to carry on is the one generally labeled "average cost." Elementary in nature, it is a system wherein costs are totaled for a given period and then divided by the number of items produced to arrive at a cost-per-unit answer. Variations of this have been in use since accounting was originally devised.

When viewed in the light of present-day needs, the inherent deficiencies of this average-cost system are obvious. It is particularly unsuited for control purposes. In seeking to control costs or other production factors, it is necessary to have a knowledge of what costs should be. It is equally important to be able to obtain, in as short a time as possible, data on whether costs are too high or too low and the reasons for such variations. Obtaining this information through use of an average-cost system is quite comparable to using manual computation instead of machine calculations. It can be done, but it takes time, money, and effort—all items directly effecting profit or loss.

In the price field, it is quite difficult for management to formulate equitable prices using an average cost as a basis. Volume is a most important factor, and the effects of volume on costs is of cardinal consideration. Management certainly does not want to place itself in the position of raising prices as volume drops off, which is the opposite of lowering prices when volume increases. Yet, that is exactly what happens to average costs. Likewise, in setting price, management will want to know the impact on cost of changes in product composition; he will want to know what makes up the cost and whether or not the cost can be expected to be a normal one. In short, this cost represents an historical average. Yet, in setting prices, management must be thinking in terms of future costs if it is to continue in business.

As we said earlier, the system that enjoys almost universal usage is the standard-cost system. Standard costs have come to be the generally accepted method of costing in the major portions of American industry. The development of this type of system was considered a major step forward in accounting practices in the Twenties, and it was, when compared to what had preceded it. Both technological and sociological progress is again demanding a change to conform with the times. Most variations of the standard-cost system have one common defect: that of dealing with volume variance.

The primary problem with standard costs results from the necessity of displaying volume variances. Volume variances are described as being the responsibility of the sales manager, but rare is the sales manager who can understand them fully. It is very difficult for him to see the relationship

between his sales goal and the variance figure with which he is presented. There is also the difficulty experienced by the accountants when they are confronted with the necessity of distributing volume variances in an equitable manner to products within a general group.

One of the most distressing effects of volume variance is that it may mislead management because of its illusory nature concerning inventory increases and decreases. For example, with high production and low shipments, there is nevertheless developed a low or favorable volume variance and hence relatively higher profits. It may be that in the next accounting period, however, because of an out-of-balance inventory situation, production must be kept low despite higher shipments. The low production of course produces larger or unfavorable volume variance. Management naturally becomes perplexed, and begins to think, perhaps unconsciously, that the best way to make itself look good is to keep production going regardless of what happens to finished-stock inventories. The accounting statement may reflect an increase in profit or delay the disclosure of an eventual decrease in profit while extra costs are incurred for carrying higher inventories.

Another problem with most standard-cost systems is that they are difficult to use for profit-planning purposes except at one sales-volume level. It is necessary to devote considerable time and effort to establishing normal volume levels, and then to go through the process of determining standard costs at that level. Meanwhile volume levels may actually change, or someone may want to see what costs would be like at another level, and the process of answering under varying conditions is rather long and tedious.

Although many of us do not do it for one reason or another, it is not too difficult to discover both major and minor objections in today's accepted cost systems. However, if accounting practices are to keep pace with the other phases of business, we must undertake critical reviews from time to time. As a result of a critical review of our own practices and requirements, we were able to develop and adopt techniques to create a cost system that we feel does provide a multiple-purpose management tool.

As we reviewed our own requirements, it appeared that the best answer might be found in a standard-cost system with modification in the treatment of fixed expense and adjustment of several other items to meet the rather considerable objections we had to the usual concept.

In brief, these were the objectives we wanted to accomplish:

(*1*) Eliminate volume variance. (*2*) Eliminate the importance of normal volumes. (*3*) Provide management with out-of-pocket cost displayed on the statements. (*4*) Set a value on inventory that was reasonable and yet did not fluctuate because of operation of the cost system. Further we did not desire inventory values that needed to be changed every time volume changed. (*5*) Establish cost-control statements by cost center such as are normally obtainable with standard costs. (*6*) Show labor, expense, and material cost separately on the top profit and loss statements. (*7*)Accomplish all these objectives with minimum clerical effort.

We believe that the manner in which we approached these objectives

could be followed with equal success by other companies. There was no abrupt change in our methods. Instead, the change was gradual and followed certain existing patterns. In fact, our beginning was probably very similar to that of any standard-cost installation. We set standard material costs; we established cost centers; and we deviated a little in the makeup of the usual cost center budget in that we were careful not to mix labor with expense in any particular account.

As was stated in our list of objectives, we wanted to be able to show on our profit and loss statement the separation between labor, material, and expense segments. We therefore approached this problem from the standpoint of eliminating the previous concept of having direct labor and indirect labor separated in the budgeting operations, and have considered labor as a single item. We have carried this concept of separation of labor through all of our budgeting and expense-control operations.

In the detail cost and variance statements we do break down the item of labor to show its various components; for instance, we show an item for various types of direct labor and for various types of indirect labor. We carry this separation of labor from other expense items to the extent that we do not include in a maintenance budget, for instance, any labor cost at all.

By keeping labor as a separate item throughout the entire accounting procedure, we are able to evaluate the cost impact of labor negotiations by a quick review of our detail profit and loss statement.

In the case of overhead items (and remember that we have excluded labor from this category) we have divided the overhead expenses into those of an entirely fixed character and those of an entirely variable character; and each of these we have separated from those which are of a fixed as well as of a variable character. In the latter group, we have made an arbitrary separation between the fixed increment in the fixed and variable expense accounts and the variable proportion. We have also divided the labor items between fixed and variable where such action was necessary. Because of the special treatment of these components of cost of sales, we are now able to carry to the profit and loss statement variable labor as an item, variable material as an item, and variable overhead as an item. The sum of the three, when considered at a standard budgeted level, produces what we call standard variable cost of sales.

Variances from standards are carried to the profit and loss statement and are shown separately on that statement for proper analysis. Those labor and overhead items that are entirely fixed are carried directly to the profit and loss statement as a separate item, which is displayed below the display of variances.

In the statements as now prepared we have ready access to material with which we can work to give management prompt and accurate answers. For cost of sales, we are able to show separately: standard variable cost, variances, and fixed costs. Each of these items can be broken down into their components of material, labor, and expense.

With this information, our statement presentation shows first a profit con-

tribution at standard variable costs. Also, on month-to-month comparisons, since neither manufacturing efficiency nor volume affect the computations, variations in the percentage of profit can only result from changes in the sales mix or in sales prices.

I wish to call your attention particularly to the very unusual and informative bit of information that this segregation of cost of sales will give to the manufacturing and sales executives. Cost accountants are asked many times for information about out-of-pocket costs. Manufacturing departments would like to know out-of-pocket cost information, so that they can gauge their total cost of products when they have variations in volume. The sales department always want to know out-of-pocket costs so that it can tell how deeply it can cut prices to meet competition, or to determine what the margin will be if prices are varied upward or downward. In my years of experience with costing problems, I have spent many an hour trying to develop out-of-pocket costs on a particular item, and then I was never sure, nor was management ever sure, that we had arrived at a satisfactory answer. To be able to show such information on a profit and loss statement for a product line is a major accomplishment, and our cost system, as it is developed, does give this information.

The next item on the profit and loss statement is profit computed on variable costs including variances. The chief value of this figure is that it provides a sound basis for reviewing the impact of all the variances from standards and permits ready adjustment of price considerations.

We next display factory fixed expense. Since these fixed costs are not taken through inventory, we have completely eliminated the necessity for volume variances. Our fixed costs are seen in relation to the sales volume for a particular period and for a particular product line. That is completely proper because we must look at fixed expense as a cost of being ready to do business. Since, by definition, fixed costs do not vary with the number of units produced, these same costs cannot be considered a cost of production.

One of the more significant results of the approach we have taken automatically gives a valuable tool for profit-planning purposes. We can develop a composite profit-to-volume chart using the ratio of profit contribution at variable standard cost to sales for each product as the mathematical slope of the profit line on the chart. With this chart, we not only see our present break-even point, but we can easily make adjustments in projected volume on product mix, and graphically illustrate what will happen to profits and break-even points under these and many other changing conditions.

One of the final major points of our direct-costing system is the distribution of variance and fixed expense to product groups. Expense and labor variance distribution is handled the same as with any standard cost system. Our fixed expense distribution is easier and more accurate than is volume variance. In essence, we determine fixed expense by cost center or group of cost centers. When only one product goes through the cost center, the whole amount of fixed expense is, of course, applicable to that product. When

two or more products go through the same cost center, an apportionment has to be made among the products based on the relative usage of the facilities by each.

Reviewing what we have accomplished to date with our direct-costing system, we feel that the objectives mentioned previously have been attained. The direct-costing system more than adequately meets all needs from an accounting standpoint. But over and above this, we are certain that our system has produced many major benefits for management—benefits we feel could not be achieved as efficiently and economically with any other system. In this direct-costing system our managment has found an effective, multiple-purpose tool for valuation of inventory, for pricing, for profit analysis and, in general, for more efficient conduct of production and merchandising operations.

As with the introduction of the steamboat, the automobile, and the airplane, there have been criticisms leveled against this direct-costing system. It is important to note, however, that these come not so much from management but rather from the profession.

Perhaps the only technical accounting point of any real importance that has been developed as an argument against it has been the way in which it has treated inventory valuation. This criticism, in the light of objective analysis, just does not hold much weight because we must admit that the accounting profession has not as yet established any hard and fast rules on how inventories shall be valued.

Generally, what does inventory represent? It states the dollar value of a certain type of asset. Inventory is the residue of the cost-of-sales calculation. It can be and is modified and adjusted by every cost system. In summation, inventory can be practically every or any figure we wish it to be.

There is no standard rule for the valuation of inventories and every cost accountant in every company varies the valuation procedure to some extent. I have seen cost systems that allowed the single item of direct labor to be the valuation base for inventories; and I have seen other systems that allow inventory to include all items of a company's expense, including a fair proportion of selling and general administrative expense. There is also no standard gauge to compare the valuation of inventory on a LIFO basis with other bases. It is therefore neither unusual nor unreasonable that a good, solid, down-to-earth plan of inventory valuation such as is developed from the basic-cost concept should be added to the list.

As a matter of fact, it is my firm belief that the direct-costing system is one method of valuing inventory that might be used by all manufacturing concerns. It is the one white hope of accounting to obtain a standardization of inventory-valuation practice. I should like to propose that the CPAs, who represent the best brains in the accounting profession, consider this point in their deliberations on this very important subject.

There are two very definite advantages in using direct cost as a method of valuing inventories:

(*1*) Inventory values will tend to remain stable because they are not

affected by variations in manufacturing efficiency or in production volume.

(*2*) The dollars and cents value applied to a particular unit can definitely be analyzed to determine that all factors going into it are truly applicable.

Some question has also been raised concerning the use of direct costing for external reporting. Some accountants seem to be fearful of the attitude that might be taken by the Department of Internal Revenue. It is our opinion that no serious objection could be made in this respect if accountants themselves could agree on direct costing as a proper method of valuing inventory. As was previously mentioned, direct costing would provide a basis for stabilizing inventory values and minimize the fluctuation that, during periods of rapidly changing conditions, would normally occur.

Writing on this particular aspect of direct costing, (*i. e.*, acceptance by all concerned) in the July, 1953, issue of the *NACA Bulletin*, Mr. Herman C. Heiser, Specialist in Industrial Accounting, Lybrand, Ross Bros. & Montgomery, stated: "In practically all cases, acceptance in any of these areas (Management, CPA's, Investors, SEC, and U. S. Treasury) is dependent upon acceptance in others. Management will be reluctant to adopt direct costing if the independent public accountants, the SEC and the Treasury Department will not accept it. On the other hand, neither the independent public accountants nor the Treasury Department will accept direct costing if only a handful of companies have adopted it. How, then, will the question of acceptability of direct costing for external reporting be resolved. It must not be supposed to be an insoluble problem. It would appear that, if a large number of companies have thoroughly evaluated the usefulness of direct costing and demonstrated its acceptability by its adoption for internal reporting purposes, general acceptance by the public accounting profession, the investing public and Treasury Department is quite possible."

From my experience I would say that the acceptance procedure has started. At least the first step has been taken inasmuch as direct costing is being use by more and more industrial companies. The widespread interest in this subject, as evidenced by the inclusion of these discussions on the agenda of the Institute, is a further indication that action is being initiated in the second step—that of acceptance by independent accountants.

In summary, the proof of the pudding is in the eating and, in this instance, the eating is what management thinks of this type of cost system. In our case we have had a very excellent response from management to the information that we have been able to show and to produce from the basic cost system. I might list some of these advantages as I have seen them operate for the last four or five years.

(*1*) Management is able to see at a glance whether any change in the profitability of any product line is due to a change in the sales department's effort. This would be evidenced by a change in the profit at the level of standard variable cost, and it is very readily understood from the top profit and loss statement whether such a change results from change in price, or from additional allowances for freight absorption, cash-discount changes, or product-mix changes.

(2) The point of out-of-pocket expense, which has been explained earlier, has been of greater benefit to management's judgment on price changes.

(3) The separation of labor from other segments of the variable costs has made it very effective in promptly considering changes in price coincident with changes in labor costs and fringe benefit costs.

(4) It is also quite apparent that if an inventory value does not change with volume, forecasting of changes in sales volume for innumerable reasons can be readily interpreted and the changing profit situation can be known in a matter of minutes. I know of no other system which produces this type of information so quickly or so accurately.

(5) We have no volume variance problems to explain, and management understands very readily the allocation of fixed expense to product lines where it does not understand the allocation of volume variance to product lines. This results in a direct interest in the amount of fixed expense charged to a particular product line and the details back of our top profit and loss statement show, in addition, this fixed cost by items, so that it can be readily reviewed and analyzed by the manufacturing organization.

(6) We provide management with a concise and accurate method of measuring the human element in all segments of managerial operations. The operating statements, from a well conceived and executed system of direct costing, not only show the effect of policy decisions on the various elements of cost as previously outlined, but also, by necessarily grouping costs by their various elements, automatically summarize those for which each manager or executive is responsible. It is obvious that these statements then become excellent guides for evaluating managerial results and abilities.

(7) We maintain the benefits of standard costs in that budgets are established on a very similar basis and are used in the detail manufacturing departments in the same way that standard cost budgets are normally used.

It is evident that in conducting today's business we must use realistic accounting methods. We should not hesitate to develop and use plans which provide up-to-the-minute facts. This is particularly true in the way the profession treats the all-important inventory evaluation. We have found that the direct-costing system does this in the best possible manner.

In opening, I referred to the research study on direct costing which was published in the April, 1953, issue of the *NACA Bulletin*. Perhaps it is appropriate that I also close with reference to the same study.

Pointing out that there was not as yet sufficient operating evidence to draw definite conclusions concerning direct costing, the survey listed both advantages, of which there were seven, and disadvantages, of which there were four. The study states in the last paragraph that, "Companies interviewed in the course of this study feel that most of the (above) disadvantages can be overcome or are less important than the advantages which they obtain from direct costing."

As a participating company in the survey, that was our opinion approximately a year ago. Since then, the success of direct costing as used in our operations serves to substantiate this opinion.

The partnership of our state societies and the Institute

GEORGE O. CARLSON

Partner, Ernst and Ernst, Los Angeles Chairman, Institute committee on coordination of activities of state and national organizations.

This session of the annual meeting is the latest in a series of new steps taken during the year to reach an old objective: a better integration of the efforts of our profession's state and national organizations.

There has, of course, been a great deal of cooperation between them for some time. Much of that friendly spirit has been due to the fact that many of us hold membership in both our state associations and in the Institute. I might add as an aside that more of us ought to do so. One of the many benefits of this dual membership is that we can apply the knowledge acquired in one organization to the management of the other. This is particularly true of the state society presidents. As you doubtless know, they are members of the Institute's council by virtue of their state office. Thus, in effect, they represent their societies in the deliberations of the governing body of the national organization; though it must be added that their presence on the council does not jeopardize the independent status of their societies.

Part of the friendliness between the state associations and the Institute has also resulted from the realization on all sides that there is a natural division of labor between them. It is logical for the Institute, for example, to handle federal legislative issues, to establish liaison with administrative agencies in Washington, to organize the profession's relations with other national organizations, to provide leadership in the development of standards, to plan and promote a nation-wide public relations program. It is equally reasonable for the state societies to concentrate on meeting state legislative challenges, on creating better relations with key groups in local communities, on conducting education programs for their own members.

Although a high degree of cooperation has existed in the past, there is good reason to believe that the partnership of our state associations and the Institute is even more effective today than ever before.

If this be so, much of the progress can be attributed to five steps taken dur-

ing the year. The first of these occurred last summer shortly after the council authorized the creation of a separate department—the State Society and Membership Services Department—within the Institute.

At an informal meeting in New York, several members of the coordination committee sat down with the AIA staff to review the current work of the department. As indicated by its title, the department has a double job. Its task, in terms of membership, is largely one of communications—keeping members informed of Institute activities to insure their continuing interest in the organization, calling their attention to Institute material that might aid them to render still better service to more clients, alerting them to ways and means of securing greater personal recognition as professional men.

This task of direct communication with the membership is vitally important. If group action is required, however, the Institute must rely heavily upon the state societies. Only they can organize the concerted local-level effort that will always be necessary for the realization of the profession's objectives. In view of the Institute's dependence on them, it seemed to us at that conference that the department should concentrate on strengthening the state organizations.

One of the best methods of doing so, in our opinion, would be to encourage more of them to employ full-time staff executives. Obviously, the membership has a strictly limited amount of time to devote to professional affairs. It is also obvious that the continuity of leadership provided by a first-rate executive can contribute greatly to the effective management of our state organizations. The possession of such talent on a full-time basis will enable the societies to develop a broader program of activities and services. That, in turn, will stimulate a growth in membership, and greater numbers will produce an increase in financial resources. Neither of these results will be entirely automatic; but they will be a lot easier to achieve in a society with a paid staff than in one without such assistance.

But what should be done for those state societies which cannot be regarded, even by the greatest optimist, as ready for the employment of an executive? The department must, of course, be prepared to help these societies, but the aid should generally be designed in terms of the long-range goal of securing staff executives. That means the societies ought to be helped most of all to obtain the maximum number of members and the maximum amount of income.

There are various promotional devices that can be utilized to gain more members and more revenue. None of them will be really effective, however, unless the state organizations constantly furnish tangible evidence of their usefulness to all CPAs. That takes us back again to a program of activities and services. What are the urgent challenges confronting the profession? How can they best be met? How can the full strength of the profession be brought to bear upon them?

It was readily apparent to us at our conference in New York that these questions could not be answered satisfactorily without a wider exchange of views between the state societies and the Institute. Consequently, we decided to invite the state society presidents to a special session during the April meeting of the council in Arizona.

There was nothing revolutionary about this decision. The presidents had assembled on a number of occasions during earlier council meetings. But the previous sessions had been largely devoted to receiving the official mid-year reports of Institute committees concerned with matters of interest to the state organizations—legislation, public relations, and coordination. Naturally, these documents looked back to past achievements; they did not look forward to the development of a coordinated program of action for the future. The special session envisioned at the New York conference was to have just that purpose.

As we worked on that coordinated program through the fall, it became increasingly clear that no hard-and-fast outline of activities would be satisfactory—now or in the immediate future—because of the varying strength of the state societies. If the program were geared to the smallest society, it would be inadequate for the largest; if keyed to the largest, it would exceed the capacities of the smallest; and even if designed for the average, it would be too ambitious for some twenty-four societies of below-average strength. Consequently, something less ambitious in scope seemed in order. When thirty-five of the state presidents met in Phoenix, we directed their attention to seven fields of opportunity open to the profession. These so-called "priority targets" were: the recruitment of high-caliber young men and women for the profession; greater compliance with technical standards; greater compliance with ethical standards; cooperation with bankers; the CPA's role in taxes; the state legislative situation; and better service to small business.

The outline, it must be added, was hardly more than a statement of these objectives. Some brief mention was made of the projects that might be undertaken to achieve them; but there was no attempt to provide a detailed forecast of the assistance the Institute hoped to furnish the state societies. No effort was made to include such a forecast because some of the projects and materials were then in the planning stages, with the likelihood that a number of them might not survive the scrutiny of committees and that others might be added when the need for them became apparent. It also seemed desirable to ask the organization of state society executives—formed two years ago in Atlantic City—to review the preliminary outline and to suggest changes in it.

That was done at a three-day meeting back in New York immediately after the council session. Ten of the executives were selected by the chairmen of their group to attend. All of them, being full-time executives, brought to the conference an intimate knowledge of the practical problems of state society management; and because they served organizations of different sizes, from the largest to some of the smallest, they approached the issues with realism.

Incidentally, I should like to inject at this point a brief note of thanks to the state societies for contributing the time and talents of these men and women. Your reward for releasing them from their state society duties may not always be immediately evident; but we are confident that the whole profession will ultimately profit by the work they performed with such devotion during that three-day session.

Having subjected the coordinated program to this double inspection—first on a policy level with the presidents, then on a work level with the executives

—we were in a position to put it into final shape. This priority program is included as Appendix to this paper.

I do not intend to waste a lot of time with a lengthy discussion of it. I should like to emphasize one point, however. This outline is not in any sense a battle-order to the state societies. The Institute has no authority to issue commands to the societies, which would have every right to resent such interference with their freedom of action. We have merely sought to enlist the whole profession in designing a year's program of activities that will advance our common aims; and to offer a brief description of the materials the Institute has produced or will produce to aid the state societies in executing all or part of that program on a local level. Nor should the outline be regarded as tailor-made for any society. Local situations will undoubtedly require different projects or at least a different emphasis. It would be deplorable if anyone felt constrained by the existence of this outline to suppress his personal judgement on the needs of his own organization. Knowing that CPAs rightly pride themselves on their independence, this precautionary statement may not be necessary; but—just to preclude any possibility of misunderstanding—I want to repeat that this document is simply a device to focus the united energies of the profession on the achievement of some of our priority objectives.

I mentioned earlier that five steps were taken this year to strengthen the alliance between the state societies and the Institute.

Three of these have already been mentioned: the informal meeting of members of the coordination committee with the Institute staff, the special session for state society presidents in Phoenix, and the conference of the ten full-time state executives. The last two steps are being taken here in Chicago.

On Saturday, nearly all of the twenty-five full- and part-time state society employees conducted an all-day workshop on various aspects of state-society operations. In addition to taking a look at this coordinated program, they pooled their knowledge on such problems as organizing successful meetings, the development of chapters, membership promotion, budgets and accounting, and state legislative coverage. Information on all these topics was assembled and circulated in advance; and each of the discussions was led by one of the full-time executives. It was, in other words, an invaluable exchange of know-how born of experience. The result ought to be a more effective management of our societies.

But the final responsibility for the successful operation of our state societies rests, of course, upon us, the members. No one who has ever seen an efficient staff executive at work would question the enormous benefits to be gained from such assistance. The executives themselves, however, would be the first to emphasize the vital importance of membership participation.

That explains the inclusion of this technical session in the annual meeting program.

It is the fifth of those steps toward the goal of better integration of efforts on the part of our state and national organizations. It is directed, primarily, to state society and chapter officers, directors and committeemen; but we hope that it will interest anyone who believes, as I firmly do, that much of our

personal future will be determined by the work of our professional societies. If you agree with that statement, I trust that you will accept this meeting as not merely an opportunity to listen and learn, but to speak and teach. Only if we have such a free exchange of views can we expect to make further progress toward the goal of a better integration of the efforts of our profession's state and national organizations.

Appendix • Priority Program 1953–54

I. Recruitment of Personnel for the Profession

Project	*AIA Plan*	*Local Action*	*Cost*
Personnel Project Package	Revised package containing various booklets and reprints on accounting will be distributed in December.	Arrange interviews with educators and talks to students on public accounting as a career.	None
Career Film *Accounting—The Language of Business*	Ready by January 1; promotion and instructional material on the 20-minute film to be mailed in advance. Distribution and servicing of prints to be largely handled by commercial agency.	Encourage use in high schools, preparatory schools and colleges; promote showings on TV stations; consider placement of print in college or educational department film libraries.	AIA to be charged $2.75 per showing; state societies may be asked to share some of cost for showings in their area. Cost of print for local film libraries: about $50 each.
Career Leaflet *Professional Help Wanted*—4 pp.	Available by November 1.	Distribute to high schools, particularly in connection with film and "career days."	Reasonable number of copies free; available at cost with state society imprint.
Career Booklet	A new longer booklet to replace current pamphlet, *A Career in Public Accounting*—to be published in 1954.		

II. Greater Compliance with Auditing Standards and Cooperation with Bankers

Project	*AIA Plan*	*Local Action*	*Cost*
Audit Report Survey	Preliminary results to be ready this winter; final summary in late spring.	Arrange joint meetings on state or chapter level with bankers and other credit executives, using final tabulation as basis.	

Project	AIA Plan	Local Action	Cost
Bank Audits	Revision of existing case study on current bank audit programs in three states. Ready December 1953.	Develop cooperative programs with state or local banking groups.	
Tape-Recorded Speeches	Two 15-minute speeches—one on technical standards and one on accountants' liability. Available after January 1954.	Use and discuss at state society and chapter meetings.	None
Pattern Article	Article, outlining areas of cooperation between CPAs and bankers, will be available mid-winter.	Adapt and place in state or regional banking journals.	None

III. Greater Compliance with Ethical Standards

Project	*AIA Plan*	*Local Action*	*Cost*
Pattern Speech	Continuing distribution of available pattern speech on "Ethics and Income."	Address college students and professional societies.	None
Tape-Recorded Speech	Address on "Aggressive Professional Ethics."	Play at state societies and chapter meetings to open discussion period.	None
Presentation Volume for new CPAs	86-page, cloth-bound book composed of three chapters from *CPA Handbook*. Available (if desired by state societies in sufficient quantity): early spring.	Present to successful candidates at meetings or dinners held in their honor.	Probable cost per copy: 75¢

IV. The Legislative Situation

Project	*AIA Plan*	*Local Action*	*Cost*
Legislative kit	To be revised this year for 1955 sessions. Ready: November 1954.	Supply suggestions for revision; use as guide to good legislative relations.	None
Why CPA Standards Are Important to You	To be revised by January, 1954.	Suggest changes; distribute as necessary to legislators and others concerned with the regulation of the profession.	5¢ each
Memo to Legislators	To prepare a concrete answer to the issues most often raised by public accountants. Ready: January, 1954.	Adapt to local conditions for distribution to legislators when necessary.	None

Research Bulletins	To issue a series of statements by the state legislation committee giving pro and con arguments on eight points of legislative policy. First of series to be issued in January.	Consider for possible incorporation in legislative programs.	None
Interstate Practice Principles	To encourage study of seven principles developed by interstate practice committee.	Consider for possible incorporation in legislative programs.	None

Note: Work to be carried out this year by the commission on standards of education and experience requirements and the Institute's committee on accounting personnel is likely to provide additional information useful in communications with legislators.

V. The CPA's Role in Taxes

Project	*AIA Plan*	*Local Action*	*Cost*
TELEVISION			
Spot announcements	Four 20-second films to be produced in cooperation with the IRS—distribution thru Directors of Internal Revenue.	Contact Director of Int. Rev. to coordinate TV station contacts, tie-in with promotion of locally produced programs.	None
Locally produced programs	Program plan to be mailed in November—will include outline script.	Arrange programs, preferably with Director of Internal Revenue.	None
RADIO			
Spot announcements	Promotion material to be mailed to state societies in November. Jinx Falkenburg and Tex McCrary will record the spots.	State societies offer disc to stations.	$3 for each disc ordered by a station
"Tax Your Wits" Two 13 1/2-min. programs	Approval disc to be mailed to state societies and chapters in November. Narrator: Walter Kiernan.	State societies and chapters arrange broadcast of programs—can use to lead off local series.	$5 for each disc with two programs
Locally produced programs	Program plan to be mailed in November—will include outline script.	Arrange programs, preferably with Director of Internal Revenue.	None
NEWSPAPERS AND MAGAZINES			
Series of articles	Series to be mailed to state societies and chapters in November.	Place articles in newspapers (preferably through state press associations or services).	None

Tax-hint articles	Distributed to 6000 trade magazines and to employee - stockholder publications.	None	
SPEECHES			
Pattern talk	To be mailed to state societies and available on request in November.	Address civic clubs, trade associations, etc.	None

VI. Better Service to Small Business

Project	*AIA Plan*	*Local Action*	*Cost*
Articles on Value of CPA's Services	Continue to supply articles to trade magazines, (91 magazines with 2,000,000 circulation have printed material since program began in 1950). Reprint of each article to be sent on publication to state societies.	Consider ordering additional reprints for distribution to local businessmen in trade served by magazine; follow-up with talks before trade association.	Approximate cost of reprints: 10 cents each. Add mailing expenses.
Pattern Articles	Available now.	State societies adopt for state or regional trade publications.	None
Pattern Speech	Ready by early spring.	Use in follow-up appearances before trade groups.	None

Organizing a state society program for the year

CLIFFORD C. BEASLEY

Managing director, Florida Institute of CPAs.

The annual reorganization of a state society program is in many respects comparable to the setting of quotas in a well-defined sales organization. The potential needs of those who will use the product; the development of methods for reaching those who have the need; the assignment of the right personality to the various areas in which the need exists; and the providing of the proper motivation to insure a fulfillment of the quota; all of these factors are applied in planning and putting into effect a state-society program for certified public accountants.

It has been impossible to study the constitution and by-laws of all existing state societies. Therefore, what I have to say will not in many instances apply to some of our state groups, although I believe that there is enough similarity in the patterns of organizations in our state societies that we can make general recommendations that will either directly apply or may, with modification, be adapted to virtually any type of organization where certified public accountants have banded together in the interest of furthering the profession.

In the research that I have done I find that in nearly every state there exists a parent state-wide organization with some kind of regional or city breakdown. Most states adhere to the chapter style of arrangement, with each chapter an integral part of the state-wide or parent society.

At the present time, the state organizations vary from those states having secretariats under the management of a full-time executive to those states that are still depending upon an elected member secretary, or other officer, to carry out the functions of planning and executing the activities of the state society. For the purpose of this discussion, it appears that we should assume that the more desirable organizational setup is a state society maintaining a central office with a full-time executive responsible to the elected officials of the state society.

First of all, in programming for each year, consideration should be given to the constitution and by-laws that cover the society. If a society is to accomplish its purpose, its constitution and by-laws should encompass the progress

of the society. A society should be incorporated and a proper safeguard set up within its constitution to insure that an aggressive professional program can be effected with ample legal protection for the membership. In the constitution and by-laws, elected officers should be specified, with time for election and terms of office established, and the fiscal year set down. For administrative purposes, the employee executive should be assigned the responsibilities generally indicated for the elected secretary. This insures continuity in records and security of the corporate seal; it also serves to expedite and insure more efficient services to the membership.

The constitution and by-laws should clearly identify the types of membership and eligibility standards therefor. In turn, the amount of dues for each classification of membership should be clearly stated. In the constitution and by-laws should also be found procedures for the granting of membership and the expulsion of members. Although there are various other items that may be incorporated into a constitution and by-laws, I find that in many instances charters of some of our societies have not been revised since the day they were drawn and that many of the so-called fundamentals I have mentioned have completely been overlooked.

In planning a program for each fiscal year, an obvious assumption is that the membership has afforded through its vote a slate of officers eminently qualified for their jobs. There is nothing more discouraging and frustrating to those who are charged with the responsibility for charting the course of a state society than to find among the officers a lack of interest, an attitude of headline hunting, and an unwillingness to give the necessary amount of time to study the society's needs and explore methods to fill these needs. Too frequently, not enough attention is given by the membership to careful selection of officers. Weak leadership makes for a weak society, and successive slates of uninterested officers will, within the span of a very few years, make for a struggling, poorly financed organization.

Therefore, for our purpose let's assume a society where the membership is alert and vitally interested in electing men with leadership ability and capacity for the job. Let's assume that officers are brought up through the ranks, that each has served well in his local chapter, that he has proven his ability in a given area of responsibility through outstanding committee work in the state-wide society. Let's assume that he is ambitious enough to want to advance further in his profession, yet unselfish enough to work in harmony with those who share with him the executive responsibilities for the society.

Now that we find ourselves with a strong executive board, let's approach the problem of planning and executing a successful program for twelve months of the fiscal year. Committees are of paramount importance in a state society. The committees are of varying types. Some are charged with the responsibility of carrying out assignments of standing importance to the society, such as finance and budget, constitution and by-laws, nomination of officers, and membership. These are actually the committees that assist the executive board in its administrative responsibilities. Secondly, we have committees that continue uncompleted projects from previous years, or are

given responsibility for initiating new projects to be completed within the present fiscal year. The other type of committees are those which accept assignment from the executive officers for exploring and determining the feasibility of new projects in which the profession should interest itself either as a service proposition or for the possibility of creating new areas of remunerative public-accounting practice.

The relationship between the committees and the executive board must be clearly defined for sound administrative purposes. In all instances, the executive board must formally set its policies, and these policies must be adhered to in the functioning of the committees. Committees may frequently recommend policy, but the prerogative of policy determination must at all times be maintained in the executive group of officers.

Committee appointments should be a major consideration of the officers of a society. Annual appointments should be studied well in advance of the beginning of a fiscal year. In some states, officers of the society are elected six months in advance of the fiscal year in which they take office. In most states, however, officers are elected at the annual convention and take office immediately. There is much to be said in favor of the former plan.

In societies whose officers are elected in advance, the membership has an opportunity to make known its recommendations for improvement of the general program of the society. In turn, the officers have ample opportunity to inquire into and better acquaint themselves as to the needs and the personnel that may be fitted into committee assignments to meet these needs. Advance elections further afford opportunity for joint meetings with the outgoing executive group, thereby orienting the new officers into their responsibilities. All of this adds up to a new administration and its committees being prepared on the very first day of its fiscal year to "take over" and get its program into operation.

At this point, it would be an oversight not to mention at least one pitfall with reference to committee appointments. Many society presidents are elected with a conviction that things haven't been democratic enough in the society. They are of the opinion that there are too many "forgotten men" in the organization. They go in with a determination to change this pattern. With rare exception, the first step in bringing about this new day is to address a letter to the membership, requesting that each member reply listing in order of preference the committee assignments he most desires. The result is a deluge of replies, a request of at least ten to one for assignment to committees that have received the most publicity the previous year, either by virtue of the particular projects they were assigned to or because of the unusual talent thereon. Automatically, the new president is in a dilemma as to how to honor these requests. He is upset because he is well aware that, in many instances, in spite of their requests, individuals simply won't work, and thereby would, if appointed, doom the committee to failure. The president has placed himself in an embarrassing position. Usually he ends up creating new committees, assigning members thereto, with full knowledge that he has jeopardized the entire society program for the year because of the inactivity that will result

in these particular committees. It is much better to have fewer committees, with all of them active, than a large paper organization with long lists of names that requires a great deal of detail and time but is short on results.

If committees are to accomplish their purpose, there must be meetings of the committees. The geography of a state, location of major cities, and the concentration of membership will influence selection of committee personnel. In Florida, for example, the distance between Pensacola, Jacksonville, and Miami is such that appointment of personnel from each of these cities to any given committee is from the outset a strike against getting full attendance at a committee meeting. Likewise, in my state, we find approximately one-third of the membership concentrated in the Greater Miami area. This in itself dictates the appointment of numerous committee members from this area in order to insure meetings of the committees, but rejects the desirable practice of having all geographical areas represented on each committee. New York, California, Illinois have similar and other problems. All of these factors must be taken into consideration when planning the program for a society each year.

Another very important consideration in society programming is the correlation of state society activities with those usually more or less independently planned by the local chapters. Where chapters are a part of a state society, it is important that each administration clearly understand the relation of one to the other. The state-wide society is the parent organization. The chapters are the children of the parent group. Membership in chapters should not be permitted without affiliation with the parent group. This principle should be set forth in the constitution and by-laws. If this plan is strictly adhered to, it tends to cement the uniformity of purpose and objective of the profession in every corner of the state. It insures a common objective in matters of legislation. It strengthens the uniform interpretation and enforcement of proper professional standards. It affords an adequate means for dissemination of state-level policies. It equalizes the economic strain of membership on individuals. These and many other benefits can accrue if both the state-society officers and the local-chapter officers review annually ways and means whereby their activities can be more effectively integrated.

From what has been said here one might conclude that officers and committee members are the only important factors in planning for a society's fiscal year. This is not true. The entire membership—individual by individual—is important. All plans must point to serving the collective needs of the entire profession with particular emphasis on those who are affiliated with and actively support the society.

The financial planning for a society is of major importance. While this is generally a committee recommendation, the administration of society funds is in the hands of the executive board. Budgeting deserves a major portion of the executive group's time at the outset of the year. Strict adherence to the budget should be insisted on throughout the year. The executive secretary should have ample opportunity to advise on matters of budget but should not dictate the budget. In fairness to the executive secretary, every member

of the finance and budget committee should clearly understand the intent of all budgeted items. Once this is understood and approved, the executive secretary should have delegated to him total responsibility for administering within the policy set down by his executive board. From this point on it is a matter of getting the greatest possible return for the individual member from the dollar he has invested in his profession's future.

The suggestions in this paper have to do with the over-all planning that is necessary with the reorganization of the executive board each year. The detail of activity within this large pattern is actually what makes the organization effective. Officer by officer, committee by committee, each must carry out the responsibility assigned if the planning is to become a total success. It isn't possible to praise enough those state societies whose officers are carrying on an aggressive program without the aid of full- or part-time executive assistance. It is commendable that so many states are moving in the direction of establishing full-time secretariats. Those states that do have full- or part-time executives are striving to pool their resources in the interest of being helpful to each other and to states not yet having acquired such assistance. The American Institute of Accountants is affording the finest leadership and assistance in motivating these state programs. Co-operation of this type promises more effective planning in the future, and with better planning the profession is certain of greater advances. To plan for the future is to insure success. Let's plan carefully in our state programs. Let's assist the American Institute of Accountants in its planning. In so doing we collectively raise the standard of public accounting.

The employment of a state society executive

J. WESLEY HUSS

Resident manager, Lybrand, Ross Bros. & Montgomery, Louisville. President, Kentucky Society of CPAs.

Since the turn of the century, the accounting profession has experienced a phenomenal growth not only in numerical size but in professional perspective as well. As a part of this advancement there has been a broadening of horizons by the various state societies of certified public accountants, for within these groups the development has been equally astounding.

The various services performed by the state societies today bear little resemblance to the activities undertaken even as recently as twenty years ago. From a bare nucleus of members, loosely banded together primarily as a forum for the annual election of officers and directors and for the purpose of holding one or two technical meetings each year, the state societies have expanded their objectives until now they serve their members in a greatly enriched capacity. This advancement, however, has not been uniform within the various states. The number of members in the respective societies and the geographical distribution of the membership throughout the state have been factors influencing the development in each particular society. In addition, this development requires strong leadership on the part of a few members. Equally as necessary is a wide acceptance on the part of a large segment of the membership of the goals set forth by the leaders. Generally speaking, situations favoring development are more readily found in states wherein the majority of the certified public accountants live in one area, rather than in states wherein the membership is widely scattered without there being any predominant focal point. It is pointed out, however, that this difficulty may be partly corrected through chapterization.

If the stature of a state society may be measured in terms of breadth of activities, then the manner in which these expanded services are centralized and the method whereby they are implemented become of prime importance. Unfortunately, broadened activities create more work for some-

body. To impose this increased load upon a small group of officers and directors, substantially all of whom usually are active practitioners, creates an almost insuperable burden. It is only natural, therefore, that the mechanics of carrying the burden should be delegated to an executive office. Through this delegation, the actual functioning of the society is carried on by the executive office with the responsibility for direction of general policy still remaining in the hands of the elected representatives of the society's membership. At the present time there are 11 states with full-time executive secretaries, 13 states and the District of Columbia with part-time assistance, and 24 states with no executive offices. The number of members in these state societies with full-time executive offices has a very broad range. Seven of the states have over 1,000 members, yet three states with fewer than 700 members have a full-time executive office. Kentucky, the state I represent, has only 279 resident members and 28 nonresident members, yet employs not only a full-time executive secretary but a full-time clerical assistant as well, although there are 16 states with memberships larger than ours that are presently without any executive assistance or employ an executive secretary on only a part-time basis.

I cannot resist sketching in outline some of the early struggles we had and the problems that faced us before we established an executive office. Much in this pattern may be familiar, and I hope our solution will be helpful to others.

Our society was incorporated in 1924. From that time until September, 1948, we had no paid secretary, such duties being performed by the society's elected officers. Our meetings were irregularly held and were usually of a technical nature. There was very little committee activity. Since probably 90 per cent of our members during this period lived in the Louisville area, our society became practically a Louisville society. Throughout the depression and during World War II, we continued almost in name only and our meetings became less frequent. In fact, we even went one whole year without any meeting at all. Obviously this type of operation accomplished little in the way of service to the profession. By 1948 the number of CPAs in Kentucky had increased substantially, and the percentage of the total membership living in Louisville had declined. Because of the increase in duties it became difficult to obtain anyone to take the office of secretary. It was at this time that we first considered establishing an executive office, and in September of 1948 one of our members was employed on a part-time basis as an executive secretary. Under the able direction of this person we were able to accomplish a number of objectives. Our system of record keeping was revised, minutes of meetings were kept, and a bimonthly publication was started. We commenced holding regular monthly meetings and annual outings, expanded the number of committees and increased the committee activities, and were able to provide a central clearing house for society problems and functions. Since Kentucky is a regulatory state, the duties of the part-time secretary embraced activities for both the state society and the state board.

In 1952, our part-time executive secretary asked to be relieved of his duties in order to devote his full time to the practice of his profession. Having experienced the advantages of an executive office and realizing the difficulty in attracting another competent person to work part time in this capacity, it was decided that we should establish a full-time executive office to handle the functions of both the state society and the state board.

Preliminary problems

At this point we were then faced with the same three preliminary problems that confront any society considering expanding its activities through the employment of a full-time executive secretary, namely (*1*) selecting the right person; (*2*) determining the activities to be undertaken by the executive office; and (*3*) financing the operation.

Selecting the right person. We felt that the position could best be filled by a person of mature age, who was not necessarily an accountant, who liked dealing with people, who had co-ordinating and executive ability, and who had a past record of activity in community affairs. It was felt that an ability to arrange for meetings, an ease in meeting and getting along with people, a knowledge of public relations, and a capacity for writing were prime requisites for this position. We were fortunate in obtaining an executive secretary with a master's degree and a background of eleven years of high school teaching experience, five years experience as county superintendent of schools, and two years experience in department store purchasing, and with a past record of responsible activity in service clubs, church work, Chambers of Commerce, the American Red Cross, Community Chest, and other community activities.

Determining the activities to be undertaken by the executive office. After selecting the proper person to fill the position, it is necessary for the society officers and directors, working with the new executive secretary, to determine what additional activities should be undertaken. My own feeling is that no attempt should be made to build an empire in one day but, rather, that a conservative approach should be used, soundly laying the foundation for each newly added activity. A poorly executed activity is worse than none. Since the general basic objectives of all state societies might be considered to be reasonably similar, I thought it might be helpful if I outlined rather briefly the present functions carried out by our executive office.

As mentioned earlier, our executive office serves both the society and the state board. Let us first consider the work done for the society:

(*1*) Arranges for all meetings: Each year we have regular monthly directors' meetings, six regular members' meetings, an annual business meeting, two institutes on accounting of two days duration each, an educational seminar, a Christmas party, a summer outing, and numerous committee meetings. The executive secretary arranges the place of the meeting, sends out the meeting notice, handles any publicity, arranges the speakers' table, and takes care of any auxiliary entertainment or social hour that might be appropriate for the occasion.

(*2*) Public relations: We carry on our public relations program through a speakers bureau, television and radio broadcasts, news releases, college and high school interest programs, membership in other professional organizations and civic organizations, and through friendly relations with state authorities in Frankfort. Working through the committee in charge of these various public-relations outlets, the executive secretary makes all the arrangements for instituting and carrying out this program.

(*3*) Administration of code of ethics: The executive secretary investigates alleged violations and makes a full report to the ethics committee. Any directives of the committee are carried out by the executive secretary.

(*4*) Bimonthly bulletin: The executive secretary handles the layout and publishing of the bulletin, makes arrangements for its printing and distribution, and sells advertising space.

(*5*) Records: Permanent records of the society membership, as well as the society's financial records, are maintained in the executive office.

(*6*) Correspondence: A vast amount of correspondence with the members, the public, the American Institute of Accountants, other state societies, etc., issues from this office.

(*7*) Miscellaneous: In addition to the duties outlined above, our executive secretary correlates our program with that of the Institute; assists the president in selection of committee personnel; attends state, regional, and national meetings of the profession; operates an employment service; arranges with the University of Louisville for CPA examination coaching courses and for an internship program; suggests activities for committee work; and generally represents the profession wherever expedient.

In addition to the state society duties, he handles the following functions for the state board:

(*1*) Administers the CPA examinations twice yearly, including the handling of the physical arrangements for the examination and clearing all applications for board approval.

(*2*) Watches for state violations through subscribing to a clipping service and by reviewing telephone directories, and makes investigations of any indicated violations.

(*3*) Reviews practitioners' letterheads, publishes an annual register of certified public accountants and public accountants, collects annual fees, and issues membership cards.

(*4*) Maintains all files and records for the state board, keeps the minutes of the board meetings, and handles all correspondence.

(*5*) Maintains public relations with the profession, the public, and state officials.

(*6*) Attends the Institute's board of examiners meeting, co-ordinates the activities of the state board and the state society, and maintains contact with other state boards of accountancy.

I believe that the functions just outlined indicate that even for a small state society, a program may be devised that will adequately occupy the full time and attention of an executive office.

To assist our executive secretary, we have a full-time office secretary. The society and the state board occupy office space in a centrally located downtown office building in Louisville. This office space consists of two rooms and provides a meeting place for committees, group conferences, and interviews. Our library, which was very generously provided by contributing practitioners, is available not only to society members but to any others to whom it may provide proper assistance.

Financing the operation. As it does to all salesmen, the time eventually comes when it is necessary to answer the customer's question as to how much the cost will be. This is the toughest of the three problems, for there is obviously a limit to what a small society can afford to pay for an executive office. In Kentucky we operate on a budget of somewhat less than $17,000 a year, such budget being provided primarily by state society membership dues of $15 a year for residents and $5 a year for nonresidents, plus annual dues of $15 for state registration of certified public accountants and public accountants. I think it entirely feasible for a state society to operate a full time executive office on an annual budget of less than $12,000. Last February, a committee of state society administrative executives, with the assistance of the staff of the American Institute of Accountants, prepared a society budget based upon an active membership of 300. This budget is shown in Exhibit 1. It includes, as a method of financing, the utilization of $1,000 from surplus during the first year of full-time operation of the executive office. In fact, such supplementary assistance may be necessary for several years. In Kentucky our budget in the early years was augmented by requesting society members for voluntary contributions. We are now on a self-sustaining basis. While the revenues and expenses forecast in the budget will probably not precisely fit any one state society's situation, I believe that this budget will provide a framework within which a financially sound plan may be developed.

Exhibit 1. State society budget

(Prepared by a Committee of State Society Administrative Executives, with the assistance of the staff of the American Institute of Accountants)

From surplus	$ 1,000
Revenues	
(1) Dues (300 at $25)	7,500
(2) Application fees (25 at $5)	125
(3) Group insurance commissions	300
(4) Interest on investments	125
(5) Textbook sales profit	100
(6) Accounting symposium or tax conference	350
(7) State board administration (400 renewal fees at $5)	2,000
(8) Miscellaneous and other	—
Total	$11,500

Expenses

(1) Salary, administrative	$ 5,000
(2) Salary, clerical (part time)	1,800
(3) Social security expense	81
(4) Postage	400
(5) Telephone	300
(6) Office supplies	60
(7) Office and general expense	250
(8) Printing, stationery and mimeographing	1,000
(9) Travel and general, executive secretary	650
(10) Equipment	300
(11) Annual meeting	300
(12) Insurance administration	35
(13) Rent (if office space not provided by state board)	750
(14) Miscellaneous and other	574
Total	$11,500

Case studies of some state society projects

RAYMOND R. RAINS

Executive secretary, North Carolina Association of CPAs.

Using the "case study" technique, I shall describe some of the successful projects carried out by state societies during the last year or so. There is plenty of material for such a report. To select from the many worthwhile activities that have been undertaken, I started out by reviewing four dozen or so which had been passed on to me by the state society and membership services department of the Institute. Before I had finished, however, I decided that I would have to narrow the field down more or less arbitrarily.

Thus, only six projects will be discussed in this paper. The first will highlight the area of external bank audits by certified public accountants; the second, the promotion of the radio and television tax shows; the third, the continuing education of staff personnel; the fourth, publicity for an annual meeting; the fifth, the handling of legislation sponsored by a society; and the sixth, the distribution of a publication. Fortunately, they reflect something like a cross-section of the work of the 49 state societies, although it is no small task to decide where to cut to find such a cross-section, for the societies vary greatly in their manpower and funds. They range from a membership of about 7,000 to a membership of 21, from a budget of over $200,000 to one of a few hundred dollars, from a full-time paid staff of 14 persons to no staff at all. The projects selected cover most of this variation.

Let's proceed to the first one—programs for independent bank audits by certified public accountants, arranged jointly by state societies of CPAs and state bankers associations. While these have been conducted simultaneously in several states, their most complete development so far has been in Iowa, Pennsylvania, and New York.

For the sake of brevity, however, I should like to concentrate on the work done in Iowa. This procedure will have the added advantage of showing what can be done in a society with relatively limited financial resources and with a total resident membership of about 150.

Here's what happened. The Iowa Bankers Association in cooperation with Lester A Pratt, CPA, of Washington, D. C., sent a questionnaire to all of Iowa's state and national banks asking searching questions about audit and control practices. The results showed room for improvement; and the Federal Deposit Insurance Corporation, concerned over the startling increase in bank defalcations since World War II, showed enough interest to distribute copies of Mr. Pratt's article on the survey results to all of its member banks.

Up to this point, the Iowa Society as such had not participated in the work. When it heard the knock of opportunity, however, the society moved fast to open the door. With due deliberation, but with admirable speed, a special committee was appointed and a five-point program was proposed. Known as the "Iowa Plan," it included a bank audit school for Iowa CPAs, co-operating committees of the society and the Iowa Bankers Association to seek means of improving bank-audit programs, a pattern for bank audits to be drafted by the society and submitted to the bankers, participation by CPAs in the discussions of the Iowa State Banking Conference, and stimulation of still greater interest in bank audits among bankers.

The proposal was followed up last April, when the Iowa Society met with IBA to discuss audit and control practices. A transcript of the addresses delivered at the meeting was edited and is now being printed as a booklet directed to the banker of Iowa. Also, an article was written on the CPA's services to bankers, and this has been accepted for early publication in the *Northwestern Banker.*

The results of the Iowa Plan have been both direct and indirect. Directly, the CPAs of the state have benefited by enlarging their potential area of service. Indirectly, they have benefited through improved relations with bankers, through the state-wide newspaper publicity on the plan, and through the national publicity in banking and accounting publications.

The state society and membership services department of the Institute has published a description of the activities in Iowa, Pennsylvania and New York, called *Bank Audit Programs in Three States.* It contains some of the materials actually produced, including three booklets published in Pennsylvania on *Audit Safeguards and Internal Controls, Minimum Scope of External Bank Audits by Independent Public Accountants,* and *Supervision of Directors' Examinations by Independent Public Accountants,* with instructions for ordering the longer booklet published in New York, called *Safeguarding the Bank's Assets.* A path leading in a similar direction seems to be indicated for other states societies, and several of them have already decided to follow it.

My second case study—on promotion of the radio and TV tax shows—could have been made in many of the state societies, for this tax season public service has become nationwide through the cooperation of the Institute and the states societies. Last year the radio and TV shows were presented on 595 stations in 36 states, Alaska, Hawaii, and the Virgin Islands.

In several states, however, special angles to the promotion of such shows have been utilized. The Georgia Society, for example, with a total membership of about 400, was not only the sole state society without an executive

secretary that used the tax shows more than 40 times last year; but also cleverly turned a handicap to its advantage. The handicap was the lack of a TV station in Augusta. This fact, however, did not stop the public relations chairman of the Georgia Society. Undaunted, he placed the TV spots in five moving-picture theatres.

Another new approach last year was the production of live quiz shows on taxes using local CPA talent. Twenty state societies—California, Colorado, Florida, Georgia, Illinois, Indiana, Iowa, Louisiana, Kansas, Kentucky, Massachusetts, Michigan, New Jersey, New York, Ohio, Oklahoma, Oregon, Pennsylvania, Tennessee, and Texas—participated in 95 productions of this type, many of them presented with the co-operation of Internal Revenue officials and lawyers. In Florida a wrinkle was added to this wrinkle by having six of the seven live TV programs produced in the state sponsored by the Florida State Bank.

The Institute plans to give even greater encouragement to locally produced shows this year by providing more materials especially designed to facilitate their production.

Case study number three concerns a continuing education plan. Such plans have been conducted by all of the societies, in one sense, through regular state society and chapter meetings, regional and graduate study conferences, publications, and so on.

The California Society's continuing education committee, however, feeling that a more formal approach was needed, began several years ago to seek an answer to the question: How could a series of courses in practical accounting subjects be organized and administered on a state-wide basis?

Operating on the principle that the way to begin is to begin, the committee worked out a plan and turned to the extension division of the University of California for help in carrying it out. The university agreed to a trial run in Los Angeles during the spring of 1951 and—if it succeeded—to sponsor other courses in extension branches throughout the state. A course in "report writing" was offered during six weekly two-and-one-half hour sessions in March and April for a fee of $15. A second section was necessary to take care of the overflow from a registration of 105 members.

The program has been rolling ever since. Local members choose both subject and instructor. A detailed outline—60 pages or longer for a six-hour course—is approved in advance. Last month, the *CPA Newsletter* of the California Society reported that in seven chapters 1,299 members of the society have enrolled in 16 separate course sections during the last two years.

Here, too, the Institute has taken a cue from the state societies—especially from the California activity and from a similar plan carried out by the New Jersey Society in co-operation with Rutgers University. Feeling that continuing education courses might be feasible in many states, the Institute has surveyed the desires of the societies in regard to a program that might be developed on a national level for local sponsorship.

The fourth activity I should like to describe is the handling of publicity for an annual meeting—particularly as it was done in Texas last June.

The usual procedure includes an advance general story on the meeting, advance stories on the speakers to their hometown papers, daily hometown stories for each person attending, stories and pictures during the meeting on speeches, election of officers, and major decisions reached.

In Texas last June, however, while an excellent job was done on news coverage, the publicity included also full-length editorials in the two major San Antonio newspapers and many bank-sponsored advertisements welcoming the CPAs and, in some instances, testifying to the importance of the CPA in our modern economy.

While the editorial approach would doubtless not be practical in every city because of newspaper policy, the approach through the bank-sponsored advertisement can probably be used almost anywhere. According to the Texas Society's publicity chairman, "The downtown banks responded favorably and were glad to do it, but the suburban banks were not. It was necessary to write a few letters, but most of the contact was over the telephone. The part of the publicity concerning banks was perhaps accomplished with less effort than any part of the publicity program."

Case study number five will outline the successful effort of the Pennsylvania Institute of CPAs to secure the enactment last summer of amendatory legislation which provides for experience requirements correlated with education as a prerequisite to the CPA examination; for the establishment of rules of professional conduct that apply to all CPAs in the state whether members of the Pennsylvania Institute or not; and for limitation on the use of the word "certified."

This political action happened to be on a bill the Pennsylvania Institute supported, but I believe that the way in which they went at it is instructive also for societies that face the problem of organizing their defences against unfavorable legislation.

The Pennsylvania Institute members had, over a period of years, developed cordial relations with their own state legislators at the most propitious time —when they did *not* want anything from them. This cordiality formed a sound basis for action.

When the time to act came, in advocating the amendment of the CPA statute, the chairman of Pennsylvania's legislation committee organized the Institute's support of the new bill through a six-point approach.

First, he wrote to the chairmen of chapter legislation committees giving them advance notice of the state-wide campaign.

Second, to get the campaign underway, he wrote to the entire membership on the day the bill was introduced in the Pennsylvania senate. His letter contained not only a copy of the bill itself, but also a summary of its principal features, the names of the senators acting as co-sponsors, and a list of the members of the senate committee on education—to which the bill was referred—with their addresses, political parties, and counties. He asked that society members and friends contact personally, if possible, or else write to members of the senate education committee urging a favorable report on the bill. He also asked the members and friends to communicate with the senators

and representatives from their districts to request passage of the bill when it had been reported from the committee.

Third, less than a month later, when the education committee had reported the bill favorably, the legislation committee chairman again wrote each society member pointing up the importance of their urging the senators to cast a favorable vote for the bill.

Fourth, one week after that, when the danger of crippling amendments to the bill were imminent, the members were again informed and asked to telephone or write senators at the state capital immediately. The bill was passed by the Senate a few days later, substantially as it was introduced.

Fifth, with the adjournment of the legislative session drawing near, members of the Pennsylvania Institute were once again requested to act—this time to encourage representatives and members of the House committee on professional licensure to see that the bill was enacted.

Finally, when the bill was passed on July 24, 1953, the chairman of the society's committee on legislation wrote a last letter asking members to write to both their senators and representatives at their home addresses acknowledging the consideration and support they had given to the accounting profession during the session.

My last case-study topic is the distribution of a publication. The distribution I am thinking of took place in Illinois during the past year, and the publication distributed happened to be a natural-business-year folder—though the principle involved would no doubt be applicable wherever the intention is to bring a message to special audiences.

This is the way the problem was tackled in Illinois. After the pamphlet *Why Fumble for Time and Money?* had been prepared by the natural-business-year committee with the advice of local bankers, the committee decided to exploit it through four channels: business and banking publications; society members; the Illinois Bankers Association, Robert Morris Associates, and the American Bankers Association; and trade associations.

Copies were enclosed with a letter to the editors of 42 national magazines. *Burroughs Clearing House, Banking, American Business,* and other publications—with a combined circulation of well over 200,000—carried articles on the folder, inviting readers to write the society for free copies. It was also sent to society members, with an order form for individual distribution to clients, and to members of the Chicago Chapter of the Robert Morris Associates, who agreed to mail copies to depositors with monthly statements.

The *Illinois Banker,* official publication of the Illinois Bankers Association, printed the pamphlet in full. The American Bankers Association distributed it at a three-day conference in Chicago.

Why Fumble for Time and Money? was sent with a covering letter to 100 trade associations. The letter offered free copies of the pamphlet for distribution to members and a speaker to talk on the natural business year. It brought requests for both. In six months over 10,000 copies of the folder were distributed. Excluding mailing expense and staff time, they cost only about $80.

A photograph of some of the magazines that carried notices of the pamphlet or reprinted it in full is included, along with the pamplet itself, letters, and lists of magazines and trade associations, in the case-study package prepared by the Institute under the title *Large Distribution of a Small Pamphlet.*

This ends my review of six projects carried out by state societies during the last few years. While there were many others equally successful—far too many to discuss in the time available—I hope that these will be sufficient to emphasize the extent of state society activities and to highlight the ingenuity and sound planning with which some of them have been approached.

Significance of events occurring subsequent to the balance-sheet date

RALPH S. JOHNS

Partner, Haskins & Sells, Chicago. Member, Institute's Council.

The significance of events occurring subsequent to the balance-sheet date is a matter that has confronted the accounting profession for many years, but accounting thought in this area has to date not become as clarified as in other areas. This is evidenced by the fact that the subject has had the consideration of the American Institute of Accountants' committee on auditing procedure for several years without a pronouncement relating thereto being issued. Nevertheless, the interest of accountants in the significance of post-balance-sheet events has increased of late, as evidenced by the number of articles written on the subject and by the number of such events disclosed in published reports. It is believed that two of the factors that have contributed toward this situation are: (*1*) Shift in emphasis with respect to the income statement from the historical concept to the earning-power concept; and (*2*) increased attention to those provisions of the Securities Act of 1933 relating to the fact that financial statements included in a registration statement constitute a representation as of the effective date.

Events subsequent to the balance-sheet date may be classified as to whether or not they are of accounting significance, although the line of demarcation is not always clear. On the theory that the accountant need not be concerned with events occurring in the post-balance-sheet period that would not concern him if they occurred during the period under examination, we are not concerned herewith with events of nonaccounting significance, as the necessity for the disclosure thereof would be a matter for management to determine. Subsequent events of accounting significance may be further classified as between those requiring adjustment of the financial statements being reported upon and those that do not. Ordinarily the latter would be taken care of by the inclusion of a suitable footnote. It is assumed for purposes of the present discussion that we are considering subsequent events of a material nature (again a matter not always easy

to determine), as obviously we would neither adjust the financial statements nor include an additional footnote with respect to an immaterial item.

It seems to me that, for purposes of discussing the subject of subsequent events, the auditing services performed by accountants in public practice in their examinations of financial statements may be broadly classified into three general groups:

(*1*) Reports involving neither the Securities Act of 1933 nor the Securities Exchange Act of 1934.

(*2*) Reports involving the Securities Act of 1933.

(*3*) Reports involving the Securities Exchange Act of 1934.

There are varying conditions within each of the foregoing groups that will be discussed hereinafter. Also, the same client may issue reports covering the same period involving two or more of the above classifications.

REPORTS NOT INVOLVING FEDERAL SECURITIES ACTS

Consideration will now be given to a discussion of procedures the auditor would employ with respect to transactions recorded or events occurring after the balance-sheet date.

"Cut-off" procedures

Let us first consider a small corporation that closes its books as of December 31 and insists that the accountant take up the final work on the audit promptly with the closing of the books around January 10 and only one report is rendered, usually designated a long-form report, about January 27. As part of his auditing procedures the accountant will make some examination of the transactions recorded in January in order to satisfy himself that the December 31 balances are fairly stated. The bank statement for the month of January will not have been returned by the bank by the time his examination is concluded and he therefore will arrange with the client and the bank for an interim bank statement in order that he may have an opportunity to inspect checks returned by the bank in January that appear as outstanding in the December 31 bank reconcilement. He will also examine the shipping and receiving records for the first few days of January in order to establish a "clean cut-off" with respect to sales, accounts receivable, inventories, and accounts payable. He will also want to examine credit memorandums issued subsequent to the balance-sheet date (and receiving records where necessary) for relatively large items that should have been taken up as of December 31. He will also want to examine vouchers recorded in January for the purpose of discovering liabilities that should have been taken up as of the balance-sheet date. The foregoing steps (which should be regarded as illustrative and not all-inclusive) constitute what may be called "cut-off" procedures and will be so designated hereinafter. (The term cut-off procedures would apply also to certain audit procedures applied to transactions occurring immediately prior to the balance-sheet date, but we are concerned herein only with transactions occurring after the balance-sheet date.) Such procedures are in my opinion a

part of generally accepted auditing standards, and are, I believe, not only covered adequately in textbooks on auditing, but followed generally in practice without too great differences of opinion as to what should or should not be done.

As a second illustration, let us assume a client permits his accountant to conduct his examination at a time convenient to the accountant. Physical inventories are taken as of December 31 (or possibly November 30), and requests for confirmation of receivables are made as of the same date. Cash is counted and reconciled as of December 31. Final work is commenced after March 15. In this instance the cut-off procedures described above would be performed in like manner. Perhaps certain columns of the cash receipts and disbursements book would be footed for the month of January. If all of the checks shown to be outstanding at December 31 were returned in January, no reference to the February bank statement or checks returned therewith would be necessary. If, however, all of the checks outstanding at December 31 had not been returned with the January bank statement, the accountant probably would look at the checks returned with the February bank statement. As to his examination of vouchers, if his experience with this client indicated that the client was extremely careful in recording liabilities as of December 31 and he found no exceptions in his review of the January vouchers, it is unlikely that he would devote much time to an examination of the February vouchers. If, however, his experience with the client was that it was lax in recording liabilities as of the balance-sheet date, and his review of the January vouchers contributed further toward this conclusion, he very probably would examine vouchers in February, at least of the more substantial amounts. There ordinarily would be no need to examine shipping or receiving records for February, and the auditor's review of the credit memorandums issued in February would depend on the policy of the company with respect thereto and previous experience in this regard (his ascertainment of the total credit memorandums issued for the month of February might indicate to him that it would be unnecessary for him to examine any of the details).

In a still different situation, let us assume that our accountant obtained a new client after March 15 whose books were kept on the calendar-year basis. In this instance there has been no opportunity for the accountant to observe the taking of the year-end physical inventories, nor to count cash, nor to confirm accounts receivable as of December 31. Arrangements must therefore be made by the accountant to do this work as of a later date—let us say, March 31. This latter date therefore becomes the "verification" date for the application of our cut-off procedures with respect to cash, accounts receivable, inventories, investment securities, and the like. Under these circumstances it becomes therefore necessary for the accountant to work back from March 31 to December 31 in order to satisfy himself that the amounts as shown in the client's records as of December 31 are fairly stated. It follows that the accountant will necessarily have to apply comparable audit procedures to the period from December 31 to March 31

with respect to cash and other transactions as is done with respect to transactions recorded during the year under audit. Despite the similarity of the audit procedures applied, the steps taken with respect to transactions recorded subsequent to December 31 nevertheless constitute part of the cut-off procedures.

Let us consider now the situation where a commentary or detailed report is issued thirty days subsequent to a condensed report. For purposes of discussion, let us assume the detailed report is rendered March 31 and the condensed report is dated February 28. Theoretically, it would be better if accountants could render their detailed reports simultaneously with the condensed report, but this is rarely practicable. To overcome this situation, some accountants date their detailed report the same date as the condensed report even though rendered thirty days later. What is the responsibility, if any, of the accountant for events occurring during the month of March? His "cut-off" date with respect to accounts receivable confirmations may be March 20 and, if this date is mentioned in his comments, precludes using February 28 as the date of his commentary report. One solution is to date the certificate, if incorporated in the commentary report, the same date as the date of the certificate included in the condensed report and date the commentary report itself as of a current date (March 31). In this way, it does not give the appearance of the client withholding the distribution of his accountants' report in instances where the report is distributed to banks or other creditors. Occasionally, a report is dated "March 31 as of February 28." The effectiveness of this procedure in protecting the accountant has not been determined, although it is difficult to see how such dating could be less favorable to the accountant than the use of a current date without qualification.

In my opinion, the accountant need not make any systematic examination of the transactions recorded during the month of March under the foregoing circumstances. There may be exceptions with respect to accounts receivable confirmations that he will want to dispose of by reference to the records. He may include information in his comments concerning collections on accounts receivable received subsequent to the balance-sheet date, and his cut-off date for this purpose may be March 20. In this situation he should make it clear that such information is "as shown by the books," so that the reader will not be led to believe that such information had been audited. It seems to me that the accountant need examine the transactions in the month of March only in the event information comes to him from other sources that leads him to want to investigate the recording thereof in the books (a note for a substantial amount may be due March 15 from a debtor of doubtful standing as to which the accountant will wish to be informed as to the disposition made thereof).

I believe that the cut-off procedures that are followed by independent public accountants may generally be distinguished from the accountant's investigation of subsequent events other than those involved in the cut-off procedure.

Investigative procedures

What are these other sources through which the accountant may obtain information in connection with his investigation of subsequent events? It is generally regarded that a reading of the minutes will be helpful, and with this view I am in complete agreement. In the case of a listed corporation issuing published reports to stockholders, the minutes are more than likely kept by a specialist and are reasonably complete. In such instances the accountant should examine the minutes up to the latest practicable date prior to the release of his certificate to be included in the published report. In reading minutes the auditor should give attention not only to meetings of stockholders and directors, but also to meetings of the executive committee or any other committee having authority over matters affecting the accounts and financial statements. Also, he should assure himself that the minutes of all meetings are made available to him (in unusual circumstances he may wish to obtain such assurance in writing). If the minutes have not been written up to date, such steps should be taken as may be appropriate in the circumstances to obtain information concerning the meetings in question.

There are many instances in the case of smaller corporations, however, where the minutes are not as complete as they might be, and the accountant's interest in the minutes is just as likely to involve seeing that the board of directors has approved some transaction that has already been consummated (it is amazing how many transactions are approved by directors after the event, including even the payment of dividends) as to disclose subsequent events of a material nature. In the case of listed corporations, monthly meetings of the board of directors are usually held; whereas, in the case of many small unlisted corporations, meetings are less frequent. If the accountant is reading the minutes in the month of March, he should read the minutes for any meetings held subsequent to December 31 as may be included in the minute book, as well as those for the meetings held during the year under audit. I see no reason for his making a point of reading the minutes for the period between the date of the condensed report and the date of the detailed or commentary report, however, unless something comes to his attention that makes him want to specifically ascertain information on a particular matter.

A most fruitful source of information with respect to subsequent events is inquiry of and discussion with officials of the client. This is usually done at the time the accountant reviews his report with the client. This is also a good date for the accountant to use in the dating of his certificate, which will usually mark the conclusion of his field work. In the case of published reports to stockholders, it is also a good policy for the accountant to read the drafts or proofs of the president's letter.

A third source of information available to the accountant in his investigation of events occurring subsequent to the balance-sheet date is the reading of interim financial statements prepared by the client. In looking at such

statements, which should be done with a critical eye, the auditor should compare them generally with similar statements for the preceding period or periods, and possibly discussing them with an appropriate individual in the client's organization. The auditor should endeavor to assure himself that the latest internal financial statements are made available to him. In my opinion, it is not necessary to apply usual auditing procedures to such financial statements and, particularly, the auditor need not check such financial statements to the books as has been suggested by one writer.[2]

REPORTS INVOLVING THE SECURITIES ACT OF 1933

Ordinarily, financial statements purport to speak only as of their date or period, and not as of any later time (even the date of issuance); and this is so even though neither the management nor the auditor can be oblivious to any event occurring up to the date of issuance that has had a material effect upon some item or items of the statements. This is not the case, however, with respect to financial statements contained in a registration statement filed with the Securities and Exchange Commission under the Securities Act of 1933. In accordance with the provisions of that Act such financial statements purport to speak as of the effective date of the registration statement. This legislative provision places a unique responsibility upon accountants; namely, the investigation of events occurring between the date of the accountant's certificate and the effective date of the registration statement. Accountants have not been in agreement as to how best to meet this responsibility, and the legislative provision has never been conclusively interpreted by either the Securities and Exchange Commission or the courts. There is nothing that parallels this situation in an accountant's practice.

Mention has been made of the fact that the accountant would ordinarily obtain a statement from the management relating to events occurring between the date of the balance sheet and the date of the accountant's certificate (supplementing his reading of corporate minutes to a late date, reading of unaudited interim financial statements, and inquiries of responsible officials) in order to assure the auditor that nothing has happened during this interval that should be disclosed in the financial statements in order that they will not be misleading. A similar statement should be obtained from the management covering the period from the date of the accountant's certificate to the effective date. The reading of the minutes, reading of interim unaudited financial statements, and inquiry of responsible officials should also be brought down to a current date. If an amendment to the registration statement is filed and the accountant is called upon to sign a new certificate or new consent, it is a good policy for the accountant to adopt a similar procedure (obtaining statement from management, inquiry, etc.) in each such instance.

It follows from the foregoing that I believe a reasonable investigation on the part of the accountant covering events occurring between the date of his certificate and the effective date to meet the requirements of the Secur-

ities Act of 1933 that the financial statements are not misleading in any material respect consists of: (*1*) reading minutes; (*2*) reading unaudited financial statements covering period subsequent to certified financial statements; and (*3*) inquiry of responsible officials; such inquiry ordinarily to be supplemented by a written statement from the management to the accountant.

If the financial statements included in the registration statement had previously been covered by the accountant's certificate as of an earlier date, as, for example, in a published report to stockholders, I believe the foregoing steps performed by the accountant would constitute a reasonable investigation covering the period from the date of the earlier certificate to the date of filing the registration statement.

One of the points as to which accountants differ is whether or not a reasonable investigation on the part of the accountant covering the periods referred to above should include reference to the books of account. Some authoritative writers advocate such procedure. I do not believe it to be essential. I would object to any requirement that the accountant should systematically inspect, review, or scan the books of account for the periods herein under consideration. In my opinion, reference to the books of account should be considered as a part of the accountant's investigative procedures only in the event that information comes to the accountant's attention by other means which would cause him to want to look at the books.

Until the differences of opinion implied in the foregoing discussion are resolved (by a pronouncement of the Institute's committee on auditing procedure, for example), the accounting profession will have to be judged by what is done by accountants generally in actual practice.

REPORTS INVOLVING THE SECURITIES EXCHANGE ACT OF 1934

The most common form of report filed with the Securities and Exchange Commission under the provisions of the Securities Exchange Act of 1934 is the annual report (Form 10-K) filed by corporations whose securities are listed on securities exchanges, and it is with these reports that we are herein primarily concerned. Again it would be desirable if the independent public accountant would render his opinion with respect to his examination of the financial statements included in Form 10-K concurrently with his certificate included in the published report to stockholders, but this is seldom possible in actual practice. The question is therefore: To what extent is the accountant concerned with events that may have occurred during the interim?

First let me say that in my opinion financial statements included in Form 10-K purport to speak as of their date or period, and not as of any later time, for there is nothing in the Securities Exchange Act of 1934 that parallels the unique provisions of the Securities Act of 1933 making financial statements included in registration statements purport to speak as of the "effective date" of the registration statement. Secondly, I don't believe the independent public accountant need be concerned(although manage-

ment may be) with events occurring after he has rendered his opinion on the financial statements included in Form 10-K, but before his client has filed the report (Form 10-K) with the Securities and Exchange Commission.

As to events occurring subsequent to the date of the accountant's certificate included in the published report and the date he signs his certificate covering the financial statements included in Form 10-K, it is my opinion that the accountant need take no positive steps—not even those heretofore described as investigative procedures—to inform himself with respect to such events, provided, as mentioned hereinafter, he uses the same date on both certificates. I do believe, however, that the accountant should give consideration to events of a material nature occurring during this period of which he may learn, regardless of the manner such information may come to his attention.

The foregoing view is consistent with the philosophy generally held that the 120 days specified in the Securities Exchange Act of 1934 as the period within which Form 10-K shall be filed is in the nature of a time allowance for the mechanical completion of the report, and should not be regarded as a period to be subjected to normal auditing procedures. To my knowledge the Securities and Exchange Commission has not issued any rulings on this point, but it seems reasonable to presume that the Securities and Exchange Commission regards Form 8-K (required to be filed by the tenth day of the following month with respect to certain types of transactions) as the means by which it, and hence the public, is kept informed as to events of a significant nature.

As to the dating of the accountant's certificate included in Form 10-K, I have made a comparison of a number of Forms 10-K with the related published reports to stockholders as to the dates of the accountants' certificates. Of 137 instances, the vast majority, 109, indicated that the accountants involved followed the practice, which I believe to be a desirable one, of dating the certificate included in Form 10-K the same date as the certificate included in the published report to stockholders. In 20 instances a later date was used and in 8 instances an "as of" dating was used. Obviously if a later date is used in the Form 10-K certificate, the accountant should, for his own protection, bring his investigative procedures down to such later date.

As a matter of collateral interest, I wrote to the accounting firms involved in the 20 cases where a later date was used for their Form 10-K certificate inquiring whether or not a "subsequent event" had occurred making such later date advisable. Of the replies received to date it appears that in only one instance was there a specific reason for adopting the later date.

SIGNING ADDITIONAL COPIES OF REPORTS

Occasionally a client will ask his accountant to send him additional copies of reports previously rendered. The question arises as to whether the accountant need concern himself as to events that may have occurred between the date of the certificate included in the report in question and the date he is

asked to sign the additional copies. One writer has stated that "in such cases I see no more reason for requiring a subsequent investigation than I would for asking my client each day, or year, what he was doing with the copies he already had." [9] In view of the fact that furnishing additional copies is primarily a typing or other duplicating process, I see no reason for taking exception to this point of view. However, when such a request is made by a client I would be inclined to inquire as to whether or not anything unusual was under consideration; not necessarily as a condition precedent to the issuance of the addition copies of the report, but as evidence of my interest in the affairs of the client and the possibility that there might be a merger or other transaction pending which would require additional professional accounting services.

Sometimes the request is in the nature of signing manually additional copies of a series of annual published reports to stockholders, perhaps for credit purposes. If the concern making the request is still a client, in all probability the accountant will be sufficiently familiar with his client's affairs to be in a position to evaluate the significance of signing such reports. If the concern is no longer a client, the situation takes on a somewhat different aspect. I am not saying that in the latter instance any auditing procedures are required in the circumstances beyond inquiry as to the purpose for which the reports are intended to be used, but I do believe that the accountant should at least *think* about the implications of signing additional copies of reports, as the signing of any report by an accountant involves some measure of responsibility and therefore should not be done in a purely perfunctory manner.

If additional copies of a report previously issued are rendered to a client, it is presumed in the foregoing discussion that they are in every sense copies, that is, that there have been no changes incorporated in the reports and that the certificate date remains the same. If for any reason the report is changed in any respect, including the date of the certificate, the report is in effect a new report rather than a copy of one previously rendered, and the situation should be viewed anew accordingly. As indicated hereinbefore, reports are occasionally dated "October 23, 1953 as of March 15, 1951"; but the practical significance of this procedure, that is, the extent to which the accountant is protected in such instances, has not been determined.

If an accountant is requested to certify to financial statements included in a registration statement of a concern that is no longer a client, it is a good policy for the accountant to include an assertion in his certificate to the effect that he has not examined the accounts for any subsequent period.

SUBSIDIARIES

The extent to which investigative procedures should be applied to the affairs of subsidiary companies (or branches) will vary with the circumstances in individual cases. In part it will depend upon the nature of the client's organization—whether highly centralized or decentralized. To the

extent that a particular engagement involves an examination of the accounts of subsidiaries for a recent period, the auditor will have had an opportunity to be informed as of a late date. Ordinarily there will be less need to apply investigative procedures to subsidiaries that are not included in the consolidation than to those which are (the latter are covered by the accountant's certificate). Likewise, and possibly for the same reason, there is less reason to investigate the affairs of foreign subsidiaries than those of domestic subsidiaries. It should rarely be necessary for the auditor to visit the offices of the subsidiaries for the purpose of investigating events occurring between the filing date of a registration statement and the effective date. The auditor should make clear to officials of the registrant, however, that his inquiries apply to the subsidiaries as well as to the parent corporation.

DISCLOSURE OF "SUBSEQUENT EVENTS" IN REPORTS

There appears to be more general agreement among accountants with respect to the disclosure of events occurring subsequent to the balance-sheet date of which the accountant has knowledge than as to the investigative procedures required of the accountant to ascertain whether or not any subsequent events of significance have occurred. It is generally agreed that no matter how the accountant obtains his information concerning subsequent events of a material nature, whether through extensive investigation on his part, limited investigation, inquiry, or happenstance, he should evaluate the significance thereof. We should not lose sight of the fact, however, that the primary responsibility with respect to disclosure rests with management. Failure on the part of management to adjust the financial statements for a material subsequent event of an accounting nature, or to add or revise a footnote as the requirements of the situation may call for, puts the accountant in the position of deciding to what extent his opinion may thereby be affected. Fortunately, qualified opinions resulting from situations of this kind are few, as normally the accountant and his client would agree on a satisfactory report treatment for the subsequent event as would be the case with events occurring during the period under examination. Subsequent events falling within the nonaccounting category would normally be covered, in the case of published reports to stockholders, in the president's letter. While ordinarily such items do not concern the accountant, as they generally need not be covered in the financial statements or the related notes, it should be observed that in a registration statement under the Securities Act of 1933 they might, in some circumstances, require mention or reference in the summary of earnings or the notes thereto. While it is not a good policy to clutter up the financial statements with nonessential data, in case of doubt as to the materiality of an item or whether or not it is of accounting significance, it is better to resolve the doubt in favor of disclosure.

Standards of disclosure of subsequent events have not as yet been formulated by the profession; *i.e.*, what types of events require disclosure. When such

standards are established, whether or not they will apply uniformly to registration statements and annual reports remains to be seen. Perhaps so, but I doubt it. I can visualize a subsequent event that may warrant disclosure in the summary of earnings section of a registration statement, but would not require disclosure in an annual report.

LETTERS TO THE REGISTRANT OR THE UNDERWRITERS

Registration statements may or may not include interim financial statements (and schedules), and such interim financial statements may or may not be certified, depending upon the circumstances. If they are certified, the auditor has, of course, the opportunity of keeping informed as to the affairs of his client up to a comparatively recent date. If they are not certified, the auditor may be requested to furnish the registrant or the underwriters a letter to the effect that he has not made an examination of the financial statements of the company for that period, but that he has applied limited procedures and has made pertinent inquiries of responsible officers of the company to the end that such limited procedures and inquiries disclosed no information that would require modification of the uncertified financial statements and schedules. Obviously, in order to furnish such a letter, the auditor will have to take such steps as may to him be appropriate to support his conclusions. Occasionally a client will request the independent public accountant to undertake certain audit procedures with respect to the unaudited interim financial statements as a protection to management—more than would be required to furnish the aforementioned letter, but still short of a general audit. He would obviously respond to any such specific request.

If the registration does not include interim financial statements, whether certified or not, the independent public accountant may be requested to furnish the registrant or the underwriters a letter relating to material changes in the financial condition of the registrant during a period subsequent to the date of the certified balance sheet. In such a letter the accountant will point out that he has not examined the accounts of the company subsequent to the date of the certified balance sheet, but that he has applied limited procedures thereto for the period from the date of the certified balance sheet to a subsequent specified date and has made pertinent inquiries of responsible officers of the company to the end that such limited procedures and inquiries indicate that there were no material changes in the condition of the company during that period, other than those which occurred in the ordinary course of business. If a request to furnish such a letter is made of the independent public accountant, he will have to take such steps as to him may be appropriate to support his conclusions.

Independent public accountants are occasionally requested to furnish letters to the registrant or to the underwriters on other matters, such as relating to compliance (in all material respects) with the pertinent requirements of the Securities Act of 1933 and of the instructions, rules, and regulations of the Securities and Exchange Commission and relating to the ac-

countant's independence; the latter letter, of course, would not involve any examination of the registrant's accounts, although it does involve generally accepted auditing standards.

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Events occurring subsequent to the balance-sheet date

ALAN P. L. PREST

Partner, Price Waterhouse & Co., New York. Has served on Institute's publication committee.

It is generally agreed that the primary responsibility for adequate disclosure of important events occurring subsequent to the balance-sheet date rests with the officials of the company, since such events have a bearing on the financial statements that represent management's progress report. The independent accountant is called upon to express his opinion on the representations made by management. Thus, if the disclosures are not reasonably adequate, the inadequacy is first chargeable to the company's officials, whether the transaction or event occurred before or after the date of the financial statements. If the independent accountant decides that the disclosures are inadequate, he must make the disclosures he believes to be necessary in his own opinion on the financial statements. If, however, no additional disclosures are incorporated in his opinion, he has signified his approval of management's disclosures.

Before embarking on a study of some specific cases of events occurring subsequent to the balance-sheet date, it would be logical to review any pronouncements by an authoritative body that might help to clarify the independent accountant's responsibility for their discovery and disclosure. If such a pronouncement were available it would provide a reasonable starting point for determining what procedures should follow.

The independent accountant should be aware of the statement contained in Section 11 of the Securities Act of 1933, which defines the basis of a defense of persons other than issuers who are charged with civil liability for false registration statements. It states in effect that no person other than the issuer shall be liable who shall sustain the burden of proof that he had no reasonable ground to believe, and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein, or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert.

The act also states that, in determining what constitutes reasonable investigation and reasonable grounds for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property. This is hardly the type of statement that would prove helpful in defining the independent accountant's responsibility with respect to subsequent events.

The courts likewise offer very little help on this point. Mr. Louis N. Rappaport, in an article appearing in the March, 1953, JOURNAL OF ACCOUNTANCY, dealt very adequately with what is apparently the only reported civil suit instituted under Section 11 in which a court has been called upon to consider an independent accountant's responsibility for the disclosure of events occurring after the date of the financial statements. This case, known as the *Shonts* case, was decided about fourteen years ago by the District Court for the Southern District of California. For this discussion it is sufficient to mention that the court held in favor of the independent accountant as the event in question occurred twelve days after the date of his opinion. The event occurred on January 31, 1937, and it is not clear whether the effective date of the registration, which was stated to be February 3, 1937, as of January 19, 1937, had any bearing on the decision. Suffice it to say that this case does not establish a good precedent on which to base a conclusion that the independent accountant's responsibility ceases as of the date of his opinion.

The subsequent events, which form the basis of the following comments, were drawn from what appears to be the most prolific and, at the same time, public source of specific cases. They were found primarily in registration statements filed during the first half of 1953 under the Securities Act of 1933. This source was utilized because it generally permits the maximum interval of time for the development of the event; namely, the interval between the date of the financial statements and the effective date of the registration statement.

Almost half of the registration statements selected for review disclosed subsequent events. Notations were made of a total of 187 events contained in 84 registration statements that were covered by the opinions of 24 different firms of independent accountants.

The results of this study will be considered from the following standpoints:

(*1*) What types of subsequent events were encountered?

(*2*) Where in the registration statement were the events most frequently disclosed?

(*3*) Did the subsequent event have any effect on the date of the independent accountant's opinion?

(*4*) How long after the date of the financial statements did the independent accountant's responsibility extend?

(*5*) Through what procedures were most of the subsequent events brought to the independent accountant's attention?

(*6*) What procedures are currently being followed by the independent accountant to ascertain the existence of subsequent events for an S-1 filing?

To obtain an indication of the profession's experience and current practice with respect to the last two points, brief questionnaires were mailed to each of the 24 firms of independent accountants whose opinions were contained in a registration statement disclosing a subsequent event. The larger firms, of course, received several of these questionnaires, and it may be interesting to note that, in total, approximately 75 per cent of the questionnaires were returned.

What types of subsequent events were encountered?

A study of the subsequent events disclosed that they fell into three distinct categories: (*1*) those which could be measured in dollars and have been given recognition in adjustments of the financial statements; (*2*) those which could be evaluated in dollars but are to be accounted for in the future; and (*3*) those which could not currently be so measured.

Events of the first category included tax refunds and retroactive rate increases or decreases. Very few examples of this type of event would come to light in this type of review, unless the adjustment in the financial statements was described in the notes to the financial statements.

Upon analysis, the 187 events were found to fall into the following categories:

Description of event	*Number of times event was reported*
Expansion or contraction of short-term borrowings; transactions or proposals involving additional financing; changes in capital structure, and resulting effect on surplus restrictions	76
New tariff or rate effective subsequently or retroactively; release of impounded revenue; increases in costs of public utility companies	23
Dividends declared or paid; stock dividends or splits	18
Acquisition or proposed acquisition of assets or stock of another corporation	12
Securities called for redemption; redeemed, purchased, retired, cancelled, or exchanged	10
Agreements for construction or acquisition of additional plant facilities	6
Amendment of loan agreement or trust indenture, and effect on surplus restrictions	5
Payment of income tax or receipt of refund, or agreement with Bureau	4
Establishment or amendment of pension plan	4
Entry into lease agreement or sale and lease back agreement	4
Changes in depreciation policy or completion of depreciation study	4
Reduction of work hours, strike, wage dispute, wage increase and effect thereof	4
Description of or transactions relating to stock-option plans	4
Miscellaneous	13

The miscellaneous caption includes (*1*) comments on interim earnings between dates of balance-sheet and opinion; (*2*) status of litigation or receipt of amount of judgment; (*3*) comment on subsequent collection of profits earned in countries where exchange restrictions exist; (*4*) write-down of properties occasioned by revision of geologists' estimate of crude-oil reserves; and (*5*) description of transactions that produced a deficiency in working capital at the effective date.

As may be noted, the list includes many events that could materially change the significance of the audited financial statements from a "prospective" point of view, such as those involving increased wages and material costs, rate adjustments in the case of utilities; and increases or decreases in dividend restrictions resulting from additional borrowings or reduction in debt.

Where in the registration statement were the events most frequently disclosed?

By all odds, the most common place was in the notes to the financial statements, sometimes in the form of a reference to the forepart of the prospectus, such as the section dealing with pending litigation.

The disclosures were generally found to be interspersed among or even made a part of other notes. As I shall point out later, I believe that, in most cases, the statements would be more meaningful if the notes dealing with the subsequent events were clearly segregated from the other notes, with appropriate cross reference where necessary.

The notes to the summaries of earnings were found to refer to events affecting past and future earnings, capitalization changes, future bond interest, and preferred-dividend requirements.

In only one of the registration statements was a subsequent event mentioned in an opinion and, in that case, it was introduced by amendment to supplement an explanation contained in the opinion originally filed.

Where the subsequent events involve a substantial merger, a reorganziation, recapitalization, or other very material adjustment, it is quite common to furnish, in addition to the regular financial statements, such pro forma statements as will adequately show the effect of the transactions described. This technique was recently used in the proxy statement of a movie company that, under a consent decree, was about to separate its picture making and exhibiting functions into two separate and distinct corporate entities. In this situation, the financial statements were supplemented by pro forma balance-sheets of the new theatre company and the new picture company, and related pro forma profit and loss statements for three years. In addition, a statement was submitted showing the balance-sheet of the old company before the reorganization, the effect of the reorganization and separation, and the resultant pro forma balance-sheet of the old company. A note to this statement disclosed that the adjustments made in accordance with the plan of reorganization and segregation of assets and liabilities gave effect to the proposed formation of the two new companies and the proposed transfer of assets and liabilities to those companies, all of which was to take effect after the date of the balance-sheet. The note went on to state that the opinion of independent public accountants obviously does not cover such proposed transactions.

An interesting illustration of the disclosure of a subsequent event in the opinion of the independent accountant was noted in the last annual report of an automobile manufacturer. A paragraph in the opinion stated that as a part of the company's program for the continuance and expansion of its automotive and other operations a wholly owned subsidiary had entered into an agreement to purchase the inventories, plant and equipment, and certain other

assets of another motor company and that arrangements had been made for substantial additional financing and for certain changes in the debt and capital structure of the company and its subsidiaries. It further stated that the transactions had been approved by the stockholders of the selling company and that further details of these contemplated changes were contained in a note to the financial statements. The note covered more than two pages of the printed report, and the effect of the transactions was reflected in two pro forma balance-sheets that accompanied the reports; one for the consolidated companies and one for the wholly owned subsidiary that had entered into the described agreement.

Did the subsequent event have any effect on the date of the independent accountant's opinion?

In many instances, it was not practicable to compare the date of the opinion in the published accounts of the company. However, a study of twenty-five registration statements reveals that, in general, four different approaches were used in the selection of the date of the opinion:

(*1*) In the ten instances the opinion in the registration statement was dated after that of the published accounts and coincided with or was subsequent to the date of the subsequent event.

(*2*) In seven instances the opinion was dated after the occurrence of the events mentioned in the notes but "as of" the date of the opinion that appeared in the published accounts of the company.

(*3*) In six instances the date of the opinion appearing in the published accounts of the company was retained even though events occurring subsequent to the date of the opinion were covered in the notes to the financial statements.

(*4*) In two instances the opinion date of the published accounts was retained, but the subsequent events were clearly segregated from the other notes by a center or side caption indicating that such events occurred subsequent to the completion of the examination by the independent accountant.

Although the last method was used only twice, it seems to me to be by far the most realistic, since it has the dual advantage of leaving intact the notes originally covered by the independent accountant's opinion and of clearly segregating for the reader the events that have occurred subsequent to the completion of his examination. The segregation of the subsequent events gives them a connotation different from the other notes, which I believe to be desirable.

This method is illustrated in the case of a company that filed two registrations within a period of about six months. The last note in the first filing stated that the long-term debt presently being negotiated by the company would impose certain restrictions in the availability, for the declaration of cash dividends, of the earnings retained in the business.

The second registration included unaudited financial statements for an interim period and three notes appearing under a center caption "Events Subsequent to Completion of Examination by Independent Public Accountants." The first of such notes disclosed the consummation of a ten-

year loan agreement, described the basis of restriction on the earnings retained in the business, and showed the amount of the restricted surplus at the date of the interim statements.

One additional case was noted in which the independent accountant dated his opinion "November 14, 1952 (except as to Note L of 'Notes to Financial Statements' as to which the date is January 31, 1953)."

How long after the date of the financial statements does the independent accountant's responsibility extend?

The possible effect of a subsequent event on the date of the independent accountant's opinion logically leads us to a consideration of the period for which his responsibility may last. Under certain conditions, there may be as many as four different periods. The first period would extend from the date of the financial statements to the date of the opinion in the published report to the stockholders. This date would generally coincide with the completion of the independent accountant's field work. If there is an abnormal delay in furnishing such opinion to the client, the period of the independent accountant's responsibility might be extended.

The second period would extend from the date of the financial statements to the date of the opinion in the appropriate annual report (usually Form 10-K) filed with the Securities and Exchange Commission. In this case, the opinion date is generally the same as the one used in the report to stockholders; and, again, if there is an abnormal delay in forwarding such report to the client or to client's counsel, the period of the accountant's responsibility might be extended. Obviously, the independent accountant's responsibility should not be extended by any undue delay on the part of his client in issuing the report to stockholders or in filing the appropriate report with the SEC.

The third and fourth periods, which are interrelated, would arise if the same company filed a registration statement under the Securities Act of 1933. The third period would extend to the filing date of the registration statement, and the fourth period to the effective date, generally not more than twenty days after the filing date.

Section 2 of the 1933 act states in effect that in case any part of the registration statement, when such part becomes effective, contined an untrue statement of a material fact or omitted to state a material fact required to be stated therein, or necessary to make the statements therein not misleading, any person acquiring such security may sue the independent accountant who has, with his consent, been named as having certified any part of the registration statement.

I believe it is frequently quite impracticable for the independent accountant to continue to apply any procedures up to the exact time the registration statement becomes effective. When the effective date is accelerated or unduly delayed, the independent accountant may receive no warning from the client or the client's counsel of its approach. Furthermore, it is obviously impracticable to hold senior staff members in readiness to complete the last minute procedures at the numerous important locations of a highly decentralized company.

It is my view that the independent accountant must recognize responsibility for the application of his opinion to the financial statements, in the form in which such statements actually become effective, but that the period of responsibility should be limited by a date known to and under reasonable control of the independent accountant. As a practical solution, although one that still has certain drawbacks, I would suggest that the period of responsibility should terminate on the date that the independent accountant signs his last consent.

The filing of an amendment after the effective date of the registration statement is not common, however. Three instances of "post-effective" amendments were noted in this study, and two of these involved pending lawsuits and had the effect of supplementing the litigation section of the prospectus. Obviously, the independent accountant would not be charged with any responsibility for post-effective amendments of this nature. In the third case, the post-effective amendment consisted of certified year-end financial statements to supplement the unaudited interim statements and the independent accountant was therefore directly involved.

Through what procedures were most of the subsequent events brought to the independent accountant's attention?

Replies were received to the questionnaire in respect to 109 subsequent events, with credit being given to 220 procedures for knowledge of such events. As I anticipated, many of the replies indicated that more than one procedure brought about disclosure of the event. Based on the total number of accredited procedures, it can be said that 75 per cent of the events were brought to light by the following three basic procedures. In 82 instances, they were disclosed by discussions with officials responsible for financial and accounting matters and, incidentally, the replies indicated that quite a wide variety of other company officials were also consulted in this connection. In 57 instances, they were disclosed by reading minutes of meetings of stockholders, boards of directors, or executive committees and, in 27 instances, they were disclosed by reviewing company financial statements subsequent to the balance-sheet date.

The replies indicated that only 12 of the events, or roughly 5 per cent, were disclosed by reviewing the client's books, and most of these events dealt with the expansion or contraction of liabilities or capital structure. In 10 of the 12 cases, the replies indicated that more than one procedure had disclosed the event and, in each of the 10 cases, reviewing the books was coupled with discussion with officials or reading minutes, or both. This might indicate that knowledge of the events was obtained by the latter procedures, and that the books or particular accounts therein were resorted to for substantiation of the details of the event.

What procedures are currently being followed by the independent accountant to ascertain the existence of subsequent events for an S-1 filing?

As previously indicated, the questionnaire included a list of certain procedures that were believed to be generally applicable in ascertaining subsequent events for an S-1 filing. While a few of the independent accountants

failed to reply and some responded in very broad terms, I believe a tabulation of the 59 replies from 16 of the 24 firms of independent accountants will be of interest. The procedures and their indicated utilization by independent accountants are shown below:

Procedure	*Percentage utilization*
(*1*) Reading the minutes of meetings of stockholders, boards of directors, or executive committees	100
(*2*) Discussing matters with:	
(*a*) Officials responsible for financial and accounting matters;	100
(*b*) Other officials of the company	46
(*3*) Reviewing the company's financial statements subsequent to the balance-sheet date	100
(*4*) Obtaining representation letter from company's officials	86
(*5*) Obtaining letters from company's counsel concerning pending litigation, etc.	61
(*6*) Reviewing client's books	54
(*7*) Undertaking other procedures	30

The independent accountants who indicated that they reviewed the client's books were asked to be specific in this respect, and it was noted that, almost without exception, they reviewed the general ledger, the subsidiary ledgers, and the books of original entry.

The obvious lack of consistency in the replies to the question of whether or not the independent accountant should review the books warrants further analysis. The replies from five of the larger accounting firms showed that one firm consistently reviewed the books, one firm consistently did not review the books and, in the case of the remaining three firms, the practice was inconsistent between offices. The replies from the other firms, with two or less registration statements each, were about equally divided on this question.

The inherent dangers of including a review of the books as a basic procedure are many and serious. First, it would immeasurably increase the responsibility of the independent accountant in the area of subsequent events; second, the investors, who are not members of our profession, would not recognize the limited effectiveness of such a review and would not realize that its application in practice varies widely; third, its effectiveness would be dependent upon the prompt and complete posting of the books; and last, but by no means least, it would bring the limited review into the area of an audit made in accordance with generally accepted auditing standards which, in my opinion, is neither essential nor desirable for this purpose.

I question very seriously that any material event that did not come to the independent accountant's attention through a review of minutes, discussions with officials, or a review of subsequent financial statements would be discovered by anything less than a most thorough review of the records after the date of the financial statements. Furthermore, I do not believe that the client should bear the additional expense of such a review. After all, the events with which we are concerned are material events; and in most cases a material event should be dealt with by board action, and in all cases

it should be known to the officials of the company. I conclude therefore that a review of the books should not be undertaken for the purpose of ascertaining the existence of subsequent events, but should only be utilized as a means of substantiating the description or effect of the event.

Some of the independent accountants indicated that they also analyzed or reviewed specific accounts and several indicated that they agreed the subsequent financial statements with the general ledger. Some accountants also indicated that if subsequent financial statements were not available they then reviewed the general ledger and other records.

The other procedures indicated by some of the replies to the questionnaire were more in the nature of procedures dictated by particular engagements. For example, with utility clients, the accountants reviewed depreciation, court orders, and regulatory commission orders. Our main concern, however, is the establishment of basic procedures that may reasonably be expected to be followed by independent accountants in order to develop the existence of subsequent events on any engagement.

Before attempting to draw any conclusions from the questionnaires or express my own views on the best procedures to be followed, let us consider another side of the question. What sort of statement is the independent accountant called upon to make on this phase of an engagement and by whom is it required? If there is no registration statement involved, he is not generally required to make any statement on the subject. On the contrary, the independent accountant secures a representation from the management of, and counsel for, the company to the effect that no events have occurred since the balance-sheet date that would have any material effect on the financial statements at that date. If any such events have occurred they should be set forth in the representation letter.

The situation is somewhat different in the case of a registration statement involving underwriters responsible for the marketing of securities. They normally call for a letter signed by the independent accountant stating in substance that although he has not made an examination of financial statements for any period subsequent to the audited balance-sheet date, he has made a limited review covering such period. It bears reiterating that these limited reviews fall far short of an examination made in accordance with generally accepted auditing standards.

We as independent accountants are, therefore, concerned with the establishment of some general agreement as to the scope of a limited review, so that our responsibility with respect to the post-balance-sheet period will be recognized by the accounting and legal professions, the Securities and Exchange Commission, and the financial community, and will not be misunderstood by the investing public. It must be recognized that the accounting profession can only set minimum standards and, if the individual situation is such that other procedures are indicated, the decision as to the extent and application of the additional procedures rests, as in the scope of a regular audit, with the independent accountant.

I believe it is safe to conclude, and the replies to the questionnaire bear

out, that a limited review should include these basic procedures: (*1*) reading of all minutes of meetings of stockholders, boards of directors, or executive committees; (*2*) reviewing the company's financial statements subsequent to the balance-sheet date; (*3*) discussing matters generally with officials responsible for financial and accounting matters.

As an adjunct to these basic procedures and to have a clear record on the engagement, I believe that the independent accountant should secure the following: (*1*) a representation letter from the company's officials containing appropriate reference to subsequent events, and (*2*) a letter from company's counsel concerning pending litigation. In certain instances, it may also be desirable to obtain a letter from the secretary of the company stating that all minutes have been written up and presented for inspection.

Any or all of these basic procedures may very well indicate that other procedures should be followed, other officers and key officials consulted, or certain accounts or records examined. Very frequently, further procedures are required to determine the actual occurrence of the event, its significance, scope, or ramifications, and the date of its occurrence. Obviously, the repayment of bank loans, additional borrowing, sales of bonds or securities, and similar subsequent events would require procedures of an auditing nature on the part of the independent accountant to ascertain that the company's footnote relative to the event was complete and factual. The necessity for the disclosure of the subsequent event, however, should have become apparent through one or more of the basic procedures.

The additional procedures, which may be of the utmost importance in an individual engagement, are not, in my opinion, basic procedures to be undertaken on every engagement but more in the nature of supplementary steps that should be undertaken by the independent accountant, if in his judgment they are required. The strength, soundness, and standing of the profession has, for a great many years, been based on the judgment of its members rather than on strict adherence to fixed procedures, and I believe, that we should apply the same philosophy in our approach to the problem of subsequent events.

The work of the committee on accounting procedure

CARMAN G. BLOUGH

Director of Research, American Institute of Accountants. Formerly chief accountant of Securities and Exchange Commission.

The committee on accounting procedure was expanded to its present form, and given its present authority to issue statements on accounting principles, at a meeting of the council of the American Institute of Accountants held in September, 1938. At that time the committee on accounting procedure was increased to twenty-one, representative of all sections of the country, of all types of accounting firms, and of teachers of accounting. At the same meeting, the establishment of a research department to assist the committee was authorized, and on January 30, 1939, the executive committee adopted a program for its organization.

In its earlier years the research department was primarily, if not exclusively, a service department to the committee on accounting procedure. In more recent years the research department's work has been expanded into other areas of Institute activity, but even today a greater part of the department's time is devoted to the affairs of the committee on accounting procedure than to those of any other committee.

The decision of council to expand the committee on accounting procedure, and to authorize it to issue pronouncements on matters of accounting principle and procedure, was based on the belief that it was necessary for the accounting profession to take steps to reduce the areas of difference in accounting followed by businesses, primarily those whose reports were being distributed to security holders. The need for narrowing the range of choices in accounting procedures had only recently become obvious through the increased amount of information that was being disclosed by companies filing with the Securities and Exchange Commission.

During the fifteen years since its creation in its present form, the committee has kept this purpose uppermost in mind. It has recognized that unless the accounting profession itself took the steps necessary to reduce the areas of conflict in accounting procedures, where they are significant in the presentation of financial information to the public, some other means

of eliminating them would be developed. Either some governmental body, such as the Securities and Exchange Commission or a federal incorporating agency such as has been proposed by bills introduced in Congress on various occasions or some other public body, perhaps not too friendly to accountants, would make the choices.

APPROACH TO PROBLEMS

Early in its career the committee discussed the desirability of approaching its problem by attempting to prepare a comprehensive statement of accounting principles that would be virtually all-inclusive. While to many this seemed to be a desirable objective, it became apparent very quickly that it would take years before any such statement could be prepared. In the meantime the committee would be performing no function in the direction of reducing current controversies over accounting principles. Furthermore, it was considered doubtful whether it ever would be feasible to prepare a statement of accounting principles that would be sufficiently comprehensive to afford a practical guide to settling any very large number of accounting problems. Accordingly, the committee quickly rejected this idea and decided to deal with specific areas of difference.

Thus, in its first report to the council in the spring of 1939 the committee said: "The present plan of the committee is to consider specific topics, first of all in relation to the existing state of practice, and to recommend, wherever possible, one or more alternative procedures as being definitely superior in its opinion to other procedures which have received a certain measure of recognition and, at the same time, to express itself adversely in regard to procedures which should in its opinion be regarded as unacceptable. In considering each case, particularly where alternative methods seem to possess substantial merit, it will aim to consider the conflict of considerations which make such a situation possible and thus gradually to prepare the way for further narrowing of choices." That still correctly expresses the policy of the committee as it functions today.

The committee has always taken its work seriously. It has attempted to deal constructively with those areas of difference which have been of the greatest significance in practical application at the time. The subject matter dealt with is brought before the committee in various ways. Members of the committee, the research department, and other committees of the Institute have suggested most of the questions. The SEC has raised some. The New York Stock Exchange has presented others.

Criticisms of committee

From time to time, criticism has been leveled at the committee for various reasons. Some have felt that the committee spoke too positively, while others thought it did not speak positively enough. Some have felt that the committee has issued too many bulletins, while others have felt that it does not issue enough. Some have complained that the members do not know far enough in advance the proposed action by the committee, and

others have suggested that the membership should approve the action of the committee before any statements are issued. Still others believe that the committee should be given the authority to bind the membership by the issuance of its bulletins without any further action by the membership.

As a result of such complaints the council has, from time to time, reviewed the activities and responsibilities of the committee with a view to determining whether any change should be made in the authority granted to it.

The most recent and thorough review of the committee's work, and the most careful consideration of the desirability of making any change in the authority granted to it, was made as a result of a resolution of council at its meeting on September 23, 1948, to the effect that the basic question of the issuance of pronouncements by committees of the Institute should be referred to the executive committee with instructions to report fully on the matter at the spring 1949 council meeting. The executive committee appointed a subcommittee to study the matter, directing it to give its first attention to the work of the committee on accounting procedure. After extensive investigation of the work of the committee, the subcommittee recommended that no basic change in the authority granted to the committee on accounting procedure should be made.

The committee's charter

The rather extended report of this subcommittee constitutes, to all intents and purposes, the charter under which the committee on accounting procedure is now operating. It is a codification, in effect, of the various resolutions and actions by council or the executive committee with respect to the committee's operations. It also incorporates certain rules for action the committee on accounting procedure had set up to govern itself which, having now been approved by council, are just as binding as if they had been included in the original grant of authority.

As stated in the subcommittee report, approved by council in the spring of 1949, the rules considered binding on the committee on accounting procedure are as follows:

> "1. A requirement that bulletins or pronouncements cannot be issued without approval of two-thirds of the Committee.
>
> "2. A position that bulletins shall not be retroactive.
>
> "3. A disclaimer of any authority beyond that of the Committee itself and the strength of its own reasoning.
>
> "4. Bulletins shall disclose the names of dissenting members and, when requested by them, carry brief explanations of such dissents.
>
> "5. There is to be maximum exposure possible and practicable in the circumstances of the thinking of the Committee prior to final Committee action and the issuance of a bulletin, but the amount of such exposure that is practicable in the circumstances is in the discretion of the Committee. This rule does not require or even imply that the bulletins need to be approved by other organizations or by state societies or by Council or by membership or otherwise.

"6. Effort is to be made to complete accounting research bulletins in the summer so that they might be issued in the fall when they would be most useful to the membership.

"7. While not a rule of the Committee, it nevertheless was enunciated at the authorization of the Committee that its membership should be large (21 members), representative of all sections of the country, of all types of accounting firms, and of teachers of accounting. That general structure has been adhered to, and it is believed it should continue to be the basis of the appointment of the Committee.

"8. There has grown up a precedent for giving a chairman an opportunity to serve more than one year in order to provide continuity, but, fortuitously or otherwise, the appointments have never run beyond three years. This limitation should be continued.

"9. Turnover in the Committee has been held down deliberately because it was believed necessary to permit new members to orient themselves and familiarize themselves with the efforts of the Committee and one year is hardly long enough for that need. Nevertheless, there should be a policy of bringing in new members to the Committee each year. A core of seasoned veterans is necessary to the functioning of the Committee provided these do not come to dominate the Committee. History shows that the seasoned members disagree among themselves and that danger of domination is remote. Continual rotation of geographical members has proved beneficial to the profession.

"10. A strong research staff has been developed and has been a prominent factor in the work of the Committee. The maintenance of such a staff should be considered as a necessary part of the Committee's charter."

The first six of these rules were originated and set forth by the committee on accounting procedure itself. The last four, of course, originated outside the committee.

Opinions voiced in bulletins

The views the committee on accounting procedure has undertaken to express have, for the most part, been made public in the form of accounting research bulletins. Up to this summer, the committee had issued 42 such bulletins of which 34 expressed the committee's own opinions and 8 expressed the views of the committee on terminology. The first of these 42 bulletins included a recital of rules formerly adopted by the membership of the Institute in 1934, and also the recommendations with respect to principles governing profits or losses on treasury stock that had been made by the predecessor committee to the committee on accounting procedure.

During the past summer, the 34 accounting research bulletins that were the expression of opinion of the committee on accounting procedure were restated and published in the form of Accounting Research Bulletin No. 43 entitled, *Restatement and Revision of Accounting Research*

Bulletins. The other eight bulletins which were statements by the committee on terminology were restated by that committee at the same time and published under the auspices of the committee on accounting procedure in a separate pamphlet as Accounting Terminology Bulletin No. 1, entitled *Review and Résumé.*

The purposes of the restatement of the 34 bulletins issued by the committee on accounting procedure itself were "to eliminate what is no longer applicable, to condense and clarify what continues to be of value, to revise where changed views require revision, and to arrange the retained material by subjects rather than in the order of issuance." The restatement was considered by the committee to be a cancellation and replacement of the original bulletins.

The *Restatement and Revision of Accounting Research Bulletins* is the culmination of a decision made by the committee in January, 1949, to undertake a comprehensive statement of accounting principles, a project the committee had, as stated previously, decided at its very inception should not then be undertaken. However, after a great deal of time and effort had been spent on the proposed comprehensive statement the committee decided that the project would take too long to complete, if indeed it could ever be completed. Accordingly, it decided to turn its attention to a restatement and revision of the bulletins it had already issued. Accounting Research Bulletin No. 43 is the result.

This restatement and revision of accounting research bulletins "involved numerous changes in wording, amounting in some cases to complete rewriting, but most of these changes were made in the interest of clarification, condensation, or elimination of material no longer pertinent." Some changes in substance were made, and these are outlined briefly in Appendix B to the Restatement.

Applicability of bulletins

In the restatement the committee has presented a new statement of applicability. This appears in the introduction and indicates that in general the committee's opinions should be regarded as applicable primarily to business enterprises organized for profit. The statement reads as follows:

> "The principal objective of the committee has been to narrow areas of difference and inconsistency in accounting practices, and to further the development and recognition of generally accepted accounting principles, through the issuance of opinions and recommendations that would serve as criteria for determining the suitability of accounting practices reflected in financial statements and representations of commercial and industrial companies. In this endeavor, the committee has considered the interpretation and application of such principles as appeared to it to be pertinent to particular accounting problems. The committee has not directed its attention to accounting problems or procedures of religious, charitable, scientific, educational, and similar non-profit institutions, municipalities, professional firms, and the like. Accordingly, except where there is a

specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit."

Bulletins not retroactive

The committee has also continued to take the position that its opinions are not retroactive. Its statement on this point in the restatement reads as follows:

"No opinion issued by the committee is intended to have a retroactive effect unless it contains a statement of such intention. Thus an opinion will ordinarily have no application to a transaction arising prior to its publication, nor to transactions in process of completion at the time of publication. But while the committee considers it inequitable to make its statements retroactive, it does not wish to discourage the revision of past accounts in an individual case if it appears to be desirable in the circumstances."

Neither of the foregoing statements needs explanation; they appear to be quite self-explanatory and there has been little misunderstanding of them. The same cannot be said with respect to the committee's statement regarding the authority of its opinions.

AUTHORITY OF BULLETINS

The authority of the bulletins of the committee on accounting procedure, and the extent to which the bulletins are binding on Institute members, have been matters of controversy almost from the inception of the committee. In its first bulletin the committee clearly stated that it regarded "the representative character and general acceptability of its pronouncements as of the highest importance," and that because of the make-up of the committee its pronouncements would be considered governing in accounting circles. On this ground, it took the position that while its pronouncements are subject to exception when "in extraordinary cases truthful presentation and justice to all parties at interest may require exceptional treatment . . . the burden of proof is upon the accountant clearly to bring out the exceptional procedure and the circumstances which render it necessary."

However, the committee, in Accounting Research Bulletin No. 4, further clarified its position by asserting that "Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached." This was immediately followed by the statement that, "It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment."

Some accountants, members and nonmembers alike, have objected to the is-

suance of accounting research bulletins by the committee on accounting procedure because, they have asserted, the bulletins have had too much influence and were, therefore, the equivalent of rules binding upon them. Others have complained that the bulletins should be more authoritative and that it should be made compulsory upon all to follow them. Between the two extremes, the position of the committee seems very sound.

It would be foolish to say that the statements of the committee on accounting procedure do not have a tremendous amount of influence in the formulation of accounting principles followed by the accounting profession and by business generally. Where else is there any aggregation of men so well qualified to speak with authority on accounting matters? Textbook authors are quoted as authorities, but here are 21 persons, each qualified to write an accounting textbook, two-thirds or more of whom have joined in making a recommendation. What better authority can be cited? Furthermore, these men are not a group of like-minded persons assembled to make a statement because of the similarity of their views. On the contrary, they are representatives of a great organization of accountants, selected for the variation in their thinking, training, and experience, who are brought together for the purpose of reaching agreement on controversial matters.

It seems, therefore, inevitable that, even though the committee may assert that the authority of its opinions rests upon their general acceptability, any principle or procedure recommended by it is likely to be immediately recognized as being so authoritative as to be a generally accepted accounting principle. The committee's prestige may not always be sufficient to cause all other procedures to cease having sufficient authoritative support to continue to be considered acceptable. In the past, however, most of the committee's recommendations have, within a relatively short period of time, been widely accepted by the business and professional community. As a consequence, alternative procedures have generally ceased to be followed to such an extent that they have had to be considered unacceptable.

It is well recognized that in extraordinary cases fair presentation and justice to all parties at interest may require exceptional accounting treatment. It is also well recognized, however, that the burden of justifying departure from generally accepted accounting procedures has to be assumed by those who adopt some other treatment. Because the weight of the committee's authority has proved to be so much greater than that of any other person or organization that has undertaken to voice accounting principles, it is only logical that accountants generally felt that, if they adhered to the committee's recommendations, they were supported by the most substantial authority. On the other hand, it has been demonstrated that, when they departed from such recommendations, they undertook the very substantial burden of justifying the propriety of the procedures they followed. Because the authority of its recommendations has thus become so well recognized the committee, in its *Restatement and Revision of Accounting Research Bulletins,* felt warranted in making the statement that, "The burden of justifying departure from accepted procedures, to the extent that

they are evidenced in committee opinions, must be assumed by those who adopt another treatment."

When are conflicting principles acceptable?

Determination as to whether an accounting procedure is still used widely enough to continue to be considered a generally accepted procedure after the committee has recommended a different one is not, in my opinion, to be made on the basis of a purely statistical compilation. To constitute authoritative support for such an accounting procedure, it seems to me those businesses adhering to it and their certifying accountants must be representative of the business and professional accounting world generally, and must be sufficient in number to constitute an important segment of those responsible for accounting policies. Those who seek to adhere to procedures other than those recommended by the committee on the grounds that they are generally accepted in practice have the responsibility of justifying their position through the presentation of facts demonstrating that there is substantial authoritative support for the procedures they have followed. It seems obvious that the evidence necessary to support such arguments must be more than a few sporadic examples. Unless an impressive array of important businesses and well-qualified and recognized public accountants support such procedures, I do not believe one is justified in treating them as being generally accepted. Furthermore, corporate practice, unless supported by competent professional accounting opinion, should not, it seems to me, be accepted as authoritative.

Influence of bulletins on public bodies

It is the exception rather than the rule to find courts making references in their opinions to the accounting authorities upon which they rely for their decisions. However, it is not uncommon for administrative bodies to make reference to the accounting research bulletins of the American Institute of Accountants as authority for positions they have taken; and it is safe to assume that, where they have been applicable, the courts have not been unmindful of them. Because committee members are not put on the witness stand and cross-examined in court cases, bulletins have sometimes been refused admission as evidence, but it is not uncommon to find them in briefs filed with the courts. This fact has undoubtedly had some influence on the court's interpretation of evidence before it.

The profession has a major responsibility to continue to eliminate the areas of difference in accounting procedures. It is important that the authority of the committee be strengthened by backing it fully. In meetings representatives of the Institute have had with members of important regulatory commissions, government officials have often expressed their hope that the accounting profession would be able to bring about unanimity of procedure, so that arguments over the relative authority behind conflicting accounting procedures would cease to be a problem in their work.

THE COMMITTEE'S OPERATIONS

The committee is a very hard working committee. As a general rule, it holds meetings four times a year. Sometimes, it has held five meetings. The attendance is frequently one hundred per cent, notwithstanding the fact that many of the members have to travel a long distance. Each meeting is usually held for two full days. Between meetings, there is a great deal of correspondence among committee members, and it is the rule of the committee that copies of all correspondence between members of the committee, or with the director of research, should be sent to all other members of the committee, the executive director of the Institute, and the director of research.

Some insight into the committee's operations can be gained by reviewing briefly what it has done during the past twelve months. First, it has issued four accounting research bulletins. Two of these (one on stock dividends and stock split-ups; the other on stock options and stock-purchase plans) were revisions of bulletins that had been issued previously. They were prepared in connection with the restatement of all of the bulletins. The third was a new bulletin designed to help accountants and management in coping with the accounting problems relating to emergency facilities.

Because of the importance of these three bulletins, they were issued as soon as they were prepared, rather than waiting until issuance of the complete restatement. The fourth bulletin issued during the year was, of course, No. 43, the restatement and revision of the former bulletins previously mentioned.

As already stated, the review and résumé of the former accounting research bulletins dealing with terminology, which had been prepared by the committee on terminology, also received the committee's attention during the year. The committee on accounting procedure reviewed this booklet and authorized its publication as a statement of the committee on terminology.

The completion of the restatement and revision has been a tremendous undertaking for which the profession and the business world owe a substantial debt of gratitude to each individual member of the committee during the years it has taken to complete the project. I shall not attempt to summarize the changes in substance made during the course of restating the bulletins, but I should like to direct your attention to those involving the accounting treatment of intangibles, which may not have received the notice they deserve.

Intangibles. The problem of accounting for intangibles has long been a troublesome one, particularly with respect to the so-called type (b) intangibles, which have no limited term of existence, and as to which there is, at the time of acquisition, no indication of limited life. The main questions have been whether it is ever appropriate to charge the cost of such intangibles to capital surplus, and whether lump-sum write-offs are sound accounting practice.

The committee first dealt with these problems in Bulletin No. 24, issued

in 1944. At that time it analyzed the problems and expressed the opinion that both practices should be discouraged. It recognized, however, that they had long been accepted and felt that the time was not opportune to take a definite stand against them.

In revising the bulletins, however, the committee decided that the time had come for taking a positive stand and, in Chapter 5 of the restatement, expressed the opinion "that lump-sum write-offs of type (b) intangibles should in no case be charged against capital surplus, should not be made against earned surplus immediately after acquisition and, if not amortized systematically, should be carried at cost until an event has taken place which indicates a loss or limitation on the useful life of the intangibles." This is but one of a number of changes in substance made in restating the bulletins. Appendix B of the restatement, which summarizes these changes, is deserving of careful study.

Many other matters have been brought to the committee's attention from time to time during the year without resulting in formal publication. For example, the research department frequently refers accounting problems to committee members for advice, which is willingly given. These problems, generally inquiries submitted to the research department by Institute members, are discussed informally with committee members either at committee meetings, or by correspondence or telephone.

Current agenda

The committee has begun work on a number of new subjects, the consideration of which was deferred pending completion of the restatement. Subcommittees have devoted considerable time to these subjects in an effort to lay the preliminary groundwork for study by the full committee in the coming year.

Accounting and inflation. Possibly no accounting subject has aroused so much controversy and such strong feeling in recent years as the question as to whether or not it would be advisable to recognize in financial statements the fluctuating value of the dollar. In Bulletin No. 33, issued in October, 1947, the committee took the position that accounting for fixed assets should continue to be based upon historical cost. A year later, in 1948, the committee reaffirmed this conclusion, although it gave its "full support to the use of supplementary financial schedules, explanations or footnotes by which management may explain the need for retention of earnings."

In the restatement, the committee again expressed its approval of these basic conclusions. However, six members of the committee expressed dissents to the reprinting of the former statements of the committee on this subject and urged further consideration of the problem. As a result, and because of similar requests from others, the subject has been placed on the committee's agenda for study. Since fourteen members voted to approve reprinting the former statements, it would appear that there is considerable sentiment for continuing to base financial reports for general purposes upon historical cost. In any event, it seems clear that extended discussions will

be required before any change in the committee's position in this respect is likely.

Pensions. One of the most difficult accounting problems facing accountants and businessmen at present is how to account for the costs arising under pension plans. This, too, has received study by the committee in an effort to develop a statement of the broad objectives that accounting procedures should seek to accomplish.

Up to the present, the committee has been unable to arrive at satisfactory conclusions in this respect, largely because of the wide variety of pension plans in existence and the particular problems each of these types of plans raises. Work continues on this project, but it is probable that a solution must await further pension experience.

Consolidated statements. Another major subject on the committee's agenda is that of consolidated statements. There are, at present, a large number of areas regarding which conflicting opinions prevail as to appropriate procedures in preparing consolidated statements. A subcommittee was appointed last summer to investigate the areas in which the committee might take action. This subcommittee presented its report to the full committee at its meeting on Friday. The report analyzed the different viewpoints as to what consolidated statements should attempt to achieve and outlined some of the problems that stem from these divergencies in viewpoints. Obviously, this project is still in its preliminary stages. Work on it will be continued.

Other projects. The committee will also give consideration during the coming year to two projects that are primarily the concern of the committee on auditing procedure. One of these is the problem of reporting on cash-basis statements. The principal question, from the viewpoint of the committee on accounting procedure, is whether or not such statements should be considered to conform with generally accepted accounting principles.

The other subject is that of reporting on events occurring between the date of the financial statements and the date of the accountant's report. The committee on auditing procedure is preparing a tentative statement on this subject and, because of the disclosure aspects of it, the committee on accounting procedure will be asked to review it.

As stated earlier, the committee on accounting procedure devotes the major part of its attention to areas of controversy that appear to be of particular significance at the time. Accounting is dynamic and in a constant state of evolution to meet changing conditions. Accordingly, it is almost certain that additional problems will arise during the coming year that will require the committee's attention. These subjects will be added to the committee's agenda as the need for consideration of them is recognized. The committee would welcome suggestions as to areas with which it should deal, and any views it should consider in connection with the subjects now before it.

CONCLUSION

In commenting on the restatement, I expressed the view that the accounting profession and the business world owes a substantial debt of gratitude to

each member of the committee who participated in the preparation of the restatement. It would be hard to overemphasize the contributions made by the members of this committee. In all of my experience with committee work, both as a member of committees from time to time and as director of research, I have never seen anything like the wholehearted participation and sacrifice of time and effort the members of the committee on accounting procedure have constantly devoted to its work since its inception. It would be impossible to pay for the services these men have voluntarily given to the profession, and it is a great tribute to the profession that so many have been willing to give so liberally to its enhancement.

Accounting for stock options issued to employees

WILLIAM W. WERNTZ

Partner, Touche, Niven, Bailey & Smart, New York. Member, Institute committee on accounting procedure.

In recent years, many corporations have adopted plans or entered into agreements whereby there has been made available to employees the privilege of purchasing stock of the corporation at a fixed price during a specified period of time. Major accounting questions arising in these cases are whether there is any "compensation" involved in such transactions and whether and to what extent a charge therefor should be made against income. In one sense, the problem is not materially different from that which is found in any arrangement whereby an employee is paid for services otherwise than in cash. Clearly, if the employee is given a house or is given an outright number of shares of stock in return for his promise to work for the company or for his actual services, there is an element of compensation to be accounted for. The problem is solely one of measuring the compensation given and then spreading the charge over the period of his services in an equitable manner. In the case of the stock option, we also have a situation in which something other than money is involved and, to the extent that (*1*) the consideration is given in return for services and (*2*) the consideration has a measurable value, there is compensation that should be accounted for. From the accountant's point of view, however, there are two very real and very major problems: (*1*) Whether the agreement, in fact, includes an element of compensation and, if so, (*2*) how what is granted should be evaluated.

TYPES OF PLANS

In recent corporate practice, the stock-option plan has been used in at least three different settings. The first, and perhaps most simple, is the situation where the employment contract of, let us say, the president of the company includes terms that permit the president, during an agreed-upon period, to buy a given number of shares at a stipulated price. Since

the option is granted as an integral part of the employment contract, there can be scarcely any argument but that the granting of the option was one of the inducements the parties had in mind in arriving at the contract. There exists, therefore, only the question of valuation.

The second class of cases is represented by the many companies that, during the past few years, have instituted employee-stock-option plans or employee-stock-purchase plans available to all employees, or to specified categories of employees. Such plans are generally inaugurated by the corporation with respect to existing employees, some of whom may already be serving under specific contracts. Rarely can the plan in such cases be viewed as an integral part of such contracts as may exist, even though the plans nearly always have some conditions based on the continued employment of the individual. Where the group of employees eligible to participate in the plan is relatively large and the amount of stock available to each relatively small, it seems to me very difficult to talk in terms of compensation, particularly where the price at which the employee may purchase the stock is substantially the same as the then-existing market price. It is equally difficult, in my view, to talk about compensation where in practice, of two employees performing substantially the same duties and having substantially the same rights under the plan, one may exercise his option and the other not. If an option plan really involves compensation, it seems illogical to account for such compensation only in the case of the employee who exercises the option and not in the case of the one who does not. It seems equally queer, under the circumstances cited, to consider that both employees received compensation but that the one who did not exercise his option gave something back to the company. So, in this case, we have first the question of whether the plan really involves a form of compensation, and only then the question of how the amount of compensation is to be measured. Some observers, in discussing the problem, have talked of this type of plan as purely an "incentive" rather than a truly compensatory arrangement.

The third use of the stock option or, more usually, the stock-purchase plan is as an integral part of a company's fund-raising program. A number of utilities have raised substantial amounts of capital by programs looking to the purchase of stock by employees. Some of these have followed this practice over many years; other have done it sporadically from time to time. Where there is clear evidence that this is the practice of the company or industry and the terms of the plan are consistent with that objective, there is to me little utility or reason to view the plan as one that involves compensation.

At the time the original Bulletin 37 was issued by the committee on accounting procedure of the American Institute of Accountants back in 1948, the principal option and purchase plans in use fell generally into categories one or three above. The Bulletin itself seems directed primarily, in my opinion, to options of the first category, that is the accounting for options entered into as an integral part of individual employment contracts.

Effect of Section 130-A

In 1950, subsequent to issuance of the old Bulletin, Section 130-A of the Internal Revenue Code was enacted. This Section granted specialized tax treatment to employee-stock-option plans if certain requirements were met as to the terms of the option, as to the circumstances under which the options were granted or could be exercised, and as to the holding and disposing of the stock thereunder. In general, the effect of this Section was to eliminate or minimize the amount of income taxable to the employee as compensation and to deny to the issuing corporation any tax deduction in respect of these "restricted" options. Once the barrier of high income taxation at the time of grant or exercise of the option or sale of the stock was removed, there appeared a large number of option and purchase plans conforming to the requirements of Section 130-A. These "restricted" options were utilized both in connection with individual employment contracts and in connection with general employee plans described in category two above. Under the requirements of Section 130-A, among other things, the option price could not be set below 85 per cent of the market value at the date of grant. Where the option price was less than 95 per cent, the employee could, under certain circumstances, be taxed on the difference between the option and market prices at the date of grant as ordinary income. Where, however, the price was 95 per cent or more of market at date of grant and other conditions were met, any gain would be considered to be a capital gain and taxable only at capital-gain rates when the stock was disposed of.

Experience with old Bulletin 37

Under the terms of the old Bulletin 37, issued in 1948, a distinction was made between compensatory and noncompensatory options. The latter, of course, were to be treated as capital-raising media in which the only entries in the accounts would be for the amounts received on sale of the stock. In the case of the former or compensatory options, the Bulletin concluded that the option should be "valued" at the date the option became the property of the optionee, and by "property date" appeared to be meant the date on which all chance of the option lapsing, otherwise than through failure of the optionee to exercise it, had vanished. Ordinarily, this date would be the date on which the option became exercisable. The original Bulletin discussed the problem largely in terms of benefit received by the optionee and utilized the "property" date as a means of distinguishing between what the employee received as compensation and what he might realize through speculation as to changes in market prices after the option became wholly his.

With the advent of the many plans that appeared following adoption of Section 130-A of the Revenue Code, two major difficulties with the existing Bulletin developed. The first arose in distinguishing between capital-raising plans and compensatory option plans, and stemmed from the rather general language used by the Bulletin in discussing this problem. The second arose

because, under the old Bulletin, an increase in market price between the date of grant and the property date resulted in a determination of an amount of compensation that was often unrelated and out of proportion to any possible benefit from the services being received and sometimes quite inconsistent with the income of the company. It could be shown too that in many, if not most, cases an advance in market price after the grant date was merely part of a general market advance based on economic developments or reflected a decline in the purchasing power of the dollar and had little or nothing to do with the services rendered by the individuals. In an extreme case, the effect of using this property date for measurement of compensation resulted in a charge to income of as much as half of the net income of the company in a relatively good year.

A third difficulty, which had special practical significance, was the fact that it was possible to evade the requirements of the old Bulletin 37 without any significant changes in economic consequences merely by careful drafting of the terms of the option, so that, instead of the option becoming the "property" of the grantee at or about the exercisable date, the option became the "property" of the grantee very close to or at the date of grant but was accompanied, nevertheless, by subsequent conditions that effectively cut off the optionee's right at some later date if he failed to abide by its terms. As a result, accountants were faced with a situation in which a sophisticated draftsman could apparently avoid the application of Bulletin 37 merely by carefully choosing the language of the agreement.

Reconsideration of the problem of when to measure compensation

In view of all of these developments and circumstances and the problems that had arisen with respect to the application of the old Bulletin, the committee on accounting procedure undertook in 1951 to re-examine the subject. As a result of extended discussion, first in a subcommittee and later in the full committee, and after exposure to and discussion with many outside persons, a revised Bulletin 37 was adopted early in 1953 and subsequently incorporated as Chapter 13-(b) of the Restatement. The revised Bulletin sought first to clarify the difference between capital-raising and compensatory options by giving somewhat more detailed consideration to the two types of option or purchase plans and suggesting some criteria for distinction. For example, to qualify as a capital-raising plan, it was suggested that the discount of the offering price from fair market might not be larger than was reasonably necessary to assure the success of the capital-raising program.

The second, and probably more important change was the adoption of the grant date as the date on which to measure compensation rather than the date at which the option became the "property" of the optionee.

There are, of course, a number of important dates in the life history of any stock-option plan. Some of them clearly have no signifiance to the accounting problem of measuring compensation. The date the plan is adopted can have no importance, since at that time nothing has been done other than to indicate an intention. The date on which an employee disposes of his

stock acquired under such a plan can have no significance, since how long he may hold the stock is entirely within his discretion. Indeed, the date on which he chooses to exercise an option is not of real signficance since, here again, once the option has become exercisable, it is the holder's choice just when he should exercise it. There remain, however, two dates that have been advocated as the point at which to measure compensation: The date of grant to an individual, and the date at which the individual can first exercise the option. The original Bulletin 37 chose this latter date for this purpose largely on the grounds, first, that this was the date on which the optionee perfected his right of exercise and, second, that the value to him of what he "got" on that date fairly measured what the corporation gave up.

It seems to me that this approach has several difficulties in theory and in practice, which can best be illustrated in terms of an individual employment contract that contains a stock-option provision. In such cases, it seems to me that the bargaining parties must have in mind values at that time and not "values" that may ultimately eventuate. To put it otherwise, at the time the contract is made, the right to buy stock at a fixed price, conditional though it may be, is what is to be valued, and valued in the light of then existing circumstances.

Consider further the comparative treatment under the old Bulletin of two contracts identical except that in one an option for 10,000 shares is exercisable immediately at the market price and in the other a 10,000-share option, at the same price, can be exercised only after one year and then only if the employee is still in the service of the company. Suppose during the year the stock advances $10 per share. Under the old Bulletin, the immediately exercisable option would be adjudged to involve no measurable amount of compensation; the delayed option would, with the benefit of hindsight, be adjudged to involve compensation of $100,000. Consider, further, which option more nearly serves the interest of the employer—the one that ties the optionee to the service of the company or the one that does not. Yet, in both cases the employee would receive exactly the same ultimate benefit.

Finally, on the side of theory, it appears to me that it is the date on which the corporation grants an option that it contracts to forego its rights to alternative uses of the shares (ordinarily, sale) and we memorialize this fact customarily by an appropriate note on the financial statements.

On the practical side, there is the further difficulty that use of the "property" or exercisable date introduces uncertainty, hindsight, and arbitrariness into the accounting process; uncertainty, because for long periods no one can tell what amount of compensation is to be accounted for; hindsight, because the propriety and reasonableness of the agreement will be judged not by the circumstances existing when it was entered upon but solely on the basis of unforeseeable future events; arbitrariness, because the future market prices used in measuring compensation will undoubtedly be affected by circumstances and conditions unforeseeable and usually but vaguely related to the value to the company of the services of the employee.

It was, I believe, considerations of this kind that led the committee, in its reconsideration of the problem, to choose the grant date as that at which compensation is to be measured so that the corporation grantor can, at the time it enters into this sort of an arrangement, ascertain for itself what the accounting consequences will be.

METHOD OF MEASUREMENT

The remaining question, of course, is how to determine the "value" of an option. In the case of an unrestricted option to buy stock at a fixed price, there is clearly an element of value which the market has long been able to measure. In the case of the Section 130-A or "unrestricted" option, however, the right of the option holder is encumbered with personal conditions, such as continued employment, restrictions on exercisability and the like, so that the right he has becomes unmarketable. In estimating value, the accountant must, therefore, necessarily resort to indirect means.

Both Bulletins concluded, and I think properly, that it would be reasonable to measure value by comparing fair market price with the option price. In determining fair market value, the Committee suggested that closing quotations on a listed exchange were not necessarily conclusive, that it was proper to take into account the fact that the ordinary expenses of selling shares could be largely avoided in this method of sale and, further, that where there was not a readily ascertainable market price, as in the case of unlisted companies, it was proper to resort to the usual indirect methods of determining fair value of the shares involved. While the Bulletin does not specify any particular relationship between market price and fair value, it seems to me, as a rough rule in the case of compensatory options, that the 95 per cent test incorporated in Section 130-A is usually reasonable.

Collateral problems

The new Bulletin also deals with certain collateral problems that arise where a measurable element of compensation is deemed to exist. Fundamentally, it is appropriate to spread the amount over the expected period of service, either as set by contract or as reasonably estimated by experience. Personally, I would see no real objection either to setting the amount up and amortizing it over an appropriate period or, on the other hand, of accruing it from time to time over the same period. There is, of course, the question of what happens if compensation has been charged off and the optionee later fails to exercise his option. As a matter of strict principle, I think a reversal of the charge to income is appropriate only if the option, in fact, never became exercisable. If the option lapsed after it became exercisable, I think, as a matter of strict principle, there has been a kind of "contribution" of value on the part of the option holder, somewhat analogous to the situation that exists in the case of forfeited stock subscriptions. The Bulletin does not specifically deal with this problem and, as a result, one member of the committee assented only with qualification. In practice, I believe that this problem will be of little significance.

Position of SEC

The problem of dealing with stock options has also been given a great deal of consideration by the Securities and Exchange Commission both before and after issuance of the new Bulletin 37. At the present time, the Commission has proposed a rule that will require that the method followed in accounting for stock-option plans shall be clearly stated but will not require adherence to any particular treatment.* The Commission's rule also calls for disclosure as to the number of shares under option at the balance-sheet date, as to the amounts of stock for which options become exercisable during the period, and as to the amounts exercised. The Commission's rule goes somewhat further than Bulletin 37 with respect to disclosure in that it calls for a statement of the difference between the option price and the fair market value, not only at the grant date but also as of the date the options became exercisable and as of the dates on which the options were exercised. The Commission is understood not to expect the required data to be given separately as to each option, or each exercise thereof, but instead that a succinct summarized statement be made. For example, suppose that options covering 10,000 shares at option prices ranging from $5 to $7 a share became exercisable during the year and that the fair value ranged from $8 to $10 a share at the respective exercisable dates. In such a case, I believe it would ordinarily suffice merely to state, perhaps in tabular form, the number of shares as to which options became exercisable, the above ranges of option prices and fair values per share, and the aggregates thereof. Similar summarization could be made as to the data called for as to the grant and exercise of the options.

CONCLUSION

Those whom I have heard disagree with the above analysis and the major conclusions incorporated in the revision of Bulletin 37 (and there are some) do so, I believe, on the ground that "compensation" to an employee is to be considered to be the value of what he ultmately gets and that this value to him thereby becomes the "cost"; *i. e.*, the "compensation," to be accounted for by the corporation. They would not, however, take into account any changes in market value after he had become entitled to exercise his option. Perhaps no treatment of a problem of this complexity can be worked out that would be wholly uncontroversial, particularly since the use of stock options (which, of course, is *not* an accounting question) is considered by many to be undesirable. It was and is the belief of the committee, however, that the proposals of the revised Bulletin are a sound and useful method of dealing with this phenomenon of corporate practice, and that the essential vice in the alternative treatment most frequently advanced is that it subjects accounting and business judgment to the vagaries of hindsight.

*Adoption of Rule 3-20(2) of Regulation S-X, effective December 31, 1953, was announced by the Securities and Exchange Commission subsequent to the presentation of this paper. See Accounting Series Release No. 76, dated November 3, 1953.

Accounting for stock dividends and stock split-ups

WALTER L. SCHAFFER

Partner, Lybrand, Ross Bros. & Montgomery, New York. Member, Institute's committee on accounting procedure.

Accounting Research Bulletin No. 11, *Corporate Accounting for Ordinary Stock Dividends,* was issued by the committee on accounting procedure of The American Institute of Accountants in September, 1941. It was materially revised in November, 1952, and re-entitled, *Accounting for Stock Dividends and Stock Split-Ups.* It now appears in such revised form as Section B of Chapter 7 of the committee's *Restatement and Revision of Accounting Research Bulletins,* which was published this year as ARB 43.

When the committee on accounting procedure undertook the revision of ARB 11, the principal fault that it found and sought to correct was the bulletin's failure to recognize the similarity in general nature and effect of a "common stock dividend" and a "common stock split-up" producing the same relative increase in number of previously outstanding common shares and the desirability of having the same accounting requirements apply, within certain areas of relative increase, to both.

There was no question in the mind of the committee as a whole as to the soundness of what I consider to be the two basic opinions expressed in the original bulletin and these still remain, unchanged, in the 1952 revision. In substance, the two opinions to which I refer are that (*1*) a stock dividend of common shares to common shareholders does not result in any income to the recipients; and (*2*) an issuance of this kind calls for "capitalization" of earned surplus in an amount equal to the fair value of the additional shares involved.

I assume that there is no need for me to go at length into the reasons for the non-recognition of income to a recipient of a stock dividend. These were clearly stated in the original bulletin and are reiterated, substantially without change of words, in the revision. Briefly, they rest on the conventional accounting concept that a shareholder has no income from a corporation until there is a distribution, division, or severance of corporate assets and on the conviction that "a stock dividend takes nothing from the property

of a corporation and adds nothing to the interests of the stockholders"† and, hence, does not result in any such distribution, division, or severance.

The discussion of the reasons underlying the accounting required of the issuer of what is ordinarily looked upon as a stock dividend have been materially reworded and expanded in the 1952 statement, but basically they, too, remain the same as those expressed in the original bulletin. In both instances, the committee has proceeded on the premise that, regardless of the fact that a stock dividend does not give rise to any change in either the corporation's assets or its respective shareholders' proportionate interests therein, many recipients of stock dividends look upon them as distributions of corporate earnings, and that, consequently, the issuer should "in the public interest" reduce its earned surplus and correspondingly increase its other capital accounts by an amount equivalent to the fair value of the additional shares issued. In the original bulletin, the committee stated:

> "Unless such relationship [of the charge to earned surplus to the fair value of the shares] is maintained, the stockholder may believe that the market value per share may be materially in excess of such capitalized rata share of the capitalized current income of the corporation, whereas the market value per share may be materially in excess of such capitalized income per share."

The 1952 statement says:

> "Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions."

For all practical purposes, both of these quotations amount to the same thing.

The committee was aware in 1952, as I presume it was in 1941, that solely as a matter of theory the positions taken with respect to the recipient and to the issuer are inconsistent and that the accounting procedure required of the issuer is in the nature of a protective device. It was the consensus of the committee, however, that this procedure had long since amply demonstrated its soundness and usefulness and, indeed, had achieved such general acceptance as to preclude any change with respect thereto on the part of the committee.

The committee did feel, however, that there were certain changes that definitely needed to be made in the original bulletin and, as I indicated at the outset of my remarks, the one it considered to be of the greatest importance had to do with the differentiation between those transactions which should be accounted for as stock dividends and those which, for accounting purposes, should be regarded as stock split-ups. In general effect, the 1941 bulletin regarded any issuance of additional shares without consideration to be a stock dividend, so long as it entailed some capitalization of earned surplus, and to be a stock split-up if it were accomplished

†*Eisner v. Macomber*, 252 U.S. 189

in a manner resulting in no increase in legal capital. This produced the situation where literal compliance with the original bulletin would require a charge against earned surplus equal in amount to the fair value of the additional shares involved in the case of every issuance consummated as a stock dividend, regardless of how relatively great in number such additional shares happened to be, and no charge whatsoever if the transaction were consummated as a split-up, regardless of how relatively few additional shares would thereafter be outstanding.

If it is agreed, as I think it must be, that a stock dividend and a stock split-up are identical in the respect that neither results in any change in a stockholder's proportionate interest in the corporation, but that each merely increases the number of shares representing such interest, it becomes apparent that, in general, there is little to distinguish large so-called "stock-dividends" from large so-called "stock split-ups," or small "stock dividends" from small "split-ups"; also, that it is somewhat incongruous to hold that the accounting treatment of transactions that are largely identical in force and effect should differ merely because of the form they may take or how they may be characterized.

On the other hand, the committee recognized that there are very marked distinctions to be made between various issuances of shares without consideration, but that these distinctions rest on what purposes the issuances may be expected to accomplish; and, in turn, that the purposes to be accomplished depend upon the relative size of the issuances in comparison with shares of the same general class which were previously outstanding.

Consequently, the committee developed, for accounting purposes, the present definitions of "stock dividend' and "stock split-up." Under the revised definitions, the terms "stock dividend" and "stock split-up" both are stated to refer to an issuance by a corporation of its own common shares to its common stockholders without consideration moving to the corporation. But the term "stock dividend" is limited to such an issuance "under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business." And the term "stock split-up" is confined to one when made "under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of its shares."

To utilize these definitions requires, of course, a determination as to when the one or the other of the "conditions" referred to may reasonably be expected to prevail. From a practical standpoint, this means in an individual case reaching a decision as to whether the transaction is likely to be viewed by recipients as a distribution of corporate earnings or, instead, accomplishes the defined purpose of a split-up. It appeared to the committee that market

reaction probably provides the best indication of an objective nature as to whether the intended purpose of a stock dividend or that of a stock split-up has been achieved. As stated in the revised bulletin, the view by recipients that there has been a distribution of corporate earnings is materially strengthened in those instances where issuances are so small in relation to shares previously outstanding that they do not have any apparent effect upon the share market price; and, consequently, the market value of the shares previously held by them remains substantially unchanged. It naturally follows that, under such circumstances, a representation that a split-up has been effected would not be credible. On the other hand, if an issuance is of such relatively great size as to have the effect of materially reducing the market value of the shares previously held by the recipients, it becomes rather inconceivable that any such shareholders of reasonable intelligence would believe that they have received anything approaching a dividend equivalent to the fair value of the additional shares.

In its revised bulletin, the committee recognizes that there is no clear line of demarcation between those transactions which should be accounted for as stock dividends and those which should be recorded as stock split-ups. Such bulletin clearly states: "Obviously, the point at which the relative size of the additional shares issued becomes large enough to materially influence the unit market price of the stock will vary with individual companies and under differing market conditions and, hence, no single percentage can be laid down as a standard for determining when capitalization of earned surplus in excess of legal requirements is called for and when it is not." Furthermore, the committee makes clear that the corporation's representations as to the nature of the issuance is one of the principal considerations in determining how the transaction should be recorded. However, as you know, it did reach the conclusion, on the basis of the review of market action referred to in the revised statement, that there would be few instances involving the issuance of additional shares of less than, say 20 or 25 per cent of the number previously outstanding, where the share market price of the stock would be sufficiently reduced as to preclude the likelihood of the issuance being looked upon by many shareholders as a distribution of earnings, or where the market action would be such as to permit the issuer to achieve the purposes of a split-up. Conversely, I think it is to be implied that issuances involving a high percentage of additional shares would more often than not have the reverse effect. In essence, what the committee has done in its revised statement is to set a presumptive dividing line between stock dividends and stock split-ups. Circumstances in an individual case may justify its being ignored. But by and large, in my opinion, it will prove to be a reasonable one and serve to bring accounting more nearly in line with present-day thought.

As a natural consequence of what I have been discussing, the committee eliminated from the revised statement the earlier requirement that, where a corporation has increased, over a period of time, its working capital or its fixed assets by investing its accumulated income over such period and is

desirous of reflecting the resulting condition in its legal capital by the issuance of a single stock dividend, the "dividend" shares to be issued *must* be arrived at on the basis that the amount charged to earned surplus will have a reasonable relationship to the fair value of such additional shares. This is not to be taken as indicative of a viewpoint on the part of the committee that such action by a company should be looked upon with disapproval, but rather that the transaction would probably have the effect of a split-up and hence *not require* the accounting demanded of a dividend. It is important to note, however, that in the 1952 statement, the committee recommends that in those instances where so-called "dividends" partake of the nature of split-ups, "every effort be made to avoid the use of the word 'dividend' in related corporate resolutions, notices, and announcements and that, in those cases where because of legal requirements this cannot be done, the transaction be described, for example, as a 'split-up effected in the form of a dividend'."

The considerations of public policy that led to the opinion that generally the issuance of a stock dividend should be accompanied by the "capitalization" of the issuer's earned surplus in an amount equal to the fair value of the additional shares involved were deemed by the committee not to arise in the case of closely held companies. As is stated in the revised bulletin, it is to be presumed that the intimate knowledge of such corporations' affairs possessed by their shareholders would preclude the implications and possible constructions considered likely in other instances. The 1952 statement expresses the opinion, therefore, that in cases of closely held companies there is no need to capitalize earned surplus other than to meet legal requirements. The committee purposely did not attempt to define "closely held." It felt that the determination as to whether or not a particular company could appropriately be so designated is a matter that must necessarily be left to exercise of judgment in the light of attendant circumstances. I should, however, presume that in any case where there is doubt as to whether a company qualifies as being closely held, full "capitalization" of earned surplus equivalent to the fair value of the dividend shares would be called for.

The 1941 bulletin contained a statement to the effect that the amount per share in the capital stock and capital surplus accounts combined, before issuance of a stock dividend, should be maintained upon its issuance by capitalization of at least a like amount of earned surplus for each dividend share. I, personally, am not aware of what lay behind the conclusion then reached that per-share capital should be maintained. Had it been selected as the only measure of capitalization I might have understood it; as a "floor," I do not. The expressed purpose of the accounting requirement that issuing companies capitalize earned surplus to the extent of the fair value of dividend shares is to prevent the retention in earned surplus of amounts many shareholders may believe have, in effect, been distributed to them through stock dividends; and it was deemed that those amounts which the recipients would have in mind would likely be the equivalent of the fair market value

of shares issued. Having provided for the accomplishment of its prime objective, it seemed to the committee in the course of its revision of the original bulletin that the requirement for further capitalization of earned surplus served no useful purpose and should be abandoned. Accordingly, this part of the 1941 bulletin was omitted from the revision.

The revised bulletin also omits the admonition, contained in the 1941 pronouncement, that in the case of regularly recurring stock dividends, the amount of earned surplus capitalized (which would, of course, govern the number of shares issued) should not exceed the amount of "current income." The term "current income" was stated to mean the income of the fiscal period in which the stock dividend is issued, or the income of a comparatively small number of fiscal periods preceding the date of the stock dividend, after deducting any prior cash dividends and capitalizations of stock dividends within such period or periods. In its reconsideration of this action, the committee felt that it should not presume to lay down, under the guise of accounting procedures, directives to management as to whether or not, and when, the latter might declare a stock dividend, and that having stated the need for a charge to earned surplus and the manner of determining the amount thereof in the event of such a dividend, the committee had fulfilled all responsibilities that it might rightly assume.

For much the same reason, the revised bulletin omitted the recommendations embodied in the 1941 statement regarding information to be furnished in dividend notices to shareholders as to the amounts capitalized in connection with a stock dividend, the particular accounts so charged and credited, and the effect upon each shareholder's proportionate interest in the corporation if he should dispose of his dividend shares. This omission is not to be taken as implying that reconsideration had led to any disagreement as to the desirability of the shareholders' receiving such information. Rather, it was prompted by the thought that the committee's pronouncement should be confined to matters of account keeping and financial-statement presentation.

All of the changes I have discussed have had to do with that part of the revised bulletin which deals with accounting by the issuing company. The only change of any materiality that was made in the section relating to the accounting by the recipient is the omission of the statement appearing in the original bulletin: "It is recognized that this rule, under which the stockholder has no income until there is a distribution, division or severance, may require modification in some cases, or that there may be exceptions to it, as, for instance, in the case of a parent company with respect to its subsidiaries. . . . " The reason for this deletion was that the committee felt that this statement was being wrongly interpreted by some as implying that the committee approves treating as income of a parent company stock dividends received from its subsidiary. The committee recognizes that the quoted matter involves a much broader question than the treatment of stock dividends; *viz.*, the sometimes questionable practice of currently accruing a subsidiary's earnings in the income accounts of its parent; but it was

not prepared to pass upon this issue nor was it disposed to confuse such issue with the matter of dividends. It is my understanding, however, that the omission of the reference to a possible modification of or exception to the general rule was not intended to imply that, in the committee's view, the practice of currently accruing a subsidiary's earnings in the income accounts of its parent is now deemed to be wholly unacceptable. The committee merely has not dealt with the question.

Emergency facilities: depreciation and tax allocation

JOHN A. LINDQUIST

Partner, Ernst & Ernst, Cleveland. Member, Institute committee on accounting procedure.

One of the nonmilitary consequences of the military action in Korea that has euphemistically been termed a police action, and the resultant state of emergency, has been revival of "Certificates of Necessity" to spur through tax concessions, expansion of facilities needed for the production of matériel of war. The tax concessions, when availed of in connection with facilities whose economic usefulness will outlast the period of concessions, are more apparent than real, because the tax benefits will probably prove to be no more than a deferment of the taxes seemingly saved, at least to the extent to which current so-called normal and surtax taxes have been reduced by the five-year cost amortization granted for tax purposes.

Amortization of the cost of facilities used for the production of matériel of war was a problem at the conclusion of World War I. As I recall, the amortization was then premised on loss of useful value. No documents corresponding to Certificates of Necessity, however, were used to define the facilities whose cost was amortizable to the extent the facilities had no value for productive purposes.

Certificates of Necessity first had currency during so-called World War II. The certificates then issued generally gave holders the right to amortize over a five-year period, or under certain circumstances not pertinent to the present situation over a shorter period, the whole cost of the facilities in respect of which the certificates were granted. The certificates authorized to be issued in the present emergency may limit (and many have limited) five-year amortization to a percentage of the cost of the facilities covered. No statistics are at hand on the number of certificates granted since the addition of Section 124-A to the Internal Revenue Code for amortization of the full cost of emergency facilities, as compared with those that fix less than 100 per cent of the cost of such facilities as permissible for five-year amortization.

It was rather common with respect to facilities covered by Certificates of

Necessity issued during the emergency created by World War II for provisions for depreciation for financial accounting purposes to coincide with deductions for depreciation and amortization claimed for tax purposes. At the end of the emergency period many companies were possessed of facilities of continuing usefulness, the cost or other basis of which had been written off. Because the facilities were continued in use in the post-emergency years, the result was income determination without a matching against revenues derived from use of the facilities, of all the costs of producing those revenues. The absent factor of cost, of course, was a charge for use of the productive facilities: namely, a charge for what we term depreciation. The consequence of the depreciation-amortization accounting practices followed during World War II, was given study by the committee on accounting procedure. This study culminated in November, 1946, in Accounting Research Bulletin No. 27 in which the committee expressed the opinion that:

> " . . . when the facts clearly indicate that the accelerated amortization or depreciation of emergency facilities at rates permitted for tax purposes has resulted in a carrying value materially less than that reasonably chargeable to revenues to be derived from continued use of such facilities and where such difference would have a significant effect upon the financial statements, the adjustment of accumulated amortization or depreciation of such facilities is appropriate."

It will be observed that the committee related its opinion to situations in which the absence of a charge for depreciation would have a significant effect. This was emphasized in another paragraph in the bulletin where the committee said:

> "The committee wishes to emphasize the fact that is does not favor an adjustment . . . in cases in which such an adjustment would not have a substantial effect upon the representations that will be made in future financial statements."

A number of companies recognized the force of the committee's reasoning and gave effect to its opinion through adjustments of accumulated amortization or depreciation allowances related to emergency facilities whose usefulness continued into the post-emergency era. Nonobservance of A.R.B. No. 27 was not necessarily indicative of disregard of the bulletin. The post-war period was for a time marked by pessimism as to the economic situation. Thus post-war usefulness of emergency facilities was in many instances doubtful. In other cases, a substantial effect on representations in future financial statements was absent.

Such retroactive adjustments of accounts as A.R.B. No. 27 contemplated are undesirable. The mere fact of their being made casts a cloud over past financial representations, particularly with respect to earnings. To forestall, if possible, a necessity for like adjustments on completion of the present five-year amortization procedure, the committee studied the problem of depreciation, amortization, and income taxes as it relates to facilities erected, installed, or acquired under present Certificates of Necessity.

The conclusions of the committee were given expression in Accounting

Research Bulletin No. 42, now Chapter 9(c) of the *Restatement and Revision of Accounting Research Bulletins*. The bulletin as originally issued, and as restated, was adopted unanimously by the members of the committee. No new doctrine is, or novel applications of old doctrines are, advocated in it.

The principle of depreciation accounting has had long and general acceptance. Procedures for accounting for taxes on income and determination of income have long been recognized, Accounting Bulletin No. 23, *Accounting for Income Taxes*, having been issued in 1944. Bulletin No. 42 expresses in relation to one phase of the accounting for present so-called emergency facilities the principles that were the background for the procedures recommended in Accounting Research Bulletin No. 27 to which passing reference has been made. Thus the bulletin's authority rests on the already general recognition and acceptance of the principles underlying the procedures with which it deals, and on the unanimity of agreement of the members of the committee that issued it.

As the bulletin points out, so-called percentage certificates, many of which have been issued, may have been responsible for what appears as confused thinking about the accounting that would most clearly reflect the applicable principles. The bulletin repeats what was said in Accounting Research Bulletin No. 27, that:

> " . . . there is nothing inherent in the nature of emergency facilities which requires the depreciation or amortization of their cost for financial accounting purposes over either a shorter or longer period than would be proper if no certificates of necessity had been issued."

Translated, if that expression may be used, the foregoing says only that, merely because facilities are termed emergency facilities and that Certificates of Necessity have been received with respect to them, the facilities should not necessarily be deemed to have useful life coterminus with the five-year period over which their cost may be amortized for tax purposes. The corollary to this is that for financial accounting purposes the rate of charge-off of the cost of the facilities should be determined in the light of the principles of depreciation accounting. To quote from Accounting Research Bulletin No. 42 what was earlier said in Accounting Research Bulletin No. 27, depreciation accounting is:

> " . . . a system of accounting which aims to distribute the cost or other basic value of (productive facilities) less salvage (if any) over the estimated useful life of (a) unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation (of cost). . . ."

The purpose of depreciation accounting is to give reflection in the accounts to the fact that "the cost of a productive facility represents the cost of the services to be derived from its use," and to the "accepted accounting practice which dictates that such cost should be matched against the revenues obtained from the services."

While loss of economic usefulness was a factor and undoubtedly an important one, it was not the only, or even necessarily the governing one, in considerations by the governmental authority issuing Certificates of Neces-

sity of the propriety of issuing a certificate for which application had been made. Among the factors required to be considered in the issuance of these certificates, in addition to that of loss of economic usefulness, were: (*a*) character of applicant's business; (*b*) extent of risk assumed by the applicant (including the amount and source of capital employed, and the potentiality of covering capital or retiring debt through tax savings or pricing); (*c*) assistance to small business and promotion of competition; (*d*) compliance with government policies (*e.g.*, dispersal for security); and (*e*) other types of incentives provided by government, such as direct government loans, guaranties, and contractual arrangements. These factors are all referred to in Accounting Research Bulletin No. 42, but they seem worth repeating here, to emphasize that the accelerated amortization for which Certificates of Necessity have been received is not necessarily in and of itself alone conclusive evidence of the economic usefulness of the facilities covered.

In some cases, as the bulletin says, it may be apparent that the probable economic usefulness of a facility will not survive, or even endure for, the five-year amortization period. In such cases the five-year period (or even one shorter) for financial-accounting purposes would be the proper basis for allocating the cost of the facility against the revenue obtained from use of the facility. The rate at which the cost or other basis of emergency facilities should be written off for financial accounting purposes should be determined by those best informed as to the period of economic usefulness of the facilities. The factors on which this judgement would be based in any particular case cannot be even cursorily enumerated here, although there might be mentioned, as does the bulletin, as being among factors to be considered, "adaptability of the facilities to post-emergency use, the effect of their use upon economic utilization of other facilities, the possibility of excessive costs due to expedited construction or emergency conditions." The circumstances of each case must govern. When the economic usefulness of the facilities described as emergency facilities will admittedly endure for a time substantially beyond the five-year amortization-of-cost period allowed for tax purposes, and the amount is, or the amounts are, material, the procedures set out in the bulletin are applicable.

In some cases of percentage Certificates of Necessity, two bases have been adopted for absorption against revenues of the cost of facilities acquired under the Certificates. A write-off over five years has been made the basis for the percentage of cost covered by Certificates of Necessity. For the balance of cost of the facilities a basis founded on normal depreciation rates has been adopted. At first glance this has the appearance of inconsistency. It may not be so in fact, because foreseeable usefulness of the facilities may point to a dual basis of depreciation accounting as appropriate in the circumstances.

The fact that under World War II Certificates of Necessity no distinction was made generally between depreciation-amortization for financial accounting purposes and depreciation-amortization for tax purposes, is not in and of itself alone a compelling argument for disregarding the procedures that Accounting Research Bulletin No. 42 advocates. Neither before nor during

World War II had any corresponding pronouncement been made by the committee on accounting procedure or any other body, so far as is known at the moment. Furthermore, there is the advantage that hindsight has given of the distortions of income reporting that were a consequence of the World War II accounting practices.

Accounting Research Bulletin No. 42 carries November, 1952, as the issue date. This date is important as it bears on the extent to which the bulletin received observance with respect to accounting for 1952 as evidenced by published reports for 1952. So is Note 2 to the bulletin. That note, whose counterpart has been subjoined to each Accounting Research Bulletin issued, says in substance that it is not retroactive. That statement of nonretroactivity may have influenced to an indeterminable extent the 1952 depreciation accounting for emergency facilities.

Among the 600 published reports for fiscal years ended between April 30, 1952, and May 1, 1953, studied by the research department of the Institute as source material for the information to be contained in the forthcoming seventh edition of the Institute publication *Accounting Trends and Techniques in Published Corporate Annual Reports,* 159, slightly more than only one-fourth, of the 600 reports directly referred to Certificates of Necessity, either as having been received or for which applications were pending. The remaining 441 reports furnished no definite information from which it could be affirmatively determined that the reporting companies had received, or had applications pending for, Certificates of Necessity. Of the 159 companies that made disclosures concerning Certificates of Necessity, 11 reported that for financial accounting purposes depreciation provisions with respect to emergency facilities had been made on a normal basis, while they had claimed, or would claim, amortization on the five-year basis for federal taxes on income. Though not necessarily a sound conclusion, it seems reasonable to deduce that the remaining companies that made disclosures of Certificates of Necessity made charges for financial accounting purposes for depreciation of emergency facilities that coincided with those claimed or to be claimed as deductions for amortization in determining income subject to federal taxes on income.

This may not necessarily reflect disregard of the procedures recommended by the bulletin. Where emergency facilities constitute a relatively unimportant part of a company's productive facilities the tendency, for practical reasons, would be to have depreciation for financial accounting purposes coincide with that claimed or to be claimed for tax purposes. The effect on reported income may have such little relative significance, that the auditor, basing his opinion on materiality, would conclude an exception was not necessary. This would be in keeping with the committee views as expressed in paragraph 9 of the bulletin. The concluding sentence of this paragraph says:

> "The committee believes that when the amount allowed as amortization for income tax purposes is *materially* different from the amount of the estimated depreciation, the latter should be used for financial accounting purposes." [Italics by author.]

The corollary of this is that when the two amounts are *not* materially different, that allowed or allowable for tax purposes may be used.

Parenthetically, the reports embraced in the Institute study did not include those of public utility and railroad companies. Such companies have been required by many state regulatory agencies, or by the I.C.C., for financial accounting purposes to relate charges for depreciation of emergency facilities to bases that recognized the economic usefulness of the facilities, although for purposes of federal taxation deductions for amortization had been or would be claimed on the five-year basis. No information has been available as to the extent to which Accounting Research Bulletin No. 42 has been observed by companies whose reports were not included in the Institute study.

All of the 11 companies that disclosed charges for depreciation less than those to be claimed for depreciation and amortization in reporting taxable income for federal taxes on income recognized explicitly or inferentially that the related facilities would have economic usefulness beyond the five-year amortization period. They also reported provisions for taxes on income that were expected to be paid during postamortization-period years because no deductions for depreciation for tax purposes would be available in such years with respect to the facilities.

Provisions for future taxes were variously explained in the reports reviewed, but all recognized expressly or by implication that present tax reductions available through taking advantage of the privilege of five-year amortization for tax purposes were temporary in the circumstances of expected economic usefulness of the related facilities after the accelerated amortization period is over. Typical of the explanations given in the published reports are the following:

> (*1*) "Since the deduction in the current tax returns of (the excess of tax amortization over normal depreciation) will result in book provisions for normal depreciation on the certified portion of the facilities being unavailable as tax deductions in years following the amortization period, the Corporation has increased its tax provision for the year 1952 by (an amount substantially equivalent to the future tax effect occasioned by such book provisions being unavailable for tax deductions) and has credited this amount to a reserve for deferred Federal income taxes."
>
> (*2*) "The use of five-year amortization results in a temporary normal tax and surtax saving."
>
> (*3*) " . . . authorization to amortize the investment in these facilities results in a temporary tax saving . . . assuming a continuation of present tax rates and earnings level."

The last two of the examples express clearly the underlying postulate on which provisions for future taxes is premised: namely, the temporary nature of the tax reduction available through five-year amortization of the cost of facilities that it is expected will be continued in use after the amortization period has expired. Companies that disregard the opinion of the committee on accounting procedure that:

> " . . . a charge should be made in the income statement to recognize the income tax to be paid in the future on the amount of which amortization for tax purposes exceeds the depreciation that would be allowable if certificates of necessity had not been issued." (Paragraph 12 of Accounting Research Bulletin No. 42.)

must, if materiality is not a factor, impliedly rest their case on expectations of materially lower, or no, taxes on income, and/or an expectation of years of unprofitable operations, or even no operations, following the end of the five-year amortization period. The one type of expectation would appear to be wishful thinking; and the other of a kind that few corporations would be willing to admit.

One final example of explanations in published reports of provisions for federal taxes on income expected to be payable in the future by reason of unavailable deductions for depreciation of emergency facilities reads:

> " . . . these facilities will be useful in the conduct of the Companies' business after the periods for amortization for tax purposes have expired . . . provisions for depreciation of these (emergency) facilities have been taken into the accounts in amounts computed . . . on the basis of the estimated useful lives of the . . . facilities. Such provisions were less than . . . the amounts computed for purposes of taxes on income. Provision has been made from income for income taxes estimated to be payable in future years as a result of the aforesaid tax amortization and accounting policies."

Two examples have come to my attention of exceptions taken by accountants because of nonobservance of the procedures recommended by the bulletin. There well may have been many more but they have not had notice because they appeared in published reports not reviewed, or in unpublished reports. In one case the exception reads:

> " . . . except that provision has not been made for estimated future Federal income taxes with respect to depreciation on facilities which will be fully amortized for tax purposes after 60 months. . . ."

In the other it reads, including the pre-opinion paragraph:

> "As indicated in Note 2 to the Financial Statements, the companies' method of amortizing emergency plant facilities resulted in a reduction . . . in the net income for the year from the amount which would have been reported if normal depreciation rates had been used.
>
> "In our opinion, except as noted in the preceding paragraph. . . ."

The first quoted exception appeared in the report of a public-utility company; the second in that of an industrial company. In the second case material amounts were involved: a difference under bulletin procedures of about $5,000,000 in the net income reported of nearly $6,600,000. This difference was understatement of income.

One last point: In the published reports included in the Institute study, charges for five-year amortization were variously disclosed and described, either separately or combined with charges for normal depreciation. The terminology employed when five-year amortization charges were shown separ-

ately included expressions such as (*1*) accelerated amortization, (*2*) amortization of defense (or emergency) facilities, (*3*) additional amortization, and (*4*) excess of accelerated amortization over normal depreciation.

While the Internal Revenue Code refers to "amortization" in respect of the five-year write-off of the cost of facilities covered by Certificates of Necessity, fundamentally the charge is one for depreciation and obsolescence. There does not appear to be any good reason why amounts charged against income for the cost of emergency facilities producing that income, should not for accounting purposes be termed "depreciation." Add, if desired, "and obsolescence." The charge is for the exhaustion of the facilities or future lack of usefulness in the production of revenue, as is the charge commonly described as being for depreciation. From an accounting standpoint depreciation would seem to be a more appropriate term than amortization, with or without modifiers of the last named. The term amortization in preceding parts of this paper has been used in deference to the general understanding that term has received through usage and is not to be deemed a contradition of what has just been said.

In summary: The opinions expressed and the procedures set forth in Accounting Research Bulletin No. 42 have two objectives: (*1*) depreciation bases for costs of emergency facilities that for financial accounting purposes recognize the economic usefulness of such facilities, as against adoption of an arbitrary five-year-write-off basis merely because that is available for tax purposes; and (*2*) recognition of the temporary nature of tax benefits from the five-year basis of write-off when economic usefulness of the facilities will survive the short write-off period, and in the accounts provision for depreciation is on a normal basis but for tax purposes on the five-year basis.

Interim statement on survey of auditors' reports

CHARLES H. TOWNS

Partner, Loomis, Suffern & Fernald, New York.
Member, auditing procedure committee.

A survey to obtain information as to the extent to which auditors, in their examinations of accounts of clients and in their reports on such examinations, are complying with standards generally accepted within the American Institute of Accountants, is now in process. Questionnaires have been sent to banks and a large number of them have been returned, although some are still currently being received. A preliminary tabulation has been made. This tabulation does not include all responses, however, and it does not give all of the details and all of the relationships that will eventually be needed in order to draw reliable conclusions from the information received.

Accordingly, the material presented here is in the nature of an interim statement or report, for purposes of informing the members of the Institute of work that is being done. It should be understood that no final conclusions can properly be drawn as to the extent of auditors' compliance with standards or their lack of compliance, until all of the questionnaires to be tabulated have come in and until all of the information in the questionnaires has been fully analyzed and the resulting information has been interpreted.

HISTORICAL BACKGROUND

As most, if not all, of the members of the Institute know, the membership, at its 1939 annual meeting, approved certain "Extensions of Auditing Procedures." These extensions required observation of clients' physical inventory operations and required confirmation of receivables, except in cases where such procedures were not applicable or not appropriate. A summary of information regarding the "Extensions of Auditing Procedures" is to be found beginning on page 20 of the *Codification of Statements on Auditing Procedure,* which was published in 1951 under the auspices of the Institute committee on auditing procedure.

Also, as most, if not all, members of the Institute are aware, the committee on auditing procedure issued, in December 1947, its Bulletin No. 23 on *Clarification of Accountant's Report when Opinion is Omitted.* The presently effective statement on this subject is to be found in the Codification, beginning on page 18. The general purport of this statement is to the effect that financial statements on the stationery of an independent certified public accountant or any of his reports on examination of accounts should be accompanied by his opinion as to whether or not the statements fairly present the information they purport to show, or, if no such opinion is given, the auditor's reason or reasons for not giving an opinion are to be stated.

From time to time banks have raised questions as to whether auditors were following the standards outlined in "Extensions of Auditing Procedures" and whether they were following the intent of Statement No. 23. In some cases complaints were heard or read that auditors were not complying with these standards.

In November, 1949, *The Michigan Certified Public Accountant* published an article by Harry M. Prevo, CPA, on the subject of the auditing procedure committee's Statement No. 23. In this article there was a summary of the results of a survey made, with the cooperation of four Detroit banks. The purpose of the survey was to find out the extent to which the CPAs in the Detroit area were conforming to Statement No. 23 and to *Extensions of Auditing Procedures,* published as Statement No. 1. The banks were requested to furnish information principally with regard to companies whose securities were not listed on any stock exchange because it was believed that accepted auditing procedures and accepted reporting standards would have been followed for all or practically all listed companies.

Mr. Prevo stated that he was amazed and shocked by the information obtained from the banks. That is understandable when we look at the figures he obtained. Of 270 reports, 146 (54 per cent) showed that standards of inventory observation had not been observed; further, of these 146 reports, 135 appeared to be defective with respect to the reporting standards of Statement 23, including 59 in which there was no opinion and no disclaimer of an opinion.

Of 282 reports, 128 (45 per cent) showed that accepted procedures with regard to confirmation of accounts receivable had not been followed. Of these 128 reports, 118 appeared not to meet the standards of Statement No. 23, including 55 which "had no reference to an opinion whatsoever."

Mr. Prevo, like any reliable auditor, qualified his statements by saying that he did not personally examine the auditors' reports, that he had felt it would be asking too much to request the banks to give voluminous detailed information and that, consequently, he was not sure that his figures were accurate down to the last percentage point. He felt, however, that it was appropriate for him to draw four conclusions, which were, in substance, as follows:

(*1*) That accountants in the Detroit area were not following standard audit procedures to the extent that might be expected;

(*2*) That reporting methods were "not as professional as they should be";

(*3*) That banks were very much interested in this problem; and

(4) That a great deal could be accomplished if similar investigations were undertaken with many more of the banks in all parts of the country.

Later, the research department of the American Institute of Accountants, for the committee on auditing procedure, made a limited survey with the co-operation of the Robert Morris Associates and banks in the New York area, principally for purposes of testing a form of questionnaire. In this survey, 111 reports were reviewed by the banks. The results were summarized by the research department and reported to the committee on auditing procedure under date of May 12, 1952. In some respects the results of this survey were more favorable as to the compliance with standards and in some respects they were less favorable than those reported in the Prevo article. In any event, both samples were relatively small and perhaps the most reliable conclusion to be drawn from the information obtained was that further information was needed and that further investigation was advisable.

THE SURVEY NOW IN PROCESS

Action was taken appropriate to that line of thought. Under date of August 25, 1952, Mr. Gordon Hill, chairman of the committee on auditing procedure, addressed a letter to the presidents of state societies of certified public accountants (Exhibit A). This letter outlined briefly the information then available as to compliance with standards and requested that the state societies cooperate in a more extensive survey. A copy of the questionnaire developed by the committee and the Institute's research department was sent with each letter. This questionnaire and the accompanying instruction sheet are presented as Exhibit B herewith.

The cooperation requested was given to the extent that on October 15, 1953, 6,281 completed questionnaires had been received. These came from 26 states and had been prepared by approximately 300 different banks. Completed questionnaires are still being received and it is now estimated that a total of about 7,000 to 7,500 completed questionnaires will be available.

The questionnaire is a four-page document, and the information provided runs to 28 major items, with analyses of some of these, which runs the total to approximately 70 items for each reply received. Accordingly, it is clear that analysis, tabulation, summarization, and interpretation is a task of considerable volume.

At present, IBM cards are being punched as questionnaires are received. A preliminary tabulation has been made of 2,985 reports. It is not now expected that all of the responses will be in before the close of the year 1953. Accordingly, the results of the survey will not be available before some time in the year 1954. The tabulations will, of course, be impersonal, without names of auditors or clients.

It is of interest to note that, of the replies so far tabulated, over 89 per cent related to reports of certified public accountants and between 10 and 11 per cent were reports of noncertified auditors. Approximately 74 per cent appeared to relate to members of the Institute and about 26 per cent were for non-members.

It does not seem appropriate to attempt to present figures or percentages, generally, at this time. There is danger that undue weight would be given to the preliminary information now available. It can be said, however, that the information received and tabulated to date indicates that compliance with standards is subject to further improvement. For example, of 2,930 answers tabulated with regard to the auditors' opinions, 539 cases were noted (over 18 per cent) in which there was no opinion and no denial of an opinion. Approximately one third of the 539 reports did say that the statements had been prepared without audit. This, under some conditions, may be considered as substantially equivalent to denial of an opinion, but only where the reader can be relied upon to understand the significance of the words.

Further and more definite information on this subject may be expected after the receipt of completed questionnaires and after tabulation and interpretation of their contents has been finished.

Exhibit A. Text of letter to state-society presidents from the chairman of the Institute committee on auditing procedure.

August 25, 1952

In recent years the Institute and the state societies have made great progress in promoting closer cooperation between bankers and certified public accountants. The number of banks which ask their loan customers for financial statements audited by CPAs is steadily growing.

At the same time, there have been quite a few complaints from the banks that many CPAs do not completely follow accepted standards of auditing procedure, as indicated by the audit reports submitted to banks. Obviously, we cannot expect banks to increase their reliance upon our audited statements unless our audits are adequate and our reports are properly prepared for use in evaluating credit risks.

The Institute's committee on auditing procedure believes that we must meet this issue squarely, and that the first step is to obtain facts about the quality of audit reports which are being received by banks throughout the country.

A small study of this kind in Michigan about three years ago indicated that many reports on which CPAs' names appeared were seriously deficient. Another limited study recently made in New York by the Institute's research department generally supports the Detroit survey. For example, the AIA survey revealed that Statement No. 23 was applied in only 25% of the cases in which it appeared to be applicable. If this condition is prevalent throughout the country, the accounting profession should know about it and take steps to remedy it.

Accordingly, the committee on auditing procedure, with the assistance of the research department, has prepared the enclosed questionnaire and hopes to have it answered by banks in all parts of the country. We hope that your society will undertake to obtain completed questionnaires from a representative number of banks in your state.

A.I.A. Assistance

The research department desires to be of every possible assistance in making the survey. If you will let Carman G. Blough the Institute's director of research, know

how many copies of the survey material (questionnaire, instruction sheets, AIA firm lists) which you are likely to need, he will send a supply immediately to you, or to the person in the society whom you designate to supervise the work. The research department is also prepared to handle the tabulation of the questionnaires and to report the results.

State Societies Best Equipped to Organize Survey

One reason we are calling upon you to organize the survey in your state, rather than trying to handle it directly from New York, is that your familiarity with the local banking situation will enable you to select the best approach to the bankers in your state. In New York, the research department worked through local members of the Robert Morris Associates and received excellent cooperation. In other areas it may be preferable to approach local banking groups or directly contact individual bankers. Care should be taken to be certain that the bank officers or employees who answer the questionnaires are thoroughly familiar with audit procedures, so that they will not make errors in interpreting audit reports in their files. In some cases it may be desirable to arrange with the bankers a "briefing" session on the questionnaire for those who will be assigned the task of compiling the data.

Importance to Bankers

The approach is important because cooperation is a requisite for success of the project. One thing we should like to suggest to you, is that it will be important to emphasize the benefits which the bankers themselves will derive from the survey. Foremost among these benefits are (1) the information they will obtain, on a systematic basis, as to the quality of the accountants' reports they are obtaining, and (2) the improvement in reports that should result from the project. The information will be available both on a local and a national basis for comparison if desired.

Public Relations Benefits

Your society should also gain public relations benefits from approaching bankers with this project, which again demonstrates the organized profession's sincere desire to improve the quality of its work.

Survey Procedure

It will be desirable to obtain from 50 to 100 questionnaires filled out by each of several banks in your state. Based on our tests of the questionnaire, this should require approximately one and one-half to three man-days' work on the part of each bank.

The reports should be selected at random by the banks, but they should include a representative number of accounting firms. A large proportion of the reports should deal with small businesses, since reports on larger businesses are so frequently of the short-form type which do not include many details as to procedures applied.

You will note that the instructions to the banks include a suggestion that each questionnaire be numbered. This is to facilitate referring back to the report, in case it should become necessary. We believe it would be desirable if you would also

include a code letter for each bank, before sending the completed questionnaires to the Institute, for the same reason. The questionnaire is believed to contain all the questions needed to get the information desired, without asking the banks to assume an unreasonably arduous chore. There are other points of information, similar to those covered by the questionnaire, which are likewise obtainable on an objective basis only from the banks. However, we would be imposing an unfair burden upon them to request such information at this time.

We feel sure you will agree that the information requested is of the utmost importance in maintaining high standards within the profession. In undertaking the project, you and your society will be making an important contribution to accountants in your state and throughout the country. A small supply of the instructions, including a filled-in sample questionnaire, is enclosed for your use in discussing the matter with those who will cooperate in the survey. If you have any questions, write to me or to Carman Blough, and we shall be glad to help.

Very truly yours,
Gordon Hill, Chairman
Committee on Auditing Procedure

GH:rc
Enclosures

Exhibit B. Instructions for questionnaire on audit reports

This questionnaire has been prepared to obtain statistical data as to the extent to which independent public accountants' reports submitted to your bank indicate:

(a) Confirmation of accounts receivable by direct communication with the debtor,
(b) Presence of accountants during the counting of inventory on hand, and
(c) Accountants' practices in expressing an opinion or in withholding an opinion.

Data is sought only as to annual reports covering a full year.

Generally accepted auditing procedures require the accountant, whenever practicable and reasonable and the items are material, to confirm accounts receivable by direct communication with the debtors and to be present during the counting of the inventory on hand to observe the client's methods of inventory-taking. These procedures may be applied on a "test" basis. When they are omitted entirely, the accountant should state that fact in the section of his report describing the scope of the audit.

In some rare cases, the accountant may be able to satisfy himself as to the receivables and inventories by other auditing procedures. In such cases he need not qualify the opinion section of his report. When he is not able to satisfy himself by other auditing procedures, the accountant should decide whether in the particular circumstances he may properly express an opinion with qualifications, or whether he must state that he is not in a position to express an opinion. In reaching a decision in this respect, the materiality of the items in the particular circumstances is usually controlling.

The questionnaire has been divided into four parts dealing with (a) the accounting firm, (b) the accountant's opinion, (c) confirmation of accounts receivable, and (d) observation of the inventory count. Please indicate by a check in the space provided the correct answer to each point as found in each audit report. PLEASE USE A SEPARATE COPY OF THE QUESTIONNAIRE FOR EACH REPORT.

A space has been provided in the upper right-hand corner of the questionnaire for inserting a code number for each report. It is suggested that you make a list of the reports, showing the corresponding code number for your information and for possible future questions as to individual reports, but please do not attach a copy of the list.

As indicated on the preceding pages, the materiality of the item is frequently a significant factor in deciding what disclosure should be made regarding the auditing procedures employed and whether an opinion should be expressed. Questions as to the relative size of the items in the particular case have, therefore, been included. This information will be helpful in judging the materiality of the items.

It would be helpful to know whether the accounting firms whose reports are covered by the questionnaires are certified public accountants. Accordingly, there has been included a section in which you may indicate whether you believe the accounting firm to be CPAs or non-CPAs. It is intended that this point should be answered on the basis of your general knowledge of the firm.

Information is also desired as to whether or not the accounting firm signing the report is represented in the American Institute of Accountants, the national professional organization of Certified Public Accountants. A copy of "Accounting Firms and Practitioners—1951" is provided to assist you in answering this question.

A sample questionnaire, filled out to illustrate a possible situation, is attached for your guidance.

Report No. 43

QUESTIONNAIRE ON AUDIT REPORTS

Accounting Firm

A. CPAs or Non-CPAs

We believe the accounting firm whose report is covered by this questionnaire to be:

__✓___ Certified Public Accountants
______ Not Certified Public Accountants

B. Representation in AIA

__✓___ The accounting firm signing the report is represented in the American Institute of Accountants.
______ The accounting firm signing the report is not represented in the American Institute of Accountants.

THE ACCOUNTANT'S OPINION

A. Type of Report

_________ Short form (usually consists of balance sheet, income statement, and surplus statement accompanied only by certificate).

____✓____ Long form (usually consists of financial statements and certificate, as above; plus, supplementary schedules and accountant's interpretive comments on scope of audit, financial position, results of operation, etc.)

B. Opinion Section of Report

The opinion was:

_________ Unqualified (though possibly subject to comments, notes, etc., which do not give rise to specific exception by the accountant)

_________ Qualified

_______ As to receivables (Because of _______ failure to confirm, _______ other reasons)

_______ As to inventories (Because of _______ failure to observe _______ other reasons)

_______ In other respects

____✓____ Over-all opinion denied

_______ Because inventory observation was omitted

___✓___ Because receivables were not confirmed

_______ Other reasons

___✓___ But opinion was expressed as to certain other items in the financial statements ("piecemeal" opinion)

_________ No opinion, and no denial of opinion

(Include here any comments which would be helpful in interpreting above answers.)

Piecemeal opinion as to "cash, inventories, prepaid insurance, deferred charges, liabilities and capital stock".

CONFIRMATION OF ACCOUNTS RECEIVABLE

A. Report states that accounts receivable were:

_________ Confirmed (_______ requested on test basis; _______ 100% requested; _______ extent of confirmation request not indicated)

___✓___Not confirmed

_______Accountant states specifically he satisfied himself by other procedures.

___✓___Accountant states specifically he did not satisfy himself by other procedures.

_______No statement as to whether he satisfied himself by other procedures.

_______No statement as to confirmation of receivables.

B. Accounts receivable amounted to:

___✓___Over 30% of current assets

_______15% to 30% of current assets

_______5% to 15% of current assets

_______Less than 5% of current assets

(Include here any comments which would be helpful in interpreting above answers —e.g., reasons why receivables were not confirmed, "other procedures" by which accountant satisfied himself.)

Not confirmed upon instructions of client.

OBSERVATION OF INVENTORY COUNT

A. Report states that the counting of inventory on hand was:

___✓___Observed by accountant

_______Not observed by accountant

_______States specifically he satisfied himself by other procedures.

_______States specifically he did not satisfy himself by other procedures.

_______No statement as to whether he satisfied himself by other procedures.

_______No statement as to observation.

B. Inventory on hand amounted to:

___✓___Over 30% of current assets

_______15% to 30% of current assets

__________5% to 15% of current assets

__________Less than 5% of current assets

(Include here any comments which would be helpful in interpreting above answers —e.g., reasons why inventory counting was not observed, "other procedures" by which accountant satisfied himself.)

In addition to inventory on hand, inventory in public warehouses was confirmed by correspondence with warehouse.

Codification of statements on auditing procedure

FRED G. PAGE

Partner, Osborn and Page, Nashville. Member, Institute committee on auditing procedure.

In his article appearing in the January, 1953, issue of the *New York Certified Public Accountant,* Mr. Benjamin Newman made the following statement:

"With the publication of the *Codification of Statements on Auditing Procedure,* a change *in substance* of *Statements on Auditing Procedures* Nos. 1, 3, and 12, was effected, and with this change has come, subtly and no doubt unwittingly, a modification of certain previously established auditing standards of field work and reporting."

Mr. Newman then asked the question: "What is this change which has gone largely unnoticed, and how substantial is it?" He then states that the so-called change relates to (quoting from the *Codification*) the "expression of an opinion in the rare situation where inventory observation or confirmation of receivables, though practicable and reasonable, is not carried out, but other procedures are employed which justify the expression of an opinion."

Mr. Newman explains what he calls the change in substance as follows:

"The change in substance effected by the *Codification* consisted in universalizing the rule as it applied to those conditions which justify the omission of the extended procedures because their employment would be unreasonable and impracticable. To quote from the *Codification*:

'In all cases in which generally accepted auditing procedures are not carried out, or generally accepted auditing standards are not applied, unless the items are not material, disclosure is called for in the "scope" paragraph, together with either a specific qualification or a disclaimer of opinion, depending upon the relative importance of the items affected, in the opinion paragraph; except that in those rare cases in which the independent auditor has been able to satisfy himself by other methods, a disclosure in the "scope" paragraph is sufficient.'

"The desirability of developing an informed background for this dis-

cussion will serve to justify an additional quotation from the *Codification*, which clarifies the application of the general rule just quoted to the special circumstances relating to the omission of the extended procedures:

'In all cases in which the extended procedures are not carried out with respect to inventories or receivables at the end of the period or year, and they are a material factor, the independent certified public accountant should disclose, in the general scope section of his report, whether short or long form, the omission of the procedures, regardless of whether or not they are practicable and reasonable and even though he may have satisfied himself by other methods.

'In the rare situation in which they are applicable and are not used and other procedures can be employed which will enable him to express an opinion, he should, if the inventories or receivables are material in amount, disclose the omission of the procedures in the general "scope" paragraph without any qualifications in the "opinion" paragraph with respect to such omission. In deciding upon the "other procedures" to be employed he must bear in mind that he has the burden of justifying the opinion expressed.' "

Mr. Newman then reaches the conclusion that the effect of the so-called new rule is that an unqualified opinion is now possible where extended procedures were omitted, even though their use was reasonable and practicable. This conclusion, with which the committee disagrees, was doubtless based upon the unfortunate choice of language in the historic preface to the *Codification*, which, in discussing auditing statements Nos. 1, 3, and 12, stated that "changes in substance" had been made. Soon after the issuance of the *Codification* the committee realized that this phrase did not convey its intent and was susceptible of misunderstanding, and, accordingly, took action to change the wording to indicate that its purpose was to clear up "ambiguities" contained in statements Nos. 1, 3, and 12, and not to make changes in substance. Notice of this change was commented upon in the August, 1952, issue of THE JOURNAL OF ACCOUNTANCY. All reprints of the pamphlet will carry the corrections.

The "ambiguities" referred to related to appropriate wording of the "scope" paragraph in those instances where the auditor had satisfied himself by other means and had not employed the extended procedures even though it would have been practicable and reasonable to have done so. The committee on auditing procedure felt that Auditing Statements Nos. 1, 3, and 12 were not entirely clear on how reports should be drafted in such circumstances.

Auditing Statement No. 1 contained the following remarks concerning the Auditor's report:

"The proposed changes will take time to bring about, and in the meantime the profession may well be faced with the necessity of submitting qualified reports in those cases in which it has been impracticable to carry out the added procedures."

"In explanation of the general principles governing the auditor's opinion,

with particular regard to explanations and exceptions, it is pertinent to state that the auditor satisfies himself as to the fairness of the statements 'by methods and to the extent he deems appropriate,' in general conformity with the auditing procedures recommended in the Institute's bulletin *Examination of Financial Statements.* Ordinarily, if he has so satisfied himself, he is in a position to express an unqualified opinion. However, if he considers it in the interest of clear disclosure of material fact to include explanations of procedures followed, he is free to do so. If, on the other hand, such disclosures are made by reason of any reservation or desire to qualify the opinion, they become exceptions and should be expressly stated as such in the opinion paragraph of the auditor's report."

"It is desirable, as a general rule, that exceptions by the independent certified public accountant be included in a paragraph separate from all others in the report and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, any particular item of the financial statements, the soundness of the company's procedures (as regards either the books or the financial statements), or the consistency of accounting practices where lack of consistency calls for exception."

"If physical tests of inventories and/or confirmation of receivables are practicable and reasonable and the auditor has omitted such generally accepted auditing procedure, he should make a clear-cut exception in his report."

These comments left many practitioners with the question as to whether the exception should be reported in the "scope" paragraph of their reports or in the "opinion" paragraph, or both.

Auditing Statement No. 3 included these comments on this matter:

"There appears to be a question in the minds of some concerning the character of exceptions necessitated by the omission of the added procedures when their application is practicable and reasonable. When the auditor has been unable to satisfy himself concerning the *amount* of inventories or receivables (or any other asset) stated in the accounts, he will continue, as in the past, to make a definite exception as to the amount. Moreover, where the added procedures prescribed in "Extensions of Auditing Procedure" are practicable and reasonable, if the auditor has not adopted them an exception is still required even though he may have satisfied himself by other means as to the fairness of the amount. What is the character of the exception in these circumstances?

"The report, 'Extensions of Auditing Procedure,' clearly refers to several types of exceptions in the following language:

'Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, any particular item in the financial statements, the soundness of the company's procedure (as regards either the books or the financial statements), or the consistency of accounting practices.'

"This leads to the obvious conclusion that when the added procedures

are applicable and the auditor has not adopted them but has satisfied himself by other methods, his exception need cover only the omission of the procedures (affecting the scope of work), without calling into question the inherent fairness of the representations. On the other hand, were the auditor not satisfied, and were his exceptions so material or the scope of his examination so limited as to negate the expression of an opinion, he would limit his report to a statement of findings, and, if appropriate, say that the limitations, or exceptions, were such as to make it impossible to express an opinion concerning the fairness of the statements as a whole."

From the foregoing it seems clear that the intention was that any of the exceptions under discussion should be reported only in the "scope" paragraph. The illustrative short-form report contained in Auditing Statement No. 3, however, seemed not only to include the exception in the "scope" paragraph but appeared to make the accountant's opinion subject to such exception. The thinking of the committee on auditing procedure, as constituted when the *Codification* was adopted, could be summarized as follows:

Relatively few cases would exist in which the application of the procedures required by Auditing Statement No. 1 were not practicable and reasonable but, where the extended procedures specified by Auditing Statement No. 1 were not undertaken because it was unreasonable and impracticable to apply them, the "scope" paragraph of the auditor's report should state the omission. If the auditor had satisfied himself by other means, the "opinion" paragraph of his report did not require qualification.

What "other" procedures are acceptable?

RUSSELL C. HARRINGTON

Partner, Ernst & Ernst, Providence. Member, Institute's Council and committee on auditing procedure.

We have before us the question of what other sufficiently comprehensive auditing procedures can be applied in the examination of receivables and inventories to enable the auditor to express an informed professional opinion on the financial statements when he has not followed the normal procedures of confirmation of receivables by direct communication with debtors and/or observation of inventory taking. Our interest in this question comes about logically as a result of experience with the requirements laid down in *Extensions of Auditing Procedures,* published in 1939 as Statement No. 1 in the series of *Statements on Auditing Procedure,* and reprinted in *Codification of Statements on Auditing Procedure.*

It has come to the attention of the committee on auditing procedure that there have been a number of instances where practicing accountants have not followed these extended procedures. In such instances, the auditors have apparently relied on other procedures to justify the expression of an opinion on the financial statements.

What are these other procedures which can be considered as acceptable substitutes to the confirmation-observation procedures? The literature of the accounting profession throws very little light on this question. I think this is understandable in view of the variety of situations that present themselves to each of us in our auditing engagements.

Perhaps this is a problem for which there is no pat solution. Certainly, the paucity of literature on this subject might well indicate the difficulty, if not the impossibility, of outlining in more than a very general way the procedures that might be adopted as substitutes for the confirmation-observation procedures. This does not mean, however, that we should not continue to seek a solution. The more we discuss the problem and talk about it, the more likely we are to reach a satisfactory and general understanding of what we mean when we say "we have satisfied ourselves by means of other auditing procedures."

The *Tentative Statement of Auditing Standards,* approved by the membership of the Institute in 1948, is the latest step in an evolutionary process that commenced back in 1917 with the publication of a pamphlet prepared at the request of the Federal Trade Commission. This pamphlet, which set forth standards and procedures for the auditing and preparation of financial statements, was revised from time to time in the light of changing conditions, the widening influence of the accounting profession, and developments in accounting technologies and techniques. Since the last revision, in 1936, these pamphlets have been superseded by *Statements on Auditing Procedure* and by the pamphlet on standards.

Practitioners in the accounting profession have always had standards; standards of personal integrity and independence, and standards of professional skill and competence in conducting their examinations and reporting thereon; but it was not until the publication of *Tentative Statement of Auditing Standards* that standards were defined and agreed upon.

We are concerned in this discussion with standards of field work, particularly as they relate to the obtaining of sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements under examination. In meeting these standards, it is clear that the element of judgment enters into the auditor's determination of the extent to which auditing procedures should be applied in obtaining "sufficient competent evidential matter." The evidence on which the auditor relies as the basis for an informed professional opinion, however, must be obtained through "inspection, observation, inquiries, and confirmations." Conformance with the standards requires the use of one or more of these procedures in obtaining evidence that is both "sufficient" and "competent."

Following the publication in 1939 of *Extensions of Auditing Procedures,* many certified public accountants, bankers, and laymen generally reacted as though the accounting profession had made a radical change in auditing standards and procedures by establishing as a rule that, wherever practicable and reasonable, the confirmation of receivables and observation of physical inventories would be considered normal auditing procedures. Actually, the only radical change was the requirement that made mandatory the procedures that had been followed to a considerable extent by certified public accountants for many years. In many auditing engagements, it had been customary for the auditor to confirm receivables and/or to check physical inventory quantities, either by reason of special arrangements to meet clients' wishes, or because the auditor felt that it was necessary to reach an informed professional opinion.

Extensions of Auditing Procedures requires confirmation of receivables and observation of inventories where either of these assets represents a significant proportion of the current assets or of the total assets of a concern. The only qualification to this requirement is that it must be both practicable and reasonable to apply these procedures. However, even in those cases where it is not practicable and reasonable to confirm receivables and observe inventories, effective substitute procedures must be employed to justify the expression of an unqualified opinion.

It is the responsibility of the auditor to devise procedures that he can justify as a basis for his opinion. The committee on auditing procedure has taken the position that there may be situations where the auditor can obtain the appropriate degree of satisfaction by using "other" procedures, but that these situations are so rare as to be virtually nonexistent. This is a sound position, because our experience as practicing certified public accountants has demonstrated the difficulty of devising satisfactory substitutes for confirmation-observation procedures.

It is not within the province of this discussion to state what other procedures may be acceptable in the situations in which the extended procedures are applicable and are not employed. It is to the situations where other methods must be employed, because the extended procedures are impracticable and unreasonable of application, that our discussion should be directed.

In view of the fact that the possibility of being able to satisfy one's self by other means with respect to receivables differs from that with respect to inventories, it would be appropriate to discuss them separately.

RECEIVABLES

Extensions of Auditing Procedures requires confirmation of receivables by direct communication with the debtors, where it is practicable and reasonable to follow this procedure. It is generally understood that it is neither practicable nor reasonable to confirm receivables by direct communication in the case of those customers who rarely confirm amounts stated in such requests and have frequently expressed their inability to do so. United States Government agencies and certain of the chain stores are examples of customers in this category. It seems to me that in such situations there are other procedures that can be employed and which would be substantially equivalent to direct communication.

I suggest that the auditor might take at least two steps to obtain sufficient competent evidence in such cases. One of the steps suggested is an extension of usual procedures in review of internal control, and the other step is an added procedure, one which would not ordinarily be needed where confirmation by direct communication is obtained.

Certainly, in the absence of confirmation, a more detailed and thorough review of internal control of receivables would be called for. This would involve closer observation of practices and procedures with respect to sales, shipments, billings, collections, and cash deposits, and the selection of a greater number of recorded transactions for checking.

This additional work on internal control would not, of itself, be sufficient to constitute an acceptable substitute procedure. It would merely serve the purpose of giving the auditor more information by which he could weigh the risk, and evaluate the degree of reliance he can place upon the internal evidence.

The added procedure I suggest is an independent identification of cash collections with individual charges to customers' accounts. This can be accomplished by the auditor maintaining control of the incoming checks, identifying

them with specific invoice billings, and accounting for their disposition through cash-receipts records and bank deposits. Evidence obtained by means of this suggested procedure would appear to meet our standards fully. It might even be argued that this is actually a "confirmation" procedure by reason of the fact that the evidence represented by the debtor's check is, in fact, "external" evidence. This added procedure, however, must include a reasonable proportion of the accounts in order to be acceptable.

It is obvious that the procedure cited represents a laborious and time-consuming operation, and this means it would be a costly operation. Where it is impracticable and unreasonable to confirm by direct communication, such substitute procedures would be required. Where it is practicable and reasonable to confirm by direct communication, there would seem to be no reason for omission of this procedure.

We should be careful not to be lulled into a false sense of security merely because we have applied the procedures of confirmation or acceptable "other" procedures. Such procedures should not be considered as substitutes for a thorough review of the records pertaining to receivables, the so-called internal evidence. Internal evidence and external evidence must be considered together in evaluating the sufficiency and competency of *all* the evidence relied upon.

INVENTORIES

Extensions of Auditing Procedures requires the auditor to be present, whenever practicable and reasonable, at inventory taking and, by suitable observation and inquiry, to satisfy himself as to the effectiveness of the methods of inventory taking and as to the measure of reliance that may be placed upon the client's representations as to inventories and upon the records thereof.

Where it is not practicable and reasonable for the auditor to be present at the time or times of inventory taking, he must, of necessity, devise other procedures if he is to express an unqualified opinion. The choice of procedures and how they are to be applied, rests entirely with the auditor.

Since the greater part of our practice, where inventories are a material factor, is in the manufacturing and trading businesses, our discussion should be limited to those areas. Probably the most frequent situations where we find we are unable to observe the taking of physical inventories are in those cases where we are employed as auditors after the client has taken inventory. Under these circumstances, our decision as to whether or not we can devise acceptable substitute procedures will depend entirely on the adequacy of the records.

If the client has good inventory and production control records, it may be possible to devise acceptable substitute procedures. In order to be acceptable, however, these procedures must include, to the extent feasible and significant, tests of physical inventories during the course of the examination.

Assuming good inventory controls, such as a perpetual inventory system, we will usually find one of two methods of physical inventory taking employed: *(1)* A complete inventory taken once a year; or *(2)* inventories taken from time to time during the year, the cycle being completed within the year. Our choice of procedures may vary depending upon which method is used.

Where a complete inventory was taken at the year end and our engagement is commenced, say, a month later, selection of a representative proportion of the total inventory and arrangements for physical counts, weights, or measures thereof to be taken under our scrutiny would be one acceptable procedure. A logically corollary step to this would be the checking of intervening transactions in the specific inventories back to the year-end figures. From this test we may be able to judge the extent to which reliance could be placed on the inventory records from which the final inventory amounts were compiled.

Where partial inventories are taken from time to time during the year and the perpetual inventory records adjusted accordingly, we could arrange for the scheduling of some of these physical counts, weights, or measures to be made during the period of our field work so that we could observe methods and procedures employed. If the proportion of the total inventory represented by these physical tests is, in our judgment, too small a sample, additional physical checks would be called for.

If we make these tests under the circumstances outlined, and if we are satisfied that the inventories are properly controlled, with appropriate adjustments of the inventory records made on the basis of carefully taken physical inventories, we have, in my opinion, employed acceptable substitute procedures.

Another instance illustrating the impracticability and unreasonableness of the observation technique is the case of the opening inventories of a new client. In this case several possibilities present themselves: *(1)* We may have succeeded another auditor who made an examination the previous year, expressing an unqualified opinion. *(2)* We may have succeeded another auditor whose examination the previous year did not include observation of physical inventories. *(3)* No auditor was employed the previous year.

Obviously, we are under an obligation to make a review of the opening inventories, if for no other reason than to decide whether we are justified in expressing even a qualified opinion on the income statement. Assuming we find no reason to question the over-all integrity of the opening inventories, the easiest thing for us to do is to qualify the opinion as to the income statement.

This may not satisfy our client, or a third party in interest, so we go to work to find procedures to substitute for physical contact with the opening inventories. In the case where the preceding auditor expressed an unqualified opinion on the previous year's financial statements, and where we can make arrangements to have access to his working papers, and to consult with him, we could determine the extent of his compliance with the procedures set forth in *Extensions.*

If we can satisfy ourselves that the previous auditor had followed all the required procedures and had obtained sufficient competent evidence, in much the same manner and to the same extent as we would have done under like circumstances, this would be an acceptable substitute procedure. If we cannot satisfy ourselves in this manner, we would have to consider the quality and availability of the internal evidence.

If the general accounting and cost records are good and the internal control

adequate, it may be possible for us to "work back" the current year-end inventories to the beginning of the year. In this connection, it should be pointed out that the application of this procedure to the detailed inventory records is a costly operation and, in many cases, while possible, is impracticable.

We would also want to compare the various components in the inventories for a period of a few prior years to study the pattern in relation to sales, costs, and gross profit. If our "work-back" gives us a figure reasonably approximating the figure recorded for opening inventories, and our other tests indicate no unusual trends, it might well be considered that we have applied acceptable substitute procedures.

If the records do not lend themselves to the application of such tests, then, it seems to me, we cannot find procedures which would be acceptable within the framework of our standards. Here, again, internal evidence as represented in the books and records is just as important as external evidence obtained by inspection, observation and inquiries. The two complement one another and must be considered together in any well-rounded audit program.

We all recognize the possibility of other situations where it will be impracticable and unreasonable to apply the extended procedures to inventories. The committee on auditing procedure dealt with two such situations in Statements No. 16 and No. 17, both published in December, 1942.

Statement No. 16, *Case Studies on Inventories,*[1] discussed procedures that might be applied in those cases where it is not practicable and reasonable to determine inventory quantities of materials such as scrap iron, iron ore, etc., stored in piles, because: *(1)* the ground on which the pile rests may not be level; *(2)* the material may comprise both heavy and light metal making it impracticable to use a common measure of weight per unit of volume; *(3)* the extent to which the pile has sunk into the ground may not be determinable; *(4)* the density of the pile may not be uniform due to a variety of shapes causing uneven packing.

The committee laid considerable stress on the operating and accounting practices of the client with respect to the piles, pointing out that, where piles are liquidated under a planned program, the auditor would have available evidence to check the accuracy of inventory records. Although the committee did not say so directly, there is a clear inference that, where this practice is followed, the auditor may have enough evidence through his examination of inventory adjustments and stock-pile records, taking into consideration his review of internal control, to satisfy himself as to the accounting for this kind of an inventory by these methods.

In the absence of inventory practices that permit checking stock-pile records through the liquidation of piles, however, the committee indicated the difficulty of obtaining such satisfaction in the following observation:

> "On the other hand, a company may operate one or more piles, each of which may undergo concurrently additions for material received and withdrawals for material used. In such a situation the company's procedure does not permit adequate periodic corroboration of stock pile records,

[1] *Codification of Statements on Auditing Procedures,* pages 33-40.

and this fact should be suitably disclosed if the amount is material and there is not adequate supporting evidence of some other character by means of which the auditor can satisfy himself."

Statement No. 17, *Physical Inventories in Wartime,* dealt with cases where no physical inventories were taken because of high production, multiple-shift operation, constant pressure, overtime work, shortage of manpower, employment of less-efficient personnel, etc. It is possible that some auditors will encounter such situations in our present defense economy. It seems to me that the pronouncement of the committee as expressed in this statement published eleven years ago is as appropriate today as it was then.

The committee did not suggest the application of substitute procedures to inventories of raw material and finished goods, but confined the discussion primarily to work in process. The committee considered this problem in the light of the book records available with the following comments:

"Probably the most satisfactory accounting record of work in process is a perpetual inventory record which ties in directly with a general ledger control account. In many cases, however, general ledger control accounts for work in process are not supported by formal perpetual inventory records, but by some form of underlying detailed cost records. Properly maintained, such detailed cost records may, in some cases, be equivalent to perpetual inventory records relating to work in process and are, therefor, sometimes susceptible of physical test checks. This is particularly true of those industrial operations which are basically of the 'job cost' type. However, it should be pointed out that the work in process inventory is constantly changing in form and amount, and its complicated nature requires of the independent accountant, a greater degree of skill than is ordinarily required in the case of raw material or finished stock.

"There will, no doubt, be cases where the only accounting record of work in process is a general ledger account, there being no underlying detailed cost records which would serve as a basis for validating the total amount of work in process. Under such circumstances the total dollar amount could not be checked without listing the quantities of all the stock covered by the general ledger account and extending them at cumulative unit costs; test checking of quantities, therefore, would not be feasible. The accountant could make an exhaustive test of the entries by which the book amounts had been developed, but this could not be considered as a satisfactory substitute for a listing of the stock and physical inventory by the company."

After pointing out that the auditor should undertake a careful review of costs, inventory records, production schedules, reports of engineers as to percentage of completion of contracts, etc., the committee concluded the discussion with the following statement:

"The aforementioned alternative procedures which might be undertaken by the independent accountant, where a company fails to make a physical check of all or part of the inventory, are set forth on the assumption that the company has some form of book record of inventory. Other-

wise, the amount of inventory would have to be determined by very rough over-all estimates which in most cases would be too unreliable to provide a basis for an informed opinion as to the financial statements as a whole."

CONCLUSION

The exercise of judgment and professional skill is required of the auditor in deciding upon the "other" procedures that can be applied in the circumstances of each case. He has the burden of justifying the procedures he employs. There can be no pat answer to the question of what "other" procedures are acceptable. Each case will present its own problems and no formula, or set of rules, can be developed to guide us in this difficult area of our practice. We can be guided only by our own sense of responsibility to meet the standards we have set for ourselves, to the end that we can justify the expression of an informed professional opinion on the financial statements under examination.

Pitfalls in preparing special reports

DONALD J. BEVIS

Partner, Touche, Niven, Bailey & Smart, Detroit.
Member, Institute's auditing procedure committee.

A definition of what we mean by special reports is required before we can consider the pitfalls in their preparation. In brief, special reports are those in which the language of the accountant's report does not and cannot conform with, or cannot be adopted or related without modification to, the standard short-form report (with or without qualifications), because there are elements present in the situations upon which the accountant is reporting that require a special type of reporting.

The need for the use of special reporting techniques in the majority of the situations with which we are concerned has been with us for a long period of time. But are these techniques in conformity with generally accepted standards of reporting? The problem we are facing arises primarily from our recognition of our responsibilities as auditors as expressed or implied in two important actions that were taken in recent years by the members of the American Institute of Accountants.

At the annual meeting of the Institute in September, 1948, the membership approved a summary of the meaning of generally accepted auditing standards as presented by the committee on auditing procedure in a special report issued in October, 1947. With respect to the "standards of reporting" the resolution contained the following:

> "1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
>
> "2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
>
> "3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

The definitive enunciation of these standards was, in part, related to certain of the Statements on Auditing Procedure that had been issued in the past by the committee and to the requirements of the Securities and Exchange

Commission with respect to the representations as to audits to be contained in accountants' certificates filed with that body.

In this discussion no further consideration will be given to the "general standards" and the "standards of field work" inasmuch as these standards should be observed, where applicable, in all types of examinations made by certified public accountants. These standards, which relate to the auditor's professional qualities and to his exercise of judgment in the conduct of his examination, by themselves do not create any problems that are peculiar to special reports, as contrasted with reports that contain the language of the standard short-form report.

The wording of the standard short-form report (without qualifications or exceptions) that is now generally used was recommended by the committee on auditing procedure in October, 1948, and reads as follows:

> "We have examined the balance sheet of X Company as of December 31, 19– and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> "In our opinion, the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19–, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

The standard short-form report that was used for several years prior to the introduction of the present form also contained references to generally accepted auditing standards and to fair presentation in conformity with generally accepted accounting principles.

The action that caused probably the greatest comment and discussion in many years among members of our profession was occasioned by Statement No. 23 of the committee on auditing procedure relating to the clarification of the accountant's report when an opinion is omitted. Statement No. 23 was adopted by the membership at the annual meeting in November, 1949, and established a new standard of financial reporting. In essence, Statement No. 23 required the CPA to state clearly and unequivocally *in all cases* the degree of responsibility he assumes when he permits his name to be associated with financial statements. This new reporting requirement was established so that readers of reports could not be misled as to the significance of a CPA's name being attached to financial statements. Statement No. 23 both expanded and clarified the formal reporting practices that were adopted by the membership in 1939 when they approved *Extensions of Auditing Procedure,* a report of a special committee of the Institute.

For those situations where the accountant is reporting upon financial statements that presumably should be prepared in conformity with generally accepted accounting principles and where his examination could be made in accordance with generally accepted auditing standards and procedures,

the problems as to reporting, created by those actions of the Institute I have just discussed, have now generally been resolved. The pattern of disclosure in these cases has been fairly well established. Deviations from or failures to observe the accepted practices can generally be laid to ignorance or to disregard of the expressions of a substantial majority of the accounting profession.

On the other hand, there are many situations where these standard reporting techniques cannot be applied and where the accounting profession has not specifically prescribed the methods of reporting to be followed. These special situations fall into at least two broad categories. The first category relates to reports on organizations that keep their accounting on a cash basis or modified cash basis. This method of accounting normally does not produce, except by coincidence, financial statements that present fairly the financial position or results of operations in conformity with generally accepted accounting principles. The second category covers reports that have a special or restricted use or purpose and by their nature require a special type of report. It has also been suggested that our everyday long-form audit reports should be treated as special reports, because special reporting techniques are involved in the presentation of the supplementary information. The usual long-form report contains the language of the short-form report and the financial statements referred to in that report, plus supplementary statistical and financial data and the accountant's comments on certain of this information. The supplementary information can be omitted without making the "top" financial statements and related notes together with the appropriate short-form report misleading. In effect, the supplementary information contains, as the name implies, additional explanations and not qualifications.

It is obvious, upon consideration, that the language of the standard short-form report with its references to generally accepted auditing standards, fair presentation, and generally accepted accounting principles is normally neither suitable nor appropriate in the first two categories. Therefore, reporting techniques must be followed that will meet these special situations and still fit, without conflict, within the philosophy of the pronouncements by the profession on reporting practices. Further, these special reports, to be of any value, must be so written that they will be useful to and understandable by the readers.

Statement No. 23 does not impose any problem in the issuance of special reports on financial statements, irrespective of whether or not they have been prepared in conformity with generally accepted accounting principles, as long as the accountant recognizes and clearly states his responsibility with respect to these financial statements. On the other hand, Statement No. 23 does not specifically apply to special reports that do not contain financial statements. It was not directed at these types of accountants' reports. The pronouncement is very clear in this respect. The statement refers only to the presentation of financial statements on the stationery or in a report of an independent public accountant. I believe, however, that, wherever appropriate, the principles of reporting enunciated in that statement should be followed by the accountant when he issues reports that do not contain financial

statements. Any opinions required of the accountant should be given in clear and unequivocal language, and his responsibility for the information submitted should be clearly indicated.

It is my opinion that the adoption of Statement No. 23 did not establish or suggest reporting standards for long-form audit reports that were greater in magnitude or different in their application than those to be followed in issuing short-form reports. The problem in long-form reports lies only in the manner in which the supplementary information is given. If this information is presented in its proper perspective and the proper language is used, no additional responsibility should be attached to the certified public accountant just because he has expanded his report to meet the needs of his client or the requirements of other interested parties. Ultimately any other interpretation of Statement No. 23 would either eliminate much, if not all, of the supplementary information that is included in long-form audit reports, or it would result in the use of hedge clauses and other similar devices to protect the accountant to such an extent that I am afraid the reports would be misunderstood by or become unintelligible to everyone but the trained accountant. The problem would also not be solved by the issuance of the certified public accountant of a separate report containing only the supplementary information. Such a report would still have to meet the accepted tests of Statement No. 23.

The effect on special reports of the standards of reporting as contained in the *Tentative Statement of Auditing Standards* is not quite as clear. That statement does not contain any reference, expressed or implied, that states whether or not the standards of reporting are to be applied either to those situations to which the standard short-form report normally is not suitable or appropriate, or to reports that have a special or restricted use or purpose. The statement, however, does contain the following:

> "In this discussion only the reporting on examinations of financial statements will be considered, and particularly the so-called short form of report; reports on special investigations or on other kinds of engagements not being under present discussion."

The short-form report (with or without qualifications) was adopted for use only in connection with statements that purport to present fairly the financial position and results of operations in conformity with generally accepted accounting principles.

Accordingly, it must be assumed that the reporting requirements of the *Tentative Statement of Auditing Standards* were intended to apply to those reports (both short-form and long-form) and special reports on financial statements that give a fair presentation in accordance with generally accepted accounting principles and were not intended to apply to those situations that do not conform unless they come directly within the purview of the matters specifically covered by the statement. I think, moreover, that this is a logical assumption. The statement was issued to cover specific matters that were the subject of considerable discussion at the time. To extend its application to new or different matters would be unwarranted. This interpretation of

the *Tentative Statement of Auditing Standards,* in my opinion, does not establish a double set of reporting standards on financial statements. Reports issued on cash-basis financial statements should state the accounting principles that have been followed. As long as these reports clearly show what they purport to present, the accountant is complying with the spirit of the statement. This conclusion also applies to accountants' reports that do not involve complete financial statements or do not contain any financial statements.

And now let us consider some of the other and perhaps more specific pitfalls that are involved in the preparation of special reports.

Coming within the scope of the first category of special reports mentioned before are those with respect to organizations for which the cash basis or modified cash basis of accounting does not and cannot result in financial statements that fairly present the financial position or results of operations because of the failure to recognize material assets or liabilities. It seems clear that in these cases the accountant cannot state that the statements are a fair presentation or have been prepared in conformity with generally accepted accounting principles. Furthermore, his qualification cannot be removed by disclosure in a footnote of the assets and liabilities that have not been recognized in the preparation of the statements. This does not preclude him, however, from stating (with adequate disclosures) on what basis the financial statements have been prepared. This presentation, in my opinion, meets the requirements of the Statement on Auditing Standards. Also, in accordance with Statement No. 23, he must state the degree of responsibility he assumes when he permits his name to be associated with the statements.

There is a "twilight" zone where the modified cash basis of accounting, or modified accrual basis of accounting, whichever it may be called, results in financial statements that come closer to a fair presentation. It is in these situations that the accountant may experience considerable difficulty in the language of his report, depending upon the materiality of the divergences from generally accepted accounting principles. But he must be precise. If he issues a qualified opinion, he must give some indication of the significance of the items to which he takes exception. If he disclaims an opinion, he should say so and give the reasons why.

Also within this first category fall those reports which relate to organizations, such as charitable institutions, whose primary interest from the financial-statement standpoint lies in the accountability for cash receipts and disbursements. The execution of their policies and decisions depends directly upon their available finances. Their fiscal years usually coincide with their natural periods of activity. As a result, the cash basis of accounting will usually provide more useful and satisfactory operating statements. The balance sheets, if they may be called that, are secondary in importance; they will indicate available funds but not necessarily other assets (such as unpaid pledges, equipment, prepaid insurance, etc.) unless a modified cash basis is used. In situations like this it would be proper, in my opinion, for the accountant to state what the balance sheet does purport to represent and that the statement of cash receipts and disbursements is a fair presentation of the results of

operations. He does not need to make any reference to generally accepted accounting principles and, as I have stated before, I do not think there is any requirement that he do so. He is concerned with a fair presentation of available funds and operating results and not with a fair presentation in accordance with generally accepted accounting principles. Adherence to such principles is not pertinent in the circumstances; the readers of the report are interested in accountability for cash and not in accounting theory. This method of reporting on the part of the accountant does comply with the spirit of both the Statement on Auditing Standards and Statement No. 23.

In summary, the pitfalls that face the accountant when he issues a report on cash-basis or modified cash-basis financial statements arise primarily from the unwarranted or misleading inferences that might be drawn from the statements or the accountant's report. Clear disclosure and proper choice of language should solve this problem.

The second category of special reports relates to those that have a special or restricted use or purpose. This category can be divided in three groups:

(*1*) Letters or reports not containing complete financial statements or any financial statements, *e.g.*:

- (*a*) Letters to underwriters as to the conformity of the financial statements and schedules included in a registration statement with the applicable accounting requirements, rules, and regulations of the Securities and Exchange Commission, and as to the effect of transactions and events subsequent to the balance-sheet date, but before the effective date of the registration statement, on the reported financial position of the company;
- (*b*) reports on compliance of companies with certain provisions of agreements or indentures relating to long- or short-term borrowings;
- (*c*) reports on contributions to pension funds or under bonus or profit-sharing plans;
- (*d*) reports on financial information filed for use and occupancy-insurance purposes;
- (*e*) reports on accounting systems; etc.

(*2*) Reports requiring modifications of the standard short-form report or the use of language that contains the implications of the standard short-form report, *e.g.*:

- (*a*) reports on financial statements and schedules filed with or meeting the accounting requirements of the Securities and Exchange Commission and the Interstate Commerce Commission;
- (*b*) reports on the Certificate of Condition required to be filled with the Commonwealth of Massachusetts;
- (*c*) attestations on income-tax returns; etc.

(*3*) Reports involving financial statements with specialized types of accounting and reporting; *e.g.*, for banks, individuals, political subdivisions, etc.

A discussion of some of the specific pitfalls that arise in the preparation of reports on the situations mentioned above is difficult because they often vary with individual cases.

Our primary concern with respect to the first group is to make certain that the language of the reports does not extend the representations and responsibilities of accountants to matters that are not contemplated or considered because of the special or restricted use or purpose of the reports. This suggests: first, that it may be desirable in these cases to indicate in the accountants' reports specifically the purposes or reasons for which they are issued; and, second, that there be clear disclosure of the scope of the examination upon which the opinions are based. With respect to the latter, if the special report is being issued in connection with, or as a result of, an examination that was made in accordance with generally accepted auditing standards and procedures, then it should be sufficient to use the same language contained in the second sentence of the "scope" paragraph of the standard short-form report. If the examination involves special or restricted audit procedures, the report should so state and include a reasonable discussion of the specific examination procedures employed. Reference to fair presentation or to generally accepted accounting principles may or may not be required, depending upon the circumstances.

The principal financial statements (and related notes) included in annual reports on Form 10-K filed with the Securities and Exchange Commission and stock exchanges should be the same, in all material respects, as those regularly issued to stockholders. Certain additional financial information, however, must be included with the financial statements in these annual reports in accordance with the rules and regulations of the Securities and Exchange Commission and must be "certified" by the independent accountants. The problem of the accountant arises in distinguishing what is necessary for a fair presentation and what is purely supplementary or explanatory material. He should not state to the board of directors or stockholders in one instance that the principal financial statements (and related notes) are a fair presentation and then turn around and state that certain additional information, in effect, must be given in order to have a fair presentation. To meet this problem, many accountants distinguish, in the language of their reports filed with or meeting the requirements of the Securities and Exchange Commission, between the financial information they consider to be essential to a fair presentation and that which is supplementary.

There is a related problem in reporting on financial statements prepared in accordance with requirements of the Interstate Commerce Commission. Accountants' reports should normally not be issued on two different sets of financial statements for the same company, prepared in accordance with different accounting practices. The possibility of misleading inferences is too great; the accountant cannot control the use of his reports. If the accounting requirements of the Interstate Commerce Commission are not in conformity with generally accepted accounting principles, disclosure or qualification as appropriate, should be made in the accountant's report.

The attestations of accountants on income-tax returns also imposes many problems. We are all aware of the many differences between good accounting and accounting for income-tax purposes. However, our relationships with third

parties and our responsibilities in the preparation of tax returns fall in a different and somewhat unrelated area and are not particularly pertinent to this discussion.

Reports involving financial statements but different types of accounting; *e.g.*, for banks, individuals, political subdivisions, etc., partake of many of the problems found in cash-basis statements and statements filed under the requirements of the Interstate Commerce Commission. The accountant must clearly state the degree of responsibility he assumes when he permits his name to be associated with financial statements of this character. As long as the reports clearly state the accounting practices that have been followed and clearly show what they purport to present, the accountant is complying with the spirit of the *Tentative Statement of Auditing Standards*. There can also be no objection to disclosing that the particular accounting practices followed by the organization upon which the accountant is reporting are also followed by other organizations in the same field. In fact, such disclosure gives credence to the propriety of the financial statements.

We can appreciate the almost insurmountable problems that readers of financial reports and accountants would have to face if we narrowed our present concepts and established different sets of accounting principles for every different type of financial activity. The troubles that would arise are best illustrated by the accounting practices that must be followed now in the preparation of income-tax returns. As a matter of fact, these various areas of financial activity are not as unrelated as it might appear. The basic concept of accountability is usually present in all financial statements upon which accountants are asked to report. They make certain representations as to the propriety of the information expressed in the financial statements. Many of the accounting principles that are now generally accepted have their influence on all statements and reports. Departures from these principles are usually made because there are special conditions present that suggest that other practices are more acceptable or desirable in the circumstances. It then becomes a matter of reporting and not a question of whether we need a new set of accepted accounting principles that could be applied in these special circumstances.

The pitfalls that are encountered in the preparation of long-form audit reports are due primarily to the fact that there has never been a specific enunciation of the auditor's responsibility for the supplementary information that is included in these reports. On the other hand, long-form reports have been an accepted part of reporting practices for a long period of time. A body of practice and tradition has been established that normally, in my opinion, should effectively prevent others from attempting to attach misleading or unwarranted inferences to the supplementary or explanatory material solely because it has been included by the accountant in his report. If it is clearly indicated or obvious that this additional financial information is supplementary or explanatory, I do not see how the accountant can be charged with any responsibility that is over and beyond, or is not recognized in, the standard short-form report, unless the accountant makes direct representations as to

the supplementary data. In making this statement, it is presumed that the supplementary data do not contain any information that qualifies or perhaps negatives the representations associated with the language of the short-form report or the inferences that would be drawn from the "top" financial statements. Furthermore, the inclusion of the supplementary data should not imply, unless specifically stated, that the auditing procedures employed in making the examination were different or greater than represented by the standard "scope" paragraph.

There are, however, certain practices I believe all accountants should follow in preparing long-form reports:

(*1*) Where both a short-form and long-form report are issued, the same impressions should be obtained from each. Any qualifications as to auditing procedures or accounting practices must be contained in each report.

(*2*) The supplementary data should not be presented in such a form that they could be held to be a factual representation on the part of the accountant when his examination was not intended and was not required to be that exhaustive. It should be made clear that such information is included by way of explanation, and not by necessity in order to have a fair presentation.

(*3*) Any supplementary data included should be given in its proper perspective, and equal emphasis should be given to all important matters. Overemphasis on minor matters or one aspect could lead to improper and unintended conclusions.

(*4*) The choice of language should be consistent with that of the standard short-form report (where that form is appropriate); otherwise, the reader may attach a different meaning than was intended, or he may think that the accountant deliberately intended to give a different impression.

(*5*) The language of long-form reports should not be changed each year merely for the sake of change. Changes should only be made in the interest of clarity or to report different conditions.

In conclusion, it is my opinion that our problem in preparing special reports and recognizing their pitfalls is one of interpretation of our present standards of reporting and not one of establishing a different set to be applied in each special situation. I do not think there is any conflict in this position. It does not involve any weakening of our established standards. We cannot hope to attain uniformity in wording or expression or to follow uniform reporting practices when, by their nature, the situations upon which we are reporting do not lend themselves to such practices. We must follow reporting techniques that fit the occasion. Our reports must be understandable to and satisfy the requirements of the readers if we are to meet our responsibilities as a profession.

Cash-basis statements: a reporting problem

HARRY C. GRUMPELT

Partner, Arthur Young & Co., New York. Member, Institute committee on auditing procedure.

It is surprising that any question regarding cash-basis statements still remains unanswered. Undoubtedly the first financial statements prepared by the ancient Babylonians were on the cash basis. Even today, most individuals and a vast number of enterprises keep their accounts on a cash basis or some variation thereof. Our Government recognizes it, except in cases where inventories are required to be used, as an acceptable method of determining corporate and individual taxable income. Why then, at this late date, should our profession have a reporting problem as to cash basis statements?

The answer is, I believe, that since accountancy has reached maturity, its attention has been concentrated on the far more difficult and important accounting, auditing, and reporting problems arising in connection with the accrual basis. Cash-basis accounting has been taken for granted and has generally been assumed to present no problems, or at least none of general interest.

Accounting literature on this subject is conspicuous by its absence. Bulletin No. 43, recently issued by the Institute committee on accounting procedure, restating and revising all bulletins previously issued by that committee, specifically states that "the Committee has not directed its attention to accounting problems or procedures of religious, charitable, scientific, educational and similar non-profit institutions, municipalities, professional firms and the like." —in other words, the categories of organizations that, for the most part, maintain their accounting records and present their financial statements on a cash basis.

At the present time, accountants reporting on accounts maintained on the cash basis have little, if any, authoritative guidance as to the accounting principles applicable in the circumstances other than industry practice, which is not always uniform and seldom readily determinable. This undesirable situation is aggravated by the fact that pure cash-basis situations are seldom en-

countered. Many organizations, for one reason or another, use a modified cash basis, a "hybrid" combination of the cash and accrual basis. Others, affected by tax considerations and requirements, are likely to keep their books conforming to the methods followed in preparing their income-tax returns.

In many cases, financial statements prepared on the cash or modified cash basis are materially different from those which would result had the accrual method been followed. Omission of material receivables, payables, inventories, and accruals from cash-basis "balance sheets" will obviously result in substantial distortion of indicated financial position. Whether intentional or in the ordinary course of business, deferral or acceleration of receipt of income or payment of expenses is apt to result in cash-basis operating statements completely at variance with actual results of operations.

It is suggested by some that, where such situations result, the cash-basis statements be supplemented by footnotes setting forth the differences that would result in the statements if the accrual basis had been used. Although in most cases this would be a desirable procedure, it could not, in my opinion, be considered to correct the statements, since I believe it has been generally established that deficiencies in financial statements cannot properly be cured by footnotes.

The foregoing comments do not attempt to cover in any detail the problems encountered in preparing statements on a cash or modified cash basis or the accounting principles that should apply but merely to set the background for the accountant's reporting problem.

The membership of our Institute adopted the principle, in 1948, in approving the summary of standards of reporting appearing in *Tentative Statement of Auditing Standards*, that a member accountant's report shall state whether, in his opinion, the financial statements reported upon are presented in accordance with generally accepted principles of accounting and, in 1949, in approving an amendment to *Extensions of Auditing Procedures* (Statement No. 23 (Revised)† issued by the Institute committee on auditing procedure), that whenever a member accountant permits his name to be associated with financial statements, he must either express an opinion or disclaim an opinion on the statements taken as a whole and give the reason why. This, coupled with the language in the opinion paragraph of the "short form report" recommended by Statements on Auditing Procedure No. 24,‡ would seem to require that in the case of cash basis statements the accountant's report must either (*1*) express the conventional opinion that they "present fairly the financial position and the results of operations in conformity with generally accepted accounting principles," or (*2*) specifically disclaim any such opinion and state that expression of an opinion is precluded because the statements are prepared on a cash basis. I do not believe the third alternative (to express a qualified opinion) is appropriate, as the variance between cash basis and accrual basis accounting will either be immaterial (in which case a conventional opinion may be expressed) or material.

If such variance is material I do not see how the accountant can properly

†*Codification of Statements on Auditing Procedure*, pages 18-20.
‡*Ibid*, page 16.

render a conventional opinion, since the financial position and results of operations can hardly be said to be fairly presented on any basis, much less in conformity with generally accepted accounting principles, if substantial items are omitted from reported assets and liabilities or reported income and expenses do not reflect income earned during the period and applicable costs and expenses. On the other hand it would, I believe, be overly academic and unrealistic and would seriously weaken the accountant's usefulness to the public if he were required to take the position that he could not express any opinion on the statements because they were not prepared on an accrual basis. Such an approach would be particularly illogical and undesirable in situations where cash-basis accounting has been followed consistently in accordance with industry practice, is recognized for tax purposes or is deemed appropriate for other good reasons, and is not motivated by desire to prepare misleading statements.

I do not believe that the foregoing dilemma is the intended or the actual result of the previously mentioned 1948 and 1949 actions of our membership, as I very much doubt that they were intended to relate to cash-basis statements. This conclusion is based on the fact that the financial statements to which the membership's action related were undoubtedly those which purported to "present fairly the financial position and results of operations" of the enterprise being reported upon. Cash-basis statements not meeting this criterion would fall without this category, as would other special-type statements, such as those showing changes in working capital, cash receipts and disbursements, taxable income, and the like. So long as such statements are clearly described so as to show what they purport to present, an accountant should be entitled to express an appropriate opinion thereon, but such opinion should not refer to fair presentation of financial position or results of operations or, presumably, to conformity with generally accepted accounting principles (since no authoritative ones appear to have been established in the case of the cash basis). The opinion should, however, otherwise comply with present established practice; that is, it should be clearly expressed or specifically denied if the examination was not made in accordance with generally accepted auditing standards or if exceptions as to the statements are such as to negative the opinion. The opinion should also state whether the statements under review were prepared on a basis consistent with the preceding period.

Cash-basis statements differing materially from those which would result from the accrual method should not be entitled "balance sheet," "statement of income," or similarly so as to give the impression that they present financial position or results of operations. Possible acceptable language might be "statement of assets and liabilities resulting from cash transactions" and "statement of income collected and expenses paid." These, however, are somewhat cumbersome and might not be appropriate if a modified cash basis is involved.

A footnote to cash-basis statements, or the accountant's report thereon, should explain clearly the basis on which they have been prepared. Ordinarily I would not consider it sufficient to state merely that they have been prepared "on a cash basis," as this would not usually give the reader an ade-

quate understanding of the extent to which they differ from accrual-basis statements. I believe that in most cases the amounts, as well as the nature, of assets and liabilities not reflected in the statements should be disclosed, as should the extent by which the operating statement presented differs from that which would have been shown if the accrual basis had been used.

It seems to me that, as a general rule, we should encourage clients to change over from the cash basis not only for the reason that we could then properly express an opinion that the statements are "fairly presented in accordance with generally accepted accounting principles," but also in order that the statements would be more useful and informative to the management, owners, creditors, and anyone else concerned.

Where it is not practicable, for income-tax or other reasons, to change the books from a cash to the accrual basis, a possible solution that should be explored would be to present financial statements prepared on the accrual basis as a supplemental to, or possibly in lieu of, the cash-basis statements. In such a case, some might consider it undesirable and possibly improper for an accountant to report on financial statements that did not agree with the books. I personally, however, see no objection to such procedure so long as it is clearly explained in the accountant's report, or preferably in a note to the financial statements, that they have been prepared on an accrual basis although the books are maintained on a cash or modified cash basis.

In reporting in a footnote to cash-basis statements, data as to assets, liabilities, or operating results on an accrual basis, or in presenting accrual-basis statements if the books are kept on a cash basis, adjustment should be made, when appropriate, for estimated income taxes applicable to such items as income accrued in one year but not taxable, on the cash basis, until a later year.

Current practices in long-form report preparation

CARL M. ESENOFF

Partner, Everts and Esenoff, San Diego. Member, Institute's auditing procedure committee.

Have you ever considered your stenographer's artistic ability? I have, because I believe the artistic arrangement of statements, schedules, and typed matter can make a big difference in the appearance and general impression given by a finished report. Although I agree with Col. Montgomery* that a traveler is not concerned with the intricate engineering problems solved in erecting a bridge, I do think the traveler has more confidence that the bridge has been properly built when its lines are graceful, its approaches pleasing to the eye, and when its over-all appearance gives an impression of stability.

Similarly, I believe that fine paper, careful arrangement, and an artistic appearance coupled with accurate information, logically presented in clear and interesting language, will impress the user of the report with the underlying quality of the service rendered. It is seldom that the reader of an audit report can evaluate the field work, the planning and the decisions that have gone into it. The report becomes the only tangible factor upon which the user may rest his judgment.

Eye appeal is especially important in connection with long-form reports which are to be considered in this paper. Long-form reports contain the same basic data that are found in the short-form report; namely, a brief statement of the scope of the examination, the opinion, and the principal financial statements. In addition, long-form reports usually include some or all of the following features: (*1*) additional statements; (*2*) analytical schedules; (*3*) comments regarding auditing procedures and financial data; (*4*) comments on the analysis of the financial figures.

The long-form report may express or disclaim an opinion but it does not include special reports involving special investigations, surveys, cost studies, analyses of tax effects, systems reviews, and similar analyses and investigations.†

*Robert H. Montgomery, C.P.A., *Auditing Theory and Practice* (Third Edition), The Ronald Press, 1921, p. 352.

†For a more detailed explanation of short-form, long-form, and special reports see American Institute of Accountants, *C.P.A. Handbook,* (1953), Chapter 19.

Before discussing current practices, it may be well to begin with some historical background in order to evaluate recent developments. As early as 1908, Harry C. Bentley‡ discussed the undesirability of having directors' audits, and the objectives of an audit by an "independent and capable accountant." In a paragraph on what an audit comprises, the author covers the verification of assets and liabilities, the possible need for taking inventories, and the advisability of verifying accounts receivable, while deriding the need for detailed checking. Bentley then devotes considerable space to distinguishing between unqualified and qualified reports.

Of greater interest was the fifteen page facsimile report that was reproduced. It started with a letter addressed to the president, which read as follows:

> "Dear Sir:
> Pursuant to your request we examined the books and accounts of The J. B. Matthews Company, at both the Hartford and New York offices, for the year ended December 31, 1906. The results of this examination are presented in the accompanying comments, and in the exhibits and schedules designated as follows: viz.,
>
> EXHIBIT A—Balance Sheet—December 31, 1906
>
> Schedule 1—Statement showing amounts due from trade debtors—December 31, 1906
>
> Schedule 2—Statement showing amount and cost of insurance in force, and the unexpired premiums, as of December 31, 1906
>
> Schedule 3—Statement showing amounts due trade creditors—December 31, 1906
>
> EXHIBIT B—Profit and Loss Statement—year ended December 31, 1906
>
> Schedule 1—Statement of production cost—year ended December 31, 1906
>
> EXHIBIT C—Adjusting journal entries as of December 31, 1906
>
> Respectfully submitted,
> Bentley, Laird & Moyer"

There then followed five pages of comments mostly on balance-sheet items but ending with two paragraphs on profit and loss items and production costs. The exhibits and schedules were arranged as indexed in the letter.

While many changes in emphasis, form, and statement arrangement have taken place in the last 45 years, it was interesting to note the similarity between the presentation in the 1908 specimen and in present-day reports.

Through the years many auditing texts have included chapters on report writing. The Institute too has done its part by including a chapter on "The

‡Harry C. Bentley, C.P.A., *Corporate Finance and Accounting*, The Ronald Press (1908). In particular, see the chapter on "The Auditor's Report" pages 246—265.

Preparation of Accountants' Reports" by John H. Zebley, Jr. in *Contemporary Accounting,* published in 1945. This chapter covered the following major topics: preliminary planning; responsibility for financial statements; variations in form of reports; general arrangement; comments on specific items; common faults in report writing; composition of report; and checking and reviewing.

Although many text books have discussed the purpose, content, style, and arrangement of long-form reports, each text shows the ideas of a single author and usually includes a single example. Similarly, in actual practice, it is seldom that an accountant sees or is able to study a report prepared by other accountants. Because of this limited availability of reports it was deemed advisable that the A.I.A. research department undertake a study of a group of reports prepared by different firms to provide data that would be helpful to the profession. Accordingly, they obtained a group of 52 specimens submitted by 39 accountants and firms from 19 states. An analysis of this group was begun in 1950 and, although the study has been delayed, it was recently completed and has now been published by the Institute. For younger men beginning their practice the study gives not only examples, tabulations, and summaries of the similarities among reports, but also considerable details covering unique treatments of special situations. For practitioners of greater experience the booklet should provide an interesting source of comparison.

For purposes of the booklet, the study has been divided into three sections. Section I tabulates, analyzes, discusses, and summarizes the contents of the 52 reports. Section II sets forth selected excerpts from the reports in order to illustrate both typical and unique treatments. Section III presents five complete specimen reports with brief comments as to the outstanding features of each.

On the fly-leaf as well as in the body of the booklet, the research department is careful to note that the reports and excerpts are presented as illustrations of what is actually used and not necessarily as ideal models that should be copied blindly. It is through case studies and numerous examples that the independent practitioner will be able to develop an acceptable yet distinctive report.

In analyzing and discussing the 52 reports in the first section, the research department has made an extensive study of 35 different points. The studies began with such practical considerations as physical characteristics, which include the number of pages and the size and folding of paper, and ended with accountant's seals and printed restrictions. In between, the analysis covers such items as footnotes to principal financial statements, reasons for no expression of opinion and cash audit procedures.

In the second section of the booklet the excerpts given covered among others such important topics as aging of receivables, comments on confirmation of receivables, examination of inventory, how qualifications of opinions were expressed, and analysis of variability of expenses. A number of pages are devoted to application of funds statements, and several popular forms and accepted variations in terminology are shown.

The specimen reports reproduced in Section III were apparently selected

because they illustrate quite different formats and arrangement as well as types of business. The reports cover a medium-size manufacturer, a larger manufacturing company producing a variety of products, an automobile dealer, and a modest-size manufacturer of paper products. The other report is one used for staff training. It contains many footnotes including possible variable treatment of important segments of the report.

At the end of Section I of the booklet is found a description of a typical or composite report. Such a report would be on 8½ × 11 paper in a heavy brown paper cover with the firm name, address, and "Certified Public Accountants" printed on it. Typewritten on the cover would be the client's name and the words "Audit Report." The accounting firm's name would appear as a letterhead and the other sheets in the report would be plain paper, numbered consecutively.

The contents of the report would be arranged in the following sequence:

Index
Address and salutation
Scope and opinion
Text of comments
Signature
Principal statements
Supporting schedules

Some of the important features to be found in the typical report are listed in the following paragraphs.

The scope and opinion paragraphs would be consecutive and would be patterned after the "short-form" report, but would not be identified by a caption.

The text of the report following the opinion section would consider operations first. The discussion would include the current and preceding years' figures in a condensed, comparative statement. Such statement would show increases and decreases as well as percentages with net sales being equal to 100 per cent. Very little comment regarding the operations would be included in the report.

The next part of the report would deal with the balance-sheet items as they appear on the principal balance sheet. Usually at the beginning of this section, condensed, comparative balance sheets would be presented, including amounts of increases or decreases. Next would come a discussion of the accounts receivable which would include a sentence or two regarding the confirmation as well as an aging schedule of the accounts, and perhaps some comment on the collectibility of the accounts. This would be followed by a brief explanation of the inventory procedures used by the client and auditor in taking and checking the inventory. Then there would be presented any unusual changes in fixed assets and some mention would be made of the depreciation.

A discussion of the liabilities would include comments regarding unusual changes in the current items, federal taxes subject to review, and contingent liabilities, if material.

The text would also include an application-of-funds statement and com-

ments relating to liability and casualty insurance coverage and amounts.

Not necessarily in the typical report, but found in many reports, are such data as organizational and historical information, capital stock structure, working capital changes, material sales or purchases of fixed assets, dividends, and some ratios.

Turning now to the principal financial statements we find that exhibit A would be the balance sheet, which is arranged in the familiar account style with the assets on the left and the liabilities and capital on the right. Exhibit B would be a statement of operations in multiple-step form with gross profit shown as well as other sub-totals before arriving at net income. The typical report would have a separate exhibit C for the statement of surplus.

Supporting schedules making up the rest of our typical report would be identified as schedule 1, 2, 3, etc., and would ordinarily include details of selling expenses, general expenses, cost of goods manufactured and sold, and fixed assets and related reserves.

Although there is sufficient similarity to set forth the elements of a typical long-form report, the study also points up a certain lack of uniformity. For example: In size of paper, while 16 out of 31 firms used 8½ × 11 paper, the other 15 used 12 different sizes. Titles for the income statement included 16 different titles in 33 reports, one title being used five times, another four, and the others three times or less. Where the income and surplus statements were combined, there were nine different titles in nine different reports. The surplus statement also shows much divergence with 16 different titles for 21 reports, with no one title used more than three times.

Other statistics produced by the study included the following list showing the types of items that were frequently covered in a report. Of a total of 41 reports, the following number discussed the item designated:

	Number of reports
Receivables (usually including examination procedures)	34
Inventories (usually including examination procedures)	31
Fixed assets (including schedules showing changes in balance of assets and related reserves)	31
Operations (usually including condensed, comparative income statements)	31
Current liabilities (often including mention of taxes subject to review)	28
Condensed and/or comparative balance sheet	24
Working capital and funds statement	22
Capital stock	20
Cash	19
History of company (including "Organization," etc.)	17
Prepaid expenses and deferred charges	16
Insurance coverage	15
Surplus	15

Fixed liabilities	14
Investments other than U. S. securities	11
U. S. securities	10
Cash surrender value of insurance	9
Working capital (as distingiushed from single current items)	8

Although a rather detailed listing of the elements of a typical report has been presented, it may be well to point out some of the areas in which some accountants are suggesting and using new treatments.

Many accountants prefer the usual practice of including a description of the auditing procedures in the regular comments concerning the individual balance sheet items. Others believe that a comprehensive statement of auditing procedures in a separate section of the report provides the more acceptable pattern.

Another controversy centers around the question of stating the purpose of the report. Some are concerned that in stating a purpose the accountant may be attempting to restrict his liability and they contend that, once the report has been delivered to the client, the auditor cannot control its use. The opposing point of view holds that there is no need to construe a statement of purpose as a qualification or limitation but that it is merely an explanation that becomes one more method of making the report more meaningful, even for those who use it for other purposes.

Another point of contention is the location of the comments. Shall they be part of the text of the report or shall they be separated from the signed letter and be placed after the financial statements and schedules? The typical report as developed by the research department study contains the comments in the text, and this form seems to have the approval of long usage. More and more reports, however, are placing the comments after the financial statements. This method appears to be favored by McGladrey in the *CPA Handbook.*

This latter location of the comments may be influenced somewhat by the question of responsibility. The positive responsibility growing out of Statement 23, the specific requirements under SEC rules, as well as the growing concern over accountant's liability have led to the feeling that there may be less liability in connection with the information in the comments if they are definitely removed from the portion of the report containing the formal opinion.

In some instances there has been a tendency to place the operating statement before the balance sheet. Of interest is the fact that both the new study of the research department as well as Zebley in his chapter in *Contemporary Accounting* show the comments on operations before those on the balance sheet, while placing the operating statement after the balance sheet.

Of more concern, however, is the meager consideration given to the operating results. Without regard for the location of the comments and financial statements, there seems to be agreement among writers on the subject that insufficient comment and analysis is being devoted to this very important segment of the report.

Another area of suggested improvement is that of graphical presentation. None of the reports included in the research department study contained line,

bar, diagram, circle, or similar graphical representations. Many students of the problem are advocating use of such devices to illustrate the figures contained in the report.

Although this paper deals at length with the contents of a typical report, it does not follow that such a report will necessarily be the most satisfactory one covering a particular engagement. It would be necessary to know the conditions under which the examination was made and the efficiency of the client's accounting department. Furthermore, the nature and extent of the reports prepared by the accounting department will have a material effect on the contents of the independent auditor's report.

During many years of service to the accounting profession, the late Ira B. McGladrey maintained a position that the Institute should do something to improve the quality of long-form reports. Yet to some it appeared that in his search for this improvement he found it difficult to present a concise statement of his objectives. While he spoke of standardization he recognized the difficulty and unacceptability of making reports stereotyped.

It seems to me that our search for standards should not be an attempt to define narrow limits of acceptability. Standards may be satisfactory only if they are conceived as very broad outposts. As noted by Walter Flack in his paper given in Atlantic City in 1951, the basic standards we now recognize are those contained in the *Tentative Statement of Auditing Standards* published in 1947. These standards as they apply to reporting procedures are as follows:

(*1*) The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

(*2*) The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

(*3*) Informative disclosures in the financial statement are to be regarded as reasonably adequate unless otherwise stated in the report.

Perhaps to these three we may add three more:

(*1*) The financial statements shall be prepared in conformity with recognized rules, conventions and principles of statement presentation.

(*2*) The report shall be arranged in some logical pattern.

(*3*) The comments shall be clear, informative and interesting, and adequate in the circumstances.

The developments that have taken place indicate that McGladrey's efforts have not been in vain. Many articles, booklets, and studies are indirectly the result of his efforts. It is my opinion that still more improvement in long-form report writing will come about by a continued discussion of the problems involved, by a greater exchange of information, and by a wider participation in annual or periodic report projects of the Institute, such as the one reviewed. Perhaps each of us can lay a foundation for the success of future projects by arranging to prepare an extra copy of one of our better reports. If several hundred firms would make such an arrangement, the research department would have an assured supply of raw material for further study.

Development and use of the budget

J. BROOKS HECKERT

Professor of Accounting, Ohio State University. Immediate Past President, National Association of Cost Accountants.

For the sake of this discussion it will be assumed that it is no longer necessary to *sell* the idea that the budget is an important tool in business management; at least, not to experienced accountants. Yet, it must be recognized that, in point of number, there are far more clients who do not have well-developed budget plans than there are who do. It would seem therefore that it is still desirable to set forth briefly, but clearly, the basic objectives of a budget system.

No company should embark on a system of budgeting merely because it understands that its competitors or other successful companies are using such a system and, consequently, assumes that the budget must be a useful management tool. Unless management clearly understands the objectives of a budget system and the problems and responsibilities involved in its development and enforcement, little will be accomplished.

It is true that a somewhat different emphasis will be placed on the various objectives in different companies. This arises from differences in the nature of operations, internal organization, and the relative importance of short-term *v.* long-term planning.

In this paper, the basic objectives of budgeting will be reviewed briefly, after which the particular problems that commonly arise in the development and use of the budget in the planning, direction, and control of business operations will be discussed.

BASIC OBJECTIVES OF BUDGETING

The basic purpose of budgeting is to find the most profitable course for the business to follow in meeting its primary service objective, and to assist in holding the business as nearly as possible on that charted course.

In most business concerns there are numerous decisions to be made as to the policies to be followed and the methods to be used. Decisions must be made, for example, as to the choice of goods and services that are to be

made and sold, the selection of customers, the level of prices, methods of production, methods of distribution, credit terms, methods of financing, degree of integration of operating units, and so on, almost without limit. Which selection of policies and methods will be most profitable? Can any combination be found that gives reasonable promise of an adequate return on the investment? If none can, the venture should be stopped, the business merged with another, or the capital shifted to other channels, before further losses result. If profitable courses are open, each should be examined and translated into its profit possibilities.

While it is easy to speak in general terms of the desirability of budgeting, the practical advantages in an actual case are not always so apparent. Conditions change rapidly in business; the actions of customers and competitors cannot be entirely controlled and, as they become known, a business must, to a degree, govern itself accordingly, regardless of any previously developed program. Plans, when made intelligently, require exhaustive study and research, and this constitutes an expensive procedure. What, then, are the specific advantages to be gained?

The benefits of budgeting lie in three primary fields of business activity: First, directly in the *planning;* second, in the *co-ordinating* phase; and third, in the *control* area. These activities are each very wide in scope and contain within themselves several supplemental or detailed advantages. A somewhat more concrete outline of the reasons for budgeting is as follows:

Planning

To base action upon thorough investigation, study, and research. Perhaps the cardinal advantage of systematic budgeting is that it tends to bring the executives to an early study of their problems and instills into the organization the habit of careful study before decision as to action. This is not easy to achieve. To many, intensive study is a distasteful exercise. Most of us prefer to postpone difficult decisions until necessity compels. Businesses as individuals tend to become opportunists; they wait until a decision is forced, then turn quickly, often without time for careful study of the problems, in the direction offering the easiest immediate escape from their troubles.

If the executives, from general manager to foremen, know that their plans are to be formally expressed and that they will be charged with responsibility for their execution, they can be brought to an earlier and more intensive study of the problems at hand.

This habit of making plans will benefit every activity. Specifically, it will relate to financial requirements, inventory levels, production facilities, production, purchasing, advertising, selling, sales promotion, product development, organization growth or expansion, labor relations—in short, the advantages can accrue to every function.

To enlist the assistance of the entire organization in determining the most profitable course. When budgeting is undertaken in ample time and on a regular schedule, there is full opportunity to enlist the assistance of foremen, salesmen, branch managers, department heads, and all operating officials—

major and minor. In some lines of business the suggestions and counsel from such sources are essential to the development of the best operating plans, and in most lines of business such assistance is highly deirable. The final plans should be expressive of the combined judgment of the entire organization, thereby eliminating such bias or prejudice as frequently affects the judgment of individual groups.

To serve as a declaration of policies. Nothing so restrains the enthusiasm and energy of an organization as uncertainty. The budget procedure provides a vehicle through which basic policies are periodically re-examined, restated, and set forth as guiding principles for the organization at large. Basic policies, not temporary expediency, should be the guiding factors of a business, and the organization should be schooled in such policies.

To define objectives. The successful manager must surround himself with capable associates who will accept his leadership and execute his program; but he must demonstrate his ability to lead. Men will follow a leader when they realize that he has a sensible plan of action and definite objectives in mind. Such objectives should be clearly expressed and, to a certain degree, should stand as goals of attainment for the entire organization. Objectives, however, must not be the product of hope but rather the logical consequence of carefully laid plans. The executive who can clearly define his objectives and delineate a program that can logically be expected to reach such objectives can command the co-operation and loyalty of his associates.

To stabilize employment. No employer of labor, regardless of his social or economic philosophy, can longer disregard the welfare of his employees. We have passed the time when workers can be laid aside at will when not needed—as flasks or patterns in the foundry. To be sure, the responsibility to workers must be balanced with the responsibility to investors and the welfare of both must be considered, but the business program must consider stability of employment. Intelligent business budgeting rather than governmental regulation offers the greatest hope for providing stability of employment.

To make more effective use of physical equipment. During the course of planning, the excess cost of idle capacity will be revealed. Moreover, in considering those plans which offer the greatest profit, the maximum use of available facilities will inevitably be a factor. The result would normally be the elimination of some of the social wastes related to the uneconomical use of physical facilities.

Co-ordination

To coördinate and correlate human effort within the business structure. In some respects this is the most important purpose of budgeting. In many concerns there is a definite lack of coördination of effort. This is a restraining factor. Full steam cannot be applied in some divisions of the business because of uncertainty as to the program in other divisions. Only when the effort of all divisions is properly timed and coördinated can the full power of united action be secured.

This, however, emphasizes another important element of budgeting and that is the necessity of constant review and revision of the plans. If unforeseen and uncontrollable situations arise (and in many industries this is certain to happen) that materially alter the operations of one division, the machinery must be available for quick readjustment of the program in other divisions affected thereby. Wars, floods, drouths, strikes, price wars, political changes, collapse of foreign markets, etc., give rise to such situations.

The success of business budgeting should be measured not so much by the nearness of the ultimate results to the original plans as by the extent to which all executives—major and minor—know at all times just what is the immediate program and what are their respective parts therein. There must be no restraint of uncertainty if the organization is to function with full power.

The chief executive is the final coördinating official, but the complexities of the modern business are such that he cannot exercise this function without the assistance and guidance of clearly defined objectives and detailed plans that are projected throughout the entire organization.

To relate the activities of the business to the expected general trend of business conditions. Numerous studies have been made which would seem to indicate that profits are fully as much (if not more) the result of changes in fundamental conditions as of competitive efficiency. This emphasizes the importance of coördinating the plans of the business with the general trend of economic conditions. The failure of economists to agree upon the causes of the business cycle and the frequent difference of opinion among business analysts as to future trends have led many executives to the point of skepticism regarding the whole matter of forecasting. The fact remains, however, that business moves through periods of activity and depression, and that there are frequently signals of the movements as related to a particular business. These signals must be watched and the plans of the business must reflect courage or caution depending upon the expected trend.

To direct capital and effort into the most profitable channels by means of a balanced and unified program. Before spending money, it is well to give serious study to the amount that can be spent profitably, where it is to come from, just how it should be spent, and what results may reasonably be expected. A certain amount of funds must be directed toward equipment and inventories and a certain amount to the promotion of sales; but these amounts must be kept in proper balance. No more should be attempted than that for which there is available capital, no more should be made than that which can be profitably sold, and no sales program should be developed beyond that needed for the planned production. Such a balance of factors directed toward a definite objective represents the ideal and, while it can seldom be fully achieved in practice, its achievement will be more likely as a result of careful advance planning. Without such planning, inventories are likely to be out of proportion to sales and production requirements, customers may be excessively financed, and irregularity is likely to arise in the use of production facilities.

Where plans and decisions are made from day to day, the program

frequently becomes unconsciously warped. Through previous training or experience, executives are often biased in the direction of sales, engineering, or finance, with the result that one factor receives a disproportionate emphasis. A well-balanced program set up in advance and based upon careful study will help to avoid this danger.

To reveal weakness in organization. As plans are made and the responsibility for their execution delegated, weaknesses in organization will be revealed. Executives will not accept responsibility unless lines of authority are so delineated that they will be unhampered in the execution of their tasks. Where joint responsibilities are necessary, provision must be made in advance for an orderly procedure of joint action. No management activity so quickly reveals weakness in organization as the procedure of systematic budgeting.

Control

To control specific operations or expenditures. While the primary purpose of budgeting is to ascertain the most profitable course for the business to follow and to develop a balanced and coördinated program which will hold the company to that course, the budget also provides a valuable tool of control over certain business operations.

Some operations and expenditures are subject to very definite control. It may be decided, for example, that $200,000 should be invested in plant expansion, that $100,000 should be appropriated for various sales promotion projects related to a new product, that 1,000 units of the new product should be sold during the period under consideration, and that these units should be manufactured at a cost of $200 each. Assuming that the plans have been predicated upon careful study and the considered judgment of the entire organization, the foundation has been laid for a certain degree of control. The investment in plant can be rigidily held to the prescribed limits in spite of the enthusiasm of production officials to go beyond. Likewise the expenditure for sales promotion can be definitely held to the predetermined plan. To be sure, the orders for 1,000 units may not be realized. This might result from the fact that (*1*) external conditions have changed rapidly and that such changes could not be foreseen; (*2*) the sales-promotion projects were not as effective as expected; or (*3*) the production of the units—either in quantity or cost—has not met expectations. In such cases, the budget provides a certain degree of control. Expenditures are limited and directed into the channels that offered most promise. If external conditions beyond the control of management change, the program must be promptly revised. If such conditions do not change and failure of execution lies within the organization, the budget serves as a very definite tool of control. The failure of sales and production performance to meet expectation provides the signal for corrective action.

To generally prevent waste. This is a more general aspect of control. A searching inquiry into every contemplated expenditure and the reason therefor —an analytical approach extending to every function and every department of the business—will constitute an effiective preventive of waste.

Budget preparation

ARTHUR H. SMITH

Manager of General Mills plant in Louisville.

In *discussing the subject of budget preparation,* I should like to concentrate on a phase of budget preparation that customarily is given little attention, and which yet, I believe, determines largely whether or not an effective budget and budgetary control program has been established. I am referring to those steps that should be taken *before* the actual budget preparation is started. Let us call them prerequisities to the budget preparation. They are very important, particularly so in the larger companies embracing multiple products, multiple offices and plants, and numerous areas and levels of management, many of them specialized. Most or all of these prerequisites should be present to a substantial degree in order to secure the advantages possible through the preparation and administration of a budget. Some of them are, in a sense, self-evident and are yet often overlooked or neglected to the detriment of the budget program.

The first group of prerequisites deals largely with an area that might be called the human side of budgeting, because the preparation and application of an effective budget requires an enthusiasm and willingness on the part of all echelons of management to participate in the preparation of such a budget, and to assume the obligations necessary to accomplish such plans. It may shock some technical accountants to read this, but to me this area of the human side of budgeting is more important and more essential to effective budgeting and control than the technical or mechanical phases, which have been pretty well defined over the years in one form or another. No single budgeting system can be universally applied, however. It must be tailor-made to the requirements as they exist. Therefore, from the technical or mechanical side of budgeting, the big job of management—particularly the accountants who are skilled in record and report development—is to apply such mechanics skillfully to the peculiar and particular problems of the company and industry involved. But even beyond the recognition of company and industry must be a full consideration for the particular background,

training, and desires of the operating management people within the company who will be responsible for preparing and administering the budget program. That brings me back to my first point, namely, the need to give full recognition to the very important human side of budgeting.

It may be somewhat of an overstatement to say that effective budgeting depends on a complete willingness on the part of management to plan and establish sound goals and then to be measured against these goals during the year. This takes on the part of management a real tough-mindedness and cost-control consciousness, which is not always easily accomplished. This is particularly true in larger companies, where management is widely distributed among many offices often thousands of miles apart, and where a certain amount of management turnover is inevitable in the normal course of business operations. Yet, if this management attitude is not present throughout the budget preparation and subsequent budgetary control cyle, effective budgeting—and effective budgetary control—cannot be accomplished to the degree it should.

Therefore, one of the first prerequisites to a successful budget program is to do everything possible to enlist and stimulate the support of all areas of management for the program. This is a never-ending, year-long job which, in my opinion, can best be accomplished by a constant requirement of accountability of actual performance to budgeted objectives throughout the year from top management down through the entire organization. It cannot be accomplished by a "once-a-year" shot in the arm.

At budget time, however, it is appropriate and effective for management to alert itself to its responsibilities for effective planning by means of a number of steps. These might include: (*1*) short letters from top management officers to their respective areas to alert them to the fact that there will be a budget, that budget time is approaching, and that the budget can make important contributions to profitable operations; (*2*) division, plant, department, staff, line, *etc.*, meetings, as the case may be, devoted to outlining the job to be done and its importance; (*3*) inquiries to various management people by the budget director and/or the budget committee to stimulate their thinking on various aspects or plans for the coming year; and (*4*) an alerting of the accounting officers throughout the company to make proper inquiries of the operating managers they serve—again as a stimulus to sound and creative planning.

Another relationship important to effective budget preparation is a clear understanding that it is the job of operating management to make the decisions reflected in the budget. It is not the job of the accountant to make the decisions. He can and should contribute his advice and counsel as a help in formulating the decisions; he can and should see that the time schedule, forms, and other mechanics of budget preparation are satisfactorily worked out; and he can and should act as a co-ordinator in pulling together the various schedules and statements into a finished budget. From a decision-making viewpoint, however, the budget preparation is both an opportunity for and a responsibility of operating management. It is an opportunity to

develop and co-ordinate a set of integrated company plans to assist in maximizing profits. It is a responsibility to develop these plans and objectives and to be held accountable for their accomplishment. The accountant cannot make the decisions since he is not held accountable for enforcing or accomplishing such decisions. That is the job and responsibility of operating management.

Another prerequisite to effective budgeting—and still in the area of the human side of budgeting—is the establishment of well-defined organization lines as to responsibility *and* authority. Each management position should be clearly defined as to its responsibilities; superior and subordinate relationships positively identified; and necessary authorities properly delegated. Definitions such as these are necessary to the effective functioning of any organization. They are particularly important in large companies where such organizational lines are pretty complicated at times.

No budget program can be completely effective unless these organizational questions are resolved. Each management person should know his responsibilities and be held accountable for their proper performance. In turn, it should be obvious that he must have the authority to accomplish these responsibilities, and be aware of the various superior and subordinate relationships throughout the organization so that he will know the proper channels to follow in order to get his job done.

During the budget preparation and subsequent cycles of controlling to the budget, the accountant should be keenly aware of these organizational questions. He is an excellent position to observe any deficiencies in these relationships, and should feel compelled to bring them to the attention of the proper people for correction.

Another important organizational question that should be resolved prior to budget preparation is the establishment of a proper budget organization whose job it is to see that a budget gets prepared. This is essential because of the numerous interrelationships of decisions, time schedules, procedures, *etc.*, inherent in the preparation of a budget. Actually such an organization could be anywhere from a fraction of one person in smaller companies to several or more people in the larger companies. Normally, it is a responsibility vested in a person with an accounting background. For purposes of subsequent discussion, let us refer to this person as the budget director.

Depending on the industry in question, the size of the company, personalities involved, existing organizational lines, and other considerations, such an organization might be under the controller, treasurer, president, or some other company official. It might be accomplished with or without the benefit of a budget committee. It might be an integral part of broader company responsibilities such as operations analyses, long-range capital investment planning, *etc.* It is usually a staff function, but could be a line function. Budget director representatives are usually appointed at the various control points (plants, offices, sales districts, etc.) to assist in pulling the budget together. They are usually accounting people, but do not necessarily report to the budget director except to carry a responsibility for assisting him in the budget preparation.

There are numerous possibilities and applications in establishing the budget organization. The important thing is to establish this responsibility clearly so that there is a focal point in the organization for planning and applying the proper steps to get the budget prepared.

The prerequisites to effective budget preparation that have been mentioned up until now are largely those which operating management should supply. They are not directly the responsibility of the accountant, although he should contribute everything he can to their full realization. The remaining prerequisites I should like to cover are those which the accountant is best equipped to develop and supply, although here again they must obviously be worked out with operating management and fitted into their requirements in a realistic and practical manner.

The first of these is a proper classification of accounts and statistics that will adequately reflect various items of volume, income, and expense. Such a classification system must not only accomplish the requirements of financial accounting, such as accurate distinctions between income, expense, capital investments, and the many other financial accounting areas with which you are all familiar in order to meet the requirements of proper statement preparation, inventory valuation, tax requirements, profit or loss determination, etc. It must also meet those requirements which operating management needs to control its business from day to day, week to week, and month to month. In order to make this important point crystal-clear, I should like to draw a distinction between the field of financial accounting and what I like to refer to as the field of control accounting. Both are very closely related and obviously need to be closely integrated with each other in order to avoid excessive accounting expense. The emphasis in each is quite different, however.

Financial accounting concerns itself primarily with recording the business transactions and summarizing them for the various purposes outlined above. In a broad way, the resulting statements obviously give management guidance and control information in their planning of the business operations. The field of control accounting, however, goes much further in providing various areas of management with data to control its operations. This area of accounting specializes in various planning, analytical, and control procedures such as budgets, cost accounting, operating analyses, product costs, costs for pricing, standard expense rates, overhead or burden allocations, break-even charts, and other devices. It emphasizes the strategic use of the mass of detailed information available in the accounting records in such a way as to furnish operating management with the detailed information it believes necessary to control operations. The classification system can be so organized that it will meet the requirements of these various control accounting uses and still meet all of the requirements in the financial accounting field, The reverse is not true, however, since some of the essentials to control accounting are not particularly requirements of financial accounting. For example, under a classification that meets the requirements of control accounting, it is essential that expense be departmentalized sufficiently so as to parallel management responsibilities as shown on the organization chart. If the classifica-

tion system does not match the supervisory structure, the budgeting and accounting records will not readily reflect the responsibilities of the managers and the actual results of their operations.

Income and expense accounts (and related statistical information) must also be segregated into natural controllable components, so that the information passed by the accountant to the responsible operating manager can be easily interpreted by him as to results and any required action. Such natural controllable components would include proper product segregations on income, and adequate segregations of expense as between such different items as management labor, clerical labor, sales salaries, maintenance materials, operating supplies, brokerage payments, automobile expense, incentive compensation, direct labor, indirect labor, and others.

Additionally, the classification system should recognize a segregation of items by degrees of variability. Products with varying seasonal characteristics should be given separate identification, either directly in the income-account classification or in the statistical-volume classification. Expense accounts should be identified as far as practical as variable or volume costs, fixed or period costs, and semi-variable or step coasts. In this paper, we cannot go into a detailed definition and identification of these three expense segregations, but in my opinion it is essential that this segregation be recognized wherever it is reasonable and practical to do so in order that these items may be budgeted properly in relationship to volume objectives, and controlled properly to the budgeted goals during the budget period.

Wherever possible, the classification system should also recognize the natural functions or activities within the production and distribution processes in order to minimize the accounting effort involved in developing proper product-cost information for operating management. I mean that various manufacturing functions such as machining, assembling, inspection, packaging, etc., should be separately identified in the classification system if it is desirable and practical to do so. Similarly, our distribution costs should be separately identified if possible as between products, selling offices, channels of distribution, etc. Many of these requirements will have been answered if proper consideration has been given to matching the classification system with the organization chart, but it is an area that should be closely watched not only for assistance in subsequent product costing, but also in identifying cost objectives during the budget preparation and for purposes of control during the budget period.

Another prerequisite the accountant should supply prior to budget preparation is an account-distribution system that is adequate and accurate. There is nothing more disturbing to a buget-enforcement program than to have operating management misled by reporting variations from budget that turn out to be the result of clerical errors in the accounting distribution rather than good or bad management performance. Occasional errors are recognized as being inevitable and, while unfortunate, I believe operating management generally recognizes that to make a clerical system foolproof would be entirely too costly to justify the end result. Repeated errors, however, will

quickly undermine operating management's confidence in the data shown on the various control reports, and will result in a substantial retarding of effective management follow-up of differences from budget. It behooves the accountant therefore to insure the establishment of an adequate and accurate account-distribution system.

The accountant should also develop variable or flexible budget procedures to the extent they are applicable to the operations of his company and industry. This is urged for a number of good reasons, including: (*1*) they provide operating management with more realistic comparisons of actual performance with budget; (*2*) they simplify the task of preparing the annual budget, particularly if standard costs have been developed; (*3*) they simplify the determination and explanation of variances; (*4*) they make it possible to carry a completely co-ordinated control program from the annual budget down through all interim management control reports (monthly, weekly, daily, etc.); and (*5*) they need not detract from the necessity for controlling toward over-all budget objectives such as annual profit, volume, or per-unit expense goals, if the full budget program is properly coördinated to the requirements of all levels of management.

This does not mean the fixed annual budget has no place in industry today. It has many applications, even under a variable budget program. For example, a budget program might apply a variable budget to manufacturing expense and yet apply a fixed budget to certain functions or expense controls, such as administrative expense, or sales-management expense.

The procedures necessary to accomplish the application of a proper variable program to company operations need to be carefully developed in order that they meet the particular requirements of the company involved. Time does not permit discussing this phase in any detail. Suffice it to say that operating management is entitled to expect the accountant to work these out within the framework of the company's control program in such a way as to give operating management factual and practical information that will permit the preparation of a proper budget and the application of a realistic control program to such budget objectives during the year.

The accountant should also provide a system of budgeting that will permit changes in such budget during the budget period as major changes take place in operations. This does not mean that budget goals should be changed for the usual variations due to bad guesses or poor performance. I strongly suggest, however, that a provision be made for budget changes where major changes in management policies occur, such as introduction of a new plant, new products, redistricting of sales territories, revisions in marketing programs, sales channels, and other such changes. Provision for changes of this character will keep the budgeted goals "tuned to the times" so that operating management during the budget period will be controlling to objectives that recognize the current mode of operation.

As another major prerequisite to budget preparation, I believe operating management should expect the accountant to develop budgetary procedures that embrace a total control program. I have already referred indirectly to

such a program, and perhaps these comments apply more to the period after the budget has been prepared. The ground work and basic data for such a total control program are developed during the budget preparation, however, and are so completely interrelated with the budget preparation requirements that I believe it is appropriate to devote some attention to this point.

In developing the budgeting procedures and the related questions on classifications, etc., the accountant should co-ordinate all of these requirements of control accounting with those of financial accounting in such a way as to establish a fully integrated program that will meet the control requirements of operating management. If properly done, this will not only reduce the accounting and clerical costs of such a program, but will also facilitate effective management folow-up on variances from established objectives. As indicated earlier, there are a number of mechanisms that have been developed over the years to assist in controlling operations, such as cost accounting by products, by operations, and by jobs; statistics on volume, margins, and per units; standard expense rates for pricing and cost control; allocation procedures; break-even charts; and various other forms of operations analyses. Within any particular company and to the extent considered necessary by operating management, the accountant should develop these various mechanisms and procedures into a unified program wherein all of the control reports and data reflect the same objectives, standards, goals, or what have you, from the foreman's daily shift report and the salesman's daily call or volume report right up to the final summary reports for top management. This will not only provide operating management with effective information to develop a sound budget, but will give it the data to assist effectively in the control of its operations.

Another important step to accomplish before beginning the actual budget preparation is the development of a detailed time schedule spelling out the dates to be followed from the start to finish in preparing the budget. This is very essential in order to alert everyone concerned throughout the company as to when certain decisions or data must be available in order to prepare the budget witin the prescribed time limits. In developing this schedule, the critical date is of course the time established by top management when it needs to submit the budget in final form for approval, usualy either to the president or the board of directors. This date is usually a short time before the beginning of the new budget period which, in the case of an annual budget, would usually be a date just before the start of the new year. All timing starts from such date, and the budget director should work back his required due dates from this "deadline" date.

The time schedule should be worked out in considerable detail, giving due consideration to working days available, mailing time between offices, management time required to clear and accept proposed objectives and plans, clerical time to summarize schedules and prepare related statements, etc. Obviously the size and importance of such a schedule will vary with the size of the company, the type of products, number of offices, etc. It is not unusual in the larger companies for such a time schedule to contain hundreds

of detailed responsibilities and due dates, and extend over a period of three or four months in the case of an annual budget.

The budget director is obviously the one to assume the responsibility for preparing this time schedule. After developing a tentative time schedule (usually in conjunction with various members of operating management to get their counsel and advice), the budget director should submit it to top management for their approval. Usually it is not necessary to submit à completely detailed time program unless management wishes to see the complete details. Ordinarily they would be interested only in certain key dates, such as availability of preliminary volume figures, certain summary expense figures, tentative profit workouts, etc.

Once the time schedule or "action schedule" has been approved, there should be a general alerting of all management to the particular dates in which they would have an interest. Here is where an effective budgt organization can do a great deal of good. Such alerting is usualy accomplished by the budget director through his budget representatives at the various control points such as divisions, districts, plants, offices, etc. Each budget representative in turn alerts his particular management group to the significance of these dates and the planning and detailed steps necessary to accomplish the required objectives within the time prescribed. It is also about this time, or perhaps a little before, that top management officers can effectively write short letters to their management personnel concerning the budget preparation and its importance, as mentioned at the beginning of this discussion.

One comment is worthy of mention concerning budget worksheets. Particularly in the larger companies, it is very desirable that these budget worksheets be set up and standardized prior to starting the budget preparation. This is very desirable in order to give all concerned as specific an idea as possible concerning the various figures required, and also to facilitate the summarizing of the data as they arrive from the various offices and departments.

The content of these budget worksheets will of course vary with the company requirements, although they usually contain provisions for "year-to-date" data as a guide in establishing the required information for the new budget. One interesting aspect of these budget worksheets that has proven to be very effective is a requirement that each budget worksheet reflecting management decisions (volume, figures, expense amounts, etc.) include the signature of the individual at the lowest control level, indicating acceptance by such person as his goals for the budget period. For example, the salesman would sign his particular volume schedule; the foreman would sign his manufacturing expense schedule; the department supervisor his administrative-expense schedule, etc. Usually, the immediate supervisor also signs the worksheet, indicating both are in agreement and underwrite the objective stated.

Up until now, I have tried to establish certain prerequisites I consider to be essential in the way of understandings and procedures before the budget preparation begins. The effectiveness of the budget, and the subsequent efforts in controlling to it are directly proportional to the attention given to

these matters. We shall now devote the remainder of this paper to certain comments on the actual preparation of an annual budget.

Assuming a going company, which has satisfactorily established and maintained the above prerequisites, and which has had a budget for a number of years, the first step in preparing the folowing year's budget actually starts at the completion of the current year's budget. From our budgeting experiences, we know that during the preparation of an annual budget many discussions develop containing numerous suggestions for changes or modifications in procedures, time schedules, classification systems, etc. These have value many times either in developing a more effective budgetary control program, or in keeping it up to date with changes in operations. It is not always possible to put such suggestions into effect immediately, particularly in large companies because of the necessity to explore them completely as to their possible effect on all areas of the company's operations. Therefore, as soon as the current year's budget is completed, there are usually a number of suggestions that should be placed promptly into proper channels for full consideration, and certainly in time for incorporation, if they are to be adopted, into the following year's budget.

Also, during the current year until the start of active preparation of the following year's budget, numerous suggestions will develop as the result of changing requirements within and without the company. Many of these will have an effect on the budgeting procedures and great care must be taken to insure that these changes are fully recognized in the budgetary control program.

The entire budgeting and control cycle is perhaps best described by a little "gimmick," which is identified by the first four letters of the alphabet: *A, B, C,* and *D.* These letters represent the budgeting and control cycle as follows:

A. Analyze your business and your industry.
B. Budget your operations.
C. Compare actual with budget.
D. Do something about variances.

The above "gimmick" is easily remembered and in its full sense completely identifies the budgeting and control program. We are probably more concerned today about the *A* and *B* portions of this program than with *C* and *D.* I am sure, however, that, while much good can come from effectively analyzing and budgeting your operations, the real payoff to maximizing profits develops during the cycle of "comparing and doing something about it." Much of the cost and effectiveness of the annual budget and its related interim reports is lost if *C* and *D* are neglected.

In talking about *A,* the analysis of your business and your industry should of course precede the actual budgeting period to the extent necessary in order that the time schedule established for active budget preparation can be met. The type of analysis and planning required at this stage prior to actual budget preparation is fairly obvious. It would include a careful review

of business and industry trends, competitive relationships, new products, working-capital and fixed-capital requirements, expense trends, territory and customer evaluations, individual product reviews—including the all-important aspects of profit contributions by products), and many other questions bearing on the past and present status of the company and its future potentials. Of course, this type of planning goes on to some extent every day in one form or another at the various management levels. This, however, is the period during which operating management should be tying together those plans which it definitely wants to set as objectives during the coming year. This period of self-evaluation is most important to a carefully planned program of action.

Because many of the analyses taking place during this time require the skill of the accountant to bring the facts out of the records, the accountant is usually very much involved in assisting operating management in crystallizing its thinking. In turn, the accountant (budget director) must also be particularly sensitive to the amount of time such deliberations might take, and be certain that they are started early enough in order to complete the budget within the time specified by top management. Again, this is particularly important in the larger companies where such deliberations take additional time because of the frequently complex channels through which such planning must necesasrily go before decisions can be reached and cleared for inclusion in the annual budget.

In talking about *B*, I am sure it is generally recognized that there are many, many details going into the preparation of the budget itself. It would be impossible to discuss all or even a sizeable portion of them in this paper. Likewise, a number of other budgets or forecasts are frequently developed at the same time the annual operating budget is prepared. These would include cash budgets, capital-expenditure budgets, inventory-position forecasts, and other "special interest" budgets. I should like, however, to make a few pertinent comments on two further aspects of budget preparation: (*1*) volume; and (*2*) the use of standard costs.

Volume, of course, is the keynote to preparing the rest of the annual operating budget. Volume is, therefore, usually the starting point and must be fairly well agreed upon before the balance of the budget can be prepared. Volume budgets are usually set by what you think can be sold, modified if necessary by your physical capacity to produce such volume. The ramifications of this problem are many, and include your pricing policies, product costs, advertising programs, industry and economic trends, merchandising abilities, productive capacities, competitor strengths and weaknesses, customer relations, governmental policies, fiscal tax programs, and many others. This is one of the most interesting and challenging problems in budgeting. Businesses have been made and broken by the shrewd ability of management to judge and plan a proper balance of these factors.

Whatever the limitations or considerations are in planning volume goals, it is usually best to have the preliminary volume figures originate in the various field offices in order to get an expression of opinion from those who are

"out on the firing line." Once the volume of deliveries has been established, other considerations of the annual operating budget can be worked out, such as production schedules, inventory positions, and the various areas of expense. (Selling prices and margins are usually considered in conjunction with the establishing of the volume budget.)

The use of standard costs can be particularly helpful in preparing the annual budget. I shall give an example involving manufacturing expense under a variable budget procedure, assuming there are standards established for all items classified as manufacturing expense. If such is not entirely the case, the items involved would need to be budgeted in the conventional way rather than as outlined below.

Since we have standards in a variable budget procedure, we have all that is necessary for controlling the operations during the year in a current and realistic manner. We also have our cost bases for inventory valuations. Hence, we have accomplished one of the major objectives of an annual budget without having had to prepare one. We also have all we need—if our standards and classifications systems are properly set—to run out our product costs on manufacturing expense, again without having prepared a detailed annual budget on manufacturing expense. Therefore, our only other principal concern is to develop sufficient data on manufacturing expense so that a profit forecast can be made in the annual budget.

This can be done very simply without having to develop detailed labor and supply schedules supporting the volume in the annual budget. Manufacturing-expense data are available from (*1*) the established standard costs; (*2*) variable budgets (for proper interpolation of standard cost changes due to volume changes); and (*3*) past experience as to variance from standard. Using these data, total manufacturing expense can usually be estimated quickly, and sufficiently accurate, to provide the data needed for a profit forecast. Detailed labor and supply schedules on manufacturing expense need not be developed, therefore, and the job of preparing the annual budget is considerably simplified.

For profit forecasting, the same can be done under a fixed budget program on manufacturing expense except that the data for interpolation as listed in (*2*) above are not as satisfactory. Since the data used for control during the year under a fixed budget program come from the fixed budget itself, however, it is necessary to develop labor and supply schedules for the fixed budget in order to have these schedules available for control during the year.

Let us now asume that the annual operating budget has just been completed. The next step should be to test the budget as to its adequacy. The first and acid test is whether the budget reflects an adequate profit. This valuation is made in a number of ways, including: (*1*) Do we have an adequate return on investment? (*2*) How does it measure up to prior years' profits, and does it reflect satisfactory growth and progress? (*3*) Is it in line with profits in the industry? (*4*) Will it meet dividend requirements? (*5*) Does it meet our objectives on the need for reinvested earnings?

Normally, other tests of the budgeted data are also made. For example, the

budget expense data might be set up by products to insure that product-cost objectives are in line with management thinking. Such a study might also be extended to include income, and a determination might be made of the budgeted profits by products, either on a full-cost basis, a "profit contribution by products" basis, or both. Break-even charts could also be developed to test the adequacy of the budget from the standpoint of proper relationships between budgeted income, and budgeted fixed, semi-variable, and variable costs.

If, in the course of these studies, operating management determines that the budgeted objectives are unsatisfactory, it becomes necessary to examine each phase of the plan to determine what action is necessary to revise objectives so that the final budget is acceptable.

After management has satisfied itself that the budget reflects satisfactory and desirable goals, it should be submitted to the proper office for formal approval. When accepted, the entire management group should be advised so that all concerned can then turn their attention (among other things!) to the job of controlling to such objectives during the year.

Budgetary control for medium-size business

CHARLES S. ROCKEY

Partner, Charles S. Rockey & Co., Philadelphia.

Accounting literature contains an abundance of material on the what, why, when, and how of budgetary control. We have both absorbed much of that material and, for that reason, I shall confine my remarks to a general phase of the subject as it relates to medium-size business that our firm considers of prime importance to the practicing CPA; namely, the responsibility of the CPA in recommending the use of budgets, and the scope of his (or her) services in connection with their installation, administration, and use.

DEFINITION OF BUDGETARY CONTROL

The term budgetary control is used here in its broadest sense, which is the control of some part or parts of the operations of an enterprise. Perhaps the simplest form of budget is a fixed budget for the control of purchases and expenses. One of the more elaborate forms might be a series of variable, different-volume-level budgets for a manufacturing enterprise for control of all income, expenditures, cash transactions, inventories, and costs with balance-sheet forecasts with varying objectives. Between these two extremes, there are many forms and combinations of varying complexity. A simple cash-flow statement is a form of budgetary projection. A system of standard costs is actually a form of budgetary control.

NEED FOR AND ABILITY TO USE

In our experience many small and medium-size businesses are well managed by the owners without the use of a formal budget plan because expenditures are watched carefully and approved and, usually, the owners have a touch for buying at the right time. This is especially true of service organizations, and jobbing and merchandising companies.

We have found it to be the case also that, when business is good, our client will let the budget procedures go by the wayside, because operating

profits come so easily. Vice versa, we have noted that, when competitive conditions are extreme, the client will state that they have to meet the selling prices of competitors regardless of what their costs show and, therefore, they raise the question why they should continue to go to the expense of maintaining and operating a cost budget especially. And so, in many such cases budgets are discontinued in full or in part. There are, of course, many situations in which the CPA will be of the opinion that a budget installation is advisable and will be of great value to the client.

As respects the need for and the ability to use budgetary control, businesses resemble ships, In businesses as in ships, requirements for control personnel and procedures increase, more or less, in proportion to size.

The small business is like a sailing ship whose skipper has most of the control facilities under his hat, and whose records are largely historical. The ship may be so affected by winds and currents that her skipper has difficulty in keeping his course or forecasting his future position.

The medium-size business is like a freighter or tanker, whose captain can use controls, maintain his course, and forecast his future position to a much greater degree than the skipper of the sailing ship.

The large business is like a large ocean liner whose captain has the personal ability to control and direct his ship but, because of the vastness of his charge, he relies on the assistance of a number of officers schooled in the specialties of each function of ship operation.

To place many of the control facilities of a steamship on a sailing ship might be sheer waste. Similarly, to place other than the simplest budgetary controls in a very small business might be inviting disappointment and would most likely be futile. On the other hand, many steamships can make profitable use of some control facilities that are developed for ocean liners, if the facilities are modified properly and personnel is available to operate them. Likewise, many control techniques of large businesses may be adapted to medium-size businesses, provided competent personnel is made available to operate them, and provided further that top management has the will and know-how to use them.

ROLE OF TOP MANAGEMENT

An important factor is the ease with which the required basic information for budgeting can be obtained from the accounts. Sometimes it is advisable to revamp the accounts before attempting to develop budgetary procedure.

To be successful, budgetary procedures must have their source of power in top management. The boss must want them and be determined to make them work. Otherwise, valuable information may be developed but not used, and costs of budget operation may be incurred that might be saved or might be productive of real benefit in another channel.

Some years ago, in making an examination for a new client, we found one of the most complete financial budgetary-control and standard-cost layouts we had ever seen. Budgets and standards had not been changed in several years, however, and top managment did not have an understanding of the

theory and purpose of budgetary control. Magnificent but worthless reports were being turned out periodically and filed unused, and thousands of dollars were being wasted in budget preparation and reporting every year while operating losses were piling up. Unfortunately, losses continued and new management was not installed by the creditors in time to save the business.

All too frequently the head of a business will want budgetary control installed in his company, expecting to do so either without much effort on his part or without thorough understanding of its nature and requirements. If the owner or executive head is really sold on the budget idea, he should be prepared to learn the principles and general techniques, and to contribute the effort required to insure successful operation of the plan.

Sometimes the chief executive is not sufficiently accounting minded to grasp the principles and techniques of the kind of budgetary control he wants and needs. Such a man must be prepared to delegate the required authority to a deputy who will act for him and report only to him. This deputy then becomes top management for purposes of this discussion.

Unless the foregoing conditions for top management can be met, we would approach installation of any but a very simple form of budgetary control with caution. Where there is doubt, simple procedures might be tried or an installation made in one department of the business at a time, and then expanded slowly as each new procedure or department is producing satisfactory results.

I well remember the admonition given to me in the early 20's by a leading practitioner in Philadelphia. That was to value your audit and tax clients so highly that you would not undertake any special budget or system work for them unless all conditions were ideal—first, with your own staff and, second, with the client's organization. Otherwise, you would be in serious danger of losing a very highly regarded audit and tax client. In such situations he suggested it would be better to recommend one of the business-system organizations to undertake special services! I believe that his advice still holds true. Many system firms, very often because of the optimistic claims in their advertising, secure much of this work, even for smaller businesses.

However, if you believe you have the proper personnel to install budget procedures, and conditions in the client's organization meet the requirements outlined in this paper, then the advice of Walter R. Bunge, CPA, budget director of Allis-Chalmers Manufacturing Company, in a talk at Milwaukee last spring, will assist you in securing and rendering such services.

A condensation of Mr. Bunge's remarks was published in the Spring, 1953, issue of *The Ohio Certified Public Accountant,* from which I quote as follows:

> "Businessmen, and those who influence the thinking of business, and those who reflect the thinking of business through writing and talks, are coming to feel that accountants have of necessity to work more for the government and its agencies than for their own businesses. They feel that the accountants ought to fill the gap of information which management lacks but needs to run its business, but they are afraid the accountants are too preoccupied with other things.
>
> Your clients may now be using budgets. If they are, are those budgets

really effective or could you improve them? If your clients are not budgeting, you may be sure that many of your clients' competitors do budget. Why not give your client the same advantage? If you do not enter into the field of budgeting, and encourage your clients to do so, someone else will. It is quite possible that that someone else may be of a non-professional character. Consultants who begin working with shop layouts, often wind up with changing the accounting system, and the next step is the budget. Why don't you start at the budget and the accounting system—with which you are eminently familiar? You know the client, you know his accounting system, and you know good accounting. You are the logical professional group to install budgetary control.

What would it mean to you or to your firm and how would you benefit if you would offer your clients a professional service of installing budgetary control systems and acting as a consultant on budgetary matters? It would do these things:

1. It would provide a means of giving your clients additional service of exceptional value.

2. It would establish a closer and continuing relationship with your client. This is true even after the installation, on a consultation basis.

3. It would provide off-season work. The client would be no more eager than you to work on a budgetary installation with you when he is engaged in the throes of annual closing, and you with his audit.

4. In offering a consulting service in budgeting, the public accountant would tend to prevent inroads by some non-professional firms in this aspect of what could and really ought to be a part of the accounting profession."

By all means take these precautions as you proceed with a budget installation: have conferences with the client weekly or monthly as you deem necessary, and bill monthly or on some other periodical basis for your services as your work goes along.

GENERAL PROCEDURE

Management should not, of course, become involved in the detail procedures but it must require each level of working staff to master appropriate detail and to maintain an unbroken chain of authority, responsibility, knowledge, and performance.

Regardless of the size of the business, the functions and duties and the chain of command in a budgetary control operation must be maintained. In a medium-size business, these elements may be confined to a very few persons, but each individual covers a wider area than would be the case in a large organization.

SCOPE OF CPA's SERVICES

General

The scope of the certified public accountant's services respecting budgetary control may vary greatly of course, dependent upon circumstances. It may encompass any or all of the following phases:

(*1*) Preliminary consideration and decision.
(*2*) General program and budgetary organization.
(*3*) Development of budgetary procedures, as respects:
 (*a*) Budget preparation and revision;
 (*b*) Accounting;
 (*c*) Reporting and corrective action;
 (*d*) Reporting to top management and general administration;
 (*e*) The Manual.
(*4*) Operation, as respects:
 (*a*) Budget preparation and revision;
 (*b*) Accounting;
 (*c*) Reporting and corrective action;
 (*d*) Reporting to top management and general administration.

In general, participation by the CPA in these phases is normally on a decreasing basis. That is, he may participate nearly always in the preliminary phase but may participate seldom in actual operation after the try-out period, except in an advisory capacity,

In audit

Our experience indicates that the CPA rarely participates in any phase of budgetary control in the usual audit except that he may review and report on the procedures, and may examine them in some detail if they affect inventories or other balance-sheet items.

Phase 1. Preliminary consideration and decision

Survey and recommendations. Ordinarily, the CPA will be called upon at the initiation of Phase 1, when management is giving preliminary consideration to the subject. Quite often, of course, the seed for the desire for operating under a budget will have been sown by the CPA, although we hope he would not do so unless he feels sure that the requirements described previously can be met.

So often our clients will not consider the operation of a budget until they are in financial trouble and are compelled to do so by a bank or other lending agency or possibly by a committee of creditors. In such instances the accountant will usually be asked to assume more responsibility for the functioning of the budget procedures than otherwise. The CPA should not be too reticent to recommend the use of budgets when it is all too plain to him that, very shortly, such procedures will be forced upon his client by a bank or a creditors' committee.

Preliminary consideration and decision can be the most difficult phase for the CPA. Here there are "Stop, Look, and Listen" signs before him. Unless he is fully informed, he would be wise to thoroughly survey the situation as respects budgetary needs, personnel, lines of authority and responsibility, executive weaknesses, accounting facilities and capabilities, or business needs of greater importance than budgets. Then, under Phase 1, he might make one of the three following recommendations:

(*1*) Defer consideration until important existing deficiencies are corrected. This may require careful approach and considerable tact.

(2) Consider the subject favorably, provided specific changes be made before proceeding.

(3) Consider the subject favorably and proceed.

Recommendations a, b, and c

The first recommendation, deferment of consideration, might be made if, for example: (*a*) Accounting facilities or capabilities are deficient; (*b*) installation of some other procedure, for instance, material or production control, would meet a more pressing need; (*c*) there is serious executive weakness or friction.

If an executive's desk is overloaded and he is immersed in detail that he should and does not delegate, his participation in budgetary control is likely to be disappointing. If a factory or department is cluttered and poorly organized or managed, the participation of its head is likely to be a failure.

The CPA might be wise to avoid close entanglement in budgetary control under such circumstances because some blame for the resulting difficulties and disappointments is sure to be attributed to him or "his system."

Recommendation (2) above, proceed after changes, might be made when required changes can be made without much difficulty and in a short time. For example, budgeting of manufacturing costs might be recommended provided a competent cost accountant be engaged. After some disappointing experiences with not making certain that procedures we recommend would be in capable hands, we now do our best to avoid that kind of situation.

Phase 2. General program and budgetary organization

The extent of the CPA's participation in Phase 2, the development of the general program and budgetary organization, may vary greatly according to circumstances, such as the scope of the proposed budgets and the size and capabilities of the business organization. If he participates to any extent, it is suggested that he be guided by the following considerations:

The goal: what the management wants and needs. This consists of reconcilement of the desires and needs of management, and conversion of the decisions into what we have termed groups of budgetary procedures. For example, an expense budget would give rise to one group of procedures and an income budget would give rise to another group.

The start: what the company has now that will be helpful or useful. It might be found, for instance, that the company has a well detailed and departmentalized expense distribution that can be adapted easily to budgetary requirements.

The additional information that must be gathered: how, by whom, and how long it will take. For example, it might be necessary to analyze and distribute many accounts to obtain necessary information on which to base a budget. Determination must be made of the accounts involved and the most practical procedure to be followed. These considerations, together with arrangements to have the work done, should enable an estimate to be made as to about when the resulting information will be available for use.

The determination of the practical paths and seats of authority and responsibility for each group of budgetary procedures, dependent on such factors as: (*1*) The operating organization; (*2*) accounting layout; (*3*) personnel characteristics; (*4*) what changes can and should be made to facilitate the budget program.

The estimates of how much in the way of new procedures can be assimilated at a time, expressed as an approximate time table for development, initiation, and tryout of each group of procedures.

Our experience indicates that, when management is in a hurry, it is prone to be too optimistic of the ability of the organization to assimilate new ideas and procedures.

When too much is attempted at one time, the project is made more difficult or is even jeopardized, and time is lost rather than gained. This applies particularly to work centers that are affected by more than one set of procedures, to executives who become temporarily overloaded, and to an accounting department that is reorganized or expanded too rapidly.

We have had some experience with that kind of situation. Quite often, many levels of personnel may have a lot to learn while having their budget duties added to their other duties. They must be given time to learn their new duties gradually, so that they can perform them intelligently with minimum interference with other duties. Similarly, new employees should have their work loads increased gradually in order to attain and maintain high performance standards.

Phase 3. Development of budgetary procedures

The CPA may expect to be particularly helpful in Phase 3, the development of budgetary procedures. The company's budget officer and accounting executive may be expected to become major participants in the program at this point. Again, depending upon circumstances, they may either carry on the work under the guidance and advice of the CPA or they may merely assist the CPA to the extent of his desires and of their own time and capabilities.

In the normal development of budgetary controls, it has been suggested that the various areas for such control be absorbed gradually, taking one area (for example, income or expense, or cash) at a time. Develop the procedures and place them in operation before attacking the next area for consideration. Nevertheless, it must be understood that all areas interlock at times. It would be wise to work out the procedures on all areas to a sufficient degree before any one area is put into operation, so that a proper coördination of all procedures can be visualized and maintained.

Phase 4. Operation

The CPA's participation in Phase 4, the actual operation of the budget, may depend upon the extent of his participation in the development of procedures, as in most system work his participation is likely to be greater during try-out periods than later.

Ordinarily, his participation in the actual operation of the budget is likely

to be in inverse ratio to the size and quality of the business organization.

In the case of a small business organization, he might perform the duties of budget officer, provided he can be at the company's office frequently enough to initiate action based upon current or fresh performance data.

In closing, I wish to reiterate what we think is the primary requisite for successful operation of budgets. To administer the budgets, there must be an executive who has the ability to interpret and evaluate the figures and explain them to the appropriate levels of management, and who has the force and authority to follow through and make the plan work. Budgetary control cannot be developed into a routine to be administered by high priced clerks, and the CPA who avoids entanglement in such a futile endeavor is wise.

The possibilities of the 1954 revenue revision act

THOMAS J. GREEN

Partner, Peat, Marwick, Mitchell & Co., New York. Chairman, Institute's committee on federal taxation.

IN this paper, I shall give a broad outline of what we might look for in the way of tax revision during the next six to twelve months.

The Brooklyn Dodgers, ever since they won the baseball pennant in 1920, have had their rooters appealing to the general public on the basis of, "Wait until next year; we'll kill them." This appeal was made whether it was a question of winning the National League pennant or whether it was a question of winning the World Series.

We have somewhat the same situation in taxation. Taxpayers throughout the country have been clamoring a long time for some tax revision. This time, unlike the Dodgers, I think we are not going to disappoint them. I see in the immediate offing an excellent chance of a comprehensive tax revision bill. Before I get to the technical tax-revision bill as such, however, I shall attempt to make some predictions with respect to some of the other fiscal policies.

In the first place, with respect to the personal-tax reduction, it is politically, economically, and socially impossible not to effectuate the ten per cent personal-tax reduction. Later on, in connection with tax revision, I shall show that the budget enters very seriously into a number of the considerations in the tax-revision bill. In view of the fact that it is already in the statute and, in addition, because 1954 is a Congressional election year, I believe that, regardless of what the budget situation may be, Congress will not seriously consider voting against allowing the ten per cent reduction.

The same thing goes almost without saying with respect to the excess-profits tax. I think that certainly it is going to expire as of December 31, and that no effort on anybody's part will be made to revive it.

If we consider the other automatic provision for tax reduction, namely,

the proposed corporation tax reduction from 52 to 47 per cent, which is scheduled to be effective as of April 1, 1954, I believe that, in the light of budget considerations, we are very unlikely to see the reduction go to 47 per cent. There is, however, some chance that a compromise might be reached in the area of 50 per cent, but the 47 per cent is most unlikely to go through.

The same thing applies to a number of the other proposed excise-tax reductions on liquor, cigarettes, automobiles, and so forth. The budget situation, as it will appear early in 1954, will not permit, in the mind of Congress, the automatic reduction presently called for.

The taxpayers of this country have been watching with considerable interest the deliberations now being carried on in Washington and elsewhere concerning technical and policy changes in our income-tax laws. Congressional spokesmen, particularly Chairman Reed of the House Ways and Means Committee, have indicated intentions of producing a major revision of the code to replace what is described as the present patch-work quilt.

Efforts in this direction on the part of the legislative planning groups have been extensive. The Treasury Department is most active and working hand in hand with the staffs of the Ways and Means Committee and the Joint Committee on Internal Revenue Taxation. Questionnaires were distributed to individual taxpayers, businesses, tax practitioners, professional groups, and trade associations soliciting comments relating to improvements in the Internal Revenue Laws and their administration. More than 13,000 replies were received in response to these questionnaires, and the replies were analyzed to determine the areas requiring the most consideration. During the past summer, the Ways and Means Committee held extensive public hearings on a list of forty subjects. No further hearings will be held before a tax-revision bill is submitted to Congress.

To try to play the role of prognosticator in such a fluid situation is certainly not an easy task, yet there are some indications of the direction in which changes may be made. The very selection of the forty subjects suggests that the Ways and Means Committee feels the problems in the areas covered by their questionnaries to be of the greatest significance. On some of these topics the testimony and recommendations presented to the committee have revealed a clear-cut consensus among taxpayers as to what should be done. In these areas there is a good possibility for change and improvement. On certain other questions the committee is faced with contradictory recommendations, which may preclude any immediate change.

Casting a shadow over the entire problem of tax revision is the possibility that budget requirements may prevent any changes at the present time that might have the effect of materially reducing tax revenues. We are familiar with the problems faced by the new administration in trimming a budget that is composed largely of expenditures commonly considered necessary for national security. This fact, coupled with the tax reductions scheduled for the end of this year and early next year, which I have already mentioned, makes it fairly certain that any changes will be restricted to situations in which the present law is grossly inequitable and where the inequity can be

removed without serious loss of revenue and without meeting new problems.

Many of the changes that have been proposed have to do with the general area of personal exemptions, including the amount of the credit for dependents and the personal exemptions, the qualifications of a dependent, and the apparently inequitable treatment accorded working wives, widows, or widowers. A number of the recommendations concerning the amount of the credit seem to be based upon the proposition that the amount is in the nature of a "cost of living" allowance. Since the cost of living has risen materially since 1948, when the present credit of $600 was established, it is argued that the credit should be increased.

Experience seems to indicate, however, that the amount of the credit is more closely tied in with the distribution of the tax burden and the total revenue yield. Any material increase in the personal and dependent credit probably cannot be made at this time because of fiscal requirements. A $100 increase would cost close to two billion dollars in tax revenues.

There does seem to be considerable sentiment for a broadening in the definitions of certain exemptions. The rigid $600 limit upon the gross income of a dependent has been severely criticized and quite possibly will be increased or eliminated completely. The dependent would still be required to file a return if gross income was $600 or greater, but the financial qualifications of dependency would be limited to the support test and not depend, perhaps, on the specific earnings of the dependent.

The number of proposals and the similarity of the recommendations concerning relief for working wives, widows, and widowers suggests that this area is one in which a liberalization may be forthcoming. Once again revenue motives may operate to prevent complete removal of the inequities, yet the Ways and Means Committee seems sympathetic to the problems of these people. If relief should be granted, it might be in the form of an additional exemption, or a deduction for actual costs of household supervision subject to some fixed or sliding-scale upper limit.

Another area in which a change appears likely is in the definition of a head of a household. Under the present law, residence within the household of a dependent or relative is a specific requirement. This works unfairly upon taxpayers who must maintain relatives or dependents in hospitals, sanitariums, or other institutions. Prior to 1944, the status as head of a household rested simply upon a moral or legal obligation to exercise family control. A return to this concept would remove the inequity against persons who are certainly as deserving of tax relief.

One additional problem of close personal interest to us all deserves some comment, and that is the matter of retirement income for the self-employed. We are all aware of the phenomenal growth in contributory pension and retirement plans that permit the accumulation by employees of substantial benefits without tax impact. Self-employed professional persons, independent merchants, farmers, and the like have no such opportunity. These groups must accumulate for retirement out of income *after* taxes have been paid, and we all know how little is left after taxes these days.

Two identical bills were introduced during the current session of Congress that would permit the tax to be deferred on limited amounts of income set aside in restricted retirement funds. These bills failed to receive favorable action, however. Considerable support has been presented in favor of the principle of these bills, including an endorsement by the President, and the chances of favorable action when these proposals are considered in connection with general tax revision in 1954 appear greatly enhanced.

While these problems of exemptions and credits are certainly of great interest to us personally, as professional accountants whose day-to-day work often involves the treatment of difficult tax problems, we also have a deep interest in the provisions of the tax law as they affect business concerns, corporations, partnerships, and individual proprietorships. In this area, as we all know, there is much room for improvement and clarification.

For a long time the field of corporate reorganization has been in a state of doubt and confusion. In a tax-free reorganization a successor corporation generally takes the same basis for the assets acquired as its predecessor. In many other respects, however, the concept of continuity implicit in Section 112 is not followed, and the successor corporation is not permitted to step completely into the tax shoes of the predecessor. Unused excess-profits credits, net operating loss carryovers, the tax-benefit rule, capital loss carryovers, and many other items are denied the successor. The result frequently is that corporate reorganizations that are economically desirable and necessary are not effectuated because of possible adverse tax consequences. This type of correction is likely to be adopted in 1954.

Closely allied with the problem of corporate reorganization is the matter of corporate distributions. In the case of liquidations there is no tax on the corporation if the assets are distributed in kind and subsequently sold by the stockholders. The Supreme Court has decided in the *Court Holding Co.* case, however, that both the corporation and the stockholders can be taxed where the sale was originally negotiated by the corporation but ultimately carried out by the stockholders. This raises the question as to whether there should be any corporate tax at all in a liquidation accompanied by a complete sale of the assets at an early date. Treasury opposition to this correction is likely, but Congress may be more liberally inclined. Along somewhat these same lines is the situation in which one corporation wishes to acquire the assets of another. It is frequently more expeditious to accomplish this by purchasing the stock of the other corporation and then liquidating it. Before liquidation, however, the acquiring corporation becomes owner of all of the stock of the other corporation, which places the liquidation within the scope of Sections 112(b)(6) and 113(a)(15). Under these sections, the basis of the assets to the acquiring corporation is the same as in the hands of the predecessor. Although this amount may be substantially less than that which was paid for the stock, the excess cost cannot be attributed to the asset base unless some recognition is given to the Kimbell-Diamond Milling Co. Doctrine. Some change should be forthcoming stipulating that the basis of assets so acquired is equal to the cost of the stock.

Another area in which some action to remove inequities is probable is in the treatment of stock options, pensions, and profit-sharing agreements. These problems have received considerable attention in recent years, and certain inconsistencies have become evident.

Another inequity, which certainly calls for correction and will probably receive some attention, is the requirement that lump-sum distributions from qualified, nontrusted plans be treated as ordinary income even when made upon separation from the service of the employer or upon retirement. Payments of this sort from trusteed funds, as you know, are granted capital-gains treatment. Whether or not the plan is trusteed, the amount distributable represents an accumulation over a period of years, and the imposition of a tax at high, graduated rates may seriously jeopardize the economic security of an employee. The simple fact that a plan is not trusteed should not be allowed to deny the application of more equitable capital-gains rates. These recommendations have a good chance of favorable action.

These areas (namely, the areas of corporate reorganizations, and distributions, stock options, and pension and profit-sharing plans) have been so changeable in recent years that a constant review of the tax law is necessary simply to keep pace with new business practices and techniques. When new business practices develop, which were not contemplated when the laws were framed, it is almost certain that inequities or distortions will result. It is quite clear and reasonable to assume that there will be some legislative action in order to bring the code more nearly in step with current business practices.

Several older problems that have been subjects of much discussion in the past are up for review, and some quarters are optimistic about the outlook for progress. One of these problems is that of providing some relief in high income years for taxpayers whose income is subject to wide fluctuation. We are all generally familiar with the relief provided by Section 107, but the limitations imposed by that section are so stringent that its benefits are available only in restricted casés. There is some chance that Section 107 will be liberalized to make its provisions applicable to types of income not now covered. Another proposal, submitted in testimony by the Institute's committee on federal taxation, suggests a procedure whereby taxpayers would be allowed to average their income over a specified period of years, with the average income determining the maximum tax rate to be applied.

There is a very slight possibility that the proposed revision of the code may see some provision for relief from the double taxation of dividends. While the potential revenue loss will prevent any rapid removal of all double taxation, there is hope that some exclusion or credit for dividends received will be written into the law. The amount of such relief will necessarily have to take into consideration the political and economic factors, and may therefore be limited to a token removal of the second layer of taxation; namely, taxation to the recipient.

Closely related to double taxation of dividends are the suggestions being considered that small or closely held corporations be permitted the option of being treated as partnerships. Obviously, there would be a serious problem

of where to draw the line, but the question of a double tax on dividends would be nonexistent under the proposed partnership option. Of fundamental importance, too, is whether the election should be an annual one or an irrevocable one. In my opinion, action on this suggestion is likely to be deferred.

One problem, which has been of considerable concern to the accounting profession, has been the widening gap between tax accounting and generally accepted accounting principles. In spite of the recognition given generally accepted accounting principles in Section 41, divergent principles have crept into the administration and interpretation of gross income, deductions, and net income. Most frequently these divergencies have to do with the timing of income and deductions and violations of the accepted principle of matching costs and revenues.

At the invitation of Chairman Reed of the Ways and Means Committee, a special committee of the Institute is currently preparing a report on this problem. It is hoped that this committee's efforts will be rewarded with a reaffirmation of faith in the applicability of generally accepted accounting principles for tax purposes, and an acceptance by the Ways and Means Committee of the Institute's committee report by an embodiment of the Institute report in principle in the Ways and Means Report on the 1954 Revision Bill. This, I believe, will be accomplished.

In addition to these broad areas, within which there is a good possibility for change, there is a vast number of other problems that are under review and in which some action may be expected. No complete exposition of all these various topics is possible within this paper, but some items have been recommended by so many groups that they must be given serious consideration.

One of the more important of these problems is the matter of using a lower-of-cost-or-market valuation for inventories computed under the LIFO method. The fact that the cost of many inventory items has reached what appears to be a peak has prevented many taxpayers from adopting LIFO for fear of freezing in inventory valuations the current high cost. Under the law, the valuation of LIFO inventories must be on a strict cost basis, as you know, and a decline in prices could result in a material overstatement of inventory values. The Institute, among others, has gone on record favoring the write-down of inventories to market in view of the generally accepted principle that declines in prices of inventoriable items should be excluded from inventory valuations. The chances for recognition of this principle should be good and only a revenue price-tag psychology can defeat it.

Another area in which a manifestly unreasonable rule is currently in effect is in nonbusiness bad debts. Even though a claim may have arisen in the course of a taxpayer's trade or business, a bad debt is deemed to be a nonbusiness one if at the time of worthlessness it is not connected with that trade or business. As nonbusiness bad debts are treated as short-term capital losses, serious inequities may result. There is a good possibility that the definition of nonbusiness bad debts will be amended to exclude debts arising in the course of the taxpayer's trade or business.

These few technical areas that I have described briefly represent only a segment of the problems that have been considered by the joint committee, or that have been suggested by taxpayers. They are, however, the areas that have stimulated the greatest interest and in which there is general agreement that some change is required. Quite obviously, no one can tell with any certainty precisely what changes will be made or exactly how any changed rules will operate. If and when additional hearings are held in the spring of 1954, we may have some better indication of the committee's intentions. Beyond the committee lie the House and the Senate. The budget problem will filter through every discussion.

There is one very general area in which we can almost certainly expect some improvement; namely, the mechanical structure of the code itself, completely aside from what the technical provisions are. Representatives of the Treasury and the Joint Committee have been devoting considerable attention to a rewriting of the code with several objectives.

In the first place, the out-dated and superseded sections will be removed. In addition, an attempt will be made to rewrite each section with an eye to its readability and internal consistency. In this task, it is hoped that many of the confusing cross-references contained in the present code, which make concise interpretation difficult, will be eliminated. This may have to be done at the cost of some repetition, but the final result could be a vast improvement of the structure of the code.

Then it is planned to rearrange the order of sections, and to collect in one place the various different rules relating to the same general problem. In the present code, interest computations are set forth in 17 different sections, returns to be filed are scattered throughout 15 different sections, and penalty provisions appear in 250 odd sections. Certainly some relocation of all these provisions will be an improvement.

It is also intended to write the code in language that is not quite so technical and confusing as at present. It is hoped that this can be done without creating ambiguities and without increasing the length too greatly. I'm sure we are all in sympathy with proposed changes along these lines.

And now, my crystal ball is worn out. Thank you, and best of luck for revision in 1954.