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**NEW RESPONSIBILITIES**  
*of the*  
**ACCOUNTING PROFESSION**



**Complete text of  
Technical and Professional Papers  
Presented at the sixty-first annual meeting of the  
American Institute of Accountants,  
Palmer House, Chicago, September 19-23, 1948**

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**AMERICAN INSTITUTE OF ACCOUNTANTS  
13 EAST 41st STREET, NEW YORK 17, N. Y.**

# **NEW RESPONSIBILITIES** *of the* **ACCOUNTING PROFESSION**



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## Accountants' Reports

### Comment on Bulletin No. 23 of the Series on Auditing Procedure

by Marquis G. Eaton, CPA

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THE HISTORY of Bulletin No. 23 of the Statements on Auditing Procedure is briefly this: Bulletin No. 1, dealing with extensions of auditing procedure, was adopted by the American Institute of Accountants at its annual meeting in September, 1939. Among other things it contained this language,

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the inde-

pendent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

Reduced to the propositions that are in point for our discussion here bulletin one said generally that no opinion should be expressed where an audit is not made, or where the opinion is meaningless because of its limitations. In those circumstances the report was to be restricted to a statement of the findings and, *if appropriate*, a statement of the reasons for omitting the opinion.

The conditions under which it is appropriate to state the reasons for omitting the opinion were not enumerated, and have had the most varied interpretation in practice. On the one extreme accountants have felt that no reports should ever be issued by them unless accompanied by an opinion, and on the other that circumstances never require a statement of the reasons for omitting the

opinion, or mention of the fact that it is omitted.

In the region of the second extreme lies a broad body of practice with which we are all familiar, and in which the accountant's name is associated with the statements without opinion. In a typical instance the accountant makes a partial audit of some accounts, or no audit at all, and writes a report in what is generally known as the long form. In it he may comment at some length, and in detail, on the auditing procedures he has followed, if any, present some analysis of the accounts, and close with his signature.

While the long form report has many proper uses, the significant thing about the type here referred to is that it makes no mention of an opinion, either as to its inclusion or omission.

Accountancy has traditionally justified this report on the grounds that nowhere in it can you find a stated assumption of responsibility on the part of the accountant, and that consequently no responsibility is ever charged to him—that if responsibility is so charged it is because of ignorance or carelessness on the part of the reader.

That the reports are given greater credence than intended is known to every experienced accountant. They are circulated as the "auditor's report" and, by the association of the accountant's name with the statements, are commonly accepted in quarters where the same statements on plain stationery would not be.

Bulletin No. 23 assumes that it is now time that accountancy cease to attribute this sort of acceptance to ignorance on the part of the reader, and places upon the accountant the necessity to state the exact degree of his responsibility for the statements. It would amend the language of bulletin one, quoted before, to read as follows:—

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted ac-

counting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements and indicate clearly his reasons therefor. He may also, if appropriate, comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an over-all opinion."

The rule would thus say, generally, that no opinion should be expressed where an audit is not made, or where the opinion is meaningless because of its limitations—this as is in Bulletin No. 1. The new Bulletin adds the further requirement that where the opinion is omitted that fact must be clearly stated, as well as the reasons therefor.

Bulletin No. 1 permitted the accountant to decide whether he should state his responsibility. Bulletin No. 23 *demand*s that he state it.

Because Bulletin No. 1 had been adopted formally by the Institute's membership the council directed that Bulletin No. 23 be submitted to this annual meeting of the Institute for discussion and action. It authorized issuance of the Bulletin as a committee statement in the meantime, so that members might consider the matter.

At its meeting in Asheville during April of this year the council extended the period allowed for consideration of the Bulletin by referring it for action to the 1949 annual meeting of the Institute's membership. The direct proposition is thus not before the present meeting.

It has been said against the Bulletin that it prohibits the long-form report. Of course this is not true. It only requires that the long-form report, if used, state the degree of the accountant's responsibility.



It has been argued against the Bulletin that it will disrupt client relationships—that a remark now appearing in the report for the first time to the effect that the financial statements are not vouched for will put a strain on relationships of long standing with clients; that a period of time should be allowed to educate them to the change; that the change will force clients into the hands of accountants who are not subject to American Institute discipline.

These arguments would seem to have more force in support of the Bulletin than against it. If client relationships are based upon a misconception of what the report means a change in the report should be made, and at once. The client's alarm at the proposed change will usually be found to be associated with the use he has been making of the reports. A creditor or other third person has been giving the reports more credibility than the accountant intended. If it is said that this is not so, that the reports are being accepted only as written, then there can be no objection to the practices prescribed by the Bulletin. It would only make certain the degree of acceptance now thought to prevail.

There can be no justification for delay in introducing the practices made standard by Bulletin No. 23. We cannot excuse a proposal to issue for just a little while longer reports which may mislead.

As to forcing clients into the hands of irresponsible accountants, the formal approval of Bulletin No. 23 will furnish a powerful instrument in the hands of reputable accountants to prevent just that thing, and is needed by them for that purpose. Without it they have no formal support for their own proper efforts to persuade clients to the right course.

Where the accountant omits his opinion Bulletin No. 23 requires that he "indicate clearly his reasons therefor." The reasons referred to are the reasons for *omitting the opinion*, and will usually be necessitated by the fact that some standard auditing procedure or other has not been followed, and the accountant has not otherwise satisfied himself. It is not

required that the accountant state the reasons the *procedures* were not followed, as that an adequate fee was not authorized. Hasty reading of the Bulletin has led some to believe that it requires the accountant to make needlessly embarrassing statements of a more or less personal nature in connection with the report. Such is not the case. In fact members of the committee on auditing procedure are believed to be willing to clarify the Bulletin to the effect that where it is unequivocally stated that no examination has been made the absence of an opinion does not require further explanation.

Much of the criticism of Bulletin No. 23 is actually prompted by the requirements of Bulletin No. 1 for physical contact with the inventory and circularization of accounts receivable. It is said that small clients cannot afford to have these things done; that a partial audit is all they are accustomed to, and is all they want.

Bulletin No. 23 imposes no requirement for a complete audit. Under it the audit may be as incomplete as the circumstances justify; or as incomplete as anyone desires, whether with justification or not; or the audit may be omitted entirely. Any kind of report may be written—the statements may be analyzed and compared, the course of the business commented upon, financial statements may be prepared without audit, and submitted without explanation. Reports of all kinds now being issued by accountants' offices may continue to be issued by them. The Bulletin requires only that in connection with such reports the accountant state what degree of responsibility he assumes in connection with them. This added requirement cannot injure the acceptance of these reports in any quarters in which they are now used except in instances where the reader is attributing more responsibility to the accountant than the accountant thinks he is assuming.

As to cost, Bulletin No. 23 imposes no added costs, except the cost incident to writing a few words in the report to outline the accountant's responsibility. Some of the argument on this point seems to

issue from a belief that everyone is entitled to an audit whether he wants to pay for it or not—that the reason it is not “practical and reasonable” to have physical contact with the inventory, for example, is that the fee to which the client is accustomed is inadequate for the purpose. Of course broader services entail greater cost. A complete audit uses more time, and skill, than a partial audit, and a partial audit more than no audit at all. Bulletin No. 23 does not protect a client in his accustomed annual fee if he wants a complete audit where he formerly had a partial audit. But the Bulletin does protect him in his accustomed fee if he wants his accustomed services. It requires, only, that his accustomed services be described in the report for what they are.

Some accountants have understood the Bulletin to require an abrupt disclaimer of all responsibility where anything less than a complete audit has been made. The Bulletin does not require this. It permits, even encourages, the accountant to state his responsibility for part of the accounts if he has satisfied himself with part but not with all. It says, “He may also, if appropriate, comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an over-all opinion.”

As an example of this in a situation where the accountant has not had contact with the inventory, nor confirmed accounts receivable, and has not satisfied himself in regard to these accounts by other means, it has been suggested that the report might contain a paragraph similar to this,

“In accordance with your instructions we did not make a physical observation of inventories nor did we confirm the accounts receivable by correspondence with your customers. In view of the foregoing omissions we are not in a position to express an opinion regarding these items. With respect to the other accounts it is our opinion that they are fairly stated in conformity with generally accepted accounting

principles applied on a basis consistent with that of the preceding year.”

Under appropriate circumstances the accountant may have omitted standard auditing procedures in regard to one or more of the accounts, but may have satisfied himself by other methods. In such a case he is not precluded from expressing an unqualified opinion. Not Bulletin No. 23, but the language of the standard report itself, would require that mention be made of the omission, but this may be followed by an unqualified opinion. In a given instance the standard report might be modified only to the extent of including this language,

“Except that it was not practicable to confirm accounts receivable from the United States Government, as to which we have satisfied ourselves by means of other auditing procedures, our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.”

Bulletin No. 23 strikes at another practice which, though not so prevalent as others mentioned, is sometimes observed. The accountant may not have been limited in his examination but may have so material a qualification as to an accounting principle involved as to preclude an opinion. Instances have been noted where the accountant has sought refuge, under these circumstances, in the mere omission of the opinion. Bulletin No. 23 would demand more. It says,

“In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements and indicate clearly his reasons therefor.”

Where the accountant only reviews and supervises the client's accounts the Bulletin would require that the report state clearly the principle limitations of this procedure as compared with generally accepted auditing standards. But even here the accountant would be per-

mitted to assume the degree of responsibility justified by the procedure he followed. A closing paragraph for such a report has been suggested in this form,

"It will be evident from the limitations in the scope of our work that we have not made an examination sufficiently comprehensive to comply with generally accepted auditing standards and therefore we are not in a position to express a positive opinion regarding the over-all fairness of the accompanying financial statements. However, on the basis of the previously described limited review of the company's accounts made by us during the year and of the explanations and information given us by officials, we report that the accompanying financial statements are in agreement with the accounts and that we have no knowledge of misstatements in the accounts or of omission to state material facts."

Another point should be made. It is indispensable to the profession that public accountancy be not restricted to public auditing. Accountants, particularly the smaller firms, are frequently employed on the basis of their skills as accountants, rather than on the independence of their viewpoints as auditors. This is entirely proper, and should not be jeopardized. The skills so made available are highly useful to business and are not obtainable elsewhere. In connection with such employment the accountant may prepare financial statements without audit, and may associate them with his stationery or his signature. The extent to which this is done is a matter of judgment, and, on the highest plane, is restricted to circumstances where the accountant adds something to the statements of a professional nature, as distinguished from clerical. But in any case, these practices are not prohibited by Bulletin No. 23, nor should they be. The bulletin only requires that the top and bottom limits of the accountant's responsibility be clearly stated.

All of the criticisms, of all kinds, so far directed against the bulletin can be dispelled by the answer to one question.

What is the reason for the association of the independent certified public accountant's name with financial statements; in what does he find justification for this part of his professional work?

It is not because he is an amanuensis. Nor does he have a relationship similar to that of a notary public to an instrument of title.

The justification lies in one or more of the skills which we accountants call professional. In this we distinguish from clerical. In a given instance the skill may have had to do with verification of the accounts, or part of them; or it may have dealt with the proper form of the statements; or with the interpretation of them. But in every instance we must make it clear just what that professional reason is.

Why, exactly, is this Bulletin so important as to justify, first its study and preparation by the committee, then its consideration on two occasions by the council, and finally its presentation to the membership of the Institute for its action? The importance lies in the fact that by our action on this Bulletin we will take one of the longest steps, forward or backward, ever taken by public accountancy in its definition of itself.

This profession has suffered from its inception, and continues to suffer, for want of definition—definition from which the public might understand what we are, and what we do—and definition from which we might understand ourselves, and point our individual courses in a common direction.

Many years ago professional accountancy had before it a proposal that it attempt a definition. This was in the form of a suggestion that the Institute adopt a classification of accountancy services. The American Society of Certified Public Accountants adopted such a classification. The Institute did not. The Society has been merged with the Institute and the profession now has nothing in the nature of a comprehensive definition of itself.

Implicit in this history is the policy on the part of the profession that definition be left to emerge piecemeal from the de-

isions we make, as a body, on specific questions as they arise. This policy is, without doubt, a sound one, and under it our definition of ourselves grows steadily.

As seen in this stream of events the great importance of the philosophy stated in Bulletin No. 23 is plain. By it we proclaim that no accountant shall ever mislead the reader of his report, either by what he says or by what he does not say. We assume the burden of so constructing our reports as to demand of the reader no understanding of auditing procedures—so that he may know our responsibilities without the need to know our practices. We say that an accountant is not a clerk—that he has a reason creditable to a professional man for being associated with the statements for he is not associated with them.

This adds more, by way of definition, than we have ever before added in so few words. It presents a simple concept to the public, one that is easy of understanding. Through the application of the prescribed practices the public will learn, and learn shortly, that the association of the accountant's name with financial statements is not undertaken lightly—that it occurs only in connection with a clear statement of responsibility—that the association has a professional purpose, and what that purpose is.

But beyond even this, and judged by the needs of the business community, and of society, where we must finally judge our every act, the usefulness of the accountant's report will be vastly improved in quarters now often poorly served.

## Monthly Reports and Reports Other Than Audit Reports

**by J. Leonard Penny, CPA**

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[*J. Leonard Penny, CPA, a partner in Hall, Penny, Jackson & Co. of Chicago, is a member of the American Institute of Accountants.*]

CONSIDERATION of the subject assigned for this paper develops a series of thoughts and ideas which are submitted for serious exploration to the members of our profession.

Accountants' reports of any type are an expression of the facts, findings, and recommendations or opinions developed in the course of an investigation undertaken as a professional engagement by members of our profession. Our services divide themselves into two broad classes of activity, namely:

Investigations, either annually, quarterly, monthly, or at irregular intervals, for the purpose of examining financial statements and submitting reports containing the financial position or condition and operating results of an enterprise for a period of time, accompanied by the accountant's opinion or comments relative thereto.

Investigations, for the purpose of developing other reports which may encompass any and all phases of business financial condition, operations, management controls, labor problems, etc., which the accountant is qualified to handle and which are for special purposes to inform owners, management, creditors, and others with re-

spect to information which properly answers the problem in the mind of the persons or person who initiated the assignment.

As these two broad subdivisions of our professional activity become fixed in our minds, other considerations grow therefrom. Some of them follow—

Bulletin 23, issued by the American Institute of Accountants in December 1947, entitled "Clarification of Accountant's Reports When Opinion Is Omitted" has reference to reports issued in connection with examination of financial statements, balance sheet and statements of income and surplus. This paper is concerned largely with other types of reports.

Representative members of our profession possess today, as the result of education (college and/or university training) and experience, a broad working knowledge of accounting, auditing, business and accounting systems, finance, economics, commercial law, the function of money, labor and management in business, and are qualified to serve business owners and management not only with respect to developing accountants' standard form of audit reports but to actively assist them, within the proper limits of our professional activity, to obtain the data to properly guide and assist them in the solution of their many problems.

The tremendous scope of business activity which confronts management is suggested by consideration of the specialized courses dealing with business subjects which are offered by our leading universities, and by consideration of the many specialized association groups which are concerned with business activity in addition to our own, such as national and local cost accounting groups, the Controller's Institute, tax groups, management groups, and many others too numerous to mention.

Many of us here present might be startled to learn the percentage of time expended in their own organizations on these special business problems as compared with time expended on regular

audit engagements. Data regarding the percentage of time so expended, if tabulated and made generally available to our group, would be of extreme interest. This field of activity is large and challenging. Successful and satisfactory completion of special assignments develops that splendid feeling of satisfaction which always results from the rendering of a constructive service.

Investigations are for the purpose of developing facts to be used for various purposes. In this connection, consider for a moment a statement regarding facts which was made twenty-one years ago by Owen D. Young, which, if fully comprehended by practitioners, particularly the younger ones, would enable many problems to be satisfactorily solved which often seem difficult of solution because of incomplete or unreliable factual data. Mr. Young said: "Facts can be applied in any field. Our curse is ignorance. Facts are our scarcest raw material. This is shown by the economy with which we use them. One has to dig deep for them for they are as difficult to get as they are precious to have." Too much emphasis cannot be placed on the importance of facts as the basis for our reports.

Monthly reports, as used in the title to this paper, have reference to monthly reports of financial condition and operations and can be considered in two categories: namely, monthly reports carrying the accountant's name and opinion, or a report without an opinion prepared in accordance with Statement on Auditing Procedure No. 23, and monthly reports prepared on plain stationery by a public accountant as a service to management without any representations with respect to the accuracy of the statements. With respect to the "Monthly Audited Reports," except in special instances, it is not economically sound for a client to arrange for such service. Where such occasion for required service does exist, the same standards of audit procedure should apply as are applicable to annual audit reports, issued either with or without an opinion relating to the statements

With respect to preparation of monthly reports from which the accountant's name is omitted, a broader field for service exists. This service can consist of (1) either regular preparation of reports from (a) submitted trial balances or (b) a limited examination of a client's records, or (2) initial preparation of reports coupled with education of a client's own employees for the purpose of training them to develop the reports. The value of these reports to a client is, in either case, in direct proportion to the care used by the accountant to develop a report which conveys the maximum amount of usable information in the most concise fashion possible, and to develop techniques and controls for the client which will result in accurate data to be embodied in the report. Additional service can be rendered to a client of an even more valuable nature by intelligent analysis of monthly reports for the purpose of reporting to clients on the significant trends which are developing in their operating or financial conditions. Many clients submit copies of their monthly reports to their professional accountants for study and comment. Those who are concerned with the problem of monthly and interim reports will find three papers of interest in the July, 1948, issue of *The New York Certified Public Accountant*. These papers, which are listed hereafter, were presented at a meeting in New York on May 12, 1948, sponsored by the New York Society's Committee on Monthly Audits, and are as follows:

The Interim Audit Report for Credit Purposes, by Sidney Lichter, CPA.

Interim Reports—An Aid to Business, by Jerome B. David, CPA.

Suggested Inventory Procedures on Interim Audit Engagements, by Kermit J. Berylson, CPA.

Now, with respect to reports other than monthly reports and audit reports. Let us term them for our purpose, "Other Accountants' Reports." The American Institute of Accountants, in its Accounting Research Bulletin No. 9, defines accounting as follows: "Accounting is the

art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions, and events which are, in part, at least, of a financial character, and interpreting the results thereof." The *Accountants' Handbook* has this to say with respect to financial statements: "The underlying function of financial statements (reports) should be conceived by the accountant to be the presentation of significant information about an enterprise to interested parties to whom 'significant information' may mean different things. Statements are prepared to meet:

1. Requirements of management in controlling operations and securing credit.

2. Requirements of investors, present or prospective.

3. Requirements of governments, federal and local, in connection with tax and other governmental matters."

At first thought, one might believe that services rendered by accounting practitioners other than in connection with audit examinations and reports on financial condition would be limited to the smaller business entities because the larger business organizations have their own staff of accounting and business experts. This is not entirely true for the broader contacts and experiences of the public practitioner equip him to serve constructively the larger business units in many ways. Experience indicates that in numerous situations internal reports in use fail to serve the purpose for which they were inaugurated or else they are outmoded and no longer serve any useful purpose, and in addition vital data which should be available is not being developed.

Alert and intelligent observation during an audit examination will provide avenues of constructive service in connection with the examinations and reports discussed hereafter. The field for constructive service to smaller business entities, not equipped with expert personnel, is broader, of course, than in the case of the larger units.

Consideration of management's problem of controlling operations and securing credit develops the following phases of business activity for which management requires reports and which present wide areas of professional activity:

1. Adequate and properly balanced financing.

2. Maintenance of properly balanced financial ratios, such as amounts represented in cash, receivables, inventories, plant, etc., in relation to current obligations, long-term debt, and stated capital.

3. Maintenance of proper operating ratios in relation to past experience and the experience of competitors.

4. Personnel problems—proper number of personnel, measurement of labor's productivity, measurement of labor turnover, proper provision for replacements of key personnel, etc.

5. Problems of distribution of product—markets, selling prices, sales policies.

6. Problems of procurement — sources of material, present markets, possible future markets, etc.

7. Problems of production—costs, mechanization of operations, desirability of piece rates for labor, departmental costs, product costs, expansion or retraction of items in the line.

8. Problems of general office procedures, accounting system, adequacy of personnel for work assigned to them, possible economies, etc.

9. Problems of forecasting future requirements and problems based on intelligent budgeting.

10. Problems of internal control.

11. Problems of taxation.

12. All other problems of management, and they are legion.

Constructive service to management can be rendered by our profession in the areas of activity indicated. In many cases, the service will consist of investigations leading to original reports on the subject matter being considered together

with instructions and forms for future internal development of the data which it is considered should be available at regular intervals.

A few case studies of this special phase activity are submitted to indicate the nature of some special engagements.

During the base period years, a manufacturer was engaged in the fabrication of three distinct lines. Volume was good, but profits were negligible. Arrangements were made with professional accountants to make an exhaustive analysis of the operating results. Factual data were developed relating to production and costs which involved various reallocations of costs and overheads which had not been intelligently distributed, and a detailed analysis was made of the markets for the three products. This investigation resulted in a decision to discontinue one of the three lines. Facilities used by that line were converted to the use of the other two and over-all operating results improved very materially in a short time thereafter.

In a recent situation, the management was complacent regarding its situation due to continuing satisfactory profits. In the course of a discussion with its accountants, it developed that unit production was declining, and selling prices were being increased, faster than unit costs were increasing. Expansion of the discussion led to an investigation which developed the facts that (1) units being produced were diminishing, (2) selling prices were being raised to compensate for the loss of unit volume, and (3) no accurate method of developing unit costs existed. By pointing out that some industries were already restored to a competitive basis and those who had reached that situation and were unprepared due to neglect of real sales effort and costing procedures were developing serious troubles, the management became very enthusiastic regarding an investigation to develop analyses of sales and a suitable system of cost finding and estimating.

All practitioners have experienced fascinating investigations in connection with proposed financing and the securing of

credit in situations where management has afforded opportunity for accountants to undertake a general investigation and report on the history, financial condition, products, personnel, facilities, etc., of a company.

There is no need for amplification of potential constructive service we can render to assist management in the solution of its problems. All that is required is professional fidelity to obtain the facts and facility for reaching sound conclusions which are of material assistance.

Some of the most interesting engagements and reports occur in connection with development of data for the investors, present or prospective. Basically, the data desired for investors is the standard form of audit report and/or a detailed audit report in many instances. Other forms of reports prepared for investors have been analyses of stated capital and surplus, analyses of property accounts, analyses of products, analyses of markets, etc.

A few case studies of engagements for investors are described as illustrative of the field for special service.

A few years ago, a banking institution became "locked in" with a substantial loan to a company which was experiencing difficulty in carrying on a profitable operation. The bank was in possession of current audit reports but requested its accountants to assist them to determine whether to loan more money in the enterprise or adopt alternative methods to recover its funds. Instructions were to investigate and report on personnel, costs, sales distribution, and methods and analyze the pros and cons of continuing the venture or liquidating it, and to expedite the work as much as possible. As a result of the accountant's investigation, which included many conferences with the bankers and management, a decision was reached to liquidate at as early a date as possible in order to salvage what was left before further losses were incurred for all concerned.

Another case involved a prospective merger of two companies located in dif-

ferent cities. Accountants for the company which was initiating the merger talks were invited to visit the competitor. After a preliminary discussion, they were requested to make an original investigation and report for the competitor, who had not previously used the services of professional accountants. Thereafter, reports were exchanged by the companies for study. After a series of discussions between them, the merger was temporarily in abeyance by inability of shareholders of each to agree on a basis for exchange of securities in the merger. The accountants were requested to submit a plan or plans for equitable distribution of the shares of the surviving company, if the merger was consummated. This they did, taking into account asset values, earning power, etc., and in their report set forth clearly the reasons underlying the suggested basis. The accountants' recommendations were adopted.

Another interesting case involved two clients engaged in different lines of activity. Company "A" owned a substantial block of the stock of Company "B" but not control. "A" desired to sell its holdings in "B" to the shareholders of "B." Several months spent in negotiation failed to develop a meeting of the minds. Both companies were clients of the same accounting firm. The accountants were requested to submit a stock valuation report. Their report set forth three possible valuations for the shares, together with an exposition of the factors used in development of the values. Shortly thereafter, the sale was consummated, using one of the valuations contained in the accountant's report.

Reports prepared in connection with matters of federal and local taxation and other governmental regulations are well known to all of us. Some of the more common types of investigations and reports accountants have made are:

Investigations of depreciation rates and policies.

Investigations of invested capital.

Investigations of base period earnings.



Special analyses of various business factors and business cycles for purpose of excess-profits relief claims.

Special analyses of government contracts.

Renegotiation reports.

Reports for the Federal Trade Commission.

Reports for wage and hour commissions.

Reports of valuations for inheritance and succession tax matters.

We can, as a profession, be proud of the acceptance of and reliance on our reports prepared during the past war for contract termination, renegotiation, and other purposes, and we should be jealous of the reputation possessed which caused these reports to be accepted in many instances with little or no investigation of their accuracy by government officials.

In conclusion, these general thoughts are expressed relative to "Reports Other Than Monthly Reports."

1. Audits and audit reports are necessary and serve a required and useful objective, and will always be an important phase of professional activity.

2. Most of our attention as a professional society is directed to that activity. Witness the fact that, with

few exceptions, accounting and auditing research bulletins are concerned solely with auditing procedures and statement structure.

3. The field for service by our profession, in addition to our activities as professional auditors, is large and not adequately explored by us.

4. Professional accountants possess, or should possess, the intelligence to decline assignments in the field of "Reports Other Than Audit Reports" in any situation which any individual practitioner is not qualified to handle properly. More damage is done by incompetent handling of an engagement than we comprehend—witness the numerous cost system installations which do not develop the desired data and result only in unwarranted expense to a client.

5. Care must be exercised in special engagements to develop, *factual* data as the basis for our reports and to submit, in our reports, data dealing with the significant matters clearly set forth. We should avoid conclusions which are not supportable by facts and correct reasoning.

6. Adherence to the thoughts expressed in items four and five can and should develop reports which practitioners can sign and submit with pride.

# Business Costs and Business Income Under Changing Price Levels

## The Economist's Point of View

by Solomon Fabricant

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THE NATION'S aggregate net income is the prime measure of the nation's economic activity. An important component of the national income is, of course, the net income of business enterprise. Now, that would be a good enough reason for economists to concern themselves with the measurement of business income. But there is another. Business income is not only important; it is also one of the more troublesome components of national income when it comes to putting together the figures and deciding what they mean. For these reasons economists have spent a good deal of time thinking of how to measure business income.

Economists have had to grapple with a number of problems. Some arise from changing price levels, some from fluctuations in the volume of production. There are difficulties caused by technological

advances, and difficulties caused by alterations in consumers' tastes. Acts of God and the King's enemies also sometimes prove troublesome. In the course of analyzing and discussing these problems—a task that is by no means over—economists have established what may be called an economic point of view towards the measurement of business income, particularly in the computation of national income. This point of view can therefore best be presented to you by considering what kinds of figures on business income economists put into their calculations of the nation's aggregate income. On this occasion we shall want to limit ourselves to the way economists handle the problem of changing price levels. That is the big problem of today.

I said that economists have been worrying about the calculation of business income. I do not want to imply, however, that the business profit figures included in national income statistics are based entirely or even largely on the calculations of economists. On the contrary, the basic data on business income—and other income as well—come out of accountants' reports. What the economist worries

about is the meaning of the accountant's figures, the coverage of these figures, and the adjustments needed to mold them to his own needs. What the economist does is to combine the figures accountants prepare for various industries, make estimates to fill in the gaps (for he wants a complete national aggregate), and introduce a relatively few—though far-reaching—adjustments to adapt the figures to his conception of the business income that is appropriate for inclusion in the national income. Even these adjustments, we shall see, are mainly applications on a larger and more consistent scale of adjustments that accountants here and there have already introduced.

The economist sometimes boasts of his advantage, over other social scientists, in possessing an objective means of measurement. The magnitude of the forces and effects with which he is concerned can be assessed with the measuring rod of money. But the economist above all is aware of the great significance of changes in the value of money. He knows that his measuring rod contracts with shrinkage in the value of money and expands with growth in its value, like the standard meter does with changes in temperature. To keep this measuring rod firm—or perhaps better expressed, to correct the observations he makes with it—the economist has developed the supplementary device of index numbers of prices. A decline in the value of money is indicated by a general price rise; a general price decline indicates a rise in the value of money. Price indexes, being essentially averages of price changes, measure these general price changes. They therefore provide an approximation to changes in the value of money. Properly used, they help to eliminate the bias that would otherwise arise were money values, such as appear in the market transactions of different times, compared as they stand.

One adjustment, then, that the economist makes of accounting figures on business income, to lessen the effect of changes in the value of money, is to multiply the dollar figures by an index of

the value of money. Or—what is the same thing—he divides the dollar figures by an index of the general price level. As is commonly said, the dollar values are “deflated” or expressed in terms of “constant prices.” Historically, this was the first adjustment developed by economists. Usually, also, it is still one of the most important.

All are familiar with this adjustment. Few today would dream of presenting figures on wages without a correction for the increased cost of living; and indexes of the prices and incomes farmers receive are, almost by legal fiat, accompanied by indexes of the prices they pay. “Real wages” and “parity prices” are common lingo. Economists, at least, are consistent in applying similar adjustments to business income. Since everyone is acquainted with this particular adjustment, I need say no more about it, except to comment on two points.

First, while economists are thoroughly agreed that correction for changes in the general price level is necessary, there is less agreement on just how much correction is needed, in any particular case. By that I mean, simply, that there are available a number of different indexes of prices (and of course there are many more that could be computed); that these usually reveal somewhat different rates of change in prices, between any two dates; and that opinions differ as to which is most appropriate for deflating business income. For the value of money depends on what is to be done with the money: whether it is spent on consumers' goods or capital goods; whether it is spent on rich-man's goods or poor-man's goods. And, also, indexes of the prices even of the same group of goods will vary with the compiling agency. Over relatively short periods of time, however, these differences are usually not great. The area of agreement is far greater than the area of disagreement. Economists, having learned to concentrate on important issues, accept approximate measures with which they may differ in detail. National income statis-

tics are expressed in round billions of dollars, not in dollars and cents.

My second comment is necessary to emphasize a point that is frequently misunderstood. The deflation procedure I have been discussing, namely, correction for changes in the general price level, does not remove all the biases or difficulties that arise from changes in the value of money. This correction cannot, by itself, place the business income figures for two different periods on a par with one another and render them fully comparable. One important reason is that the various business costs set off against gross income, in the usual profit and loss statement, are based on "heterotemporal" prices. When I first used that word I was accused of indecently coupling Greek and Latin roots. Yet it expresses the idea succinctly. What I mean, of course, is that costs charged in, say 1940, involve prices paid not only in 1940 but also in earlier years. The ordinary deflation will not take care of this peculiarity of accounting figures. Other adjustments are needed to do that, and the economist has applied them to charges for cost of materials and charges for depreciation and depletion.

The first wrinkle in the accounting treatment of inventories and thus of cost of goods sold, that bothered economists was the "lower of cost or market" valuation practice. As early as 1932, Colin Clark felt it necessary to adjust the British figures, because of it, in order to attain comparability between periods of rising prices and periods of falling prices.

Soon, however, Simon Kuznets' work on capital formation at the National Bureau of Economic Research led him to take an additional and bigger step towards adjusting the accounting figures on inventories and costs of materials. He broke down changes in the reported book values of inventories into two components. For example, when both the physical volume of inventory and the market price of the goods held in inventory rose between the beginning and end of the year, he distinguished between:

(1) the value (at cost) of the increase in the number of physical units of inventory; and (2) the increase in the value of the opening physical inventory resulting from the replacement of units purchased at lower prices by units purchased at higher prices. To the economist, only the first component represents a real accretion to the country's wealth. Only the value of the physical increase in inventory is capital formation from an economic or social point of view. The second component, the increase in the value of the opening inventory, merely represents an upward revaluation of wealth already in existence, not an addition to wealth. Being such, it should not be treated as capital formation. Nor should it be considered to be part of the business income appropriate for inclusion in the national income.

Put differently, the true current cost of materials consumed is not their original cost, but their replacement value. In a period of rising prices, then, and viewing the matter from the economic or social standpoint, accounting net income is too high, because accountants charge most materials consumed at original, not replacement, cost. Accounting profits include the amount by which inventories are revalued. In a period of falling prices the reverse is true. Accounting net income is then too low, in the eyes of the economist. Business income from an economic viewpoint should be determined by subtracting from sales a cost of goods sold in which the units sold are valued at current, not original, cost prices. This explains why the series prepared by the National Bureau of Economic Research to measure the nation's income includes as a component business income adjusted to remove inventory revaluations. The Department of Commerce has taken over the notion, and its figures on national income are similarly built up.

The economist's adjustment of inventory (or cost of goods sold) strongly resembles, of course, the "last in, first out" or the LIFO method that has come into use in some business accounts, and I therefore need not take the time to de-

velop it in detail. Nevertheless, several comments are necessary.

It should be noted, first, that this adjustment is applied by economists to *all* (or virtually all) business income. The national income figures are thus internally consistent. The data for different industries are, in this respect, fully comparable with one another. This is not true of accounting data on business income. Lifo is used by only a fraction of all business enterprises; and in the accounts of many of those using Lifo, it is not applied to all types of inventories. The adjustment made by economists was designed precisely in order to provide complete comparability between different companies or industries and between different periods of time.

The economic adjustment is different from Lifo not only in the scope of its application but also in the way it is applied. In Lifo, materials sold or consumed are charged at the cost of the most recently acquired materials. This might be the current year's price or it might be last year's price if the physical volume of inventories has been reduced from last year's level. (I am ignoring the special case of involuntary liquidation because of wartime shortages, in which the general Lifo rule is relaxed.) The economist always charges all materials sold or consumed in any year at that year's price, even when inventories are depleted during the year. The economist's method of adjustment therefore ensures that no inventory revaluation will be left in the income account to over- or under-state business income. Lifo does not. The intention, however, seems to be about the same. The purpose of Lifo, as the American Institute committee on accounting procedure states, is "to relate costs to revenues more nearly on the same price level basis than would the Fifo method." The purpose of the economist's method is to relate costs to revenues on *exactly* the same—the current—price level basis.

Though the economist tries to relate costs to revenues on the same price level basis, he cannot in fact fully attain that

purpose. Accounting data constitute his raw material. To adjust them, he has to know what fraction of inventories are reported on Lifo, what portion on Fifo. Of the latter, he has to know what portion is valued at the lower of cost or market, what portion on other bases. Furthermore, he has to know how replacement prices have changed in each industry. But he does not know these things very exactly. He has to estimate them. Our national income figures, therefore, are adjusted on the basis of approximations only. But, again, the economist is glad to get closer to his objective, even if he cannot reach it fully, rather than content himself with the unadjusted figures.

The adjustment is a very considerable one, when prices are changing greatly. The Department of Commerce correction has run as high as +4 billions for 1930, —3 billions for 1933, +1 billion for 1938, —3 billions for 1941, and —6 billions for 1946. (These estimates cover not only corporations but also unincorporated enterprises, except farms.) Even if these adjustments are surrounded by considerable margins of error—and we may be sure they are—they are worth making.

If the objective is to relate costs to revenues on the same price level basis, there is no logical reason for stopping with the materials that come out of inventory. Charges for depreciation and depletion have to be treated in the same way. Capital assets consumed in the course of current production also should be charged at current prices rather than at original cost. If they are not, business income is—from the economist's point of view—overstated when prices are rising, understated when prices are falling.

The depreciation and depletion charges available to economists are, of course, the accountants' figures. These, therefore, also require adjustment. This adjustment, quite similar in principle to the adjustment made of inventories, is rather more difficult to make, however. Available depreciation and depletion data are pretty complicated. They combine figures relating to a great host of different dates;

some are in original cost, some at cost to second owners; depreciation methods and the distinction between capital charges and maintenance charges, vary among firms and even within firms; and tax-law complications, like the wartime amortization feature and the depletion methods accepted by the Treasury Department, provide stumbling blocks.

The computation of depreciation charges reminds me of a calculation reported in *Alice in Wonderland*. Because George May once told me that it is always good form to quote from that famous authority, I won't restrain myself:

"Fourteenth of March, I *think* it was," the Mad Hatter said.

"Fifteenth," said the March hare.

"Sixteenth," said the Dormouse.

"Write that down," the King said to the jury; and the jury eagerly wrote down all three dates on their slates, and then added them up, and reduced the answer to shillings and pence.

I think that is how depreciation charges are calculated—with a heavy weight given to March fifteenth, in this country. Anyway, the economist has to unscramble the data that accountants provide him. And to the components he has to apply an adjustment involving a knowledge of changes in the prices of plant and equipment when the very character of this property also is modified with time, and the prices therefore are not fully comparable from time to time.

Despite all these difficulties, however, rough approximation seems possible, in my opinion, and when price changes are great, eminently worth while. It brings us closer to the truth than if we fail to make it. Such an adjustment was put into the National Bureau's calculations of national income for the period 1919-1938. The magnitude of the adjustment may be appreciated if we glance back at those figures. Take, for example, 1919, which followed the rise in prices during World War I. Accounting measures of depreciation of business capital goods, for that year, amounted to 3.4 billion

dollars. The estimate in *current* prices, however, was 5.4 billion, a difference of 2 billions. The discrepancy for 1920 was even bigger, 2.6 billion. For 1932, of course, the current price estimate was lower than the book estimate.

By 1947, I would not be surprised, current accounting calculations may again understate the economic measure of depreciation by some billions. But the Department of Commerce, which provides the current statistics on national income, has not followed the lead of the National Bureau in this respect, and we therefore have no real estimate. It should be pointed out, however, that the Department agrees that revaluation of accounting depreciation charges is "indicated on conceptual grounds" (*Survey of Current Business, Supplement*, July, 1947, p. 11), and of course joins the National Bureau in excluding realized capital gains and losses from its measures of business income. Apparently the Department has not made an adjustment for the difference between book and current price estimates of depreciation because of the statistical difficulties involved. But whatever the reason for not making the adjustment, by not doing so the Department of Commerce overstates current business income in its presentation of the national accounts.

I might mention, also, that the Department further overstates business income because it adds back the tax-law deductions for depletion. These figures are, of course, almost meaningless from an economic standpoint, and therefore provide little information with which to start. But while the Department's attitude is quite understandable, its figures are none the less defective in this regard, too.

I come now to a question that has not received much consideration. Partly, I imagine, this is because it has seemed rather less important than the matters already mentioned, and it is less important during a period of great change in the general price level. Yet it is worth tossing into the forum because it will help us to see more clearly the meaning of the adjustments already described.

The basic idea of the inventory adjustment made by the economist is to keep out of business income, and thus out of national income, profits or losses—realized or unrealized—that arise out of mere changes in the prices at which the existing stock of the nation's wealth is assessed. For the nation *as a whole* is no better or worse off simply because the current value of a fixed number of units in its stock or goods has expanded or shrunk. (I pass over the exception created by international trade.) But is this true of the individual firm that owns a stock of goods the value of which has changed? The logic of the economist's inventory adjustment as now made—and the same goes for the adjustment of depreciation charges and for Lifo—implicitly states that it is true of the individual firm. It is assumed that, like the nation, the firm is no better or worse off because the current value of a fixed number of units in its stock of goods has changed.

It is clear, of course, that the individual firm is in fact not better or worse off if the unit value of its inventory has merely paralleled the general price level. But what if the two have diverged? Suppose, for example, that owing to the depletion of our resources, the unit value of the stock of copper held by nonferrous-metal refiners rises more rapidly than the general price level; and that, owing to technological advances, the unit value of the stock of rayon fiber held by rayon manufacturers rises less rapidly than the general price level. Can we really say that the one group has not gained, nor the other lost, by this differential price movement? Now, if the economist is interested only in the aggregate national income, he can ignore such gains and losses, for they more or less offset one another. In that case, however, he should note explicitly that the adjusted figures he presents for an *individual* industry are exclusive of its gains or losses from differential price movements. The figures measure, in a sense, what the industry puts *into* the national product, rather than what it gets *out* of the national product.

But the economist is often interested in what an industry or firm gets out of the national product. That is, the economist is then concerned with how the purchasing power resulting from business operations is distributed among industries or firms. Then it is another matter. Whether these profits or losses are or are not included does make a difference, and in the case of a particular industry or firm may sometimes make a great deal of difference. What are the pros and cons on including them?

The gain or loss arising from differential price movements may reflect differences only in the cyclical amplitudes of prices. In that case it can be argued that the profit or loss situation is only temporary, that it will soon be succeeded by the reverse situation at the next turn of the business cycle, and that this cyclical succession need not concern us. This argument is not iron-clad. But even if it is, it does not apply to the situation in which the gain or loss arises from sustained differential price movements, that is, from trend differences, rather than cyclical differences, in price movements. Here there is no cancellation. And here there seems to be little question that to the industry or firm affected the gain or loss is real.

One may grant that such gains and losses are real yet argue against including them in the economic measure of business income on the ground that they are not part of current income, but instead reflect windfall or capital gains or losses and should be treated accordingly. To this the counter-argument is, of course, that business enterprise does not take price movements to be mere disturbances of the situation in which business is done, but part and parcel thereof. Business enterprise aims at profiting, or avoiding loss, from such movements. Indeed, the exercise of foresight in this connection is a characteristic function of entrepreneurship, and active planning by business men to influence prices—whether those of goods purchased or of goods sold—rather than passively adjusting to them, is hardly unknown.

Brief mention may be made, finally, of another point. Some of the consequences of trading on a narrow equity or margin also tend to be excluded from the economic measures of business income, by the adjustments now in use. Yet the gains or losses resulting from changes in the burden of debt as price levels rise or fall influence greatly the distribution of purchasing power. For that reason these gains or losses also must find a place in a discussion of the economic measurement of business income. I will not take the time to develop these topics. Perhaps this is because I am subconsciously conforming to that professorial model of a lecture in which a third of what is said is obvious, a third is intelligible only to the brighter students, and a third is intelligible to no one. But I will admit only that I am simply trying to uncover some of the significant implications of the adjustments now used in preparing our national income figures. Only by studying these implications can we reach a real understanding of what the current economic viewpoint means, and find direction towards bettering it. In short, I am pointing to some of the unsettled problems that a study of business income must tackle.

Let me sum up the main points, on which almost all economists agree, as follows:

Accounting calculations of business income are unacceptable to economists. Current accounting reports yield figures for different companies that are not comparable with one another. Current accounting reports yield figures for a single company's operations in one year that are not comparable with figures for the same company in another year. During a period of inflation, such as we are in, these incomparabilities are serious.

To obtain comparable figures that measure business income from a consistent economic point of view, economists are therefore driven to make adjust-

ments of accounting data, or at least to attach qualifications to them. Economists follow the principle that costs should be related to revenues on the same price level basis, and that the income of one period should be compared with the income of another period on the same price level basis. In accord with this principle, economists believe that inventory revaluations should be excluded from business income, and the income estimates of the National Bureau of Economic Research and of the Department of Commerce do exclude them. Economists believe, also, that revaluations of fixed assets should be excluded from business income, and the income estimates of the National Bureau and Department of Commerce both exclude realized capital gains and losses. The estimates of the National Bureau further exclude revaluations of fixed assets arising from the charging of depreciation at original cost. The Department of Commerce also accepts the principle, but has so far implemented it only by a textual qualification of its figures. Finally, economists believe that comparisons of income over time are possible only if adjustments are made for changes in the purchasing power of money income, and all estimators of national income provide for such adjustments.

These are not small matters that we are discussing today. The accounts of business income are matters of great public concern. Cooperation among the various groups of society, so necessary to the efficient working and progressive development of our economy, is difficult to secure when there is widespread misunderstanding of how the nation's income is being distributed. To lessen—perhaps ultimately to dispel—this misunderstanding is a duty of the economists who practice social accounting. Is it not also a duty of those who practice public accounting?



# Management's Point of View

by Joel M. Bowlby, CPA

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THE PROBLEMS presented by and the potential ramifications of the general topic of this discussion are almost unlimited. "Costs" of every type and nature are involved. "Income" necessitates interpretation—agreement upon which does not presently exist between the groups whose views are here presented; nor, in fact, within the groups themselves. "Changing price levels" requires consideration of the period of time within which such change takes place and the ratio of change; and, that most elusive factor, the future course of prices. And, in my section of the discussion, the functions and responsibilities of "management."

In the preparation of this paper, I started to review the previously expressed opinions of others on the subject. I was amazed at the number of articles which have appeared—and no less at the variance of opinion as to the importance of the problem and the proposed methods of solution. I do not know of any subject which has arisen during my association with the profession which has provoked so much discussion. Even the small segment of the bibliography which I have reviewed makes a very imposing list.

As to "costs" and "income," my comments will be brief. All costs are affected by changing price levels, but the great bulk of such costs are reflected in the income accounts of the year in which incurred; and hence do not invite special

treatment. Major exceptions are product costs carried forward in inventories and costs representing provision for depreciation and depletion of capital assets. The latter factor is the one under most intensive discussion at this time, and I shall treat upon it at greater length; but I also propose to take the liberty of commenting upon methods of inventory valuation. The "income" that I shall deal with will be my concept, which makes little differentiation between the balance of income transferred to surplus and the so-called net income for the period reported upon—although accounting discussion seems to make much of it.

In the matter of inventory valuation, it would appear that we have about run the gamut of Ifo's. We started off with Fifo (first-in first-out); gave our blessing to Lifo (last-in first-out); have accepted (at least, in some specific instances) Hifo (highest-in first-out); and now hear suggestions of Nifo (next-in first-out).

Initially, inventory valuation reflected what seemed to be the logical flow of materials—an average cost basis of Fifo, first-in first-out. These methods were effective as a means of recovery of the invested dollar; but lacked effectiveness as to economic cost recovery. Under rising prices, an inventory stabilized as to unit content represented an ever increasing monetary value and reported profits gave no indication of the extent to which affected by the actually unrealized profit in unliquidated inventories.

To meet this shortcoming, the accounting profession accepted a less logical concept—the Lifo (or last-in first-out) method. A special committee on inventories of the American Institute of Ac-

countants in the first pronouncement on the subject (1936), reported:

"The prime purpose of the 'last-in first-out' principle—is to bring about, in the determination of profits in the financial accounts, a substantial correlation between sales prices and those raw material prices which have been causative of such sales prices.

"In its practical effect in the accomplishment of this objective, the 'last-in first-out' principle may be viewed as comparable to the 'base stock' or 'basic inventory' method of inventory valuation, the purpose of which likewise is that the revenue from high sales prices be burdened with the costs causative of such high sales prices, and not leave high price level inventories to be absorbed later by revenue representing a lower price level, upon the turn of the economic cycle."

As has been pointed out by others, experience with Lifo has not been entirely satisfactory. Many laymen believe that the Lifo company is immune to inventory losses on a declining market. Should there be no change in the number of inventory units accumulated, then no loss is realized until the price level has declined below the point at which the method was introduced. But if there is a progressive increase in the reported value of inventories despite the fact that the highest priced units are in theory charged out first, then there is denoted an increase in the physical quantity of inventory on hand. In such case, the companies employing Lifo may be the very ones in which the largest inventory losses occur, because their unit inventories, where increased values have been reported, have risen over the intervening years. At present price levels and under present tax regulations, Lifo has lost much of its real attraction—moderation of the influence upon earnings of price fluctuations; or, more realistically, the leveling of earnings—and it seems unlikely that its usage will become substantially more widespread.

Hifo (or highest-in first-out) is designed to bring inventory values gradually down to the low point in the price cycle. Nifo (next-in first-out) is limited by the necessity of speculating as to the level at which replacement will have to be made; and, to my knowledge, has not yet been put to practical application.

Personally, I prefer the base stock method for companies whose inventories consist to a large extent of homogeneous materials and whose products require an extended period of time for processing. Companies using this method almost invariably give full information regarding normal stocks and the fixed prices at which such stocks are valued. Therefore, this method possesses the advantage of and lends itself readily to adequate disclosure. Commendation of such disclosure by National Lead Company in its 1947 annual report recently appeared in *The Journal of Accountancy*, July, 1948.

With further respect to disclosure of the basis of inventory valuation, it is interesting to note that the Accounting Survey of 525 Corporate Reports recently published by the Institute revealed that a very large number of the companies included in the survey did not mention the method or methods followed in determining inventory values. My own study of corporate reports coming over my desk reveals that many corporations show inventories after deduction of reserves, with no indication of the nature or purpose of such reserves. Incidentally, I heartily concur in the views expressed by J. Harold Stewart (*The Journal of Accountancy*, August, 1948), advocating disclosure of the replacement value of Lifo inventories; classifying such replacement market value as a significant financial fact; and stating that "given the significant financial facts, stockholders today are generally able to use them intelligently, *relying as they do in an ever increasing degree upon those skilled in interpreting such facts.*" Some apprehension has been expressed that disclosure of replacement values may be seized upon as further evidence of the concealment of profits by corporate man-

agement. I see little justification for this view. Market values of marketable securities carried at cost are customarily shown parenthetically and are given weight by analysts only when the appreciation is very substantial.

The major purpose of the foregoing section of my discussion has been to show the development of inventory accounting. Average cost, base or normal stock, Fifo and Lifo have all received general accounting recognition and Hifo has been deemed acceptable without qualification by the examining accountants. Likewise, all but one of these methods are recognized by the Treasury Department for tax purposes, when consistently followed. Furthermore, computations of values under these methods do not entirely follow mathematical formulas but involve some degree of managerial judgment; and, particularly in the case of the base stock method, the determinations of normal quantities and fixed inventory prices are solely matters of managerial judgment. And, finally, disclosure of the significant facts relating to inventories and their valuation should be made; and, if made to an adequate degree, will enable the analyst to determine the effect upon current earnings of the method of inventory valuation employed in the respective case.

Hence, in the development of inventory accounting there has been attained (1) approval of several methods of valuation, for both accounting and tax purposes; (2) acceptance of managerial judgment in arriving at inventory values; and, (3) recognition of the need of adequate disclosure of significant facts relating to inventories and their valuation.

We next embark upon a discussion of the treatment of provisions for depreciation and depletion under changing price levels. Let me say forthwith that so much has been written on this subject by all segments of the public and so many diverse views have been expressed, that I foresee little possibility of my being able to "add something new." My chief purpose will be to correlate the views, give my personal opinions and attempt to

present the controversial situation in a manner that will invite orderly consideration—and, perhaps, thereby contribute to eventual solution.

For one thing, just what part do charges of this nature play in the determination of costs? Some corporations include depreciation charges in the computation of costs for the determination of inventory values. Others do not. Some companies whose operations involve wasting natural resources make provision for depletion. Others do not. Both of the foregoing alternatives are defensible and have received accounting sanction. Several of the writers have stressed the necessity of including in selling prices, provision for depreciation and depletion on the basis of present day reproductive costs and for other non-cash costs. I agree that—for the long pull—an industry and its corporate components must recover *all* costs; and that disregard of this basic principle can result in erosion of capital to the damage not only of the individual corporation and the industry but to the community as a whole. However, in my opinion, for the short term—and long term cycles are made up of a series of short term cycles—charges of this nature play but little, if any, part in the determination of selling prices. It is true that there are a few companies so dominant and firmly entrenched in their respective fields that they can establish and maintain prices for their products. But, in the great majority of cases, selling prices are fixed by the laws of supply and demand, by customer acceptance, by competition and by a host of other more or less intangible factors. You can include non-cash charges in your costs for the purpose of determining whether or not you are making a profit on any individual item, but there are innumerable instances where you cannot include them in your selling price. My point here is that too much emphasis must not be laid on non-cash charges as an element of individual product costs—it is the overall end result that counts.

Next, I want to dwell a moment on the recognized function of depreciation

charges. There seems to be almost uniform agreement, among both those who favor revision and those who advocate adherence to present procedures, that the function of depreciation charges is only to assess against income the costs of capital assets. (The definition of "cost," of course, varies; in one instance being replacement cost and, in the other, historical cost.) Likewise, there appears to be general agreement that the mere act of including depreciation charges in costs does not provide the funds for replacement of capital assets at higher price levels. Their inclusion does reduce reported profits and, thereby, enables the retention of earnings to the amount of the depreciation charges; and, so long as the charges are deemed reasonable by the Treasury Department, enables the retention of tax-free earnings. I say there is agreement on these propositions, but it is confined to a relatively small group. It is important that the public understand, and that the taxing authorities recognize them.

But the problem that faces us today—and that includes accountants, not only in their professional capacity but as a segment of the public—is more basic than these theoretical or technical considerations. It revolves around the vital question of how American enterprise is going to obtain the capital required to replace existing plant and equipment; to provide the improved and expanded facilities essential to the growing needs of a larger population and a higher standard of living; and to finance a larger volume of business at a higher price level.

I have not attempted to accumulate authoritative statistics upon the decline in value or purchasing power of the dollar since the outbreak of World War II. As a matter of fact, any set of statistics which I might present would most certainly be unacceptable to many economists, analysts and others interested. We do know that the decline in the real value of the dollar has been most marked during the past fifteen years, starting abruptly with devaluation in the early years of the Roosevelt administration and

tobogganning farther as a corollary of the economic readjustments induced by World War II. It is probably a fair approximation to say that the 1948 dollar has only about one-third the purchasing power of the 1933 dollar. Furthermore, there is every indication that we are to remain permanently on a higher price level plateau. The Council of Economic Advisers (to the President) in its report on the Economic Situation at midyear 1948 said, "And there is no likelihood of a near-time restoration of that former (prewar) value. But there is nothing sacred about the price marks of 1939 or 1926, and the attempt to restore them would probably create more hardship than it would alleviate. To be sure, we want to achieve reasonable steadiness of the dollar, although at a price level necessarily higher than in prewar times."

During the war, because of necessarily rapid turnover and price and wage controls, inventories remained at low levels; receivables were abnormally low because of restriction of consumer credit and prompt payment of war contracts or substantial advancements thereon; and non-war construction was practically nonexistent. As a result, corporate working capital rose to the highest level in history. Since the war this picture has materially changed. While working capital remains at high levels, an increasing amount is represented by inventories and receivables. As an obvious corollary, the ratio of quick assets to current liabilities is deteriorating steadily. An analysis of the net quick asset position of fifty leading corporations, reported upon by Jackson Martindell, a member of the Executive Committee and Director of Fiduciary Management, Inc. (*The Controller*, June, 1948), shows a ratio of 6.74% at the end of the 1930 fiscal year (high 17.3%; low 2.1%); 2.69% in 1946 (high 9.6%; low 1.1%); and, 1.89% in 1947 (high 6.3%; low 0.7%). Corporate funds are being transferred into fixed assets and inventories. And how is a sound cash position to be restored—to enable the extension of consumer credit to a conservative degree; to cover inventory losses;

and, probably most important of all, to finance the corporation through a period of adjustment of almost universally too high break-even points? The Report of the Council of Economic Advisers, previously referred to, contains the statement, "It is significant that the major source of corporate funds has continued to be those sums retained from current receipts as offsets to depreciation and depletion charges and as undistributed net earnings." To supplement this source—inadequate to present needs—corporations resort to public financing. Under normal conditions, much of this financing would soundly be equity financing—investments in corporate stocks not subject to repayment and upon which dividends would require to be paid only if earned and if the financial position of the corporation warranted. But conditions are as abnormal in the equity markets as they are elsewhere. For reasons not germane to this discussion—but which are none the less real—equity financing is unavailable or available only at prohibitive cost, except to corporations of the highest credit standing. As a result, the bulk of corporate financing has been provided through borrowing. Federal Reserve Board statistics report domestic corporate financing in 1947 of \$6,225,000,000, of which 76% represented debt financing and 24% represented equity financing. For the first six months of 1948, the annual aggregate was approximately the same, but debt financing had risen to 80% and equity financing had fallen to 20%. Of the net proceeds of the 1947 financing, 52.8% went into plant and equipment; 27.6% was applied to the retirement of previously existing debt; and 19.6% was added to working capital. For the first half of 1948, plant and equipment received 59%; but only 13.8% was applied to debt retirement and working capital was augmented by 27.2%.

Another corollary of the rising price level is a proportionately higher profit level—for profits must maintain a comparable relationship to the general price level and the tempo of business activity. If material costs, wage scales and busi-

ness volume are abnormally high, profits must be proportionately large. Directly or indirectly, command of working capital and additional fixed investment will be determined by the current profit ratio.

It is my belief that the questions at issue today were not raised initially by the group which I address—the accountants; but that they had their origin within the group whose views I am supposed to expound—the management. They stem from this need for reinforcement of cash resources; the unwillingness on the part of equity markets to supply the required capital except at prohibitive cost; and the approachment of the debt ratio to a point which counsels caution. As a result, corporate management is forced to look to a great degree to retained earnings as the source of financing its needs. And accountants are being called upon to find a method to which they can subscribe of assisting management in meeting these needs.

There appears to be rather general acceptance by accounting authorities of the need for increased retention of earnings during this period of high monetary profits. However, in their consideration of the problem they appear to concern themselves primarily with technical or theoretical accounting aspects—and fail to get down to fundamentals. The *Accounting Review* for April, 1948, published papers by six recognized accounting authorities debating the proposition: "Resolved that departures from the historical cost basis of recording fixed asset depreciation be recognized as falling within the scope of generally accepted principles of accounting." Three wrote to the affirmative; and three, to the negative. The papers were largely directed toward a discussion of accounting theory, but even those on the negative side did not disavow the need for increased retention of earnings. I am perhaps prejudiced, but, in my opinion, the most effective presentation was made by Howard C. Greer, who, like myself, spent many years in the profession and is now the managing officer of an industrial enterprise. Mr. Greer makes some very

pertinent comments on the subject of financial reporting, which might well be quoted here. He says—and while I have extracted only certain related statements, they are not distorted by separation from their context:

“The authors of financial statements seem to feel that they must begin offering apologies and altering techniques whenever someone discovers some fact about a business which is not measured with unimpeachable accuracy in its annual report.

“Businessmen would welcome some device introduced into financial statements which will produce a result that cannot be used against them in discussions of prices, wage rates, taxes, or profits. They would like to have the statements constitute both a measurement and an interpretation—the interpretation being favorable to the economic attitudes *which they find inescapable*.

“Businessmen are oppressed by the fact that prices and profits look high in comparison with capital investments made some years ago when price levels were lower. They find themselves the targets of demands from workers for higher wages, demands from politicians for higher taxes, demands from consumers for lower prices, and demands from their organization for the renewal of depreciating plants and equipment.

“They sense the pressure to keep prices lower than is justified, to raise wages because profit margins appear wide, to pay high taxes in support of enormous government expenditures, and they attribute these pressures to the figures which appear in their financial statements.

“The correct solution of this problem lies in the education of the public in the problems of business economics and the way in which they are affected by fluctuations in money values. This requires not a revision of accounting statements but a thoroughgoing exposition of their significance.”

And while we are on this subject of financial reporting, let me say that no report can be all things to all people. It has been my experience that very little attention is paid to corporate reports except by a very small group of substantial investors, investment managers and counsellors, and financial analysts. These men cannot obtain, from any type of report, all the information they consider essential to an appraisal of the financial position, earning power, and managerial talent of corporations in which they are or may be interested. Hence, they keep in constant and close touch with management, thereby supplementing published information. It has been recently suggested by one of the well known financial magazines—and not without merit—that annual reports be abolished; and that stockholders be furnished only with the financial statements required to be furnished to them under SEC and Stock Exchange regulations, accompanied by a brief letter from the management giving the outlook for the succeeding year. Those desiring additional information would obtain it as they do now—by direct contact with the management.

I have brought in this subject of financial reporting because several of the writers reviewed have deprecated the use of any “device” to reduce reported earnings. One of the participants in *The Accounting Review* symposium concluded his paper with the statement that:

“A courageous management needs no such device (as an earned-surplus reserve); it can inform its stockholders, with a simplicity that should prove refreshing in these times, that earned surplus and working capital are being retained in the business so that future additions to and replacements of fixed assets may be purchased without having to borrow money.

“What has become of the management that can produce such an old-fashioned statement?”

I cannot admit that the answer is as simple as that statement indicates. Man-

agement has been making just such explanations for years, couched in language understandable to anyone. But, stockholder surveys indicate that only a few read the report and not many look beyond the final figure at the bottom of the income statement.

I have referred several times to the fundamental problem, underlying the present situation. What is that problem? As I have said before, it derives from the facts that corporations need to augment working capital; that the increasing proportion of industrial debt capital is becoming dangerous; and, that sources of equity capital are drying up. To meet this situation, corporations must be permitted to retain a greater share of monetary profits—which very often include a very substantial amount in respect of inventory appreciation and capital liquidation. The proposal to revise depreciation allowances will help but such allowances will help much more if recognized for tax purposes. Attainment of this goal is more a matter of awakened social intelligence and social conscience than of accounting theory and practice. And accountants share a responsibility to assist in that awakening.

For the present, and whether or not recognized for tax purposes, I do believe that the position of management could be improved and its existence made easier by deducting, in arriving at reported earnings, an amount reflecting amortization of the estimated excess of replacement cost over historical cost. I also believe that balance-sheets should continue to reflect historical cost; and that such cost should be retained as the normal cost depreciation base. That is a very concise statement of my views on the proposal to revise depreciation accounting to reflect replacement costs. Whether they reflect the views of my fellow executives can only be ascertained when I receive their reactions. Of one thing I can be sure—they will be provocative.

Two questions will probably present themselves to my fellow accountants; Why should we reinterpret present generally accepted principles of accounting

in order to improve the position of management and make its existence easier; and, On what basis should provision be made for the excess of replacement cost over historical cost? I must confess that I am by no means sure of the answer to the first question. I have always felt that the accountant owed a primary obligation to his employer—who, after all, is the management of the corporation which employs him to review the corporate accounts. Despite the fact that accountants are now frequently selected by a non-management committee of the board of directors and the selection ratified by the shareholders, I know of no specific instance in which management's recommendation is not given primary weight. And that is not illogical, since management is assumed to serve *its* employer to the best of *its* ability. But the responsibilities appear to have expanded far beyond my previous concept. Maurice H. Stans, writing on the subject of "How New Standards of Financial Reporting Grow From Social Responsibility of Accountants" (*The Journal of Accountancy*, August, 1948), says:

"As an integral part of a powerful economic system, and the social system that has grown in response to it, accounting must therefore at all times be employed in full recognition of a primary responsibility to the broad public. This obligation extends by this concept to the benefit not only of corporations and their investor owners and creditors, but also of labor unions, government regulatory agencies, consumers, taxpayers, and the public.

"No doubt there is to be expected continued evolutionary progress in the art. In that progress, then, social responsibility should and undoubtedly will be the prime motivating force."

To certain of the social bodies mentioned, I—were I again in public practice—would admit no obligation other than the basic obligation of honesty. However, even under that expressed concept of social responsibility, it is conceivable that the profession might feel con-

strained to give some consideration to the management of a corporation, which after all is a not inconsequential unit of our social system.

As to the basis of providing for the estimated excess of replacement cost over historical cost, I advocate leaving that to managerial judgment. I cannot state my case better than was done by A. C. Littleton (*The Journal of Accountancy*, July, 1948):

"The problem of what constitutes good accounting treatment is complicated by a contest between two doctrines: (1) that experienced business judgment is the best basis for calculating periodic income since the task is quite beyond satisfactory treatment by formula; (2) that freedom to report income according to experienced business judgment will tend to become, in too many cases, merely license to manipulate the results wilfully and wishfully.

"More realistic reporting might well emphasize experienced judgment which realistically visualizes forward conditions as well as the immediate present."

The use of indexes has been advocated as a basis for revision of depreciation charges. However, I doubt that any mutually acceptable set of indexes could be arrived at. Certainly, the precise determination of replacement costs presents an insurmountable problem. My suggestion of reliance upon managerial judgment commits no one but the management. Full disclosure has been made. The reporting accountant can, if he so desires, disavow responsibility for the excess provision—although, in my opinion, he is equally warranted in disavowing responsibility for the adequacy of the provision on an historical basis. And the analyst has all the facts at hand essential to such adjustments as his personal judgment may dictate.

The procedures which I have suggested for the treatment of fixed assets, or "long-term" inventories, and depreciation and depletion thereon, do not vary widely from those which have been ac-

corded accounting sanction with respect to merchandise or "short-term" inventories. It was for the purpose of developing this analogy that I dwelt at some length on the progress of inventory accounting. Latitude has been allowed in the choice of methods of evaluating merchandise inventories. Why should not similar latitude be allowed in valuing fixed assets, the stated value of which is of far less importance than their earning power? Managerial judgment has been recognized in determining normal quantities and fixed prices under the base stock inventory method. Why should not equal recognition be given in determining the adequacy of provisions for depreciation and depletion? And, finally, full disclosure will enable the analyst to reconstruct the accounts to conform to his own judgment, should he disagree with the basis upon which the financial statements are prepared.

Just before I completed this paper, there came to my attention the remarks of Sir Geoffrey Heyworth, chairman, at the Annual General Meeting of Lever Brothers, as reported in the *London Times* of August 27, 1948. I wish it were possible for me to read to you Sir Geoffrey's remarks in their entirety and I would recommend that all of you obtain and read them—for he puts his finger directly on the importance of the impact of taxation on present earnings. He discusses reserves of £4,200,000 in respect of inventories and £3,600,000 for replacement of fixed assets. With respect to inventories, he says:

"Thus, in a period of rising prices, profits for taxation purposes are inflated by the lower cost at which materials were bought; these profits are taxed and, because of this taxation, the business is left without the means to replace the materials used in the same volume."

Correspondingly, with respect to fixed assets, he observes that:

"If we were to rely on our normal depreciation provision, we should fail . . . to maintain the fixed assets neces-



sary to continue our present scale of operations. We could avoid reducing the scale of our operations only by the introduction of new capital . . . (But) it is essential to ensure that new capital is used for proper purposes and not applied to make good failures to maintain existing capital."

Summing up, he says:

"What then must be done to maintain capital invested in industry? . . . The maintenance intact of capital invested . . . is, in the first place, a problem for industry itself. The main essential is that the problem should be fully understood by all concerned—shareholders, management, and workers. . . . But it is equally important that the problem should be appreciated by government. Unfortunately there are many signs that this is not the case. . . . Equally serious is government's failure to recognize for tax purposes a proper basis for provision for depreciation. Briefly, the government method is to treat as adequate and not liable to taxation, depreciation of fixed assets only sufficient to replace their original money cost. . . . It follows that government's current tax revenues are made up in part of taxation of something that is not a profit at all but is capital, and it is using this capital for current expenditure. Such a position is undesirable at any time but it is doubly so at a time when strenuous efforts are being made to curb inflation. . . . So far as the United Kingdom is concerned, it follows from what a government spokesman recently said in the House of Commons, that current tax revenues

include between 100 and 150 millions annually, due to depreciation allowances not being calculated on present-day values of fixed assets. The nation is using up capital to this extent each year for revenue purposes. . . . It is vitally necessary, in the interest of all classes of the community, that appropriate steps should be taken. . . . Administrative difficulties in the assessment of tax on a replacement basis are surmountable. . . . The problem does not merely touch shareholders as a class, or even shareholders plus employees; it is national in its scope, for, if the loss of capital in industry is allowed to continue, the productive capacity, and therefore the well-being of the country, will be gravely affected. Amongst the many difficulties of the moment, the importance of this problem is such as to call for urgent consideration by government, industry, and labor."

These observations could be made with equal force regarding the corresponding situation in the United States. The Institute committee on federal taxation has already recommended greater leniency by the Treasury Department in dealing with depreciation charges. This recommendation deserves the active support of all interested in maintaining the strength and virility of industry.

And so—I close with the admonition that you give not too great attention to the theoretical aspects of the proposition hereunder discussion today, but that you hew through to the essential underlying factors and devote your full energy and influence toward *their* solution.

# The Accountant's Point of View

by Samuel J. Broad, CPA

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THE ANNOUNCEMENT says I am to talk on the subject of "Business Costs and Business Incomes under Changing Price Levels" from "The Accountant's Point of View". I notice the word "accountant's" is spelled with an apostrophe "s"; it is singular. I am not sure which accountant was intended—the average accountant, the majority accountant, or myself. I decided it was not myself; and I will try to speak from the standpoint of what I believe to be the majority accountant as of today, if we can conceive of such a person. So I am going to confine myself largely to reporting, and I shall try to dilute what I have to say today as little as possible with an expression of my own personal views.

The accountant's principal concern is with the income of an individual enterprise and the status of the stockholder's investment in an individual enterprise. The degree of inflation we have experienced has made this considerably more difficult. The difficulties that arise center around the collapse of one of our basic accounting assumptions, namely, the reasonable stability of the monetary unit.

The principal question which arises from the fluctuating dollar is how income is to be measured. Should costs for accounting purposes for an individual enterprise be based on current replacement levels, or on costs stated in present dollars, or should they be limited to historical dollars?

If I sell a pair of shoes that cost me five dollars for eight dollars, and I buy another pair for seven dollars, is my profit three dollars or one dollar? Either one of these two alternatives in respect to inventoriable goods has been approved by generally accepted accounting practice.

Generally speaking, the Lifo method for inventories takes care of fluctuations in the value of the dollar to the extent they are reflected in actual transactions. Whatever its imperfections may be in theory and in detailed application, it substantially excludes inflationary inventory profits in the case of those enterprises which have voluntarily adopted it.

Turning to plant and equipment, questions have been raised as to the adequacy of depreciation charges made against income on the basis of original dollar cost when such charges are substantially less than the cash required to be spent to maintain the present level of productive facilities. Some take the view that provision for such expenditures is solely a financial problem and that if additional funds are required, they represent an increase in capital investment. Others claim, on the other hand, that it is unrealistic to say that profits have been earned if they are not available for disbursement as profits, but must be retained merely to maintain—not to expand, but merely to maintain—present productive capacity.

While the Lifo method allows a charge against income for incurred replacement costs as far as inventories are concerned, no similar method has been approved or made available in respect to plant expenditures.

Let us look for a moment at the cash aspects of the problem, its financial side. Inventories have had to be replaced as business went along. Business has had no choice but to replace goods sold, and to find the funds necessary to do so, if it is to continue in business. Properties have not yet been replaced. They are, of course, in the process of being replaced, but at much higher costs. They will be in process of being replaced for many years to come. The financial drain represented by the excess of new costs over old will continue. The requirement for funds will be cumulative.

The accounting problems arising from major price advances relate to the measurement of costs and income. The question is whether capital should be measured solely by reference to the historical dollars invested, or whether the assets themselves represent the capital. The former is the conventional accounting and legal viewpoint of capital, as a sum of money. The latter views capital as the assets represented by the money rather than the money itself. Can there be a profit if provision is not made for the maintenance of the productive assets?

### **Solutions Suggested**

Many solutions have been suggested in an attempt to deal with these partly financial, partly accounting and partly economic problems. They fall into certain general groups, and I shall touch upon them briefly. First of all, a suggestion has been made by some that accounting statements should be modified and amplified to the extent necessary to reflect economic income. I don't know how seriously the suggestion has been made but attempts have been made to develop such a formula. It would require the adjustment of inventory costs, cost of sales, to replacement value; the adjustment of depreciation costs to a basis of replacement value; the measurement of rents under long-term leases by reference to the present rental value of the property; and the adjustment of interest rates from the rate

paid to the current interest rate on borrowings, and so forth.

Such a procedure would leave so much to judgment and so little of historical facts, of objective measurement, would remain that I think we have no choice but to say that we as accountants cannot undertake it; nor would we wish to express any affirmative or positive opinion on the results.

Another suggestion which doesn't go so far calls for a general restatement of the accounts, plant and equipment as well as inventories and other property assets. There are several such suggestions, varying somewhat in detail. Generally, suggestions for a restatement of the accounts are based upon the feeling that both balance-sheet and income statement are unrealistic under present conditions; that the income statement should be on a basis consistent with the balance-sheet and that there should not be charges against income which are not related to the amounts of the assets shown on the balance-sheet.

This suggestion would not be limited to a reflection of the changing value of the currency, but would undertake to reflect current values of the asset; in effect, cost of replacement at present levels. It would be achieved either by appraisals, or by indices related to the particular type of assets. That, of course, is one of the difficulties with the proposal, that it requires either appraisals or a quite elaborate series of detailed indices.

As to these indices it has been suggested that to measure value in current dollars there should be separate indices year by year, for example, for buildings in Ohio, or for certain types of machinery in California, or so on. The accuracy of the result would depend upon the extent to which the properties and indices were broken down. Serious difficulties are involved in developing past indices in the detail necessary for such purposes. The chief objection I see, however, to such a suggestion is that temporary conditions affecting the indices for various parts of the country or for various types of equipment would be reflected

not only as to current expenditures but also in the remeasurement of expenditures of a similar type in the same localities in prior years. Temporary price aberrations would be made more or less permanent in the base figures.

Under this proposal depreciation and other costs would, of course, be related to the adjusted figures. Such a restatement to be of value would have to cover all the assets, including inventories. Difficulties would probably arise also as to the use of the Lifo basis under the tax regulations which require that no basis other than Lifo cost be used for reporting purposes.

Another type of change which has been suggested is more limited in its scope. When we receive salaries, or interest on bonds, or dividends on stock, we receive a certain established sum of money in dollars of the present time. Corporate income, generally speaking, is not a certain fixed sum of money; it is a difference; it is the excess of revenues over costs, the algebraic sum of positive and negative factors.

The suggestion is made that the revenues and the costs should be measured in one homogeneous unit of currency, today's dollars. If any of those costs represent the amortization or depreciation of costs expended in dollars of earlier years they would be converted to dollars of the current year. The conversion would be made by means of an index. I understand it is very difficult to develop an accurate general index to measure the purchasing power of the dollar. Economists recognize a dollar as a sum of money in somebody's hands, not as something having value in a vacuum or in the abstract. A dollar may thus have different relative purchasing power depending on what the holder is going to spend it for. But whether the general index should be 150 or 175 we all know either is more accurate than one of 100.

What is left, however, if we could obtain such an index and apply such a formula, would be the income obtained by deducting from revenues in current dollars expenditures measured in cur-

rent dollars, and bringing out a result expressed in current dollars.

I think the fourth and final group of suggestions would come under one classification. They are to the effect that there should be no basic change in accounting practice, that we should go on substantially as we are, but with additional informative disclosure — supplemental schedules or explanations or footnotes— showing the effects of currency changes on the financial statements. I shall come back to this later.

### **Background**

These four groups, I believe, pretty well summarize the various solutions which have been suggested by different people. We might next perhaps consider the background against which our choice between these alternatives must be made. We have first to recognize what has been stated as the primary objective of periodic reporting, namely, the objective of maximum usefulness of the financial statements to the greatest number of users. That, of course, raises further questions: Who is to measure their usefulness? Who is to determine what is most useful? We may tell people, for example, that a city apartment is much more convenient and more useful than a suburban home, that transportation is better and that it is nearer to the schools and the stores and other conveniences; and we may get a lot of people to agree. Other people will say they prefer a suburban home because they want more light and air and want their children to grow up in the country where there is more room. To them the advantages of suburban life outweigh its disadvantages.

In this respect everyone decides for himself what is most useful to him. That fact was recognized as to financial statements in the recent survey made by the American Institute of Accountants. Letters were sent out to several hundred business executives, economists, statisticians, controllers, lawyers, teachers, and other groups. They were asked their opinion whether any substantial change

should be made in accounting methods to provide satisfactory reporting of corporate income in view of recent changes in price levels. (The number was not sufficiently large that the results can be considered to be, and they are not claimed to be, statistically conclusive.)

The response to this and a number of related questions was exceptional. There were some very thoughtful discussions in the letters that were received in reply, both pro and con. There is no question, however, as to the preponderance of opinion at the present time on the questions raised. It was substantially in favor of making no basic change in present accounting method.

The significance of the replies, as I see it, is this. Based on a preliminary report (the final report is yet to come) almost one out of three indicated a desire for a basic change. Somewhat over two-thirds were opposed. However, if the same question had been asked a year ago those desiring a change would probably have been a much smaller minority. If it had been asked two years ago, it would probably have been laughed at.

Further, of those who answered no, who thought there should be no basic change, about 40 per cent expressed the view that further and supplementary information bearing on the subject should be included in financial statements. Thus the majority of those who replied were in favor of furnishing supplementary information.

Another part of the background against which the choice between the various alternatives mentioned is to be made is the extent to which inflation has progressed and how much further it may go. Is there a point at which financial statements based on historical cost lose their significance and if so where is it? I think we might consider this question by comparing our situation with, say, that of France. The French franc before World War I was worth about 20 cents. Recently the latest devaluation was on the basis of about 1/3 of a cent—1/300 of a dollar—per franc. If measured in

dollars, the value of a franc today is about 1/60 what it was, and inasmuch as the value of the dollar has also declined, is considerably less in relation to the pre-World War I franc. There is no question that in France financial statements based on historical cost had lost their significance. A change was necessary throughout the whole economy. Property assets were permitted to be stated in new francs without tax effect.

Of course, if we compare that situation with our situation here, the extent of inflation is very much less. The maintenance of stability of the dollar is not today, however, and is not likely for some time to be, a major objective of national policy. The maintenance of employment and of low interest rates on government debt *are* the major objectives. And both of these are inconsistent with a stable dollar.

Mr. Bowlby has suggested that a dollar today will buy about one third of what it would in 1933. We have no general index of the general purchasing power of the dollar; but there are several special indices for cost of living, construction costs, etc. I think most of us would agree, as a general proposition and without too much argument, that we can buy only about one half or two thirds as much for a dollar today as we could buy eight or nine years ago. Most people seem to agree that inflation to the extent we have already experienced has had some result upon the significance of reported earnings, and that it has increased the limitations of financial statements.

But we are still left with the question whether there has been enough of a change in the value of the monetary unit to warrant, or require, a major and basic change in accounting procedures. This is a question upon which opinions have differed, do differ, and doubtless will continue to differ. It has been the source of long and continued debate. It requires consideration not only of what we would gain by a change, but also what we might lose in the usefulness of financial statements.

## Results of a Change

Obviously, neither business itself nor accountants can legislate as to forms and procedures and make them mandatory. On the other hand, many people think and have suggested that if a basic change were regarded as permissive rather than mandatory, the result would be to limit further the comparability of financial statements and to add one more variation to the too many variations already existing in current practice. Any such course would have to be hedged around with requirements for showing the effect of the change.

Again, until the situation is more fully understood generally, a basic change of this nature, it is felt by many, would tend to confuse readers of financial statements and nullify in the public eye many of the gains already made towards the clearer presentation of financial statements.

Whether a net gain or a net loss would result from a basic change in accounting procedure depends upon the relative weight which the individual gives to the advantages and the disadvantages which it would bring. The whole subject has been given intensive study by the committee on accounting procedure. It will continue to receive the consideration of the Study of Business Income group, which is sponsored by the American Institute of Accountants and financed jointly by it and the Rockefeller Foundation. This is a study group comprised of businessmen, economists, lawyers, statisticians, and others, as well as accountants.

At the present stage there seems little doubt that the majority view, both within the profession and among users of financial statements outside the profession, is that the disadvantages of a basic change outweigh the advantages it would bring, that inflation has not yet proceeded to a point where original dollar costs have lost enough of their practical significance to warrant or require their restatement in terms of a depreciated currency, and that public acceptance, and perhaps also ac-

ceptance by the taxing authorities, as well as a more general understanding of the effects of inflation, based on further study, are necessary if such a change is to be accepted and not misunderstood. They raise the question whether, in the words of the poet, we should not

“. . . rather bear those ills we have  
“Than fly to others we know not of.”

There is no doubt, on the other hand, as to the existence of a desire that additional financial information bearing on the subject be given. People want to know how the earnings and the position of an individual enterprise have been affected by monetary inflation. Such information would add materially to the usefulness of financial statements and should be encouraged. It would aid also in bringing about a more general understanding of the situation.

Experimentation will undoubtedly develop means of doing this. Some companies which are greatly affected may go so far as to include supplementary statements, restating their earnings and their investment in terms of current dollars. Others may show the extent to which profit must be retained to provide for replacement of inventories and productive facilities and the extent to which such expenditures exceed historical costs charged against income. This will tend to measure the inflationary profits included as income. Accountants should encourage such supplementary data directed towards making the statements more useful and more informative. Stockholders, employees and the general public should be informed that a business must be able to retain out of reported profits amounts sufficient to replace productive facilities at current prices if it is to stay in business.

Further, inflationary profits, even if we consider them as real, and recognize them as realized, are not on a par with operating profits. They deserve separate identification. To give supplementary information which will accomplish this will increase the usefulness and the value of financial statements.

# Organization and Administration of an Accounting Firm

## Organizing and Perpetuating An Accounting Partnership

by *Ira N. Frisbee, CPA*

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**T**HE FORMATION of an accounting partnership is a result of a natural desire of man to provide permanence and continuity for his professional activities. Under state laws, corporations cannot be formed to engage in accounting; the partnership is the only alternative to a sole proprietorship. Yet many clients of a sole proprietorship are corporations and the lives of these organizations are not limited by physical frailties. How can an accounting partnership be organized to provide a reasonable certainty of survival to serve the organizations having unlimited lives?

In considering the partnership organization, we must recognize that it provides for a very personal relationship. The partners must be mutually agreeable and willing and able to cooperate. Sometimes the relationship will prove to be very trying and will test the very character of the partners themselves as much as their accounting and business ability. It will

measure their judgment, reveal their greed, prejudices, and pettiness, and show whether they are large or small persons.

Provision can be made in organizing a partnership to avoid many disturbing questions or disputes. The articles of copartnership should be written to cover all sources of disagreement that can possibly be removed or settled upon at the inception of the partnership, with provision for amendments when needed later. These articles should state the business purpose, the period of time, the name and place of business, the amount of the respective capital contributions, and the division of profits. Also, they should determine the restrictions to be placed upon activities outside the partnership, the allocation of partners' votes upon various matters, and the accounting methods to be followed in maintaining the partnership books. Provisions should be included as to the retirement of partners and the effect of the death of a partner.

Our discussion will consider the problems just enumerated, chiefly from the point of view of small or moderate-sized firms. Also, it may be well to note that the importance of some of the problems

will vary depending upon whether a partnership is formed to combine the practices of two or more practitioners or is formed by admitting one or more employees as partners. Particular emphasis will be given to the problems that accompany the admission of employees to partnership and their advancement to greater participation in the profits and capital.

Some of the provisions of the partnership agreement do not involve serious problems and can be determined without controversy between the contracting parties upon the formation of the partnership. Nevertheless, these provisions later may become very important, particularly if disagreements arise. Disputes have a tendency to grow and spread into areas in which mutual understandings were assumed to exist but unfortunately were not reduced to writing. For example, a statement of the types of business or professional activities to be carried on, the duration of the agreement, the exact name of the organization, and the place or places of business may not appear to be important at the inception of the partnership. However, circumstances may arise to cause or to accentuate misunderstandings if these provisions are omitted.

The statement of the business purpose should specify in rather a general manner all of the usual activities of an accounting practice in which the partners are likely to engage, unless there is reason to exclude any activities. Also, it would appear desirable to specify not only the business of certified public accountants, accountants, tax consultants and advisors, but also such activities as bookkeeping, business management, and business or financial consulting or advising. Otherwise, it may be contended later by a partner that the business of public accounting does not include various advisory positions and such management occupations as treasurer, trustee, receiver, or administrator which are important services that may be included at least temporarily as a part of an accounting practice.

As to the duration of the partnership, the term to be specified probably is of limited significance. The chief purpose

in stating a term is to provide a definite date for reviewing the agreement and for determining whether changes are to be made in renewing it. Some firms have attempted to provide for perpetual existence by specific provisions that death, incapacity, or retirement of partners do not dissolve the partnership unless the remaining partners unanimously agree to dissolution. This point of view recognizes that an accounting partnership is to be entered into by the partners much as they would enter into the state of matrimony, namely, until death (or old age) "us do part." Other partnerships have provided short periods of duration, such as one year, with the apparent attitude that the marriage will be reviewed and renewed, either "as is" or with changes in the agreement. Both points of view are tenable; a period of, say, ten years has some merit as one that recognizes the latter point of view and yet makes the specified term so long that "divorce" will be less likely.

Provisions as to the partnership name and the city or cities in which offices are to be maintained present no particular problem. It should be mentioned in the agreement that the name may be changed by amendment of the partnership articles and that other places of business may be added by agreement, so that a new partnership agreement will not be required on such occasions.

Turning now to what we may term strictly "mercenary" problems of operation, we have the matters of (1) capital investment, (2) drawings and divisions of profits, and (3) restrictions on outside activities of partners.

One of the first questions that may arise when a sole proprietor decides to take in an employee or employees as a junior partner or partners is: what capital is to be invested by them, or is it necessary that the new proprietors make any capital investment? Actually the amount of capital required is relatively small. There should be no problem of financing the partnership if the sole proprietor was able to finance his own operation because no greater capital should be required upon promoting an employee



to a partner. The question is important chiefly from two points of view: namely, from the standpoint of perpetuating the partnership, and in order to recognize and purchase a share of the existing goodwill. As to the former, is it necessary that junior partners contribute any capital at all? No doubt many senior partners find it more convenient to furnish all of the initial capital rather than to compute a formula for the respective contributions. Nevertheless, if this condition should continue indefinitely, junior partners may never come to regard the business as partly theirs. Therefore, it can be argued that capital contributions should be made pro rata by all partners from the inception of the association.

On the contrary, the real result of a junior partner's contribution of capital may be to effect a sale from the senior partner who has been operating the business, inasmuch as no additional capital should be needed. This usually imposes some hardship on the junior partner if he is to pay even as little as \$1,000 as his contribution, and it probably benefits the senior partner very little if at all. In the opinion of this writer, such an *initial* contribution of capital is unnecessary; the junior partner or partners can agree to furnish their share of *additional* capital as and if it is needed in the future. In the meantime, they will share in the profits and in this way have an interest in the most important asset of an accounting business—the ability to earn these profits, which we term "goodwill." Also, it does not seem desirable for a sole proprietor to charge his employees with a value for the goodwill upon their entering the partnership. Presumably these employees have had some part in creating the goodwill. Then, too, particularly in a small business, goodwill is not necessarily permanent; continued effort is required to maintain goodwill. Furthermore, although goodwill is measured by the profits earned, there may be other factors of a temporary nature that have caused a part or all of the profits. In prosperous periods an accountant's earnings may be large chiefly because his clients are expanding, or even over-ex-

panding, and because they are enjoying a temporary feast of business which may be far in excess of normal conditions.

These last arguments do not apply in the same degree to large accounting firms that have created a relatively permanent goodwill factor by reason of a wide and long-established reputation for able performance and who have a diversified clientele spread over many states or countries. It is logical for such firms to value their goodwill and to charge new partners something for it inasmuch as it is relatively stable and can be expected to withstand business vicissitudes.

As to the problems of dividing profits and fixing monthly salaries or drawings, no partnership agreement is likely to provide for the exact details in a permanent fashion. Yet we all know that this is the most important matter in the thoughts of nearly all, if not all, of the partners. In small organizations, particularly, jealousies and even greed may cause disrupting dissatisfaction. How can an agreement eliminate these dissatisfactions?

The initial agreement can provide definitely the manner of dividing profits in the first year and also the amounts of monthly drawings. It can and should set a pattern for later periods. Also, it should provide a method of deciding on changes in profit sharings as the junior partners assume greater responsibilities and become more valuable. But usually it cannot provide permanent profit-sharing ratios if junior partners are assuming greater duties and senior partners are becoming less active. This possibility can be recognized in the agreement by specifying that the drawings and the profit percentages will be adjusted by vote of the partners, with a specification of the votes to be allowed to each partner for this purpose. Even though a majority of the votes may be allotted to the senior partner or partners who may be entitled to make the final determination, such a provision allows for a more complete discussion and review by all of the interested parties.

Details of the profit-sharing arrangements probably vary among accounting

partnerships more than many of the other provisions. In a study made in 1947 by a special committee of the New York State Society of Certified Public Accountants, some twenty-six accounting partnership agreements were reviewed. The provisions covering compensation, drawings, and profits varied considerably, although in a number of cases a fixed drawing was specified for some or all partners and varying percentages were assigned to each for the balance of profits. A regular monthly income as a part of the profit division seems rather essential; usually this can be fixed at a very conservative total sum well below the expected annual profit, so that something of a melon can be cut, perhaps once or twice during the year, although something should be reserved for possible losses during the remainder of the year.

Some agreements provide for extra shares of a portion of the profits to partners obtaining new clients and charge them similarly for the loss of clients. Some specify the number of hours for a base share of profits, with an additional share for excess hours. These and similar charges and credits would appear to be unjustified in the usual partnership. The obtaining of clients and the number of hours of chargeable or of total time do not necessarily indicate the value of a partner. To make special provisions for profit sharings on such bases is likely to increase jealousies and misunderstandings when more important contributions or services by other partners are not recognized.

Closely related to the problems of profit sharing is that of outside activities of partners. The agreement ordinarily should provide that the partners shall give and devote their entire time to the partnership unless exceptions are made in the initial agreement or are allowed subsequently by unanimous vote of the partners. Except for partially retired partners, usually it is not desirable that partners engage in other activities unless related to and at least indirectly beneficial to the partnership. Teaching and writing are examples of occupations

which may benefit the partnership and the compensation received may be excluded from the partnership earnings.

The prohibition of outside activities may be important also because of detrimental effects from an association with speculative and questionable ventures. Although a partnership agreement cannot regulate the business ventures of the partners, it may have some effect in preventing involved financial dealings if the partnership requires relatively the full time and attention of the partners. Also, provision can be made in the articles of copartnership to prohibit partners from giving or going on a bond or surety for other persons without the partners' consent. This both is a financial safeguard to the other partners and may give them an opportunity to inquire into the financial dealings of their partners.

Turning now to problems of partnership management, we find that it is desirable to specify in the agreement the distribution of votes among the partners for various purposes but that the number of votes each partner is allotted may vary according to the matter to be voted upon. Specifically, it is well to indicate the votes each partner shall have with respect to (1) business policies; (2) profit sharing; (3) admission, withdrawal, or removal of a partner and/or complete dissolution; and (4) amendment of articles of copartnership.

In large partnerships with many partners, the respective interests may be represented by shares and the voting on some questions may be according to the number of shares held, although on other matters the partners may have equal votes. If there are more than about six partners, it probably will be best to have a managing board or committee of from two to five partners with one of the board selected as the managing partner. Members of such a board preferably should be selected annually and each board member should have one vote on board matters regardless of the number of shares he holds in the partnership.

In relatively small partnerships, and particularly where employees have been invited to partnership as junior partners

with a senior partner or partners, a majority of the votes may be retained by the senior partners. For example, in one partnership composed of a senior partner and several junior partners who were formerly his employees, the senior partner has a vote equal to the votes of all the other partners combined as to matters of business policy, profit sharing, amendment of the articles, and the dissolution of the partnership. Thus, in these matters, the senior partner and any one other partner will constitute a majority and yet a majority vote cannot be obtained without the vote of the senior partner. However, no junior partner can be removed from the partnership without the unanimous vote of the senior partner and all partners other than the one being removed. At first thought, it may appear that a senior partner has reserved a great deal of power if his vote equals the votes of several junior partners. Yet this power probably is more potential than real, because all of the several junior partners must be convinced that the decisions are fair and equitable if the partnership is to survive. However, if there is only one junior partner, it is probable that the "old man" will continue to dominate the business until he retires, both because he will not give up one-half of the voting power and also because one junior partner alone usually cannot throw as much weight into an argument as several partners.

Accounting partnerships are not likely to fail to maintain books of account, but it is well to provide whether these shall be on a cash or an accrual basis and what fiscal year shall be adopted. The writer is not one who always favors a complete accrual basis for small professional partnerships. For example, it may be reasonable to omit the costing of work in process either on an actual or an estimated cost basis. Large organizations no doubt need to set up currently the cost of the work in progress in order to measure the income in relation to expenses and to obtain efficient management of the staff. But to maintain a work in process ledger for a small partnership, except for the hours of time and the in-

cidental expenses paid, requires accounting that may not be justified in managing a small business. It will be argued that profits are misstated when not even an estimate of the labor costs is set up for the work in process. But if the fiscal year has been chosen carefully, the unbilled work in process of a small partnership will be at a low ebb at the close of the year. Also, it is likely to approximate about the same total at each fiscal year-end so that each year's profits are not likely to be distorted, although a continuing profit reserve will exist in about the same sum from year to year. No doubt the above suggestion is subject to severe criticism from those who insist on costing each engagement. But in a small accounting office, particularly, it is not possible to maintain a uniform spread between the labor cost and the fee charged. Then, too, some engagements in a small practice, such as the preparation of tax returns, are too small or too specialized for significant cost data.

The fiscal year to be adopted is a question for the individual partnership. It will be well to consider a time after the worst rush period is over and also after the vacations are completed. September and October appear to be logical months for the end of the year for many firms.

It should be provided that the books and records will be open to inspection personally by any and all partners at any reasonable time. Also, it may be provided that the partners' accounts will be deemed to be correct unless challenged within a stated period after the close of the year.

Turning now to problems more directly related to perpetuating the partnership, we should consider the arrangements to be made for the retirement of partners. At what age should they retire, should retirement be voluntary or compulsory, and should it be complete or partial as to capital, profits, and management?

The answers to these questions will vary, partly because of differences in people and also because there are differences in the problems of large as compared with small partnerships. In the

large firm, there is much to be said for a compulsory rule or at least an unwritten understanding as to the age for retirement. Also, that age might well be set rather low, at approximately sixty, rather than sixty-five or seventy. If the firm has given adequate attention to training and developing partners, replacements will be available who are likely to be physically more able and eager to undertake the responsibilities of a large accounting partnership. Retirement at or before sixty should afford the retiring partner an opportunity to adjust himself to a less strenuous and yet an active and interesting life, which is an adjustment that usually is more difficult the longer it is delayed.

In a small partnership, specifying a definite age for compulsory retirement probably is not as common as in the very large firms because the partnership adjustments accompanying the retirement cannot be provided for so readily. From the standpoint of the individual partner the reasons for his early retirement still endure; he also is entitled to relief from the rigors of active participation in a public accounting firm. But if he has had a major part in building up the clientele and in managing the firm, it may not be easy for him to effect a complete retirement merely because he has arrived at a certain age. Also, his associates may not be ready to let him go. Replacement may not be easy, either because his associates cannot agree as to which shall step into his shoes or as to how to divide his duties, or because there is no partner strong enough to assume the head position and hold the group together. Actually, the lack of a replacement may be more imaginary than real; on the other hand, it may prove to be real when it was thought that no problem existed.

It may be difficult to weigh the advantages of voluntary against those of compulsory retirement in the smaller firms. Either decision may prove to be wrong. Usually, however, it would seem best not to compel a complete retirement at a definite age. Instead, a gradual retirement may be the best plan and the time of starting and completing such retire-

ment may well be either at the option of the retiring partner or of his associates. In small partnerships, the fact that some men are very old at sixty while others seemingly are not old at seventy is quite important.

Retirement should provide for the disposal of the capital interest of the retiring partner without causing financial difficulty for the remaining or incoming partners. To accomplish this, payments may be spread over several years. All assets of the partnership, including the value of work in process, should be properly recorded to determine the value of the interest in capital. Also, when the retirement is complete, it would seem that there should be no continuing interest in the profits; however, the speaker who follows on this program may present reasons for a contrary decision. Provision for a retirement salary or consulting fee does seem desirable, both from the standpoint of the continuing partners and from that of the retired member. Without such provision, retirement may be postponed or resisted by the member to be retired. Ordinarily, this provision for a continued remuneration and an opportunity for some association with his firm is owed to a man who has carried heavy responsibilities in building or maintaining a successful practice. Such an arrangement naturally should remove the possibility of an economic need for the retired partner to join any other firm or to engage in any way in a competing practice.

When retirement occurs by reason of death or incapacity of the partner, settlement with his estate may be as of the date of death or it may be at the close of the partnership year, if the agreement so provides. The close of the year is the more convenient time from the standpoint of the continuing partnership, but this provision gives the estate an interest in the profits or losses of the period from date of death to the close of the fiscal year, or perhaps for a much longer period, if so provided. Provision may be made for the continuity of the partnership by an article in the agreement to the effect that dissolution is not to occur

by reason of the death, incapacity or retirement of any partner. Obviously such a statement does not guarantee a permanent survival of the partnership but it does strengthen the intent of the parties.

Sometimes the partnership agreement provides for appraisals of fixed assets by qualified appraisers. This may not appear to be justified unless the partnership owns more than the usual equipment and library. However, in view of the current high prices now prevailing, there is much justification for the opposite position that the partner's estate should be paid for its share of the sound replacement values. In addition to office equipment, there are many items of supplies that may have been written off as expenses but in total constitute a sizable asset for inclusion in the valuation of a deceased partner's interest.

As to work in process, there are differences of opinion as to the proper basis for valuation. It may be provided that, following the death of a partner, the estate will receive the partner's share of the entire profit realized upon completion of each job in process. A more equitable arrangement, however, will provide that the estate shall receive a proportion of the final profit on each job which is to be determined by finding the ratio of the standard billing price for the work in process at death to the entire standard billing price of the completed job.

We now come to the problem of valuing goodwill, which must be considered upon the retirement of living partners as well as upon retirement by reason of death. Although it may be argued that the goodwill of an individual professional man ceases at his death because of the personal service character of his work, it is difficult to prove that the personal service organization which he has built has no goodwill value. Large accounting firms continue to prosper because of the policies, the internal organizations, and the reputations which have been established and to which individual partners have contributed. To say that such an organization as a whole has no goodwill that can be passed on to subsequent own-

ers cannot be justified. On the other hand, if a firm is so small that a large portion of the work is dependent upon the efforts of one partner, there may be little if any continuing value of goodwill after his death. In every personal service partnership it must be recognized that the goodwill can fade and even disappear rapidly if the work does not measure up to standard. The surviving partners are given an opportunity to render proper service only as long as their performance is adequate; the continuing prosperity is by no means automatic for an extended period.

Under the condition of a gradual retirement of a living partner for whom a salary is provided after retirement, the need for goodwill valuation is not acute. In such a situation, during the period of the partial retirement, a successor partner or partners are to be developed to carry on the business and to increase the goodwill. But for a retirement that is to occur entirely at a definite date, a valuation formula should be set forth in the partnership agreement, particularly if the retiring partner is a founder of the business. A common basis is to take as the goodwill value from one to two years' profits, computed by finding the average annual net income for the past three or more years. Such an amount may be varied according to the number of years the partner has been in the firm, or for other reasons, and often it includes his share of the entire income, including so-called partners' salaries and interest on investment, rather than the excess of profits over salary and interest.

A rather interesting and seemingly fair method of paying for goodwill is on the basis of a reducing percentage of the gross fees in subsequent periods. Thus, as high as eight per cent of the entire gross income might be paid the first year after retirement or death and one per cent less in each succeeding year, such as seven per cent the second and six per cent the third, until eight years have elapsed when no more payments are to be made. Although the payments are based upon gross income they do not qualify as an expense of the continuing

partnership but are to be treated as a purchase of goodwill. From the standpoint of the retiring partner or his estate the plan may have considerable appeal because a larger total payment will be expected under such an extended plan than would be received if settlement were in a lump sum. The burden of payment by the remaining partners should be lighter because of the deferral over several years and also because the amount depends upon the volume of work obtained.

The lump sum settlement, based upon a valuation formula that depends upon past profits, appears to be quite common and it has the advantage that there is a definite determinable goodwill value for estate tax purposes. Leniency in the provision for payment can be provided by permitting several semi-annual, or even annual, payments.

If there are not many partners and only the problem of valuing and paying for goodwill at death is to be considered, the writer believes the best plan is to have the partners take out term life insurance on partners other than themselves, if they are insurable, in amounts adequate to pay for the goodwill interest of such partners which can be specified in a purchase and sale agreement or in the partnership articles. Frequent review of the adequacy of the policies should occur in order to have the goodwill valuation related to current profits, and the new valuation should be inserted in the purchase and sale agreement or in the partnership articles. The important advantage of the plan is the pay-as-you-go feature which insurance provides when there is lump sum settlement for goodwill. Payment of a definite sum is assured to the estate of the dying partner, yet no burden is placed upon the remaining partners.

Thus far, we have been considering provisions that may be placed in a partnership agreement to avoid later misunderstandings that may result in dissolution, and also the provisions that may help to perpetuate the partnership after death or retirement of a partner. We must not fail to recognize that there are

many other problems in operating an accounting partnership which cannot be covered adequately in the partnership agreement. Although these problems cannot be discussed fully in the time allotted, attention may be directed briefly to a few.

First, there should be a division of duties and responsibilities, with a delegating of authority for such matters as office management, staff assignments, hiring of staff, and the assignment of partners to engagements. Then, too, it is important to have meetings of partners often enough to hold the group together and to give them opportunity to discuss grievances or differences, as well as to formulate policies.

Although the partnership agreement can provide rather definitely for a division of profits, it probably cannot anticipate adequately the proper division in the case of an extended illness of a partner, caused by overwork on a heavy assignment or for other reasons. Also, what participation shall be allowed a partner while in the armed forces or during some other public service? Even the increasing participation in profits to be allowed to junior partners should not be fixed unalterably but may be settled annually if the agreement so provides, thus avoiding frequent amendment of the articles.

The method of valuing goodwill for certain purposes may be specified in the partnership agreement. But when new partners are admitted the measuring of goodwill may offer a different problem. As previously suggested, if the new partner is an employee who has given many years of service to a small partnership, the charge for goodwill may be omitted, or at least it may be nominal. If, partners enter from outside, as from their own practice or from a government agency, even though they may be presumed to bring with them particular earning capacities, a charge for goodwill may be justified if there is a recognized differential in the respective contributions of the partners as compared with their profit sharing.

Even the matter of compulsory or optional retirement and the details of such

retirements cannot be fixed with rigidity. Large firms have the best opportunity for an unviolated plan. They do not want any partner to become an indispensable man. In small or medium-sized firms, one or more partners may be of great importance at the outset but the relative statures may change in later years. Therefore some flexibility in arranging retirements is needed and it may become desirable ultimately to have a compulsory retirement plan not previously contemplated. Usually there must be a balancing of retirement provisions to encourage retirement sufficiently and yet to leave adequate profits and capital for the remaining partners distributed according to their ability and efforts.

To summarize our discussion, we may conclude that many partnership misunderstandings can be avoided by having a

carefully prepared agreement stating explicitly the rights and responsibilities of the partners. Nevertheless, many important provisions affecting future years cannot be included because the attending conditions cannot be foreseen. Some of these conditions concern the health, ability, energy and personality of each partner. Other situations that affect the permanence of a partnership are related to general economic conditions, such as booms and depressions, price inflation or deflation. For example, a retirement plan adopted far in advance of retirements may fail to consider the effects of price inflation or price deflation. While the partnership agreement can be rigid in some respects, it must recognize that human and economic fluctuations may require new decisions on important partnership problems.

## Tax Aspects of the Partnership Agreement

by Charles F. Coates, CPA

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### Partnerships for Professional Practitioners

IN CONSIDERING the form of a practice organization of certified public accountants, attention naturally centers toward the formation of a partnership in order to place full responsibility for their acts upon practitioners so joining together. Rule 11 of the rules of professional conduct of the American Institute of Accountants forbids its members from engaging in the practice of

public accounting in corporate form. Many of the states have statutory prohibition against either the practice of public accounting or the use of the designation "certified public accountants" by corporations. Likewise, some state organizations of certified public accountants prohibit corporate practice of public accounting to its members.

Although partnerships are not subject to federal income taxes, Section 187 of the Internal Revenue Code, requires a partnership return for each taxable year, sworn to by one of the partners, to be filed whether or not transactions of the partnership result in net income. Each partner includes in his individual return his share of certain items appearing on the partnership return, whether distributed to him or left in the partnership.

## **Tax Concepts of Payments Made Upon the Death or Withdrawal Of a Partner**

As compared to a partnership, in theory of existence, a corporation is regarded as a legal entity distinct and separate from the stockholders composing it, and is so treated for federal income-taxation purposes. The law endows a corporation with legal personality. The death or withdrawal of a stockholder in no respect affect the corporate existence.

A partnership can be created by agreement of its members and may do anything which is not unlawful. However, a partnership lacks the "continuity of being" inherent in a corporation. Under normal conditions, if a partner dies, the partnership ceases. If a partner sells or otherwise transfers his interest in the firm, the partnership is automatically dissolved. A new partnership may be formed by the surviving partners.

As previously stated, practicing certified public accountants, by virtue of their relation to the public and professional development, cannot avail themselves of the corporate form of organization. Therefore, a professional practitioner ordinarily does not create a business which can produce income for his dependents after death. After a lifetime of practice, the only assets available for realization in a public accounting partnership may consist of little more than used office furniture and equipment, possibly a few second-hand textbooks plus his uncollected accounts and work in process.

In order to avoid disruption of the business resulting from such liquidation, the partners, while all living, may provide by contract for the continuation of the business despite withdrawal or death of a partner. Thus, for both economic and social reasons, partnership agreements providing for the continuation of the business upon death or withdrawal of a partner have become relatively common. The forms of such agreements vary but, from the standpoint of Federal income tax consequences, they may be classified under two general headings

- (1) those under the "purchase concept,"
- (2) those under the "income concept."

The Internal Revenue Code and Regulations have not clarified the treatment of cases arising under such circumstances and it has been obvious that the approach of the Commissioner of Internal Revenue has been to attempt to collect the highest taxes possible, irrespective of being consistent from case to case.

Courts have applied the "purchase concept" when there has been surrender by the decedent of valuable property recognized as such by the parties and the intention of the parties to effectuate a purchase and sale, supported by language of the partnership agreement expressing the transactions in terms of purchase and sale.

In cases where the partners, while all living, have agreed, in event of decease of a partner, to continue the business and distribute a share of post-death net earnings to the deceased partner's estate for a period of time, the courts have applied the "income concept."

## **Decisions Under "Purchase Concept"**

Following are some of the cases under the "purchase concept," which resulted in the surviving partners being subject to individual federal income taxes upon all the net income of the partnership out of which payments were made to the estates of the deceased partners.

In the case of *Arthur K. Pope v. Commissioner*, 39 F (2d) 420, decided in 1930 involving a fire insurance business, payments were made to the estates of members of a former partnership pursuant to a new partnership agreement between two surviving partners and three new individuals, such payments representing a share of new partnership profits. The Court held the partnership agreement effected a sale of the interests of the two estates to the new partnership.

In the case of *Willard C. Hill*, 14 BTA 572, decided in 1928 involving an insurance agency and brokerage business, the partnership agreement provided, upon death of one partner, there should be



paid to his estate for a period of years a share of partnership earnings to which deceased would have been entitled if living and upon completion of such payments the business became the sole property of the surviving partners—the Tax Board held that the partnership agreement provided for sale of the deceased partners' interest to the surviving partners.

In the case of *Stephen J. Callahan*, 14 BTA 584, decided in 1928 involving a general fire insurance business, the partnership agreement provided, upon death of any partner, surviving partners should have an option of purchasing the deceased partner's interest, payment to be a proportionate share of the deceased partner in earnings of business for three years succeeding death, or a cash payment. Upon death of two partners, survivors organized a new partnership with three new members, and it was agreed estates of deceased partners would be paid a fixed percentage of profits of the new partnership for three years, but such estates would assume no responsibility under the new contract. This arrangement was agreed to by the executors of the estates and distributions were made to them. The estates were also paid amounts which the two deceased partners had contributed to the capital of the old partnership. The Tax Board held that upon death of the two partners, the partnership was dissolved; the estates were not members of new partnership and amounts paid to the estates were for sale of the deceased partners' interests.

In the case of *Raymond S. Wilkins*, 7 TC 519, decided in 1946 involving a law partnership, the partnership agreement provided upon any partner's decease, payment to his estate within one year of an amount equal to one-fourth the amounts distributed to decedent during the two years preceding his death. The Court held, payment so made at an arbitrary figure, regardless of period in which earned, was equivalent to purchase of a receivable by the surviving partners and all fees collected during

period of settlement were taxable to the surviving partners.

In the case of *Arthur C. Hillmer*, 27 BTA 1165, decided in 1933 involving a general brokerage business, the partnership agreement provided, upon death of one partner, there should be paid to his estate, in partial satisfaction for the assets so acquired, a percentage of the net profits of the partnership for a period of years—the Tax Board held that the payments were the personal obligations of the surviving partners.

In the case of *W. Frank Carter*, 36 BTA 60, decided in 1937 involving a law partnership, the partnership agreement provided, upon death of any partner, his estate should receive a sum equal to one-half of the amount received by the deceased partner during the two calendar years next preceding his death in payment of his interest in the firm and its assets—the Tax Board held the payment was a sale.

In the case of *Bavier C. Miller*, 38 BTA 487, decided in 1938 involving an insurance business, the partnership agreement provided, upon death of a partner, his interest would cease and be divided per capita among the surviving partners, who were to pay to his estate, in monthly installments, the deceased partner's share of earnings up to date of death and for thirty months thereafter—the Tax Board held the payments to represent the purchase of the deceased's partner's interest.

In the case of *Estate of George R. Nutter*, 46 BTA 35, decided in 1942 involving a law partnership, affirmed on other grounds sub nom. *Edward F. McCleunen, et al v. Commissioner*, 131 F (2d) 165, there was an investment of capital in, and tangible property owned by, the partnership; there was a clear recognition that each partner had a valuable capital interest in the partnership assets. The gross estate included the value of a contract between the partners providing for payments of a percentage of net profits of the succeeding partnership for a certain period after death, as consideration for the deceased partner's interest in capital, assets, receivables, possibilities and goodwill of

the firm. The Court held that such payments after the partner's death were not income of the deceased's heir to whom it was distributed.

### Decisions Under "Income Concept"

The "income concept" has been applied in decisions where, upon the death of a partner, by partnership agreement contracted during his life, his estate continues as a partner or becomes a partner in a new partnership and such participation in post-death earnings is not for the purpose of purchasing the interest of the estate.

In the case of *Bull v. United States*, 295 U.S. 247 and 55 Sup. Ct. 695, decided in 1935 involving a business of ship brokers, the partnership agreement provided that, in event of death of a partner, the survivor should continue the business for one year thereafter, and the estate was to share profits and losses in the same manner as if the deceased partner was living. It was held that the Commissioner erred in asserting an estate tax upon the estate's share of post-death income, which was paid in 1921, and subject the same amount to income tax in the hands of the estate which was paid in 1930. Suit for recovery of both the income tax and estate tax was instituted in 1930. Although the statute of limitations for bringing suit had expired, the Court held the estate tax recoverable on the grounds that in the claim for income taxes asserted by the government in 1925, the taxpayer was entitled to recoupment for the estate taxes because retention of the money by the United States was against morality and good conscience. The Supreme Court concurred with the Court of Claims decision that the amounts paid to the estate as profits after the decedent's death were income to the estate.

The Supreme Court's decision led the Income Tax Bureau and even the Board of Tax Appeals to believe at that time that post-death income-sharing agreements afforded a method of tax avoidance in that they felt the decision permitted

only an income tax upon the estate in a post-death "income-sharing arrangement," whereas in the case of a "purchase arrangement" an income tax could be imposed upon the survivors and an estate tax upon the decedent's estate. Because of that interpretation, the Bureau thereafter was inclined to hold that a "purchase arrangement" was present in every borderline case. This interpretation was clarified in the case of *Estate of George R. Nutter* 46 BTA 35, affirmed by the First Circuit, wherein the Court pointed out that the Bull decision prohibited an estate tax upon the identical money which the estate received as income, but the decision did not preclude estate tax upon the value of the right of the estate to receive post-death partnership earnings, which under the partnership agreement were paid expressly for the deceased partner's interest in the partnership.

In the case of *Walter T. Gudeon*, 32 BTA 100, decided in 1935 involving a life insurance agency, an agreement required a general agent to pay to a deceased partner's estate certain amounts based on renewal commissions on business written before his death. The Tax Board held that the net income taxable to the surviving partners was the net earnings from all commissions less the amount required to be paid under the contract to the deceased partner's estate.

In *Gussie K. Barth*, 35 BTA 546, decided in 1937, the petitioner was the widow of a lawyer who had been a member of a law partnership prior to his death, under a partnership agreement which provided that the partnership should not be immediately dissolved upon the death of a partner, but his interest therein should be determined by payment to his widow or estate over a period of three years of certain stipulated percentages of the profits to which the deceased partner would have been entitled if he were living. It also provided for continued individual ownership of capital assets. The surviving partner continued the practice of law, under the old firm name, and made the payments provided for in the agreement. Taxpayer reported

these amounts as income and later claimed overpayment on the ground that the payments were capital items, received by her as consideration for the sale of her husband's interest in the firm pursuant to his contract with his surviving partner. The Tax Board held the amounts received by the taxpayer did not represent capital payment, but that they were properly treated as income.

The case of *Richard P. Hallowell, 2nd*, 39 BTA 50, decided in 1939, involved a partnership engaged in marketing wool. Capital was essential to the business and each partner made substantial contributions. The partnership agreement provided that, in the event of the death of a partner, the partnership should terminate after six months, or earlier by notice of a majority of survivors, but that all of the survivors might elect to continue the partnership as to themselves until the end of the period prescribed for the life of the partnership in the articles or until the interest of the deceased partner terminated, whichever was longer. It was provided that during the continued existence of the partnership the estate of the deceased partner should continue to have the same interest in the profits and be responsible for the same share of losses as the deceased partner would have had or borne, had he lived, but that the estate should have no voice in the management of the business. The agreement further provided for the method of determination and settlement of the capital interests of the partners. The controversy involved the Commissioner's treatment of all partnership profits after the partner's death as income of the surviving partners. The Tax Board felt it was unnecessary to decide whether the estate was or was not a partner during the period in question, since, in any event, it was clear that the estate had a direct right, by virtue of the partnership agreements, to a share of the partnership income as such.

In *Estate of Hunt Henderson*, 4 TC 1001, decided in 1945 involving a sugar refining business, where provision in partnership agreement was made for continuance of partnership for one year

after date of death of partner, the Court held the deceased partner's share of profits and losses for fractional year belonged on the return filed for that period, and thus all remaining portion of accounting period belonged on return filed for his estate.

In case of *Estate of Frederick C. Bellingier*, Tax Court Memo Decision; Docket No. 4562 (Entered Feb. 14, 1946) involving a law partnership, taxpayer and his estate, after his withdrawal from a law partnership firm, received each year for two years an amount equal to the proportion of the firm's profits which he had been receiving during the period of his membership in accordance with the partnership agreement. The Tax Court held the payments taxable to decedent's estate upon the findings that decedent made no contributions to the partnership and had no assets or investment in the firm which they could have bought from him upon his retirement.

### **Charles F. Coates et al 7 TC 125 (1946)**

The *Coates* case is of particular interest to professional practitioners. It related to a partnership of certified public accountants and was decided by the Tax Court under the "income concept." It was reviewed by the entire Court without a dissent and was acquiesced in by the Commissioner of Internal Revenue.

*Essential Features of Partnership Agreement.* The partnership agreement provided that upon the death of a partner his estate would continue as a partner for five years and that the estate would be paid (1) the amount of his undrawn earnings or so-called capital at date of death, plus (2) a participation in the net earnings of the partnership for five years from the end of the month in which a partner died. The essential features of the partnership agreement are as follows:

1. Parties agree to become partners. Any partner may withdraw on three months' notice. Partnership books are kept on a calendar-year basis.

2. In event of withdrawal or death of any partner, it shall not operate to dissolve the partnership, but the estate of a deceased partner shall continue as a partner for five years from end of month in which death occurs. Partners may admit additional partners, but the death percentage of a deceased partner shall not be affected. To provide funds to finance partnership, undrawn earnings shall be treated as capital of the partnership. Provides for stated participation percentages in net earnings for each partner while living, and lower participation percentages in net earnings after death of a partner for five years.

3. Drawings during a year shall not exceed 85% of prior year earnings, but not to exceed partners' interest as shown by the books.

4. Partner's estate payments shall be made in equal quarterly installments, but finally paid for any year not later than the last day of February of succeeding year.

5. No partner shall engage in any business in competition or take any engagement that the firm might undertake or had declined to undertake.

6. In event of death of any partner, partnership shall continue as an existing partnership between surviving partners and estate of deceased partner. Capital interest of deceased partner shall be determined and settled as soon as possible, but not more than five years, from date of death in equal quarterly installments without interest. Upon the death of a partner, work in process shall be valued at twice the cost thereof, which increase shall be credited to capital accounts of deceased partner and surviving partners.

7. To effectuate more surely performance of contract and to protect the estate of the deceased partner, the partnership agreement constitutes a Trust Co. to be trustee for the several parties and their respective estates with stipulated powers, providing:

In the event of death of a partner and until his estate is fully paid under the agreement, surviving part-

ners will furnish monthly financial statements showing condition of affairs, partners' interests, amounts paid and unpaid under agreement, analysis of capital accounts of each partner.

Said trustee has power to examine books and investigate on his own account the condition of partnership for protection of the estate of a deceased partner.

Charges for services of trustee shall be paid by partnership. Said trustee at its discretion shall have power to require liquidation and immediate settlement in full with estate of a deceased partner, if not satisfied that letter and spirit of agreement is being faithfully performed, or interest of partner's estate is becoming impaired. The trustee is empowered to enforce the agreement by any action at law and in equity including appointment of a receiver.

8. If surviving partners fail to carry on and fully perform under the agreement, earnings and capital interests of estate of deceased partner shall first be paid out of liquidation proceeds, and balance of earnings interest remaining unpaid of the five years' period, established for a deceased partner's estate, shall be computed on the basis of average annual earnings of the two preceding calendar years.

9. In consideration of the terms of the agreement, surviving partners have the right to continue to use the name of the deceased partner in the partnership name as it was used immediately prior to his death.

10. In event of withdrawal of a partner, he forfeits all claim to death benefits and remaining partners may continue business under same firm name as theretofore, and upon payment of his interest, he shall not insist upon liquidation of the firm. In event of withdrawal, a partner agrees not to engage in public accounting directly or indirectly in Connecticut for a period of five years, nor serve in that capacity any then client of the part-

nership located within or without Connecticut.

11. In event of misconduct or inattention to business of the partnership, senior partners have right to elect to give written notice of the retirement of such partner forthwith, whereupon he shall no longer participate in the net earnings of the firm.

12. The partnership agreement was executed by the various partners and also the Trust Co. named therein as trustee to evidence its acceptance of the trust.

Between December, 1941, and November, 1945, three of the six partners signatory to this agreement died and in each instance there was a sickness period approximating two years prior to death. During this period two of the partners were paid their regular percentage participations in the net earnings of the partnership as though active, while the third, contemplating an extended sickness and in realization that his working days were over, agreed to reduction of his percentage participation to his death percentage stated in the partnership agreement without prejudice to the rights of his estate under the agreement.

When the first partner died in December, 1941, the estate appraisers decided the right to receive post-death earnings was too speculative to warrant valuation for estate inventory purposes and accordingly assigned no value thereto. Upon field examination of the estate return, the federal examining officer assigned a valuation to this contractual right to participate in post-death earnings based on the partnership earnings for the past five years, reduced however to present value because the payments were made from partnership earnings over a period of five years after death. The resultant additional estate tax was paid.

The income-tax returns of the surviving partners were field examined for the years 1942 and 1943 and the federal examining officer held that all earnings of the partnership subsequent to the death of a partner were taxable to the surviving partners. The surviving part-

ners and the estate of the deceased partner had made income-tax returns for those years including their individual share of income under the partnership agreement. The income-tax cases went to the Tax Court of the United States.

*Contentions of Internal Revenue Bureau in Coates Case.* The Commissioner of Internal Revenue, before the Tax Court, contended (1) that the payments of the partnership firm to the estates of the deceased partners from earnings after their deaths constituted income of the surviving partners, (2) the estates were not partners and the post-death payments did not constitute a distribution of partnership income as such, (3) only the living partners could render the personal services and they should be taxed for the income which they earned, (4) the post-death payments constituted a purchase by the surviving partners of a deceased partner's interest in the partnership, that the partnership firm had "goodwill" which had a definite value; a part thereof was the partnership name which had a value, (5) the treatment as income of the post-death payments out of earnings by the Court of Probate for the District of Hartford, Connecticut, was not binding upon the Tax Court.

*Contentions of Surviving Partners in Coates Case.* The contentions of the surviving partners before the Tax Court were: (1) post-death income of the partnership paid to a deceased partner under the partnership agreement was not the income of the surviving partners; (2) each partner agreed by written contract to percentage participations in earnings to each partner during his period of activity as a partner and for five years after his decease, provided he was a partner at time of death; (3) the partners each recognized that each contributed his share to the building of the firm and that some part of the income earned after death of any partner could be attributed to the time and skill which the decedent devoted to the firm during his lifetime; (4) each partner realized that he might be the one first to die and he was willing to place a contingent lien upon his future earnings in return for

his receiving such a lien upon the other partners' earnings for the benefit of his estate; (5) the partnership agreement was a contract made before death in consideration of the reciprocal commitments by all and was basically an agreement for the sharing of income, not a contract of purchase and sale; (6) the estates of the deceased partners were partners of the partnership together with the surviving partners by express terms of the partnership agreement; (7) the estates of the deceased partners share in post-death partnership earnings under the terms of the partnership agreement and surviving partners have no greater share in the partnership income than the partnership agreement stipulated; (8) the only income taxable to the survivors is the amount reserved to them by the agreement.

**Tax Court Decision.** The Tax Court decision was written by Judge Kern without any dissents. The Court quoted Section 182 of the Internal Revenue Code which provides:

"In computing the net income of each partner, he shall include, whether or not distribution is made to him. . . .

"(e) His distributive share of the ordinary net income . . . of the partnership . . ."

Reference was made to the case of *Bull v. United States* 55 S. Ct. 295 U.S. 247 and quoted from that decision as follows:

" . . . Where the effect of the contract is that the deceased partner's estate shall leave his interest in the business and the surviving partners shall acquire it by payments to the estate, the transaction is a sale, and payments made to the estate are for the account of the survivors. It results that the surviving partners are taxable upon firm profits and the estate is not. Here, however, the survivors have purchased nothing belonging to the decedent, who had no investment in the business and owned no tangible property connected with it. The portion of the profits paid his estate was therefore income and not corpus; and this is so whether we consider the executor a member of the old firm for

the remainder of the year, or hold that the estate became a partner in a new association formed upon the decedent's demise.

"Since the firm was a personal service concern and no tangible property was involved in its transactions, if it had not been for the terms of the agreement, no accounting would have ever been made upon Bull's death for anything other than his share of profits accrued to the date of his death . . . and this would have been the only amount to be included in his estate in connection with his membership in the firm."

Reference was also made to the cases of *Gussie K. Barth* 35 BTA 546 and *Richard P. Hallowell, 2nd*, 39 BTA 50 and with respect to the latter case said:

"We felt it unnecessary to decide whether the estate was or was not a partner during the period in question since, in any event, it was clear that the estate had a direct right, by virtue of the partnership agreements, to a share of the partnership income, as such."

With respect to the question of purchase or sale the Court said:

"The agreement in the instant case provided for the use of undrawn earnings of the partners as the capital of the firm, each partner to be credited on the books with the amount left by him in the business. This is the only 'capital' account the members of the firm had. The office equipment was fully depreciated, the library consisted largely of material renewed each year, and the leases were for short terms. All of these assets were of only nominal value and were not even considered by the partners in the negotiations leading to the execution of the partnership agreement. This agreement provided further for liquidation of the 'capital' account by payment to the estate of a deceased partner after his death of this 'capital' interest in the firm, computed as therein authorized. These payments have been or are being made, and are not the subject of this dispute. It was not the intention of the parties that any interest of a deceased partner be left in the firm, and none has been or will be left in the

firm after the expiration of the time allowed for the orderly liquidation of the capital accounts. Having provided for the return to the estates of any valuable capital interest the decedent had in the firm, it is difficult to find any evidence of an intention to sell that interest to the surviving members. Certainly no language of bargain and sale is used in the agreement. Although respondent feels that the deceased partners had a valuable interest in the goodwill and partnership name, it is apparent from the entire record that the parties to the agreement placed no value upon these items. Ordinarily no value, or nominal value, will be given to goodwill attaching to a personal service partnership such as one composed of physicians, attorneys or accountants. See 38 C.J.S., p. 952: Rowley, *Modern Law of Partnership*, Sec. 331. See also *D. K. MacDonald*, 3 TC 720. There is no evidence in the instant case which would justify a conclusion that the parties to the partnership agreement involved herein intended to make a sale of goodwill upon dissolution of the partnership by death, in return for payments to the deceased partner's estate out of income earned after his death. Since the instrument in question does not purport to make a sale of goodwill, upon liquidation, and since, according to general standards of value, the goodwill of this particular partnership would not be sufficiently valuable to be the subject matter of, or consideration for, a sale, we do not feel justified in assuming or reading into the agreement language from which we could spell out an intention to make a sale upon dissolution. . . .

"These payments were not made in liquidation of any capital interest of the deceased partner in the firm's assets. The only payments of this nature required upon the death of a partner were the payments on account of past earnings and work in process, here designated as the 'capital account.' In addition to these payments, the estate of a deceased partner was entitled to the payment of a share of post-death earnings, not in consideration of a sale of partnership

assets on liquidation, but in consideration of mutual promises contained in the original partnership agreement having no relationship to such a sale. These payments arose out of and depended upon the contract and their character must be determined by its terms. The estate acquired, upon the death of the partner, a vested contractual right to a share of the earnings, as earnings, and this right was fortified by a power lodged in the trustee to require a liquidation of the business if its rights were not fully respected by the surviving partners. When and as the income was earned, it became immediately subject to the pre-existing rights of the estates to their share of it. The amounts so distributable to the estates were not distributable to any surviving partner, with the result that here, as in *Richard P. Hallowell, 2nd*, supra, the disputed amount attributed by the respondent to each surviving partner may not be regarded as "his distributive share, whether distributed or not, of the net income of the partnership."

The treatment for income-tax purposes of the partners' estates of the valuation upon which the estate tax was paid remains to be decided. Claims for refund of estate income taxes have been made based on the contention that this right to receive post-death partnership earnings by the estates is in the nature of a wasting asset and the valuation placed thereon for estate tax purposes should be amortized over the five years of estate participation in such earnings. For protective purposes, in view of the statute of limitations, claims for refunds have also been made for the return of the estate taxes paid upon such valuation.

The claims for refund of income taxes paid by the estates based on amortization have been rejected by the Commissioner and suit has been started in the U. S. District Court of Connecticut. Trial has not yet been had.

It is the present understanding of counsel that the government would be willing to refund the estate tax paid on the valuation assigned to post-death partnership earnings.

# Coordination of the Colleges and the Profession For Placement of Accounting Graduates

by Victor Z. Brink, CPA

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**T**HE LINKING of the problem of coordination of the colleges and the accounting profession with the problem of placement recognizes the dependence which the profession has come to place on the colleges for new personnel. While there is still evidence of reluctance in some quarters to recognize the need for college-trained men, the college standard is fast becoming the accepted one by all reputable practitioners. It is fitting therefore that we should consider the means by which the profession can most effectively coordinate its activities with those of the colleges in the broad program of placement.

Sound coordination is always based on long-run mutuality of interests and this mutuality is particularly evident in the case of the accounting profession and the colleges. Both groups are interested in the development of well rounded, useful individuals. Thus the colleges are interested in preparing men who will achieve professional stature and who will make a contribution to the business and social economy. Similarly the profession is interested in everything which is done by the colleges to prepare its graduates for a successful professional career because of the dependence on the part of the profession for personnel of this type.

The study of the problem of placement has been a specific assignment of the newly formed committee on placements of which the writer has during the past

year been the chairman. The placement problem, however, immediately takes one into some of the broader problems and conditions which underlie and are related to effective placement. These broader areas involve the work of the committee on education and the committee on selection of personnel. The reports of all of these committees have been made available through the publications of the American Institute of Accountants but many of the matters discussed in them will necessarily be involved in the present considerations.

## Viewpoint of the Colleges

While the general objectives of the colleges and the profession are the same it will be helpful to view the problem separately in somewhat greater detail through the eyes of the colleges—or more especially through the eyes of accounting educators. I have, over the years, spent a considerable amount of time in the field of accounting education and as a result have been in an advantageous position to view the problem from the viewpoint of the colleges.

In the first place, the accounting educator is interested in having students enroll in accounting courses who are sufficiently mature and qualified to be receptive to the educator's teaching efforts. One of the greatest satisfactions the teacher can have is to see students respond to classroom instruction and to develop technical capacity. On the other hand, students who are not properly qualified to carry the course successfully constitute one of his greatest burdens. The accounting educator is therefore



definitely interested in anything which contributes to greater selectivity of students taking work in accounting.

When the accounting curriculum is completed the educator's further satisfaction is in the success of his former students. This satisfaction is undoubtedly a mixture of the zeal for service—the true mark of a good teacher—and human pride in personal achievement as reflected by the success of the students. Every teacher likes to point to prominent practitioners as being his former students. This pride in their students' achievements in the profession is also a powerful incentive to the educator to do everything possible to give the student the best possible chance for success through the most effective kind of placement.

Another important aspect of the problem is the desire of the accounting educator to have a close personal relationship with the various firms and practitioners who employ the graduates. Part of this desire relates to the aforementioned interest in effective placement. Part of it lies in the wish on the part of the educator to be recognized by the practitioner as a part of the professional fraternity. The accounting educator resents being classified as a theorist or as a person otherwise unaware of practical problems and needs.

The views expressed here have been principally from the standpoint of the accounting educator. Other people in the colleges also play important rôles, such as placement officers, deans, and other officials. But whether in the front or behind the scenes the accounting teachers are the guiding spirits and effective coordination depends on and must begin with these teachers.

### **Viewpoint of the Profession**

Next, let us view the problem through the eyes of the practitioner. The major consideration here is the rendering of the proper kind of professional service to the firm's clients. The major interest of the practitioner is, therefore, in securing staff assistants who will possess the tech-

nical qualifications to understand and follow instructions and who will have the kind of personal qualifications which will favorably impress the client. In addition the practitioner is interested in the man's capacity to develop judgment and technical capacity through experience and supervision so that there can be a filling of the gaps in the higher staff and partnership levels as the need arises. The problem of the practitioner is, therefore, to find the kind of young men who will meet these needs and who will thus contribute to the success of his firm.

The attack on this problem, sooner or later, takes the practitioner to the major source of his men—the colleges. The larger firms, as is well known, carry out their "recruitment on the campus" programs and smaller firms find themselves forced to do their recruiting at the same time to avoid being left with the choice of only the poorer students. The practitioner thus becomes interested in colleges and college educators because of the bearing it has on the accomplishment of the major personnel objective.

The practitioner who thinks in more long-range terms and who is cognizant of the needs of the entire profession of which he is a part is interested in additional matters which while more removed from the immediate problem are basic and important. These matters involve the improvement of vocational guidance at the earlier stages and the development of more effective academic preparation through curricula, teaching materials, and related methods of training. All these factors are to be weighed and evaluated in accordance with the practical test of what effect they have on the technical and personal qualifications of the graduates who become the new staff additions. The benefits, of course, are not restricted to the individual firm or practitioner but apply to the entire profession of which the particular firm is a part.

### **A Plan of Coordination**

The foregoing comments on the views of accounting educators and practitioners should have provided ample evidence

of the existing common interests of the two groups and of the soundness of effective coordination. We are ready, therefore, to consider in a more definitive manner a working program for the needed coordination. It is not within the scope of this paper to provide such a program in all its details. Nor is it intended to attribute finality to the elements which comprise such a program. As a personal view, however, the writer believes that a sound and effective program of coordination involves five major types of activity, as follows:

### **1. Dissemination of Information**

The first important need is for the profession to provide information as to what the practice of public accountancy involves and as to what the requirements are for a successful career in the profession. This is especially important for students who are formulating decisions as to whether or not they will study accounting and for accounting students in the earlier stages who are considering whether or not they will specialize in this field. It is likewise important for vocational advisers, teachers, and all others connected with educational work.

The carrying out of this activity involves on the one hand printed booklets, articles, and similar publications. Much has been done along this line, as, for example, the excellent booklet prepared by the American Institute of Accountants entitled *Public Accounting as a Career*, but more can still be done. A second major means of disseminating information involves speeches and other personal appearances where more informal presentations are made and questions can be answered. This type of activity must be carried on continuously and must, of course, involve the efforts of practitioners throughout the country. The coverage must include all colleges and all of the important groups of students at secondary levels which are the sources of college enrollment.

In the writer's opinion, it is the latter type of oral presentation which presently represents the greatest need and which

promises the greatest possibilities of benefit. One of the reasons for this is, of course, the more effective way which is thus provided of giving information to students. Of equally great importance is the fact that the personal appearance method provides the opportunity to the students to see first hand the kind of men who are successful practitioners and thus to decide whether or not they find a similar projection of themselves satisfying.

Because of the great potential benefits it would seem that there should be a more definite plan for carrying out this phase of the placement program, over and beyond the type of thing which is worked out directly between individual educators and practitioners. This is something the Institute itself might well consider. It is quite possible that a systematic program of personal appearances organized and administered by the Institute would provide results which would well justify the costs which would be involved.

### **2. The Testing Program**

A sound program of testing is a second cornerstone of effective coordination. Such a program has been in the research stages for almost five years under the competent direction of the committee on selection of personnel and is now rapidly being put on an operating basis. The entire program has thus far involved the expenditure of nearly \$100,000 in addition to a substantial amount of assistance rendered by Doctors Ben Wood and Arthur Traxler and their associates.

The testing program involves two major phases which relate in turn to two distinct areas of the placement problem. The first of these phases has to do with the determination of whether or not a student should embark upon a program of specialization in accounting. For this purpose there is available the Orientations Test, which is a test of the general intelligence and mental alertness of the student from the viewpoint of professional accounting. In addition there is the Strong Vocational Interest Test,

which is a test of interest (as contrasted with ability) in professional accounting work. The results which can be obtained from both of these types of tests involve benefits which are quite obviously important to students, teachers, and practitioners alike.

The second phase of the testing program involves Achievement Tests. These are tests relating to knowledge of, and ability to apply principles of accounting and auditing. Through these tests a uniform yardstick is provided which provides comparable achievement scores for students irrespective of the college or geographical area. Many thousands of tests at all levels have already been given in the colleges, and it is expected that within a short time a large percentage of graduates seeking employment will be able to present the small IBM card which has been developed. This one punched card contains a complete record of the candidate's scoring on all tests. Moreover, the Strong Interest Score is compared with a profile indicative of the interests of some 2,000 practitioners. The other scores are shown in percentile terms which give a clear comparison, percentage-wise, of the applicant's score with those of the thousands of others who have taken the tests referred to.

It seems quite clear that the testing program thus far developed, and as it will be extended more completely, will be one of the most useful tools available for dealing with the problem of placement. It is entirely possible also that the scope of the program might be further extended to see what could be done in the way of testing personality, strength of character, and the like. At least careful consideration should be given to these other types of testing which if successfully developed could be of inestimable value.

### **3. Personal Working Relationships of Practitioners with Colleges**

Another basic feature of the plan for coordination involves the establishment of close personal working relationships between the practitioners and the col-

leges. This means that the practitioner goes to the campus and meets and comes to know the accounting educators. It is a principle which is equally sound for firms of all sizes, and is to be applied in the locality or localities from which the particular firm needs and expects to obtain recruitments.

The personal relationship has many important aspects. The educator comes to know the various firms and their special needs, which are based on size, nature of practice, and the like. Similarly the practitioner is brought closer to the problems with which the educator is engaged. Furthermore, the most convenient means is provided for the practitioner to see the students who are available for employment. The result can only be more effective coordination and hence more effective placement. In the writer's opinion no program of placement handled by a central bureau, no matter how efficiently administered, can be as successful as the direct personal relationships between practitioners, the college educators, and the available students.

### **4. Internship Arrangements**

A fourth element of the plan for coordination is an arrangement under which the accounting students spend a part of the winter season actually working on the staff of a practitioner—usually referred to as the internship plan. From the standpoint of the practitioner he has the needed assistance during his peak season and in addition he has an opportunity to look over the man as a potential permanent employee when he graduates. From the student's standpoint he has the opportunity to learn by doing and to apply the theory he has been studying in the classroom. Also he too can look over his employer and decide whether or not he finds the prospect of a permanent relationship with that particular employer pleasant.

The mutual benefits of the internship arrangement are so great that one wonders why it is not universally in effect. The major reason for its tardy development is that the college's course schedule

is not always set up so that the student can leave the campus conveniently at the time of the practitioner's busy season. Where, for example, classes are on a two-semester basis the student's absence for a part of a semester will be objected to by other instructors in the non-accounting courses. The solution is, of course, a recognition by the college that the internship plan is so vital that the necessary internal changes in the general course program must be made to make the internship work possible. However, definite progress is being made in the way of setting up internship plans at particular colleges. Ohio State University has long carried on a successful program and more recently the entry of the University of Michigan and the University of Texas into this field has been brought to the attention of the writer. Antioch College has for a long time carried out a slightly different type of arrangement but one also which involves the temporary assignment of students to the staffs of practitioners during their academic program. Undoubtedly more and more colleges will respond to the need and initiate plans of the internship type.

### **5. Standard Specifications for Inquiries and Applications**

The final feature of the plan of coordination involves the development of standard forms to be used by both employers and students. The forms to be used by employers will cover the qualifications of the man wanted and the major features of the employment arrangement. The forms to be used by students would cover the various types of qualifications and the special interests as to the kind of employment wanted.

One advantage to be gained is that the forms would be prepared on the basis of careful study of the various forms now in use and presumably the forms developed would be the most comprehensive and complete of any that are now avail-

able. A second advantage is that the form of the data would be uniform throughout the country and this would make the data comparable and usable by all interested parties with maximum convenience. This latter result should be of substantial value to all practitioners who are reviewing applications.

Here again is a type of activity which might well be undertaken by the Institute working in close collaboration with the colleges. There would seem to be every reason to believe that the providing of standard forms would be welcomed by all of the interested parties and that the benefits would amply justify the costs which would be involved.

### **Conclusion**

There is one aspect of the entire placement problem which deserves special mention. We have currently been in a period when qualified personnel have been in short supply for the needs of practitioners. As a result the colleges have experienced no difficulty at all in placing their graduates and in some cases because of this fact do not regard the placement problem as a serious one. The increasing number of accounting graduates will perhaps sooner than we think change this situation. Then the importance of all of the elements of the plan for coordination which leads to effective placement will become more evident.

Actually under any conditions of short or long supply the program is important. The profession has never come close to perfection in obtaining the proper flow of qualified personnel. The importance to the profession of getting graduates of the best qualifications is the ever present impetus to a sound plan of coordination between the practitioners and the colleges. It therefore deserves the best attention of the entire profession. Our attainment of the benefits will, however, be directly dependent on the extent to which we as practitioners do our part.

# Accounting in England and Canada

## Money and Credit

## Law and Accounting

### Significant Changes in British Company Law

by Gilbert D. Shepherd, MBE, FCA

[Gilbert D. Shepherd, CA, is immediate past president of The Institute of Chartered Accountants in England and Wales.]

THE Companies Act 1947, which introduced extensive changes in company law, contains 123 sections and nine schedules, running in all to 136 pages. I am sure therefore you will understand that in about 30 minutes I cannot attempt more than a general review. The statements I shall make on various aspects of the new legislation are a much condensed version of the law itself and my words will in many instances not bear examination from a legal viewpoint.

The regulation of company matters in Great Britain is somewhat different from that in the United States. We have no real counterpart of your Securities and Exchange Commission. In Great Britain the Companies Acts apply to virtually the whole of the ordinary trading corporations, both large and small. There are other means of incorporation, for example by special Act of Parliament or by Royal Charter, but normally the ordinary commercial or industrial corporation is registered under and subject to the Companies Acts. The Stock Ex-

change comes into the picture only where a company wishes to have its shares dealt in, when various rules of the Exchange must be followed by the company concerned; these include the form in which dividend announcements are made and the information to be given in prospectuses.

Even companies known as "private" companies are subject to the statutory requirements, although with certain exceptions. Private company status has been adopted by a large number of small family businesses which desired to have the benefits of limited liability without the normal publicity attaching to their affairs. On 31st December, 1946, there were 200,809 such companies registered. These included, however, a considerable number of companies not of the family business type, for example, companies which are subsidiaries of public companies. The qualification for a private company is three-fold:

(a) The number of members must be limited to fifty, excluding employees;

(b) The articles must prohibit any invitation to the public to subscribe for any shares or debentures;

(c) The articles must restrict the right to transfer shares.

Prior to the 1947 Act all private companies, whether subsidiaries or family businesses had the benefit of the private company concessions, of which the most important was that the annual accounts need not be filed with the Registrar of Companies.

In 1943 the Board of Trade set up a committee on company law amendment under the chairmanship of Mr. Justice Cohen, and the committee is commonly known as the Cohen Committee. After forty-seven meetings, including many at which evidence was heard from a wide range of bodies and individuals, the Cohen Committee in June, 1945, produced a monumental report, recommending various changes in company legislation. It is on this report that the Companies Act of 1947 was based. The Cohen Committee felt that new legislation was desirable in three main directions: Firstly, as much information as is reasonably required should be made available both to the shareholders and creditors of companies and to the general public. Secondly, means should be found of making it easier for shareholders to exercise more effective general control over the management of their companies. Thirdly, the observance of the requirements of the Companies Act should be vigorously enforced, and where companies are improperly or dishonestly conducted their affairs should be investigated and the offenders prosecuted.

This main approach and some of the detailed provisions may suggest a far from satisfactory state of affairs in the company world, so I hasten to add that the Cohen Committee was satisfied, by the evidence, that the great majority of limited companies, both public and private, are honestly and conscientiously managed, and that the system of limited liability companies has been and is beneficial to the trade and industry of the country and essential to the prosperity of the nation as a whole. It was felt, however, that any possible opportunities for abuse, which must exist if the regulations are to be tolerably flexible, would

be much reduced by action on the lines mentioned. The Cohen Committee hoped that its recommendations would not place unreasonable fetters upon business which is conducted in an efficient and honest manner and that the result of the changes proposed would be to strengthen the already high credit and reputation of British companies. The Bill to implement the Cohen report was considered in great detail by both the House of Lords and the House of Commons on a non-party basis; and in due course it became the Companies Act 1947, since consolidated with that of 1929 in the Companies Act 1948. All the new provisions have been in force from 1st July, 1948.

### **Annual Accounts**

Possibly the most significant of all the changes are those relating to accounts and audit. These provisions are by no means the bulk of the 1947 Act, but their practical effect will be widespread. The provisions affecting annual accounts are based almost entirely on the series of recommendations on accounting principles issued by the Council of the Institute of Chartered Accountants in England and Wales between 1942 and 1944. To the Council it is a matter of satisfaction and encouragement to know that the principles recommended have so soon earned statutory recognition. On the other hand, as I pointed out in the booklet which the Council has issued on various difficulties arising under the new Act, a statutory requirement is more rigid than a recommended principle; in many respects, therefore, the new Act is more exacting and inflexible in its detailed accounting requirements than the broad principles recommended by the Council of the Institute.

I will not attempt to burden you with the detailed accounts requirements, as this would take a very long time and would not be of great practical use to you in the United States. The main principle, however, is stated very shortly in section 149 of the 1948 Act as follows:

“Every balance-sheet of a company shall give a true and fair view of the

state of affairs of the company as at the end of its financial year and every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year."

The Act also contains detailed requirements as to specific matters to be stated in the balance-sheet and profit and loss account. These are contained in the Eighth Schedule, but they are without prejudice to the overriding principle I have just quoted.

So far as the balance-sheet is concerned the detailed requirements, designed to secure a true and fair view, are aimed at the clear separation of shareholders' capital and reserves from liabilities to third parties; the separation of loan or overdraft liabilities from trade liabilities; the separation of fixed assets from current assets; and the disclosure of the method of arriving at the amount of fixed assets under each heading. Normally, fixed assets are to be shown at cost less accumulated depreciation provisions. The new requirements are designed not only to enable the shareholders and others to appreciate the nature of the assets and liabilities and their interest in the company; they are also designed to deal a death-blow to the practice of creating and maintaining secret reserves. It is no longer possible to hide substantial reserves by, say, heavily writing-down assets or heavily undervaluing stock-in-trade or heavily overstating liabilities. Any such excesses are now required to be shown as reserves. This has, of course, necessitated certain special exemptions from the normal requirements in the case of banking, assurance, and some other types of company, where full disclosure of the financial position would not be in the national interest or, in certain cases, in the best interests of the company and its shareholders.

For the first time in the history of company law the new Act lays down the nature of the information to be given in the profit and loss account. The schedule to the Act gives detailed particulars of

items to be stated separately; but these are subject to the overriding requirement that the account must give a true and fair view of the profit or loss of the company *for the financial year*. The intention is that the account should disclose in the fairest manner the profit or loss arising from the year's operations. This involves showing separately any material respects in which any items are affected by transactions of a sort not usually undertaken by the company, or otherwise by circumstances of an exceptional or non-recurrent nature, or by any change in the basis of accounting; it also involves the disclosure of transfers of material amount to or from reserves. These requirements clearly prohibit the understating of profits in good years and the over-stating of them in less favorable years by means of undisclosed transfers from reserves. Among the items that are required to be shown separately are depreciation of fixed assets, investment income, loan interest, taxation and the basis on which the taxation charge has been computed. It is now obligatory to show in the account the amount of the proposed dividends, a practice previously recommended by the Council of the Institute.

There are two other major changes in regard to the annual accounts which again reflect the recommendations of the Institute Council. Both requirements represent the enforcement of what had already been accepted as best practice. Firstly, it is now necessary (except in the case of the first accounts under the new Act) to show, in both the profit-and-loss account and the balance-sheet, the comparative figures for the previous year. Secondly, in the case of holding companies it is, for the first time, compulsory to submit what are called "group accounts." Group accounts may be submitted in the form of a consolidated balance-sheet and a consolidated profit-and-loss account of a company and its subsidiaries, or in various other forms. The Act allows considerable latitude in form, and time alone will reveal how practice will develop. It seems clear, however, that the intention behind the

Act is that, wherever practicable, group accounts should take the form of consolidated accounts; and for this purpose the accounting dates of subsidiary companies are to be altered where necessary to coincide with that of the holding company unless there are good reasons for not so doing.

The alternatives to consolidated accounts can be used where the directors are of opinion that it is better for the purpose of presenting the same or equivalent information as would be given by consolidated accounts, or of presenting the information so that it may be readily appreciated by the company's members. The alternative forms consist of more than one set of consolidated accounts dealing, respectively, with the company and one group of subsidiaries, and with other groups of subsidiaries; or of separate accounts dealing with each of the subsidiaries; or of statements expanding the information about the subsidiaries in the company's own accounts; or any combination of those forms.

There is a new definition of a subsidiary company. Very briefly, Company B is a subsidiary of Company A if Company A is a member of B and controls the composition of its board, or if A holds more than half the nominal value of the equity share capital of B, or if B is a subsidiary of A's subsidiary. The full definition is complicated, but its effect is to cover a much wider area of inter-company relationships than did the 1929 Act. There has always been some difference of opinion as to whether a subsidiary could lawfully hold shares in its holding company. Any doubts have now been set at rest by a prohibition on such holdings. You will also be interested to know that the long-accepted accounting practice of treating profits earned prior to acquisition of a subsidiary as being capital now has statutory force.

Parliament has recognized that the detailed provisions of the new Act in regard to accounts must, to a considerable extent, be regarded as experimental, and has therefore wisely empowered the Board of Trade to modify the require-

ments in individual cases; moreover, the Board may by order alter or add to the requirements, in particular the detailed requirements of the Eighth Schedule. Any order made by the Board of Trade under these powers must first be approved by Parliament if its effect is to render the requirements more onerous.

## **Auditors**

The position of auditors under the new Act is considerably strengthened, but at the same time their statutory responsibilities are made more onerous. In most respects, however, the responsibilities laid on the auditors are no more than had already been accepted by reputable accountants as being good audit practice. Under the old law the auditor was required to report whether in his opinion the balance-sheet showed a true and correct view of the state of the company's affairs, according to the best of his information and the explanations given to him and as shown by the books of the company. Under the new Act auditors are required to report:

(a) Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purpose of their audit;

(b) Whether in their opinion proper books of account have been kept by the company so far as appears from their examination of those books;

(c) Whether the balance-sheet and profit-and-loss account are in agreement with the books; and

(d) Whether in their opinion and to the best of their information and according to the explanations given them the accounts give the information required by the Act in the manner so required, and the balance-sheet gives a true and fair view of the state of the company's affairs as on the accounting date, and the profit-and-loss account gives a true and fair view of the profit or loss for the year ended on that date.

You will observe that there is a small but significant change from "true and



*correct* view" to the more onerous "true and *fair* view." The statutory duty to report on the profit-and-loss account, and the requirement to say whether or not proper books of account had been kept, are both new. Moreover, the somewhat limiting words "as shown by the books" under the old Act no longer appear. The auditors are required also to report on the group accounts, stating whether in their opinion they have been properly prepared in accordance with the provisions of the Act, so as to give a true and fair view of the state of affairs and of the profit or loss of the company and its subsidiaries dealt with by the group accounts, so far as concerns the members of the holding company.

Since the auditors are appointed by and report to the shareholders, Parliament has decided that their remuneration shall be known to the shareholders. Hitherto, it has been a not uncommon practice (though by no means universal) for the members in general meeting to appoint auditors at remuneration to be fixed by directors. In future, where the remuneration is not actually fixed by the company in general meeting it is necessary for it to be disclosed in the accounts. You may also be interested to know that auditors' "remuneration" for this purpose includes expenses.

The auditor's tenure of office has been made more secure by providing in effect, for automatic re-election at each annual general meeting without any resolution being passed, unless a contrary resolution (of which special notice has been given) is passed. Where such notice is given, the auditor has the right to make representations and, provided these are not of unreasonable length, to have them circulated to the members of the company. This is certainly a measure of security which will be welcomed by the profession and will avoid the risk of an auditor who has done his duty too faithfully being eased out of office by undesirable means. Auditors now have the right to attend any general meeting and to be heard on any business of the meeting concerning them as auditors. An-

other significant change is the clear indication that it is for the auditor to decide what information and explanations are necessary for the performance of his duties.

In view of the additional rights which have been given to auditors and the additional responsibilities laid on them, it is not surprising that the Act make provisions directed towards both the competence and the independence of the auditors. With regard to competence, a person does not qualify for the appointment as auditor unless:

(a) He is a member of a body of accountants established in the United Kingdom and for the time being recognized for this purpose by the Board of Trade; or

(b) He is for the time being authorized by the Board of Trade to be appointed either as having similar qualifications obtained outside the United Kingdom or as having obtained adequate knowledge and experience in the course of his employment by a member of a body of accountants recognized for the purpose of (a) above or as having before the 6th day of August, 1947 (the date on which the Act was passed) practiced in Great Britain as an accountant.

The foregoing provisions (which may be of direct interest to some of you) do not apply in the case of a private company which at the time of the auditor's appointment is an "exempt private company," a status to which I will refer later. This exception was permitted by Parliament largely because it considered that the number of qualified persons available was insufficient to extend the requirements to all the existing small family companies. The new provisions regarding independence extend those of the 1929 Act and are designed to prevent the auditor being in a position to be influenced by the directors or officers of the company. In the case of a group of companies an auditor who is not qualified for appointment as auditor of one company in the group is automatically dis-

qualified for appointment as auditor of any other company in the group.

### **Exempt Private Companies**

The question was raised in evidence before the Cohen Committee whether private companies should continue to be exempt from the obligation to file accounts with the Registrar of Companies. The Committee's recommendations, which have now found their way in somewhat amended form into the new Act, are in the nature of a compromise, which may or may not prove successful in practice. An attempt has been made to distinguish between private companies that are genuinely of the family business type and those which are not.

The Act creates a status known as "exempt private company" for which the principal privilege is the continuance of the exemption from the obligation to file accounts. Such companies must in the first place be private companies, which I defined at the beginning of my talk; secondly, no body corporate must be the holder of any shares or debentures; thirdly, no person other than the holder must have any interest in any shares or debentures; fourthly, there must not be more than fifty debenture holders; fifthly, no body corporate must be a director of the company and neither the company nor any of the directors must be a party or privy to any arrangement whereby the policy of the company is capable of being determined by persons other than directors, members and debenture holders, or their trustees. There are complicated exceptions to some of the conditions, which defy any attempt at general explanation; they are designed to preserve the exempt status in special circumstances such as where shares are held in trust for employees, or where capital is provided by a finance company. You will see, therefore, that an extremely complicated piece of machinery has been put together with the object of preserving to family companies the privacy they have hitherto enjoyed in regard to their financial position. Private companies which are not "exempt" must now file accounts.

### **Books of Account**

The 1929 Act required a company to keep proper books of account. The new Act now defines "proper" as such books as are necessary to give a true and fair view of the state of a company's affairs and to explain its transactions. Hitherto there has been some doubt as to whether loose-leaf records, so often adopted in practice, were strictly "books" within the meaning of the 1929 Act. These doubts have now been set at rest by providing that any register index, minute book or book of account required by the Act to be kept by a company may be kept either by making entries in bound books or by recording the matters in question in any other manner. It is also provided that where records are kept by some means other than bound books, adequate precautions must be taken for guarding against falsification and for facilitating its discovery. This is a somewhat odd provision since the wording of the section implies that the requirement to take precautions does not apply to bound books!

### **Members' Extended Powers**

I have already mentioned that one of the principles of the new changes is to give the shareholders more effective general control over the management of their companies. Among the provisions which operate to that end are that every member and debenture holder must now receive a copy of the annual accounts twenty-one days before the annual general meeting. Also the period of notice for that meeting has been increased from seven to twenty-one days. For private companies an interesting innovation is that in future a proxy will be allowed to speak at a meeting on any matter on which the member he represents could have spoken. A specified number of members now has the right to require notice to be given of a resolution intended to be put to the annual general meeting and may require a statement thereon (limited to one-thousand words) to be circulated. That is one of various

provisions which may be of value to a minority which feels itself oppressed.

A principle of company law in Great Britain is that a company possesses only the powers taken in its memorandum of association at the time of incorporation. Under the 1929 Act the memorandum could be altered only subject to confirmation by the Court; even so, the powers of alteration were limited to alterations such as those desirable to enable it to carry on its business more economically, or to attain its main purpose by new or improved means. Acts done by a company outside its powers are *ultra vires*. This principle has led to the "objects" clause of the memorandum being drawn very widely when a company is incorporated, with the result that the *ultra vires* doctrine has in practice carried little protection for the shareholders whilst carrying considerable danger to third parties. The Cohen Committee recommended that as between the company and third parties the company should have the same powers as a natural individual and that the Memorandum should operate as a limitation only between the company and its directors.

Parliament has not seen fit to approve so fundamental a change in the principle of company status, but very much the same effect has been achieved by providing that the Memorandum may be altered by special resolution without confirmation of the Court. Proposed alterations the subject to any objections which may be lodged (broadly speaking, by 15% of the members) and the old limitations as to permissible changes remain; but it would seem that changes that would not have been permissible under the 1929 Act will in future be valid, provided no objection is raised in the manner provided by the Act.

Another provision designed to ensure that the shareholders have a reasonable measure of control is that the directors' report must deal with any change during the financial year in the nature of the company's business, or in the company's subsidiaries, or in the classes of business in which the company has an interest. This disclosure must be made so far as

is material for members to appreciate the state of the company's affairs. If, in the opinion of the directors, it would be harmful to the business of the company or any of its subsidiaries, the information need not be given.

### Nominees

One of the matters which received detailed attention by the Cohen Committee was the question of nominee shareholders. The belief that the practice of placing shares in names of nominees was being used to conceal the seat of control or for dubious purposes had led to a demand that the real ownership should be disclosed. The Committee recommended provisions, of great complexity and carrying heavy penalties, designed to ensure that the real ownership in all cases is disclosed. The recommendations would have resulted in enormous work, and even then it is doubtful whether they would have been adequate to catch the persons for whom they were really intended. These were not adopted in the Act. Instead, the Board of Trade is given power to appoint inspectors to investigate the membership of a company where it appears to the Board of Trade that there is good reason so to do. Where such inspectors are appointed their powers are extremely extensive.

### Public Subscriptions

New provisions have been introduced to protect persons who subscribe to public issues of company securities. A public issue now has a much wider meaning than hitherto, and includes various kinds of offers for sale not previously covered. No allotment of shares or debentures can be made on the first two days after the issue of the prospectus. Moreover, if the prospectus states that application has been made, or will be made, for permission to deal on any stock exchange, allotments become void if application is not made within specified times. If permission is refused, the application money must be refunded, and it is necessary to retain the money in a separate banking

account so long as the company is liable to repay.

To enable the prospectus to provide more information than hitherto about the company's affairs, the auditor's report on profits or losses must cover a period of five years instead of three years (although in practice the Stock Exchange requires ten years); also, the auditor must now report on the assets and liabilities. Prospectuses may not include reports by "experts" such as valuers or accountants, without the experts' written consent. The new legislation renders expert liable to compensate persons subscribing for loss they may sustain by reason of any untrue statement in any expert's report appearing in the prospectus. A criminal liability may now fall on directors or others authorizing the issue of a false prospectus.

## **Directors**

A visitor from another world might be excused for assuming, from the new legislation, that a director is a dangerous breed of creature. Certainly Parliament has singled out directors for provisions of the most extensive nature, designed to prevent abuse and to impose penalties for offenders. It is, however, only fair that I should remind you that the Cohen Committee was satisfied that the great majority of limited companies, both public and private, are honestly and conscientiously managed. The more drastic of the new provisions are in the main directed against a small minority. The simple principle involved is that since directors stand in a position of trust, shareholders should have full information on such matters as the financial interest of their directors and the benefits they take.

There are complicated new provisions requiring full disclosure of all emoluments, pensions and compensation, and it is necessary to distinguish between emoluments received as director and those received in a managerial capacity. Previously, remuneration other than as directors' fees need not be disclosed. The amounts now to be disclosed must

also include the estimated money value of any benefits received otherwise than in cash. Examples of this kind of thing are, of course, the free use of living accommodation, or supplies of goods and services without charge. Such benefits are likely to be a cause of difficulty to auditors; a specific duty is laid on them to include in their report, so far as they are reasonably able to do so, a statement giving the required particulars, if the requirements relating to disclosure are not complied with.

With certain minor exceptions no company (other than an exempt private company) may now make loans to its directors, or guarantee or provide security for loans to them. Nor is it now legal (except under certain existing contracts) for remuneration to be paid to directors free of income tax; any provisions of the articles or agreements for tax-free payments will, in future, be treated as though the net amount provided for is the gross amount. The register of directors is required to show details of all other directorships, a provision likely to cause considerable practical inconvenience, particularly in the case of groups of companies. There must also be a register of shares (of the company and of others in the group) held by, or in trust for, a director, or of which he has the right to become the holder.

A director may be removed by ordinary resolution before the expiration of his period of office, notwithstanding any agreement or article to the contrary; although this does not deprive him of any claim he may otherwise have to compensation. Resolutions for the appointment of directors must be put separately for each director, unless the general meeting agrees otherwise.

You may possibly have heard of the suspicion which Parliament has, in effect, placed on the competence of persons who have reached the age of seventy. No person of seventy years of age may now be appointed or reappointed a director, except by special resolution passed with knowledge of the age of the person concerned. There are certain transitional provisions for existing directors, and in

any case the age limit is subject to the company's articles, which may be amended to override the statute. The matter is thus one for the shareholders to decide. The practical effect of the new provision is that shareholders will have knowledge of the age of persons over seventy years and may, therefore, apply the statutory prohibition if they so desire. The age limit is not applicable to directors of private companies which are not subsidiaries of public companies.

Perhaps one of the most unfortunate aspects of company affairs is the notorious apathy of shareholders. They have now been given considerably extended rights and means of control, but it remains to be seen whether they will take sufficient interest to secure benefit from them. It is probably as true in the United States as it is in Great Britain that shareholders are content to receive dividends, without paying much attention to the report and accounts, so long as the dividends are satisfactory and arrive with regularity. It is only when this smooth state of affairs begins to roughen that most shareholders begin to show interest and criticism. This outlook can never be cured by legislation. Indeed, the Cohen

Committee itself wished to emphasize that its objective of strengthening the credit and reputation of British companies would be attained more by shareholders selecting the right governing body of each company than by the provisions of any statute.

I cannot end my remarks without referring to the American Institute of Accountants and to American standards of corporate accounting. Last year, Percival Brundage addressed our summer course at Oxford, and he brought with him some examples of published company reports and accounts. These were of the most enlightened and informative standard and impressed upon us the great care and thought devoted to this subject in the United States. American practice has certainly provided a lead to the profession in the issue of group or consolidated accounts. More recently Jackson Smart addressed our 1948 Oxford course, and reminded us of the wealth of bulletins issued by the American Institute, which I am certain have played, and will continue to play, a vital part in the development of the best practice in the United States and beyond.

## **Socialisation in Great Britain and Its Effect on the Accounting Profession**

**by Sir Frederick J. Alban, C.B.E., J.P., F.S.A.A.**

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**T**HE TITLE demands consideration of three questions: (1) What is meant by the socialisation of industry? (2) What is meant by the accountancy profession?

(3) What is or is likely to be the effect of the first on the second?

In an endeavour to answer these questions, it may be convenient to review the subject under the following broad headings: (A) Historical background; (B) Objectives of the British political parties in the general election of 1945; (C) The "nationalization phase"—action taken or pending in Great Britain; (D) The ac-

countancy profession and the effect of socialisation on the profession, and (E) Conclusion.

### **(A) Historical Background**

In Britain socialisation of industry has not so far meant the administration of industrial undertakings by a department of the central government, except in certain special cases, for example: the postal, telephone, and telegraph service; the manufacture of arms and military equipment at Woolwich Arsenal.

The telephone service was acquired from the National Telephone Company by the Government and transferred to the Post Office as far back as 1911.

**MUNICIPAL TRADING.**—One of the early manifestations of socialisation was municipal trading in gas and water.

Prior to the 1939-45 war, the acquisition from private enterprise, or establishment of these and other public utilities by local government authorities had gone a long way and was still proceeding at a fair pace.

As regards electricity, each local authority had, under Section 37 of the Electric Lighting Act, 1882, a statutory right to purchase the local company's undertaking at the expiration of 21 years (and every 7 years thereafter) from the date of the Provisional Order at the "then-value" of the undertaking.

Other industrial enterprises of the public authority type, e.g. local road passenger transport services, whether by tram, trolleybus, or bus, had also for many years been undertaken by local authorities.

Another stage in the evolution of the public authority was the formation of joint boards—usually voluntary combinations—some for trading and some for rate fund services. Water boards were more frequent than gas, electricity, and transport boards.

Of these, a conspicuous example is the Metropolitan Water Board, which was established in 1902 by statute to take over eight London water companies. The board is a joint authority consisting of sixty-six representatives, elected pre-

dominantly by the local authorities within whose areas the board is supplying water. The board serves an area of 576 square miles and in the year ended December 31, 1946, supplied an estimated population of 6,280,000 in London and the home counties with an average of 318.5 million gallons per day, and also provided bulk supplies to neighbouring authorities which averaged 6.7 million gallons per day.

**PUBLIC CORPORATIONS.**—In addition many bodies, known as public authorities, had been established before the 1939-45 war by governments of the right as well as the left for the administration of particular public utilities, for example:

*The Port of London Authority*, established in 1909—when Mr. D. Lloyd George (as he was then called) was president of the Board of Trade in the Liberal government of that time—for the ownership, management, and administration of the dock and handling facilities of the Port of London.

*The British Broadcasting Corporation*, established in 1927 by a Conservative government for the administration of broadcasting in Great Britain and Northern Ireland.

*The Central Electricity Board*, established in 1927 by a Conservative government to supply electricity in bulk to authorised undertakers; and, for that purpose, to construct and operate the grid system and to control the operation of the associated "selected generating stations."

*The London Passenger Transport Board*, which was established in 1933 by a Coalition government (in pursuance of a Bill introduced by the Labour Party) for the provision of local transport services whether by road or rail (other than the suburban services of the main line railways) within a radius of approximately twenty-five miles from Charing Cross.

### **OTHER FORMS OF SOCIALISATION.—**

*Social Insurance* was inaugurated by the Old Age Pensions Non-Contributory Scheme of 1908, followed by the Na-

tional Insurance Act of 1911 (Part I covering medical help and sickness benefits, Part II dealing with unemployment in certain industries). Subsequent developments were the addition of contributory old age pensions, widows' pensions and children's allowances and the extension of the area of unemployment insurance, with the comprehensive National Insurance Act of 1946.

*Marketing Boards* were established under the Agricultural Marketing Acts of 1931 and 1933 to organise the sale, distribution, and pricing of agricultural and dairy products. The schemes arose from the great agricultural depression of the early 1930's.

*The Sugar Commission* was set up by the Sugar Industry (Reorganisation) Act, 1936, to keep under review generally the sugar position in the United Kingdom, and in particular to maintain the growing of sugar-beet as a permanent element in British agriculture: the act entrusted the arrangement of growing sugar-beet and manufacturing and refining to the British Sugar Corporation, Ltd.

*The Development Areas* (formerly known as Distressed Areas or Special Areas) are parts of Great Britain where special help and encouragement are given for industrial development, in order to mitigate exceptional unemployment.

## **(B) Objectives of the British Political Parties in the General Election of 1945**

The principal cleavage between the Conservative and Labour parties was in the sphere of domestic policy.

**LABOUR PARTY.**—In a document entitled "Let us face the future," issued before the date of the election was known, the Labour Party outlined a modified programme of nationalisation representing what the party regarded as the limit of what could be achieved in one Parliament.

Their industrial programme advocated the public ownership of the coal, gas, and electricity industries; of inland

transport services by rail, road, air, and canal; and of the iron and steel industries; all on the basis of fair compensation. These were described as basic industries "ripe and over-ripe for public ownership and management in the direct service of the nation."

The document explained that, while the Labour Party's ultimate purpose was the establishment of a socialist commonwealth, socialism could not come overnight as the product of a week-end revolution, and it was necessary to make the industrial programme selective.

Other points in the Labour policy were: Public ownership of the Bank of England and the harmonising of the operations of the other banks with industrial needs; public supervision of monopolies and cartels; the shaping of suitable economic and price controls to secure the provision of essential things first and to old prices during the transition from war to peace; and the establishment of a National Investment Board to determine social priorities and promote better timing in industrial investment.

Land nationalisation was not included, although this was proclaimed as an ultimate objective. As a first step it was proposed that the state and local authorities should have wider and speedier powers to acquire land needed for public purposes.

The Labour Party emphasised that they did not wish to retain or impose economic and price controls for the sake of control but merely as a safeguard "against the chaos which would follow the end of all public control."

**CONSERVATIVE PARTY.**—The "Care-taker" government—predominantly Conservative—joined issue with the Labour Party on all these matters.

Mr. Churchill's "Declaration of policy to the electors" insisted on the virtue of free enterprise as opposed to state control. "This is the time for freeing energies not stifling them. Britain's greatness has been built on character and daring not on docility to a state machine. At all costs we must preserve that spirit of in-

dependence and that 'Right to live by no man's leave underneath the law.'

The Government's Four Years' Plan for reconstruction consisted in the main of policies worked out and agreed by the Coalition government for the provision of "food, work, and homes" and for the extension of social security on the lines of the Beveridge Report of 1942 on that question.

To find plenty of work with individual liberty to choose one's job, said Mr. Churchill, free enterprise must be given the chance and the encouragement to plan ahead. Mutual cooperation between industry and the state, rather than control by the state, was among the first essentials; and nothing must be done to "paralyse the spirit of adventure" in the development of overseas trade. In discussing methods of promoting industrial efficiency and raising the level of production the statement continued:

"We should examine the conditions and the vital needs of every industry on its own merits. We believe in variety, not in standardised and identical structure, still less in bureaucratic torpor. We will not allow drastic changes of ownership to be forced upon industries on no evidence except a political theory and with no practical regard to the results they may bring. To us the tests will always be—what will conduce most to efficiency, and what will render the greatest service to the community. . . . As against the advocates of state ownership and control, we stand for the fullest opportunity for go and push in all ranks throughout the nation. This quality is part of the genius of the British people, who mean to be free to use their own judgment and never intend to be state serfs, nor always to wait for official orders before they can act."

While some controls—and food rationing—would continue to be needed until normal times returned, the government stood for the removal of controls as quickly as the need for them disappeared. Controls originally imposed on behalf of the consumer tended to bind him down

and injure him as soon as circumstances changed, and his interests must be watched. The government's intention was to "guard the people of this country against those who, under the guise of war necessity, would like to impose upon Britain for their own purposes a permanent system of bureaucratic control."

Some specific proposals affecting industry were that a central authority should be appointed by the Minister of Fuel to promote, and if necessary enforce, groupings and amalgamations in the interests of more efficient organisation of the coal industry; and that charges of abuse of their power by monopolies should be brought before an independent tribunal for public hearing.

The government promised by stimulating scientific research and encouraging the scrapping of obsolete plant and methods to work for an improvement of the efficiency and productive capacity of industry generally.

Other undertakings were to keep prices from rising, to protect the purchasing power of savings from inflation, to make an early reduction of taxation, and to simplify the tax system.

The result of the General Election of 1945 is well known. The Labour Party achieved an independent majority of 146 over all other parties and groups combined.

### **(C) The "Nationalisation" Phase—Action Taken or Pending in Great Britain**

The form in which socialisation, or nationalisation as it is called, of industry has been pursued by the Labour government since the war is really an expansion—with some important modifications which are referred to later—of the policy followed in the past by governments of all colours of providing for the administration of public utilities through bodies known as public authorities. But this policy has been pursued on a much more far-reaching scale than ever before.

The *National Coal Board* has been set up to manage and administer the whole



of the collieries and ancillary businesses in Great Britain.

The *British Transport Commission* and its attendant executives have been set up to take over the direction and control of all inland transportation in Great Britain by rail, road or waterway.

The *British Electricity Authority* has been set up to take over the responsibility for the generation and distribution of electricity throughout Great Britain.

Under an act which received the Royal Assent on July 30, 1948, twelve area boards will be established for the *Gas Industry*, while there will be a Gas Council, with financial, advisory, research and educational functions.

The public authorities established for these purposes are in no sense departments of the central government. They are not administered by what we know as the civil service. Their staffs are not government officials, but employees of the respective public authorities.

The responsibilities and duties of each public authority are laid down by Act of Parliament, and the same Act of Parliament gives the authority adequate powers for the discharge of those duties. They engage their own staffs, on their own terms, and are free to fix salaries, wages rates, and conditions of service without government interference.

The public authorities are, however, to be distinguished from statutory or public companies in several important respects, for example:

Their issued capital is entirely in the form of debt capital, and latterly the necessary capital is either provided by, or raised with the aid of guarantee of interest and capital given by, His Majesty's Government.

It follows that none of the stockholders has any "equity" interest in the revenue or capital of the undertaking.

It follows, too, that the stockholders have no right to appoint or control the members of the public authority who are responsible for administering its affairs. The present practice is for such members to be appointed by the minister in charge of the related government department;

for example, the Minister of Fuel and Power for the Coal Board and the Electricity and Gas Authorities, and the Minister of Transport for the Transport Commission.

The bases of compensation to stockholders and proprietors have not been uniform. The following principles have been adopted:

*Net maintainable revenue:* In the cases of the Bank of England and Cable & Wireless.

*Stock Exchange quotations on stated dates:* In the cases of the Railways and Road Transport, Electricity (but not local authority) Undertakings.

*Values of physical assets:* In the cases of Road Transport and privately owned railway waggons.

*A global amount fixed by a tribunal with reference to net maintainable revenue:* In the case of Collieries.

The public authorities more recently created differ from their predecessors in the important respect that the appropriate minister is empowered, by the constituting act, to give directions of a general character as to the exercise and performance by the public authority of its functions in relation to matters which appear to affect the national interest.

The important point to bear in mind for the present purpose, however, is that socialisation of industry in Great Britain has not meant administration by a department of the government, but by a body known as a public authority specially created for the purpose; a body which is largely autonomous in the management and administration of the responsibilities entrusted to it by Parliament, subject to directions of a general character by the appropriate minister on matters affecting national interest; and a body which enjoys the benefit of a government guarantee of its capital.

The existing examples of nationalisation may be regarded as forms of state capitalisation rather than "out and out" socialism. This question was considered in an article in a recent issue of *The*

*Economist* (June 19, 1948). The following extract illustrates the point:

"There is nothing very surprising about the persistence of the demand for workers' control of industry. Whatever its present ideological basis may be, the springs which fed the British Labour movement were the orthodoxies of Marx and Engels, and among them 'ownership by the workers of the means of production, distribution and exchange.' That is a golden ideal which became implanted in the minds of working-class socialists while this century was still young, and it has done as much as anything to keep the movement alive throughout its lean times. Many years ago, however, the impossibility of its achievement, except in the sense of 'ownership by the state as trustee for the people,' became apparent (partly as the result of the lessons of Russian industry after 1917) and the official policy of the party moved quietly away from syndicalism towards nationalisation—or as some would say, from democratic socialism to state capitalism. But the leaders never dared make explicit to the rank and file of Labour that they had abandoned workers' ownership; it was too useful as a forced draught to keep the fires burning. The divergence of thought has been severe, as the Grime-thorpe and Waleswood coal strikes demonstrated. It is significant that the most extreme advocate among the unions of complete syndicalism is the Union of Post Office Workers, which has more experience of nationalisation than any other.

"The main argument against the direct control of industries by those who work in them—whether the doctrine is christened syndicalism or guild socialism—is that it does not work, any more than the various experiments that have been made throughout history to run an army by delegates from the ranks have ever worked."

That there are certain technical advantages arising from nationalisation (similar to those arising from any large-scale

amalgamation) can scarcely be denied, e.g.: (i) unified operation in the case of, say, electricity; (ii) standardisation of plant, equipment and appliances; (iii) bulk purchasing; (iv) uniformity of administration.

The claim frequently made in the past—though not without qualifications—that large-scale production enables the cost per unit of output to be reduced by technical improvements and the wider spreading of overheads, is not yet proven.

Price policy in connection with the new bodies is a matter on which very little guidance, in the form of official pronouncements, has yet been given. The conditions are monopolistic so that there is not much restriction on the general level of charge (e.g. coal). Nor is it clear how far charges will be "postalised," i.e. the same electricity prices in rural areas as in urban areas.

Before passing on to deal with the impact of nationalisation on the accountancy profession, certain non-accountancy aspects may be very briefly noted:

(a) The problem of managerial structure in socialised industries has not been solved (e.g. the recent troubles of the National Coal Board).

(b) There was certainly over-centralisation in the initial stages. The British Overseas Airways Corporation has now, for example, embarked on re-organisation which involves complete decentralisation, a reduction of the top layer, and the passing of responsibility down to the lowest levels. In effect, some of the nationalised industries will be compelled to go back to a small unit on matters of day-to-day management.

(c) Selection and promotion of personnel present difficulties. Nomination of members of a board by a minister is not an entirely satisfactory procedure.

(d) Nationalisation does not solve labour problems!

## **(D) The Accountancy Profession**

In Great Britain, as in America, increasing attention is being paid to the scope of accountancy in relation to the

administration of the affairs of business enterprises.

The days when a man holding a recognised accountancy qualification was spoken of as having "left the profession" when he took up a salaried post in the organisation of an industrial undertaking have gone by.

The profession can therefore be regarded as having two aspects: (a) Accountancy as practised by those who hold themselves out as public accountants (a long-established and well-recognised entity), and (b) Accountancy as exercised by those who are actually working in industry itself (a more recent conception).

Both branches of the profession must be taken into account for the purpose of considering the effects of socialisation on the accountancy profession.

#### EFFECTS OF SOCIALISATION ON THE ACCOUNTANCY PROFESSION

At the outset it should be appreciated that the public authorities set up for the administration of particular public utilities do not submit their accounts in the form traditionally associated with government administration.

They are business enterprises, publicly owned, and their income and expenditure do not form part of the national budget and are not subject to Exchequer administration.

They are required by the Acts of Parliament under which they are constituted to keep separate accounts and to publish annual accounts prepared in accordance with the best commercial practice.

Thus, the Coal Industry Nationalisation Act, 1946, requires the NATIONAL COAL BOARD to keep proper accounts and records. Each year the board must prepare a statement of accounts for publication and the statement must conform with the best commercial standards. The National Coal Board themselves say in their Annual Report for the year 1947 that: "The obligation to conform with the best commercial practice sets a high standard for the board's accounting arrangements."

The Transport Act, 1947, which established the BRITISH TRANSPORT COMMISSION and its associated executives, requires the commission to keep proper accounts and other records and to prepare an annual statement of accounts in such form and containing such particulars and compiled in such manner as the minister may from time to time direct with the approval of the Treasury. In particular, the annual statement is to be so framed as to provide, as far as may be, separate information as regards the principal activities of the commission, and, in combination with the periodical statistics and returns rendered by the commission, to show as far as may be the financial and operating results of each such activity.

The Electricity Act, 1947, similarly provides that the BRITISH ELECTRICITY AUTHORITY shall keep proper accounts and other records in relation to the business of the authority and shall prepare in respect of each financial year a statement of accounts which must conform with the best commercial standards.

The acts establishing the public authorities provide that the accounts of the respective bodies shall be audited by an auditor or auditors to be appointed annually by the appropriate minister. (In passing it may be noted that no compensation is payable in respect of the loss of the existing individual audits which are eliminated).

In practice independent firms of professional accountants, or members of such firms, have been appointed, and, indeed, in the case of the British Electricity Authority, the Act of Parliament specifically provides that no person shall be qualified to be appointed auditor of the authority or auditor of an area board unless he is a member of one or more of: the Institute of Chartered Accountants in England and Wales, the Society of Incorporated Accountants and Auditors, the three Scottish bodies of Chartered Accountants, or the Association of Certified and Corporate Accountants. There is a similar provision in the Gas Act for the audit of the accounts of each area board, with the addition of membership of the

Institute of Chartered Accountants in Ireland as a qualification.

Thus, not only are accounts to be prepared on bases complying with the best standards, but these accounts will also be audited by independent professional auditors in no way under the control of a government department.

These points are important in considering the impact of socialisation on the profession of accountancy.

None the less, the effect on the profession of a large-scale transference of separate industrial units to one all-embracing public authority can only be far-reaching, for example:

**CONCENTRATION OF AUDIT WORK.**—One large-scale audit (and in some cases a small number of area or sectional audits) will be substituted for a number of smaller audits, with a tremendous concentration of the function of the professional auditor.

The full effect of these changes has not yet been felt by public accountants practising in Great Britain.

The affairs of the dispossessed companies and the settlement of the compensation payable to them has still in many cases to be settled, involving professional work of a special character.

The public authorities have sought the cooperation of the profession and have appointed firms to act for them in preparing accounting reports relative to acquisition and compensation.

Again, arrangements were made, in some cases, for local sections of the accounts of a public authority to continue to be audited, for the time being, by the auditors who previously undertook that task. This, however, is a passing phase.

Broadly, however, it seems inevitable that, while there will still be an independent audit of the accounts of public authorities, there must be an ultimate concentration of this audit work in the hands of the larger firms of practitioners—to the virtual exclusion of many of the smaller firms previously engaged upon this work when the industries were carried on by large numbers of smaller industrial units.

**DEVELOPMENT OF "INTERNAL AUDIT."**  
—The establishment of public authorities will affect the scope and scale of professional auditing in another direction.

There is bound to be a large extension of what is known as "internal audit" by staffs of experienced auditors, carried on the payroll of the employing body for the purpose of carrying out detailed checkings.

Thus, the National Coal Board decided in the first year of their establishment to follow this policy and to organise an internal audit staff. They say in their Annual Report for 1947\* that:

445. In recent years a number of large business organisations have adopted what is known as "internal audit," that is, they have a staff of experienced auditors who carry out detailed checking in collaboration with outside auditors. Some of the largest concerns in the coal industry had internal audit staffs who were mainly engaged on the checking of wages.

446. It would be necessary in any case to develop a staff to review systems of internal check and to test the efficiency of accounting and other techniques and this work can most conveniently be associated with audit work. Moreover the detailed checking involved in audit can be carried out more economically by an internal audit staff than by outside auditors.

447. The board accordingly decided to organise an internal audit staff. The whole of the arrangements were settled in conjunction with the outside auditors and approved by them. The programmes of internal audit were settled in consultation with the outside auditors and all reports and working papers of the internal auditors were available to them. The outside auditors verify that the internal auditors are in fact carrying out an effective check.

448. A small internal audit staff is attached to each area, under the control of an Area Internal Auditor, who,

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\* *Extracts printed by permission of the Controller of H.M. Stationery office.*

although attached to the staff of the Area Chief Accountant, reports direct to the Divisional Chief Internal Auditor and thus has the necessary measure of independence. Similarly, the Divisional Chief Internal Auditor has the right to report direct to the Board's Chief Internal Auditor at Headquarters, who in turn has the right to report direct to the Board.

449. The nucleus of the internal audit staff was found from those already engaged in this work in the coal industry. New appointments have been made from the staffs of firms of accountants, mainly those with large practices in the coal industry, and from other staffs with extensive experience of coal industry accounts. On 31st December, 1947, there were 198 internal auditors in the coal industry, of whom 51 held professional qualifications.

The Annual Report of the National Coal Board for 1947 goes on to say that:

"Nevertheless the total cost of the internal audit staff of the Board, together with the fees payable to professional firms of accountants, including the auditors appointed by the Minister, is less than the audit fees paid by the coal industry before nationalisation."

The foregoing extracts are clear evidence of the impact of socialisation upon the work of independent firms of professional accountants and of its reaction upon the personnel of the profession.

**ACCOUNTANCY AS A PART OF MANAGEMENT.**—Coming now to the effect of socialisation upon accountancy as part of industrial administration, it will be apparent that the effect of socialisation of industry on the scale pursued by the Labour government can only be to make even greater demands upon accountancy services as a part of management.

First of all, the scale upon which the new public authorities are to operate is so vast, and the industries they administer are in many cases so complex, that these considerations of themselves must

warrant an intense development of accounting for purposes of control and purposes of management.

Thus, to take two examples, the National Coal Board at December 31, 1947, employed a total staff of 746,000 and their income for the year 1947 totalled £371 million; and at May 16, 1948, the British Transport Commission employed 803,000 persons (a number which will be largely increased when all contemplated transfers to the British Transport Commission have been completed) and their traffic receipts are already running at the rate of nearly £400 million per annum.

With such vast activities to administer the public authorities must look to accountancy to provide for them the financial information by which their operations can be properly managed and controlled, whether locally in small units or nationally for the undertaking as a whole.

The second point is that socialisation has virtually meant the establishment of nation-wide monopolies for the administration of the services which have been the subject of nationalisation, with, in some cases the elimination, and in others at least a lessening, of the influence of the corrective factor of "consumer's choice." (The consumer who does not like the coal he is getting cannot transfer his custom to another supplier. But no doubt this is a *pro tem* survival of wartime restriction which may disappear.) Again, the motive of profit-making for the sake of profit is removed, although the bodies are intended to be self-supporting. Their main objective is not to make money but to administer efficiently and economically, in the national interest as well as in the interest of the employees, the affairs entrusted to them.

This is a direct challenge to those who aver that the profit motive, and "consumer's choice," are in the long run the only reliable checks on efficiency in business administration. Will nationalisation's hope triumph over experience?

Certainly without the checks of "profit" and "consumer's choice" other

checks upon efficiency, other measurements of efficiency, become essential.

They must largely be built up by financial and statistical methods, and in fact there has lately been much talk in responsible British newspapers of the establishment of "economic efficiency audits" external to the public authorities which are administering socialised industries.

Should the accounting and other tests of efficiency that are devised not operate properly, inefficiency will not be located and the effect in the long run must be that our standard of living will fall.

It is therefore clear, from any angle, that the concentration of industrial management in the hands of these public authorities must impose increasing demands upon the accountancy profession for the development of accounting as part and parcel of the function of management.

### **(E) Conclusion**

In the short run, it seems clear that socialisation must take away much auditing work previously carried out by professional accountants in public practice when particular industries were administered in relatively small units. Large-scale, but still independent, audits will be substituted, though, as indicated by the National Coal Board, the audit demands are likely in total to be lessened, particularly when regard is had to the projected extension of the practice of internal audit.

There will thus be some curtailment of the width and variety of experience hitherto enjoyed by the *average* practising accountant—experience which is the foundation of the service that an accountant is able to render to his clients.

But it is necessary to place in proper perspective the effects of socialisation on the profession.

Other factors of vital importance must be taken into consideration. Among them are the following:

(i) Eighty per cent of industry and distribution remains in the hands of private enterprise, albeit subject to a considerable measure of control.

(ii) Private enterprise calls increasingly for the services of practising accountants in relation to management problems (including finance for modernisation)—a question discussed in an admirable paper by Mr. Eric A. Camman, CPA, at the meeting of the American Institute of Accountants in 1947. This factor applies to large and medium-sized and small concerns.

(iii) The increased responsibilities placed upon auditors by the Companies Act, 1948, both as regards public and private companies.

(iv) The complexities of direct taxation—*income tax, sur-tax, the profits tax, and, for this year, the special contribution (a quasi-capital levy); also death duties (estate, legacy and succession duties).*

(v) The change of the basis of income tax in relation to agriculture—from a legal and conventional basis of rent as the measure of profit to precise profits as disclosed by accounts.

(vi) The impact of government controls upon industry and the distributive trades—arising partly from anti-inflationary measures and partly as the outcome of a planned economy (including price regulation, quotas, rationing and purchase tax).

Nevertheless, on the long view, the establishment of these vast industrial enterprises under public ownership must make even more clamant the demands of management for the service which only accountancy can give in the day-to-day administration of large-scale industrial concerns.

It follows that the professional accountancy bodies in Great Britain must devote more and more attention to what is commonly known as industrial accounting, as distinct from professional auditing by practising accountants, if the demands upon the profession as a whole are to be adequately met.

The continual widening of the accountancy profession's service to the community is no new thing. My colleague at this conference—Mr. Gilbert Shepherd, M.B.E., F.C.A. (the immediate past

president of the Institute of Chartered Accountants in England and Wales) referred to it in a talk to the Manchester Business Club in January last under the title of "Undertakers, Physicians, and Builders."

As he pointed out, accountants' work was in the first instance that of *undertakers* to the business world in the capacity of liquidators and receivers in bankruptcy. From the duty of giving corpses a decent burial accountants passed to the next stage of development, that of *physicians* keeping the body economic in sound financial health. Finally the constructive stage is being reached with accountants as *builders* assisting in the promotion of economic effectiveness.

Moreover, I may refer to the work *Precision and Design in Accountancy* of my colleague Mr. F. Sewell Bray, F.S.A.A., F.C.A. To quote the review of the *Financial Times* (January 29, 1948):

"Though much of Mr. Bray's book is taken up with an exposition of some of the technical problems faced by accountants, the first section attempts a general definition of the status of the profession. It might well be called an essay in the philosophy of accountancy.

"Mr. Bray admits that in the past accountants have been apt to take too narrow a view of their functions. The press of everyday business has tended to obscure the fundamental principles of their technique. The history of accountancy so far has been, perhaps, little more than the development of a method of analysis and classification that can be applied to all economic transactions. For the future, however, Mr. Bray envisages accountants as the supremely important checkers of industrial efficiency, whether privately or nationally owned. 'Net operational profits,' he writes, 'are coming to be regarded as indices of efficiency, while our published profit and loss accounts are beginning to be expected to show the share of the final product accruing to the various factors of production, particularly that of labour and management.' Accountancy is thus

turning into a systematic record of the working of the economic structure of society, expressed in terms of monetary symbols. At present the machinery of comparison between one business and another still requires much development. The accountants' professional organisations are well aware of this, and Mr. Bray's book should stimulate their researches."

This transference of work and change of direction are likely, however, to have an important bearing upon the staffing of public accountants' offices and the training of qualified accountants. At present, admission to the examinations in the case of the Institute of Chartered Accountants is limited to those who have served articles of clerkship, and in the case of the Society of Incorporated Accountants and Auditors is virtually restricted to men who have had a minimum number of years' experience in public accountants' offices.

Industry, understandably, has made considerable demands upon these professionally trained men for posts in industrial organisations.

This demand for men trained in public accountants' offices is likely to increase with nationalisation.

But if, on balance and for the reasons which have already been given, the public practice of accountancy should diminish, there may be a smaller supply of qualified men upon which industry can draw.

What the solution of such a dilemma—if it arose—would be remains to be seen.

There is no question but that training in a public accountant's office at its best gives a variety of experience, under conditions of independence in relation to the affairs of the concern whose accounts are subject to audit, which cannot usually be attained within industrial enterprises.

On the other hand, a training in the office of a public accountant is not of itself sufficient to develop the outlook and the techniques which are essential to meet the present demand on accountancy

in industry, to say nothing of the increasing demand which is likely to be made in the future.

It may be that flexibility can be introduced and that those training in the accounting departments of socialised industries may be released temporarily to spend one or two years in the offices of practising accountants. Reciprocal facilities for those training in the offices of practising accountants may also be practicable.

The development of professional education has become of paramount importance, and a general welcome has been given to the scheme arranged between the universities and the professional bodies. The scheme enables men who are qualifying for the profession to take a university course and a degree, integrated with professional training. Short refresher courses for members, organised by the professional bodies, are held from time to time at colleges at Oxford and Cambridge, and there has been a marked intensification of the activities of the district and students' societies.

It may be contemplated, in certain of the specialised sections of the profession in industry, that each such section will train its own recruits—a course in fact followed in the past by some government departments and likely to be adopted in the new National Health service. Such training—from the standpoint of practical experience—would be based on a restricted field.

The alternative was strongly expressed recently by Mr. Basil Smallpeice, A.C.A., in a lecture dealing with "The Impact of the New Economic Situation on the Accountancy Profession" (*The Accountant*, April 17, 1948).

He recalled that the profession of accountancy is now being practised in two spheres—the original one of public practice and the new one of industrial management. He stressed that in training articulated clerks "we are growing neither public accountants as such, nor industrial accountants as such, but accountants capable of being either," and he argued that accountants in practice should have a working knowledge of the new techniques, in the same way as a medical practitioner who is not a specialist has a working knowledge of the whole field of medicine so that he can diagnose the complaint and advise when the calling in of a specialist is necessary.

This problem—the training of the public accountant of the future—is engaging the serious attention of the professional bodies in Great Britain. It is one for which no ready solution is at present apparent.

*[Sir Frederick's paper originally contained extensive exhibits pertinent to this discussion. Lack of space prohibits reproducing them here, though persons interested may borrow copies of the complete paper with exhibits from the library of the American Institute of Accountants.]*



# The Regulation and Control of the Public Accounting Profession in Canada

by E. J. Howson, CA

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IT MAY BE of some interest to you to learn of the progress being made in Canada toward the regulation and control of those practising as public accountants in the various Provinces of the Dominion.

In these days of widespread investment by the general public in the shares of all kinds of business enterprise; consumer interest in rates charged for public utility services; the growing demands of labor unions for basic information on which to judge the fairness of labor rates; the expanding participation of government in business through tax structure and controls, the professional accountant finds his field of responsibility broadening and extending far beyond the narrow circle to which it was confined in early days of the profession. Because of the rapidly growing interest and participation in business and finance by the general public, it is essential that confidence be established in the integrity, judgment, and ability of those holding themselves out as professional accountants. Hence the necessity of some centralized and adequate regulation and control over the educational standards and conduct of those practising as public accountants.

In Canada, educational matters are under the control of the Provinces, of which there are nine. In each Province the training and education of professional accountants has been entrusted to certain organizations formed for that pur-

pose usually by incorporation under the terms of a Special Charter issued by the Provincial legislature. Such organizations have full control over the terms on which membership is granted. They may set up educational standards, hold examinations, and their members have the exclusive right to whatever form of degree is authorized in Charter.

The Institutes of Chartered Accountants, modeled on the pattern of the Scottish and English Institutes, were first in the field. The first Institute was organized in Quebec and secured its charter on July 24, 1880.

The aims and objects set out in that charter are as follows:

The objects of the corporation are to promote the efficiency and usefulness of its members and to afford opportunity for giving expression to their opinions upon all questions bearing upon or affecting their calling.

On February 1, 1883, the Institute of Chartered Accountants of Ontario was granted a charter. Its aims and objects are set out as follows:

The objects of the Institute shall be to promote and increase the knowledge, skill, and proficiency of its members in all things relating to the business or profession of an accountant, and to that end to establish classes, lectures, and examinations, and to prescribe such tests of competency, fitness, and moral character as may be thought expedient to qualify for admission to membership.

Subsequently, in every other Province in the Dominion an Institute of Chartered Accountants was organized and secured a charter, the last one being

granted in Prince Edward Island on April 27, 1921.

The only exclusive right included in the charter was the use by its members of the appellation CA or FCA. However, the Institutes and their members have established such a degree of confidence in their integrity and ability, that they dominate the profession in all Provinces.

On May 15, 1902, a Dominion Association of Chartered Accountants was organized and granted a charter by the Dominion Government. Among its sponsors were prominent members of both the Ontario and Quebec Institutes. The general idea behind its organization was to provide a means of coordination and cooperation between the Provincial Institutes already in existence. While the idea was sound, the Provinces were not ready for it at that time and the Dominion Association carried on as an independent unit for some years.

However, as the years passed and the profession became established, the need for a coordinating body became increasingly apparent and, after prolonged negotiation, the Dominion Association of Chartered Accountants was reorganized and became the means through which coordination was established.

As a result, reciprocal relations between Provinces have been established, uniform examinations for intermediate and final students of all Institutes have been set up, and the Institutes have a central body through which they can consult and act in unison in the improvements in standards, ethics, etc., and a body through which chartered accountants, as a unit, may express their viewpoint on subjects of public interest and make representations in regard thereto.

In the meantime, however, other organizations with similar aims and objects had applied for and received charters in the various Provinces, and there is nothing to prevent as many more being established. In most cases a great majority of their members never intend to go into public practise. One or two have established educational courses and adequate examinations but with limited requirements of practical training. The

others have no course of education and no examinations and no particular standard of ethics, and yet any member of any of these organizations has the right to practise as a professional accountant under whatever appellation the charter of his organization entitles him to use.

Individuals with no affiliations, whatever, may also hold themselves out as public accountants.

The situation in the British Isles is very similar to the situation prevailing in Canada. There they have the senior organizations, i.e.,

The Institute of Chartered Accountants in England and Wales

The Society of Incorporated Accountants and Auditors

The three Scottish Societies of Edinburgh, Glasgow, and Aberdeen

and a host of other organizations and individuals practising as public accountants.

Under such circumstances, the simplest method of effective control of the profession would seem to be by an amalgamation of all existing organizations having the semblance of an inherent right to be included and the granting of a charter by the government to the amalgamated body giving it the exclusive right to regulate and control the profession from then on.

This method was not acceptable to the senior organizations in the British Isles since they wished to maintain their individual identity as organizations. To do this and achieve the general aim of regulation and control, they conceived the idea of the formation of a Council for England and Wales and one for Scotland in which all organizations and the public are represented.

Under the provisions of the bill nobody can practise as a public accountant in England or Scotland who is not a member of either a qualifying or recognized body, except certain groups of individuals who have been in practise for a specified time prior to the bill coming into force, who may be granted a certificate to practise as public accountants on application to the Council created by the bill.

Through its right to investigate and pass on the qualifications set up by any body for the granting of diplomas of membership, the Council has practical control over educational requirements and professional standards.

The bill in its present form has the unanimous support of all the bodies interested in the practise of public accounting.

In Canada the question of regulation and control has been a subject of controversy for some time. The first positive action to institute such provision was taken in the Province of Quebec when, on April 16, 1946, legislation was passed vesting in the Institute of Chartered Accountants of Quebec the regulation and control of the profession in that Province. The provisions of the bill required that all members of certain other organizations in the Province of a similar type, whether practising or not, be granted membership in the Institute together with certain others whose inclusion was based on other grounds.

Provision was also made for the licensing of those who had been in practise for a specified period and who were not members of any organization but whose livelihood was derived from the practise of public accounting.

Qualifications for membership have been broadened by including as a basis therefor, alternatives to passing the Institute's own examinations, such as a licentiate diploma in commerce and finance from one of the three universities in Quebec. The examining body set up for passing on applications for membership in the Institute includes representatives from each University. The practical experience required for qualification to admittance as member has also been modified.

The Bill has been in force for over two years and the situation is reasonably satisfactory.

In Ontario, the members of the Institute of Chartered Accountants decided to endeavour to establish regulation and control in that Province through the formation of a General Council patterned more or less after the English and Scot-

tish type, thus preserving the identity of the different bodies, but bringing all under a central control with the right to limit the entrance of any other organizations into the field of public accounting unless they can establish educational and professional standards for their members in keeping with those set by Council as obligatory.

Licensing of those who are not members of any Society but who can demonstrate that their livelihood has been gained through the practise of public accounting will be provided for.

The bill has been prepared and it is hoped will be brought before the Legislature at the next session. Under such a bill, the educational and professional standards of the constituent bodies can be brought up to a uniform standard and all codes of ethics brought into conformity.

In the Maritime Provinces of New Brunswick and Nova Scotia, the problem of the best means of establishing regulation is under serious consideration and some action in the near future may be taken.

In the Western provinces the problem is not nearly as acute. In those provinces the Institutes are very closely associated with the Provincial Universities which in turn have close relationships with their Provincial governments. In the Prairie Provinces, because of the predominance of agriculture, there has been less inducement for other organizations to become established. In spite of these favorable conditions, however, the question of regulation and control is being given serious consideration.

I am informed that, in well over half the states of your own country, laws have been enacted to prevent the practise of public accounting by unauthorized persons. It is therefore apparent that in all three countries mentioned, there is a growing public demand for some assurance that those practising as public accountants are both competent and dependable. It is submitted that only through some adequate system of regulation and control of the profession can a basis for such assurance be established.

# Money, Credit and Inflation

by Kenneth K. Du Vall

[*Kenneth K. Du Vall is president of the First National Bank of Appleton (Wisconsin).*]

**A**CCOUNTANTS, because of their increasingly important function of advising and counseling top management in business, have a vital interest in—and a real need to understand—the problems involved in managing money and credit in the critical period our nation entered with the end of World War II.

It is for these reasons that I propose to explore with you the background upon which is cast such recent front-page news stories as that appearing under the caption "Senator Taft Says New Interest Rate Is Inflation Brake." I propose to suggest some of the problems—I don't presume to have all of the answers. My discussion must of necessity be limited by my qualifications—as a banker—and not as a professional economist.

Most of you need not be reminded of the fact that only a very few years ago the bankers of the country were being openly criticized for their reluctance to take risks—for their failure to adopt courageous and aggressive loaning policies. In 1944 organized banking became aroused and engaged in a countrywide campaign exhorting bankers to make credit available to every worthy borrower for every worthy purpose.

Contrast, if you will, this 1944 point of view to that prevalent today! In 1948, bankers are being criticized for doing too well a job they were accused of neglecting only four years ago. Twice, in less than a year, the President of the United States has urged Congress to enact laws aimed at controlling and restricting bank credit. At the special session last month a Republican-dominated Congress empowered the Federal Reserve Board to raise

bank reserves and impose controls over consumer credit. The issue is not merely political. It has deep roots in the nation's economy.

What has happened to cause this rather abrupt and complete change in the thinking and attitude of our leaders—in and out of government? Are bank loans dangerously high? Has the expansion of bank credit been a major cause of inflation? Why are we concerned about the trend of bank credit? Finally, if our concern is well founded, what can be done about it?

As to the first of these questions—are bank loans dangerously high—we may gain perspective by looking at the record made since the end of World War II and comparing it to a like period following World War I. The loans of all banks in the United States reached a figure of some 43 billion dollars at the close of 1947, or roughly, a gain of 13 billion dollars over the figure established at the end of 1945. The gain in these two years was about 42 per cent. Going back to a comparable period following World War I, loans rose from some 22 billion dollars on June 30, 1918, to almost 31 billion dollars on June 30, 1920—a gain of some 8 billion dollars, or about 37 per cent. Surely the 42 per cent gain following World War II compared to 37 per cent following World War I is not alarming and neither is the total of 43 billion dollars on December 31, 1947, compared to 31 billion dollars on June 30, 1920, a cause for real concern. On the other hand, need I remind you that the inflation of 1919-1920 was followed by drastic deflation in 1921.

Passing on to the next question—has the expansion of bank credit—post World War II—been a major cause of

inflation—we enter somewhat more controversial ground. Let us start by measuring the growth of bank loans against some of the more commonly used yardsticks of general economic activity. It might be well to look at this phase of the subject from two angles, namely, the longer term point of view, say, from 1939 to 1947, and the shorter term point of view, say the calendar year 1947.

As to the longer period—1939 to 1947—it may be observed that in the year 1947 the dollar value of our “gross national product” was estimated at 254 per cent of the figure set down for 1939; our “national income” in 1947 was 280 per cent of 1939; at the close of 1947 the index of “industrial production” was 171 per cent of the closing figure in 1939; the index of “commodity prices” rose by the end of 1947 to 211 per cent of the December 31, 1939 index. Bank loans, in this same period, increased by 195 per cent—modest enough in comparison to the other indexes. Evidence of this nature has led some observers to conclude that bank loans have followed and not led the pattern of the nation’s economy. Thus, it is reasoned, increased bank loans are an inevitable result and therefore not a cause of upward spirals in the economy. The logic in drawing this conclusion from the premises is clearly open to challenge. Is it not equally logical to conclude, for instance, that the increase in bank loans of 195 per cent caused the other indexes to rise?

However this may be, the shorter, more immediate period of the year 1947 makes a statistical record that casts considerable doubt on the proposition that the increased use of bank credit results in no appreciable inflationary pressure. Between January, 1947, and January, 1948, while bank loans were increasing by some 21 per cent, commodity prices rose by 17 per cent but industrial production moved up by only 3 per cent. To assume a simple, direct relationship of cause and effect between bank loan increases and price increases would be an unjustifiable simplification of a complex situation. On the other hand, there is no denying that the considerable increase in

bank loans in 1947 did add to available purchasing power and evidently did not result in larger production.

As I have said, admittedly we are on controversial ground when we try to decide whether or not the increased use of bank credit causes inflation or is the inevitable result of inflation. While I do not wish to labor the point, let me make one further observation. Quite obviously, more money is needed by the economy as prices rise and more dollars are tied up in accounts receivable and more dollars must be invested in inventory even though physical volume remains unchanged. This reasoning is familiar but, it seems to me, the logic behind it is much the same as the logic behind the plea of labor for higher wages to offset a higher cost of living and the argument of the manufacturer who justifies higher prices by pointing to higher costs. Thus all of us disclaim responsibility for inflation and righteously claim to be victims. Meanwhile, none of us does anything about it. Our error, it seems to me, lies in our failure to understand the fundamental nature of the economic phenomena involved in the inflationary spiral. This spiral results from the simple fact that a cause today becomes an effect tomorrow and tomorrow’s effect, in turn, becomes a cause the following day. It seems to me that we bankers, along with many others, beg the question when we assert that rising bank credit is clearly a result and never a cause of inflationary pressure.

If we wish to point to the underlying cause of our postwar inflation we can do so with much more assurance. It has been said that the beginnings lie in eleven consecutive years of peacetime deficit financing before the war followed by the unavoidable deficits of our government during the war. True enough, we had federal government deficits for eleven peacetime years—from 1930 to 1941. However, the increase of government debt placed with the banks was offset to a large degree by the shrinkage of private loans held by the banks and, as a result, the net increase in the nation’s money supply, as a result of peacetime

deficit financing, was neither great nor an important source of inflationary pressure prior to the beginning of World War II. The huge influx of gold in the thirties was a prime factor in increasing the money supply of that period. It was the really great deficit financing of the war years and more particularly the large amount of government debt placed with the commercial banks between 1941 and 1945 that far out-shadowed the peacetime deficit financing and brought on our current dilemma.

Increasing bank held government securities by some 75 billion dollars in the four years of 1941-1945 simply resulted in the generation of a like quantity of purchasing power in the form of bank deposits and currency in circulation. This huge quantity of purchasing power, like water impounded behind a dam, was held back from the market by wartime restrictions and scarcities. In the early years of a boom the pressure of pent-up purchasing power is not immediately relieved by free spending because spending itself stimulates production and production, in turn, generates additional quantities of spending power. This being the case, the only hope of slowing down a boom lies in deferring the spending money and speeding up the production of goods and services. Bank credit may be used to make unnecessary purchases and to withhold scarce goods from the market as well as to increase production. By and large, in my opinion, most of the expansion in bank credit up to now has been helpful to the economy. On the other hand, it must be quite obvious that some part of the money borrowed has, and is, adding to inflationary pressures. As a matter of fact, after the physical facilities for production, including the labor force, reach capacity beyond which expansion of production becomes impossible, then all increases in bank credit—for any purpose whatsoever—are inflationary.

If, as I have tried to demonstrate, bank loans are not dangerously high and have not yet been a major cause of inflation, why are we concerned about the trend? This is really the \$64 question, because

clearly we come to the crux of the problem when we ponder the questions—when and where will the increased use of credit stop and who has the power and responsibility for putting on the brakes? The background for this problem lies in the fact that under present day conditions the commercial banks of the country can continue to expand credit until it reaches fantastically dangerous proportions. Their power to do so lies in their ability to replenish their cash reserves practically at will by selling government bonds in a market where the Federal Reserve Banks are virtually the only buyers.

The pattern established in financing World War II has created a serious dilemma in the postwar management of our monetary affairs. During the war the banks were called upon to absorb about one-third of the more than 200 billion dollars borrowed by the federal government. How could banks buy 75 billion dollars worth of additional government bonds between December 31, 1941, and December 31, 1945, when, on December 31, 1941, they had only 82 billion dollars in deposits plus some 8½ billion dollars of capital and, of this total in resources, only 27 billion dollars in cash? They did not liquidate loans, in fact, they increased loans from 26 billion 600 million dollars to 30 billion 300 million dollars in the four-year period. The process was relatively simple. When the banks bought bonds from the United States Treasury they simply gave the Treasury credit on their books—not cash. The Treasury drew against these credits but the funds did not leave the banking system because they were redeposited by those to whom the Treasury made its disbursements. The net result was that as the banking system's holdings of bonds grew so did its deposits, and money in the form of cash was not needed until the cash reserves of the banks began to shrink below that percentage of deposits required by law. As this problem came up it was solved by the simple device of having the Federal Reserve Banks buy enough government bonds from the banks to give them the cash reserve they

needed. With reserve requirements of approximately 20 per cent of deposits the banking system could sell \$100,000 worth of bonds, acquire that amount of reserves and then proceed to buy bonds of five times \$100,000, or \$500,000, and again swell its deposits to the limit. This process went on and on and did not stop with the ending of war. It did not stop because the Federal Reserve System has seen fit to continue to support the market for government bonds at levels of par or above. The banking system—postwar—has continued to acquire reserves but instead of buying government bonds has made loans.

This situation, unique in our monetary history, can only mean that the nation's 15,000 privately owned and managed banks are in a position to keep on expanding credit as long as they own government bonds and the Federal Reserve Banks are able and willing to buy them. At the present time the commercial banks own more than 65 billion dollars of government bonds and it is estimated the Federal Reserve Banks could absorb 40 billion dollars of additional bonds without any change in the present laws. Following the reasoning outlined above, 40 billion dollars in cash reserves could support credit expansion of five times 40 billion, or say, 200 billion dollars. Maybe there is no cause for alarm in the total of 43 billion in loans outstanding at December 31, 1947, nor in the doubling of loans since 1939, but alongside these figures the potential 200 billion dollars really becomes a nightmare. Now, no one with any sense of responsibility would suggest such a figure as a serious possibility. In using it I only wish to point the limits of the problem and the real reason for concern over the trend in bank credit.

The fourth question I raised at the beginning of these remarks was this—if our concern over the trend of bank credit is well founded, what can be done about it? Clearly, either the banks acting voluntarily will achieve a proper measure of restraint or the central banking authorities must be granted additional powers. The American Bankers

Association recognized this choice clearly when it launched its anti-inflation or credit control campaign in January, 1948. The bankers of the country were urged to adopt measures of restraint, to weigh all loan applications in the light of their effect on the nation's economy. They were urged to preach the need for thrift and for deferring all unnecessary purchases in their communities. While it is too early to judge, and it is probably unwise to single out this campaign as the sole force at work, it is a fact that the rate of loan expansion by all banks in the United States has been decelerated so far in 1948. The trend in recent weeks again points upward.

Time alone will tell how successful a voluntary program of self-restraint can be. Competitive pressures in banking and from loaning agencies outside banking, plus the understandable tendency of bankers to meet local problems at the local level regardless of the nation's over-all problems, has led to considerable discussion concerning measures the government might and should take if the bankers cannot work out a sound solution among themselves.

In this field of government control a controversy has arisen concerning the need for additional power to be granted the Federal Reserve Board as the country's constituted central banking authority. The chief objectors to additional authority all seem to say the Federal Reserve Board and the Treasury Department have enough power now if they would only use it and they generally end up by suggesting that money rates should be allowed to rise and more or less seek a natural level. This end could be achieved by a variety of means but all plans contemplate either dropping support for government bonds or allowing their price to drop some points below par. Historically, the device of allowing, if not encouraging, money rates to rise somewhat precipitately has been used to stop inflation. In fact, the use of this device by the Federal Reserve System has been pointed out as a primary force behind the deflation that occurred in 1920-21, in 1929-32, and 1937-38. It may

very well be that the action of the Federal Reserve System did bring an end to the inflationary trends under way prior to the dates mentioned. However, it should be noted that the excesses leading to corrective action were not brought on by the monetary authorities and someone had to force a correction before the excesses of the times led on to even more disastrous results. Of course, no one wishes to be held responsible for bringing on serious deflation and everyone agrees that bringing on a mild or healthy deflation is like courting a mild case of leprosy. This is why the political leaders of both parties shy away from meeting the problem head-on.

Aside, however, from this delicate problem of stopping inflation without causing serious deflation, there are even more grave problems to be faced in 1948-49. A situation without parallel faces the nation with a debt of 250 billion dollars upon which the annual interest bill, at the low rates now prevalent, is over 5 billion dollars. Increasing the interest bill of the federal government raises a controversial social question, to wit: shall we take more funds from taxpayers in order to pay higher returns to those who own government securities? The answer to this question cannot be an unequivocal no when we consider what is happening to those who must live from a fixed dollar income. Aggravating the over-all problem of a huge debt and its colossal cost is the fact that some 51 billion dollars of the total is in the form of E, F, and G bonds that are redeemable on demand at the holder's option. If United States bonds bearing interest of  $2\frac{1}{2}$  per cent per annum are allowed to drop marketwise, they could reach a price placing their yield on a basis higher than E, F, and G bonds. Would not the holders of E, F, and G bonds be tempted to exercise their option to demand payment so as to re-invest in the more attractively priced marketable bonds? This raises the ever-interesting question—where would the United States Treasury obtain the funds to meet any substantial part of this potential demand upon it? Aggravating the problem

is the fact that the commercial banks of the country with about 10 billion dollars in capital funds own approximately 66 billion dollars of government bonds. Simple arithmetic will show that theoretically a drop of 15 points below par would wipe out all of the capital structure upon which 137 billion dollars of deposits rest. Now, indeed, this application of simple arithmetic is dramatic in making a point, but it does depart somewhat from the truth because a substantial portion of commercial banks' holdings are short and intermediate term bonds which would not follow the same price pattern if government support were abandoned.

Perhaps I sound alarmist—perhaps I haven't taken into account all of the pertinent factors in this brief look at a complex problem. If so, remember that I am undertaking to outline the problems and not necessarily give the correct answers.

If no one cares to take the responsibility for precipitating a serious deflation by the time-tested method of drastically tightening the money market, what else can be done in the monetary field to prevent continued inflationary pressure?

The suggestions advanced by the Federal Reserve Board in the past two years are all in the direction of tightening the reins on the money market without bringing it to a dead stop. This would be done by regaining for the central banking authority control over the lending policies and reserve position of the commercial banks—a control that was lost as a result of the wartime financing of the federal government.

The controls are qualitative in nature and quantitative. A so-called qualitative control over bank lending exists today in the form of Regulation "U" of the Federal Reserve System which sets the percentage a banker may loan on listed securities in all cases where the proceeds of the loan are used to carry or purchase listed securities. A second qualitative control is that over consumer credit which is shortly to be resumed, after a lapse since November, 1947, as



a result of laws enacted by Congress last month.

In the quantitative field Congress took mild action last month when it gave the Federal Reserve Board power to raise member banks' reserves by 4 per cent on demand deposits and 1½ per cent on time deposits. In trying to solve the problems of control over credit by merely increasing the amount of required reserves some really ticklish problems are encountered. In fact, results somewhat the opposite of those desired may actually be achieved.

For instance, there is the problem of bank earnings. Obviously, if banks are forced to immobilize a larger and larger portion of their funds in reserves that earn no return, they might conceivably really start reaching for loans which carry higher rates of interest than government bonds. If banks are pushed too far in this direction they may cease to be a reliable market for the United States Treasury which, in the event of a return of deficit financing, may suddenly need a cheap market for new security issues.

Again, with the commercial banks owning some 65 billion dollars of government bonds, it is hard to see how the power to increase reserve requirements by a mere 3 to 4 billion dollars—which is the increase likely to be achieved by the use of the power granted by Congress last month—can be really effective. Aside from the psychological impact of such a move it would probably have no appreciable result other than to cause the transfer of government bonds from the commercial banks to the Federal Reserve Banks. It is more realistic to conclude that the authority to increase reserves is a stop-gap measure offering a breathing spell while we observe the course of business in the several months ahead. Obviously, if it becomes evident that inflation has run its course no further action need be taken. If it hasn't, then only time has been gained and the fundamental problem remains.

These and other reasons, such as the continued inflow of gold from abroad and the ever possible return to the banks of excessive currency from circulation,

have led some of the experts, including Marriner Eccles, to suggest that the banks be required to keep a secondary reserve which, at the option of the banks, could be invested in short-term government bonds. This suggestion has been vigorously opposed because for the first time in our history it puts the government in a position virtually to force banks to buy and own its securities bearing whatever rate of interest the government chooses to pay.

One final observation concerning control over the money and credit mechanism of the country is this: the country's commercial banks are not the only institutions with the power to add to the spending stream—almost at will—by selling government bonds to the Federal Reserve Banks. The large institutional owners of government bonds—particularly the insurance companies—are in the same position as the banks except they lack the ability to use the funds several times over—an ability peculiar to banks because of the operation of reserves.

It seems quite clear that plausible objections will be raised to any plan looking to taking control away from bankers and giving it to duly constituted authorities. In banking, as in many fields of private enterprise today, we still hope to find some means by which we may "eat our cake and still have it."

To summarize, it is my belief that we Americans have been temporizing and compromising in the face of a dilemma—because we still fear the possibility of deflation more than the consequences of inflation. Time now runs against the likelihood of this course proving to be a happy one. We had better begin contemplating the wisdom of taking unpleasant medicine before we are the victims of a serious illness. The prescription is simple: "do any and all things that will curb or postpone spending by government or private buyers in the market place until and unless real production—not production measured by dollars of decreasing value—begins to catch up with the demands of an over-eager world."

# Law, Accounting and the Public Interest

by Tappan Gregory

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IN HIS LEARNED WORK, *The Spirit of Laws*, Montesquieu promulgated this dictum: "The beasts have their laws, and man his laws." But once upon a time, long, long ago, while man still consorted with the creatures of the wild, he and the beasts lived by instinct under the same law, the law of fang and claw, the law of the survival of the fittest, the law of the jungle, of nature, harsh and cruel. At long last he advanced to a higher plane.

He knew only the natural law, demanding from him that measure of consideration he would receive from others. He exercised his natural rights—the right to live, the right to eat, the right to mate, and when he found the lovely creature with whose life he would join his own, he clubbed her over the head, and dragged her off to his cave. I seem to envision the evening, when the boys gathered with him about the fire. I can imagine that as he boasted of his prowess and regaled his listeners with stories of his great conquest in his affair of the heart, his good wife, busying herself with her household duties, wore upon her face a wise and knowing smile, as though she would say, "Well, if it pleases him to believe that he had any part whatsoever in bringing us together, let him give himself the credit. It does no harm, and it will make him easier to live with." I offer you this bit of profound wisdom, dredged up from the abysmal depths of the bottomless pit of ignorance of such matters that I have been digging for myself during a lifetime of bachelorhood.

Discipline was maintained in those days in the event of the commission of

acts of violence, by the family of the subject of the violence to whom was accorded the right to visit punishment upon the offender.

Then man acquired agrarian habits and began to follow agricultural pursuits and abandoned his nomadic ways. As his sedentary habit of life began to develop, he must needs combine with his fellows against the depredations of those with predatory instincts. Thus families joined forces and the tribe was born. It was natural that the strong man of the community should be its chief, and as its success depended on his welfare, his life became of great value, and so men of violence who had formerly been committed to the tender mercies of the family of him who had been injured, must now respond to the judgment of the tribe, if the offense were committed so near to the presence of the chief as to place his security in jeopardy.

This procedure perhaps comes as near as anything to what might be called the criminal common law. For a time it was, in growth, not unlike the development of the common law on the civil side. You will remember that when a suitor first demanded a writ under which he might seek damages for breach of contract, the law courts advised him, "We have no such writ. There has been no trespass." Further deliberation, however, persuaded them that unless they met the exigencies of the situation by the exercise of some ingenuity, they would soon be largely ousted of all their jurisdiction by the Lord High Chancellor, and would become innocuous and useless. So they devised a new writ of Trespass on the Case on Promises.

Thus did our statutory law develop on both the criminal and civil side by

crystalizing and making certain in specific terms those things which had long been recognized by custom and usage. It did not create out of whole cloth new offenses, new sanctions, new procedures.

It was the sound of the voice of conscience, the ability to distinguish between right and wrong, that inspired for the first time the conscious development of law, and it was only when this transpired that man began to realize that he could not do as he chose and go his way in peace, unmolested, unless there were laws, rational, fair, agreeable to the governed, not by dictate from some higher authority, to preserve and protect the liberties he held so dear. Without law there could be nothing but disorder.

I believe it was the elder Pitt who said, "Where law ends, tyranny begins."

The practice of the law is a profession, as is the practice of accountancy. Those who follow these professions, especially educated and trained, if they are worthy, will recognize always that their objective must be service. Unfortunately, they are not endowed, nor are they subsidized and therefore they will of necessity require some compensation for what they do. But this consideration should never be allowed to crowd out the high ideal of service—service to clients, to their fellows in their respective professions, to these professions as a whole, to the public, to the nation, and to the welfare of mankind.

Every lawyer must recognize that at the threshold of his career he takes his license not as a matter of right, but as a privilege. The monopoly which he and his brethren at the bar enjoy is not for the purpose of protecting them, but for the public benefit, and this grant is continuing only during such time as the members of the bar by their conduct deserve the confidence of the people. For it is the people themselves, ultimately, who determine those who may be trusted to represent them in legal matters in or out of court. The people select their legislators, and either at the polls or by appointment through their agents, choose their judges. Legislators and judges,

representing the people, control the privilege of admission to the bar.

It is to qualify ourselves the better to sustain these duties that we devote so much thought and effort to the raising of our standards in preliminary education and continuing education after admission to practice, in maintaining high standards of ethics and in weeding out from our ranks those who are morally unfit. It is not always easy to persuade those in authority of the desirability of more exacting requirements, and curiously enough, it not infrequently transpires that the very people who stand to profit the most by such changes are the most insistent objectors. This is nothing new. You will remember that Shakespeare put it in the mouth of Dick the Butcher to say: "The first thing we do, let's kill all the lawyers." And his patron, Jack Cade thought well of the idea.

Of course, the practice of the law has not always rested in the hands of lawyers. There was a day when the only law that was known was the canon or ecclesiastical law administered by the clergy. This may very well have been due to the fact that few, not numbered among the ecclesiastics, could read or write. None of these was a greater leader or contributed more to justice under the law than that forthright and courageous Archbishop of Canterbury, Stephen Langton, leader of the Confederated Barons, who wrested Magna Charta from King John at Runnymede. He knew of the original Charter granted by Edward the Confessor and he it was who fostered the idea that the great Charter be patterned after that earlier recognition of the dignity of the individual.

We are officers of the courts, subject to control and direction by the courts. At the same time, obligations rest upon us to insist upon the integrity of our position at the bar in the exercise of the duty we undertake to represent, single-mindedly, the interests of those who place their problems in our hands. Sometimes this brings us in respectful conflict with the courts. Never was it better illustrated than by Lord Erskine,

that greatest of all advocates, in his exchange with Mr. Justice Buller on the trial of the Dean of St. Asaph. As you know, the debate between the learned Justice and Erskine centered around the question of the recording of the verdict of the jury exactly as given, and the following passage of a few lines may be remembered to advantage by all of us. For here Erskine exhibited great firmness, great character, and great courage, without in the slightest degree trespassing upon the conventions in his relationship with the court:

MR. ERSKINE. The jury do understand their verdict.

MR. JUSTICE BULLER. Sir, I will not be interrupted.

MR. ERSKINE. I stand here as an advocate for a brother citizen, and I desire that the word only may be recorded.

MR. JUSTICE BULLER. Sit down, Sir. Remember your duty, or I shall be obliged to proceed in another manner.

MR. ERSKINE. Your Lordship may proceed in what manner you think fit; I know my duty as well as your Lordship knows yours. I shall not alter my conduct.

And he did not, and Mr. Justice Buller proceeded in no other manner.

The story of the development of accountancy is of absorbing interest to all who know something of the growth and expansion of commerce throughout the world and the manner in which men will adapt themselves to changing conditions and grow and broaden their perspective even as their problems become more complex. There is much of inspiration to be derived in the history of the extension of the duties of the bookkeeper to the present day development in the building of a great profession competent to review the work of others; to study and plan for the casting of accounts, the building of financial structure and intelligent allocations in the carrying out of great and complicated enterprises.

Even before the great advance in accountancy inaugurated in the middle of

the nineteenth century, George Watson stood out as a leader of your profession, and even before the day of George Watson, as early as the sixteenth century, there is record of the organization of an association of accountants.

Manifold duties of those conscientiously devoted to public service in the profession of accountancy exact study and learning second to none. To qualify for the discharge of these duties and the maintenance of the high levels of efficiency upon which we have all come to rely so extensively, you cannot be content any more than are we of the legal profession without seeking ever to raise your standards and to ask more of education and learning from day to day of those who would join your ranks.

Probably no aspect of accountancy today requires more knowledge, more study, more application of keen intellect, than the solution of the complicated problems of taxation current in every phase of human activity. And no matter has caused more anxiety between your profession and mine than the proper solution of the great and vital problem of how we may combine our efforts and pool our talents to serve best the interests of the people, the members of that great public who look to us for help and advice in guiding their affairs that they may know to the full extent the security and comfort in their daily lives of being able to order their affairs wisely and soundly.

I am not unmindful of the dictum of those who would say that no one but a lawyer may ever practice law, and I am fully conscious of some of the controversies presently being carried on between our two professions. Recent decisions of the courts may perhaps be subject to criticism on the ground that they may open the door to further misunderstanding and unsound doctrine. It is impossible for me to follow the argument that the construction of a law does no constitute the practice of law. It is not simple to define the practice, but of one thing we may be sure and that is that it is not confined to appearances in court and service in connection with

litigated matters. The courts have decided that any service involving the exercise of legal knowledge constitutes the practice of law.

On the other hand, I would not agree that no one but a lawyer should ever practice law. There is no magic in the word "lawyer" and when the time comes when others may render the service now committed to lawyers better than lawyers do, or as well at less cost, and subject to the same control of the courts, then the claim of the bar to the sole right to represent others in matters involving legal principles may well be challenged with reason. My premise is rather exacting. I do not speak of the opinion of the careless few, of the casual guess of those inspired in their opinion by selfish motive, but only of that situation which may arise when the fact is susceptible of definite proof.

And so I come back again to the thesis that your interests and ours, if we are to justify our claims to the confidence of those we would serve, must merge in

the common objective of that close and understanding collaboration which will make available to our clients the best that lies within the competence of both of our professions working together in common cause. What higher ideal may we have than the rendering of service and the concentration of effort to bring that service to higher levels over the years in the interests of those who rely so implicitly upon our talent and our conscience?

Lord Brougham once said in a famous speech:

"It was the boast of Augustus . . . that he found Rome of brick and left it of marble. . . . But how much nobler will be the sovereign's boast when he shall have it to say that he found law dear and left it cheap; found it a sealed book, left it a living letter; found it the patrimony of the rich, left it the inheritance of the poor; found it the two-edged sword of craft and oppression, left it the staff of honesty and the shield of innocence."

## Accounting Education

# A Critique of the Uniform CPA Examination

by J. William Hope, CPA

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THE UNIFORM CPA examination is prepared by the board of examiners of the American Institute of Accountants and has been adopted, as their own, by the examining boards of forty-six states, four territories, and the District of Columbia.

Though the candidates for the certificate to practice public accountancy as certified public accountants have unquestionable claims to fair treatment and reasonable protection in the conduct of the examination in the various jurisdictions, it must be accepted that the primary purpose of all of the fifty-three CPA laws in these United States was to protect the public against incompetent practitioners.

Any opinion that I may express in this discussion of the excellences and faults of the uniform examination as they are found by and reported to the Institute's

board of examiners gives consideration first, and of greatest importance, to the public interest. Next, in accordance with my belief, the need for fair and impartial treatment of the candidates has been the guide. Then only, though still having real weight, the integrity of the profession has been a factor in forming my opinion.

In this short critique, I will not attempt to stress the excellences of the uniform examination, for they will probably be apparent in the answers I have for the faults which are attached to it by its many critics.

Directing our attention first to the complaints that are received from the cooperating state boards which have the responsibility for testing the candidates for the CPA certificate within their jurisdictions, they being the authorities to whom our board of examiners must answer directly for its deficiencies, we learn after each examination that somewhere in the selection, type, length, phrasing, or proofreading of one or more questions or problems, the exacting standards of the examining boards have not been satisfied. For the Institute's

board of examiners there can be no comfort in the bromide, "It is human to err." Nor can we find refuge in the fact that never have errors in preparation approached anywhere near the 25 per cent variance from perfection which the candidates are allowed. Any mistakes are readily admitted and all available means taken to alleviate their affect on the candidate's position, in the course of the grading. The differences in opinion as to propriety of the substance of the questions and problems are accepted as indications of controversial matter which should be avoided in the future. The Institute's board is continually re-examining the protective measures it employs to avoid errors of omission or commission and a brief recitation of the procedures it follows in the preparation of an examination is probably in order at this point. It is understood that every question or problem in each examination must be different in texture from all the others that have gone before, requiring a constant search for new thoughts and the building of a reservoir of raw materials from which a satisfactory finished product can be prepared. In addition to the suggestions of the board members themselves, instructors and practitioners are requested to submit material, and textbooks are studied for ideas which can be adapted to use through reconstruction. This material is carefully screened by one or more experts in the fields of accounting theory, practice, auditing, and law, who are retained by the board for this purpose, and the outlines of questions and problems are prepared therefrom by these experts. They are then submitted to sub-committees of the board of examiners to be worked over, and approved or discarded. The material which is thus selected as fitting the needs is then refined in conferences of the sub-committee members and the supervising experts. At this point, capable CPAs are selected to write the proposed examination as a test of reasonableness and solution possibilities at a passing level, as well as to gauge the time allowed to candidates for completion. This "guinea-pigging" of the examination is also ex-

pected to disclose ambiguities and errors in phrasing, figures, or other elements of compilation. Adjustments are then made according to the experiences of and results obtained by the "guinea-pigs," and what is then concluded to be a finished product is submitted to the full board of examiners for study and approval. The completed examination is then processed for printing, under controls which are exerted on a very strict basis, and the printer's proof is carefully checked before final approval. Yet, for all this precaution in the selection of good material and in processing, it must still be admitted that the results are not always satisfying. Mechanical errors, where they occur, are never fully explained and there is no answer except that there can be no relaxing of the safeguards employed to avoid them. As to criticisms of the substance, it must be conceded that not even those who are responsible for its preparation believe there will ever be an examination that will fully satisfy everyone who may be concerned with it. However, the board of examiners never fails to study and inquire carefully into every complaint it receives and always accepts constructive suggestions in its continuing attempts to meet its responsibilities. The board also recognizes that the observations of detached critics can be most helpful and continues to invite their assistance. In this regard, a letter was recently addressed to the members of all cooperating state boards requesting suggestions for improvement, and the replies received were made the subject of open discussion at last Monday's meeting of the Association of Certified Public Accountant Examiners. Much that is good and useful came from this communication and discussion, and the continued interest of all state board members will insure the acceptance of the uniform examination as the fairest method of determining the qualifications of a person who claims to have the necessary abilities to meet the requirements of the public as a certified public accountant.

Consideration of the public interest in the uniform examination is confined, in this section of my paper, to that part of

the public which relies on the services of a certified public accountant as an integral part of its operating structure. Fifty-three laws in forty-six states, four territories, and the District of Columbia assure the public that the state will conduct an examination of anyone who claims to be capable of practicing public accounting as a CPA. It can be assumed that, because of these laws, the public has a right to expect that no person who is unqualified shall be admitted to such practice and that the examination shall be placed at a level which will guard against the admission of incompetents. It must be admitted that a written examination is not always a fair test of the inherent abilities of a public accountant to serve adequately the public interest, and most examiners would prefer to give some credit to candidates for experience, training, character, and other personal qualities that can not be transmitted to the examiners in a writing. This, however, would introduce the element of personal opinion and probably would create more criticism than does the written examination. It seems that there can be no better protection of the public interest than that the appointees to state boards shall always be honest and conscientious administrators whose own reputations as outstanding professional practitioners will insure the best of service in the public interest.

The integrity of the profession demands that the uniform examination be at a level which will insure that all and only those who are qualified may be entered into its ranks. This attitude frequently attaches criticism of an adverse nature to the conduct of the examination by administrators who are themselves CPAs and are often accused of setting the examination at so high a level that competition is stifled. It is safe to say that this sort of thinking is unfounded, and certainly represents a minority point of view, for the legislative bodies of fifty-three jurisdictions would not permit such an abuse of authority to continue. In the recent instance where this sort of criticism had the necessary support to convince a state legislature

that there should be some relaxing of its protective law, the quick repeal of this legislative mistake is evidence enough that more careful study of the purposes and the operation of the CPA laws fully supports their desirability in the public interest. The profession does have a vital interest in the examination for, too often, the measure of the attainments of a profession is the demonstration of ability by its weakest member.

Any easing of the examination requirements would reduce the CPA certificate to a mere bauble as a reward for the accomplishments of the candidate who has properly prepared himself for this specialized service to the public. It is the complaints of some unsuccessful candidates and their supporters, however, which are loudest and have the greatest effect on legislators and other sympathizers with the causes of those they are led to believe are downtrodden.

The variety of the complaints from these sources centers around the claims that the examination is too difficult or that the profession is conducting a "closed shop" against aspirants who seek to enter the fields which those who are already certified have captured. It is probably true that the examination is difficult, but it has not been proved to be at a level beyond the capacities of candidates who have prepared themselves through education and experience for the high type of service which the public interest demands. When there is acquaintance with the fact that only one state insists on a college education as a prerequisite, some states have no public practice experience requirement, while there are others which require no such experience and no education beyond the high school level, it is not difficult to understand how some ambitious persons who have no aptitude for practice at the professional level present themselves for examination and increase the number of failures. It is also true that the percentage of passing as reported for each examination is low in comparison with the results obtained in other professional examinations. However, the CPA certificate is not a degree awarded to students



for proficiency but is a test of the efficiency of those who wish to practice public accountancy as certified public accountants. Many take this examination who either have had no education at the college level or have been engaged in business long enough to have grown a bit stale in examination techniques. It is not unusual for good men in these groups to fail on their first try, but perseverance produces the desired results and state board statistics show that about 60 per cent of all candidates eventually pass the examination. The 40 per cent balance is composed of some who are completely incapable, others who become discouraged and will not persist in their endeavors to overcome their deficiencies by further study, and a large number who do not continue to try because they secure employment in some field other than higher accountancy. This candidate experience of success with the examination is probably outstandingly good when considered in the light of the law requirements for education and training. Maybe we should not be so disturbed about complaints from sources which probably have little acquaintance with the actual conditions or are of the type which seems to delight in finding fault with the work of others, for I want to be most explicit in acknowledging that these complaints seldom come from candidates. In this regard, I addressed a questionnaire to all of the candidates who took the November, 1947 examination in my own state and asked for their opinions of the examination and their appraisal of its fairness. It is evident to me, from the more than 80 per cent of responses received, that the candidates were willing and ready to express their opinions and that even those who had failed, and were probably feeling a bit disheartened at the time, did not want the examination requirements to be lessened. All were looking forward to being some day a part of a strong profession which would continue to deserve the confidence of the public. Many expressed the conviction that members of the profession should be directing their attention to its strengthening by making the general public better ac-

quainted with the difference between a CPA and a public accountant and that our professional standing could be improved if there were some controls over everyone who offered his services to the public as a public accountant.

As you know, the American Institute of Accountants has supported the regulation of practice as one of the best means available for integrating the profession, with adequate controls and limitations on practitioners of public accounting. These efforts have met resistance within its own ranks, however, because the legislation which would be necessary to accomplish this purpose would have to embody the recognition, through registration, of public accountants who are now permitted to practice without any control or previously demonstrated ability to serve the public as accounting practitioners. The non-certified groups have also opposed such legislation because it does not give them equal standing with CPAs who have passed an examination. This proposal for new legislation has also been viewed with suspicion by some legislators because it appears to the uninitiated to be self-serving. Though I know that there are many who disagree with me, I am convinced that the proposed regulation of all public accounting practice would be good for everyone who may be concerned, for, in due time and if properly administered, the requirement for examination of all who wish to practice public accounting would warn of the need for adequate preparation, and a better quality of service and stronger controls in the public interest thereby would be insured.

Pending the time when the public will insist that all practitioners must be examined to prove their qualifications, we must continue to make certain that the examinations of those who wish to practice at the higher level of certified public accountants are conducted primarily and principally in the public interest and that we never permit selfish purposes, either of CPAs or candidates to dominate our conduct. This can be stated as the purpose of your Institute's board of examiners.

# What Academic Preparation Should a Prospective Professional Accountant Receive?

by Donald P. Perry, CPA

[Donald P. Perry, CPA, a partner in Lybrand, Ross Bros. & Montgomery, Boston, is a member of the American Institute of Accountants.]

WHILE I missed the benefit of formal schooling in accounting subjects and have not found time to undertake teaching in that field, as a practicing accountant I am keenly interested in the question—"What Academic Preparation Should a Prospective Professional Accountant Receive?" Furthermore, I am aware of the advantages and need of academic preparation for the profession and believe that the general answer to our question should be that the prospective public accountant should have as much and as broad educational preparation as he can afford in time and in money. I agree with A. C. Littleton that "a complete education for an accountancy career would necessarily be extensive; probably it should run longer than four years. It should be inclusive, that is, cover an adequate general education and a thorough business education in addition to an extensive education in accountancy as such."

Without attempting to deal with the subject exhaustively or with details of curriculums, academic credits, or content of courses, I propose only to discuss briefly the following propositions:

1. No one standard course of academic study will constitute the best preparation for every individual.

2. The general education aspects of academic preparation merit more time than they frequently are allowed.

3. Accounting and auditing courses should emphasize primarily principles and theory and secondarily, to the extent feasible in classrooms, the application of practical techniques.

4. Techniques are best learned in field practice or internship programs, arrangements for which require greater efforts in cooperation between universities and professional practitioners.

## Variation in Educational Programs Desirable

For several reasons it does not seem desirable, for the present at least, to prescribe a uniform and standardized curriculum as the best academic preparation for professional accounting. It is not practicable to determine just what such uniform requirements should be at the present stage of the profession's development. Also, it is probable that the profession will always need practitioners with varied talents and varied educational backgrounds.

In 1937 the committee on education of the Institute suggested as a normal collegiate preparation for professional work a four-year course of which approximately half the time and effort should be devoted to general subjects and the other half to business courses with emphasis on accounting. By resolution council of the Institute approved this suggestion in principle and at the same time opposed setting up rigid educational requirements which would prevent individuals otherwise qualified from becoming certified public accountants. It

maintained that the certificate should be available to candidates lacking formal education but having extensive apprenticeship training. Recognizing that many of our successful practitioners have had varied educational backgrounds, and that self-education by study or reading is possible for men with sufficient interest and will power, the council believed that the profession should remain open to those who have not had opportunity for academic preparation; and it favored substitution in such cases of a graduated requirement of extensive additional experience in practice. On the other hand the council resolution recognized the most desirable preparatory educational standards to be a full college course in liberal arts plus graduate work in the accounting field. It expressed the hope that there might be separate colleges for accounting of coordinate rank with colleges of law.

The Institute committee on education in 1942 stated that it was extremely difficult to establish minimum standards of accounting education, due to fundamental differences of opinion among educators regarding proper emphasis as between different subjects. In 1945 this committee expressed the opinion that it was impracticable to attempt to prescribe a uniform curriculum for all colleges, but believed a minimum program to be both desirable and feasible. There have been many other opinions expressed regarding the ideal curriculum preparatory to the profession, both by individual members of the American Accounting Association and by committees of the professional societies. Some of the suggested curricula have been developed in considerable detail. Well considered proposals of a concrete nature appear in a report of the committee on education of the New York State Society issued May 22, 1947.

Characteristic of the accounting profession is a considerable volume of transfer between professional work and private employment. A collateral result has been a tendency for our educational institutions to combine academic preparation for professional accounting

with training for accounting or financial positions in industry. This condition, together with the relative youth of accounting as a profession, has led young people in school and college to postpone decision in favor of careers in professional accountancy until relatively late in their period of education. Unfortunately it has been typical to find men approaching the conclusion of their collegiate or even post graduate business courses who are still undecided whether they shall go into public accounting or into the direct employ of industrial corporations. Many schools have found it impracticable to offer courses of study directed primarily to preparation for a professional accounting career, as do the schools of medicine, law and theology for their fields. The Institute and state societies have been endeavoring to educate the public, particularly young people desiring vocational guidance, concerning the nature of work and the opportunities in the profession. As a result of their concerted effort, we hope that in the future a greater number of young people will be in a position to point their sights specifically toward public accounting throughout their college years. It will then be possible for the colleges to do a more definitive job than can be done at present in laying out pre-professional curriculums.

Even if every future entrant to the public accounting field were to make his vocational decision on graduation from high school and were in a position to devote four to six additional years to academic preparation for the profession, it would still be desirable to provide sufficient electives so that each student would not be subjected to the same prescribed regimen of collegiate fare. The accounting profession and each accounting firm or office is better qualified to render service to the public if its members, in addition to a common core of accounting knowledge, have varying backgrounds with reference to which they are qualified to apply the basic principles of accounting. Indeed other professions carry on their practices to some degree with specialists, as we note

in organizations of consulting engineers, medical clinics and legal firms. The individual members of such organizations have varying qualifications arising from differences in temperament, in academic training and in experience. In public accounting types of practice vary. The requirements of large and small sized firms also may differ materially. Each firm finds it advantageous to have available in its organization men of diverse backgrounds. Some engagements are better handled by the accountant with a specialized knowledge of statistical methods, others by the man who has studied engineering. An understanding of production problems, of merchandising methods, of corporation finance, of taxation, and of economics is well nigh essential to every practicing accountant. However, almost every engagement is specialized to some extent and may be directed more advantageously by an accountant schooled or experienced in the type of problem to be encountered. Present day leaders of the profession have entered it without any single type of academic preparation. Surely the profession would suffer if its membership in the future should all be cast in one mould. The advantages of variations in academic backgrounds apply to both general education and business subjects, if not to the technical field of accounting and auditing principles.

### **General Education**

When educators and practicing accountants have considered what academic education is most desirable for professional preparation, they have usually concluded that the prospective public accountant should have the benefit of a college course at least half of which should be devoted to liberal arts as distinct from business and technical accounting subjects. The 1945 report of the Institute's committee on education stated that most deficiencies in college courses were in studies outside the accounting field and that more collateral reading was desirable to broaden the student's concepts. The committee's 1946

report stressed the need for more cultural subjects and urged that the colleges strive to develop students with inquiring minds and with ability to write and speak the English language effectively. The 1947 New York State Society committee report recommends extensive schooling in the liberal arts to develop a general understanding of the world, its history, and economic, political and social problems, and familiarity with the relationships and controls of modern life.

In reciting the qualifications of the professional accountant, Edward B. Wilcox has stressed such intangibles as intellectual stature, adaptability, insight, courage of convictions, an unassailable sense of ethics and industry. Such qualities are not developed in the broadest way by concentration on the specialized study of technical accounting subjects or of business administration. The development of thought through the ages as set forth in the history of philosophy and in the literature of our own and other languages gives the background for appraisal of present day ideas. History, sociology, political science, and economics are studies which add to our understanding and insight regarding the industrial and commercial activities which are measured and summarized and interpreted by modern accounting. A command of language both spoken and written should unquestionably be a basic attribute. As has been often said, the accountant's efforts are of little avail, if he cannot communicate their results to others. Such communications must be in language common to all educated men and not only to fellow specialists. Finally, the term "professional" implies that a man has qualified for the society of educated men, if not of scholars, that he is more concerned with ideas than with things and is ready and eager to exchange ideas, that he has developed habits and powers of logical thought. Such qualifications can hardly be attained without study and reading at least by way of introduction in mathematics, philosophy and literature or the fine arts.

Despite general recognition of the

major importance of the liberal arts in academic preparation, it appears that in practice the average collegiate program of study for prospective accountants does not allocate a comparable portion of time to these subjects. Possibly the cloth cannot be cut to fit the desirable pattern and still produce an accounting major. On the other hand, this may be in part the result of temporary pressures. The complexities and scope of accounting techniques have increased greatly in recent years, because of wartime and other governmental controls and the economic problems of the postwar period, so that colleges have encountered difficulty in compassing sufficient technical preparation with allowance also for adequate education in the liberal arts. The demand for qualified accountants since the beginning of World War II has been far beyond what could be met. Consequently, technically trained men have been snapped up irrespective of deficiencies in the broader aspects of preparatory education. Then too the careers of many young men have been interrupted by war service, leaving them with unusual urge to plunge into their life work and to make up for lost time irrespective of what would be optimum education. We in the profession as well as educators must struggle against these pressures, lest in the future we find that improvement in our basic standards shall not have been maintained.

### **Academic Accounting Education Should be in Principles and Theory**

In common with certain general trends of education in our country, which are under criticism from some educational leaders, many accounting schools have planned their courses primarily from the vocational point of view. Apparently their chief aim is to prepare students for the best immediate positions available whether as juniors on a practitioner's staff or as accountants in industry. As a result their students have become familiar with technical practices, sets of rules, and detailed methods of recording transactions and summarizing

records. But these students may have too little comprehension of the underlying principles and philosophy of accounting to understand the reasons for the rules or to be discriminating in their judgments between good and bad methods. A practitioner is not professional in fact unless he has mastered a broad understanding of the underlying principles against which he can test his decisions and opinions in practice.

A considerable body of principles and theory has been built up and is still being developed, based on an underlying philosophy of the purposive nature of accounting as representing a means to desirable social and economic ends. The validity of its principles must stand or fall on the success of accounting in leading to sound investment of capital, meeting the administrative needs of management, promoting fair bargaining between labor and management and supplying data for regulation of commerce, industry, and finance in the public good. The principles and philosophy of accounting have thus come to assume a broad significance, of an order different from that of detailed techniques of method and procedures. This significance should be recognized by our educational administrators, together with the fact that the university is better qualified to provide instruction in the theory and philosophy of accounts than it is in practical techniques. For surveying basic theory the relative sequestration of university faculties from the marts of trade provides an objective vantage point superior to the position of the professional practitioner. At the same time faculty members may be at a disadvantage in dealing with the specialized applications of accounting theory to particular situations.

Thus college courses in accounting principles should deal primarily with the fundamental philosophy of accounts and not with special techniques. Cost accounting courses should present expositions of the basic theories of the various concepts of costing. Auditing courses should cover verification methods in principle, the nature of creditable evidence and

the function of internal control. Courses in federal and state taxes should deal with the principles of taxation rather than with statutory details or forms of returns.

Furthermore the student is entitled to approach his professional studies from the broadest point of view and to have guidance in erecting a framework of theory into which his continuing advance in practice may be fitted. The professional accounting field has become so wide and complicated that it is no longer feasible in academic preparation to cover comprehensively both theory and details of practice.

This comment is not intended to imply that accounting and auditing laboratories and the practice sets used under guidance therein should be eliminated. The laboratory work and case studies are of real importance to students when used to afford an opportunity to test and evaluate the broad principles of accounting, while they also provide students with simulated practical experience. The validity of the use of practice sets is questionable if these sets are used as a medium for teaching only techniques.

### **Cooperative Educational Programs**

The young man who enters practice immediately after an academic preparation which is largely theoretical may be at an initial disadvantage as compared with the graduate of an accounting school operated from the vocational point of view. The former may encounter more difficult adjustments in bridging the gap from university to practical work and feel a let-down as he turns from debating in classroom the depreciation policies of our largest corporations to such routine matters as vouching of checks and invoices. Intelligent understanding on his part of the whole long process of professional training and development will make this adjustment easier. Many young men do take keen interest in these first practical applications of theoretical training, despite their routine nature. Nevertheless, both the

profession and accounting educators should continue exploratory efforts to find practical means of bridging this gap, such as by cooperative programs. The medical profession and engineering schools have developed successful internship or cooperative programs which closely integrate theoretical studies with practical experience. Practical work in accounting schools, however, has generally been found insufficient preparation for the profession, as evidenced by the number of accounting firms which start men fresh out of college with more or less extensive training courses. Pseudo experience from practice auditing sets, textbook cases and problems in accounting practice do not approach sufficiently to the reality of working on an accounting engagement.

Successful development of programs in the accounting field which provide intervals of real practical experience during an academic course will require even greater cooperation between colleges and practitioners than in the past, together with a willingness by both to surmount inconveniences. The schools might find it necessary to revise academic schedules, while accounting firms would need to devote increased time, effort, and attention to training programs without expectation of immediate productive reward. Arrangements for intervals of practical field work would be more feasible if the colleges presented programs of study, designed solely for professional preparation rather than commingling future practitioners in classes with students preparing for industrial accounting or other business careers. The practicing firm will have difficulty in providing a student with experience in particular areas which integrate with his academic work. But the problem is not insoluble if the firms and the schools work closely together in their educational planning. It may be that responsible apprenticeship training will prove to be a more appropriate solution than an academic course broken by periods of field practice. In any event further extensive experimentation with cooperative pro-

grams is desirable to give such plans thorough testing. Experimentation seems feasible since most accounting firms recognize the long-run advantages of a higher level of professional training.

Cooperation between educators in accounting and the profession, I believe, is closer than ever before, both in the

field of training and in research and development of accounting principles. As a member of the profession, I am happy to acknowledge our debt to individuals and groups in the educational field and believe we should pledge them our continued cooperation in all efforts to raise educational standards.

## **In-Service Training of Members Of the Staffs of Accounting Firms**

**by Richard S. Claire, CPA**

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**S**TAFF TRAINING in public accounting, as I see it, can be conveniently broken down for purposes of discussion into two aspects. One is the job of bringing the newly hired assistant or junior as rapidly as possible to the point where he can operate effectively with a minimum amount of supervision. The other is the task of keeping the performance of the experienced or senior staff man at a level commensurate with his responsibilities and seeing that he continues to grow and develop. This paper is directed primarily to the first of these two aspects of staff training. In other words, let us consider what is now being done and what probably should be done to expedite the progress of the beginner in public accounting.

Not much has been written on this subject of staff training for beginners. Three or four of the larger firms have been conducting somewhat formal programs but it is probably fair to say that they look upon their efforts as being still somewhat in the experimental stage, and

for that reason program details are not widely known. One firm has undertaken formal training for beginners this year for the first time. Discussions which I have had with representative smaller firms lead me to believe that, as a rule, they rely principally on training on the job supplemented by the use of staff manuals to bring their juniors along toward senior status.

In some respects the fact that the public accounting profession is comprised of firms of widely differing sizes makes it somewhat difficult to discuss this topic of staff training for juniors and reach any conclusion which might have universal appeal or applicability. On the other hand, the objective of bringing a beginner rapidly to the point where he can operate as an in-charge man should be common to all firms regardless of size and, in my opinion, the means by which such an objective may be attained need not vary too widely. Lack of size may be an excuse but never a reason for a do-nothing attitude toward staff training.

Before entering into any discussion of the means by which beginners may be trained, a word or two about the reasons which lie behind the unusual interest at

the present time in such training would seem to be in order. I assume that there is no disagreement with the proposition that everyone in the profession is now giving more attention to staff training than ever before.

### **From the Employer's Viewpoint**

First of all let us look at the problem through the eyes of the firm or employing accountant.

Each of us is keenly interested in drawing young men of outstanding ability into the accounting profession and, of course, into our own particular firm. If we are to attract such men we must offer more than a long period of apprenticeship unaccompanied by a planned program of training. The firms that offer the best training rightfully have a big advantage in the competition for the ablest of those who are entering the profession.

Although I must admit that I have never seen any statistics which would prove or disprove this point, there is considerable evidence that those who have invested rather heavily in training for beginners have satisfied themselves that it pays off in the long run. Those who have initialed training programs seem to continue them year after year, and more and more firms seem to be starting them.

Another reason why every progressive firm should provide its juniors with suitable training lies in the fact that the area in which a public accountant is expected to be expert is a continually expanding one. Even a junior is today expected to be more than a figure checker or a vouching expert. As business becomes more complex and intricate, so do the duties and responsibilities of even the beginning accountant. Frequently the men who come directly into the profession from our universities are somewhat surprised to learn of these broadened responsibilities, and the training program of the public accounting firm may have to stimulate this broadening process.

Obviously the universities cannot train

men in the specialized requirements of particular firms. Since firms differ quite a bit in their audit working paper procedures and styles, a training program for beginners serves a very useful purpose in this respect.

Finally, and we all hope this condition is only a temporary one, the present shortage of qualified men in the senior and supervisory levels places on beginners an unusually heavy responsibility to be able to carry out certain phases of an audit with a minimum amount of supervision.

### **From the Beginner's Viewpoint**

From the standpoint of the men who are entering public accounting, an attractive training program is an important feature.

These men are today older and more mature. They were in military service during the years in which they normally would have been starting their public accounting careers. Now they're anxious to make up for those years spent in the service. They want to be sure that the public accounting firm of their choice has plans and programs for hastening the day when full responsibility for field work will be theirs.

While they were in the armed services they were impressed by the effectiveness of the training programs that were offered. So, it is quite natural for them now to conclude that a public accounting position is sub-standard unless it includes a program for training beginners. To some the training program is the fringe benefit that tips the scales when deciding which firm to join. Such an appeal carries real weight at these times when salary scales are fairly comparable and there are more positions than qualified applicants.

### **On-the-Job Training**

The time-honored method of training an assistant by assigning him to a job and relying on the senior-in-charge to do the teaching is still unsurpassed, at least in theory, for effectiveness. Certainly



classroom teaching, attendance at staff meetings, and study of staff manuals can do no more than supplement the real development that comes from on-the-job training.

However, before we decide to leave everything to on-the-job training we should review some of its inherent weaknesses. Good audit seniors frequently are not good teachers. Even if they have the ability to teach they may not wish to take the time to explain or train; their reputations as seniors are not unrelated to meeting the time estimates for the engagements. If all is left to on-the-job training, some beginners get trained much faster and more thoroughly than others; much depends on the element of chance in assigning assistants to engagements. In many respects it is a slow but sure process; it needs to be supplemented and expedited by other means. Furthermore, if a beginner learns by emulating a senior it seems quite clear to me that the caliber of the senior's work tends to set a ceiling on the junior's performance and that is not always a healthy situation, especially under today's conditions. If something can be done to develop alert assistants to a certain degree before turning them over to on-the-job training, it is really surprising the value that can come to a firm as a whole by having them modestly prodding the seniors with suggestions of newer and better ways of doing the job.

### **Formally Planned and Conducted Schools**

The idea of conducting a school for beginners has been sufficiently widely adopted to warrant devoting more than a small portion of this paper to this training device. Obviously, training fifty beginners presents a different problem from that of training five men. Some will say that the larger group should be handled by a formally planned and conducted school but that a school for five is out of the question. My reaction to such an approach is that a real determination to train the men is all that counts; difference in size of group in-

volves only the details of executing the program.

Assuming that you agree with me that the number of juniors to be trained is of less importance than the will to do the training, let us examine some of the preliminary decisions that must be made early in the planning for a school. Objectives will have to be agreed upon first. Allow me to suggest a few that seem important to me.

A very significant objective that is sometimes overlooked, especially in the case of the larger firms, is that of a program of orientation for the new man. The school should provide something to supplant the old-style initiation into public accounting which consisted of a seat in the unassigned staff room or in the footing and comparing room, plus a bundle of literature to be read. Public accounting depends heavily on teamwork and esprit de corps. The sooner that the new man can be made to feel at ease and realize that he has joined a team, the sooner he will become an effective junior. The mystery about the new job and where the beginner fits into the organization ought to be removed at an early date. Tell him about your organization, its history, its personnel policies, its standards of performance, and what it expects from him. In fact, it's not too early in the career of your beginner to tell him about your firm's policies on certain controversial accounting and auditing questions. He'll admire your willingness to discuss such matters in the open and look upon it as evidence that he is a member of the team. Stress such points as conduct in a client's office and the importance of getting along with other staff men and the client's personnel. Explain professional behavior to this man who yesterday was a college boy.

At an earlier point in this paper I indicated that the universities can train for auditing work only in terms of generalities; now it's up to you to show the beginner your style and special requirements in matters such as preparation of audit working papers. Teach him your approach to an audit engagement. I think these objectives are the principal

ones around which you should build your instructional material, further reference to which will be made in more detail later.

Another objective which deserves an important place in the planning of a school is that of explaining why certain audit procedures are followed and why, under certain circumstances, certain ones may be omitted. Many college graduates seem to be schooled in audit procedures but are lacking in an understanding of the reasons which lie behind the importance of those steps. If, in your school, you can inject into the beginner's mind some understanding of these underlying reasons, you will eliminate much which might otherwise appear to be aimless and unsavory in the auditing routine. As in many other lines of endeavor, things become more interesting as they become better understood.

I'm sure it will be unnecessary for me to elaborate on this next point. Even though you may have hired the best men from your favorite university, your own school can do much in a short period of time to strengthen and extend the abilities of your beginners in auditing techniques.

Use your school as a means of helping the beginner strengthen what is probably one of his weakest points: his ability to write and speak concisely and effectively. This, I might add, is not easy to do.

Now that we have agreed upon some objectives, two other important points remain—operational plans must be set and instructional materials and methods agreed upon.

If your firm has several offices, one of the first questions to be answered will be whether or not to conduct a school in each office, hold regional schools, or have a single centralized school for all offices. I favor the centralized school because, among other things, it will best serve the purpose of fulfilling that important objective of orienting the junior. Furthermore, the centralized school will probably be better planned and arranged. It will command more attention and will be more likely to be carried out in an unin-

terrupted fashion. Classroom facilities will be more carefully thought out and provided, instructors will be fewer in number so their preparation and conduct can be more ably supervised and controlled. The whole undertaking will probably run less risk of interference from regular auditing assignments. It goes without saying that the centralized school will involve some costs that could be avoided if the job were to be done by offices.

Selection of faculty for the school is of such importance that perhaps it should have been the first operational consideration. Select men for their teaching ability and their wealth and breadth of experience. Your faculty will make or break your school. Make a faculty appointment a full time assignment and use only men who have reached at least managerial or supervisory status and who like the assignment. These may sound like unnecessarily restrictive qualifying requirements but I'm sure that experience will prove the soundness of my suggestion. If you try to conduct a school with a faculty selected on the basis of availability, your school will have more form than substance and the faculty will consist of a parade of unprepared men pausing briefly in the school between audit assignments.

When to conduct the school and how long to run it are other preliminary considerations. Should the men go through the school when they first join the firm or should this formal training be postponed until after they have had one season's experience on the staff? Naturally, there is much to be said for each alternative. There is a saving in unit cost if the training is provided only for those who have first demonstrated ability during a busy season and those who look like good prospects for the future. Such men can also be trained more effectively and broadly with the advantage of having first had some experience. However, I think these advantages of the delayed training plan are clearly outweighed by benefits that accrue to the men and to the firm by having them schooled before they are assigned to any audit engagement.

In a three weeks' school it is possible to give a man the equivalent of approximately six months' experience on audit assignments. You can't afford to delay this kind of progress.

As to the duration of the school, a concentrated three weeks' period seems to me to be preferable to following an easier schedule for a larger period of time. Three weeks are more or less required to provide breadth of coverage, but much extension beyond that time may result in a school that is rather dull to men who have just completed four or five years in school and who are anxious to start applying the knowledge they acquired in an academic setting. I think the school should be open to all beginners and a healthy but not overemphasized air of competition should prevail.

Now that objectives have been set and a qualified faculty has been selected for our three weeks' school, just how should we carry on from this point? Here are a few suggestions.

Divide your group, if it is large, into sections so that ample opportunity for individual help and instruction is provided. I favor instructional groups which number not more than twenty men. I would provide two instructors for each such group, not only because an active group will require that much supervision, but also to bring differing viewpoints and concepts into the discussion. Select with some care the quarters in which you are to hold your school, using regular accounting classroom facilities with plenty of well-lighted desk and blackboard space if they can be obtained.

Do all that you can, within reason, to make it clear to the students that your school is not just a continuation of their college work. Use the lecture approach very sparingly and by all means keep all activity on a realistic plane. With this aim in mind, it would probably be wise to have the students carry through a simulated and abbreviated audit. If it can be done, provide all the records, underlying documents, and supporting evidence that would be dealt with on a real audit engagement. There's nothing that will instill more confidence in a be-

ginner on his first assignment than the experience of having made his first practice run under able and abundant supervision with no client present. Don't just talk about how working papers are prepared. Prepare them and insist on standards of performance fully as high as those to which you expect to adhere on an actual engagement. Review and appraise the work of each student with care, and arrange individual conferences with those whose work is not up to par.

Encourage the men to take part in the discussion sessions which should be held as a sort of critique following the completion of each segment of the work. The quality and quantity of each man's contribution to the discussion will not only give you a line on his abilities as an accountant and auditor but will also provide the clue as to his needs for special help in the area of expressing himself forcefully, clearly, and concisely. Furthermore, lively discussions participated in by many will help to break the monotony of the finger exercises required by the audit practice case.

In some accounting firms the chasm between staff and top personnel is unnecessarily wide. As a device for narrowing this spread, as a part of the plan for orientation of the beginner, and, of course, for other obvious reasons, I would be sure the students have an opportunity to see and hear from a generous representation of top personnel in the firm. Along this same line, specialists in your firm, such as tax men, systems men, etc., should be brought in as guest speakers to tell these beginners something about the activities in each area of specialization.

As another suggestion for the school, I would like to encourage you to investigate the possibilities of using visual aids, such as slides and projection equipment. They are not only effective teaching devices but they also make it possible to present quickly and easily a wide variety of working paper styles and lay-outs.

Finally, at the completion of the school each man should be rated by his instructors not only as to the quality of his audit work and participation in discus-

sions but also on the score of personal traits that seem to need correction or development. The faculty will have learned a lot about each beginner during the three weeks of close observation, so take advantage of the situation and go to work to build a stronger junior and an earlier senior.

### **Staff Meetings**

Of course we all hold staff meetings periodically and they can serve a very useful purpose. I will deal with this training device only briefly. In my opinion, the only staff meeting that can be truly effective is the one that is carefully planned in advance and is conducted by a well prepared discussion leader. The group should be small, the meeting should preferably be held within regular working hours and, at least in so far as discussion of certain topics is concerned, it may be desirable to break the staff up into groups classified along lines of special interests or extent of experience. Staff meetings should be discussion meetings; I'm satisfied that staff meeting lectures are seldom effective as training devices.

### **Staff Manuals**

I suppose nearly every firm provides each beginner with some kind of a staff manual, ranging all the way from the revised Federal Reserve "Examination of Financial Statements" to the more elaborate manuals that some of the larger firms have prepared for their own private use. Manuals serve a very useful purpose when used in conjunction with other training devices, but I question their value when relied upon almost exclusively to do the training job. They tend to encourage the checklist approach to an audit, an approach that is filled with danger. They foster the textbook slant in solving problems which more properly are resolved by the application of reasoning and judgment.

A good staff man is always a well informed man, not only as to current developments in the fields of accounting and auditing but also as to general business conditions, world affairs, and new

developments in industry. Acceptance of this premise places a responsibility on each firm to foster and encourage its staff to become well informed. Don't underestimate the interest of juniors in matters which go beyond the scope of their day-to-day assignments. Sometimes we make the error of believing that only top personnel would be interested in or should be supplied with information about what might be called higher level matters. If you decide that it is important to have a well informed staff, make it easy for the men to get the information. Give each man a copy for his own use; don't just leave it in your library or in a rack in the staff room.

### **Practical but Not Insurmountable Difficulties**

I recognize that some of the suggestions and conclusions contained in this paper may be branded as ideal but unworkable. Cost is prohibitive, your work schedule is too heavy to allow for any frills, your staff is never available for training because of out-of-town assignments, and so on ad infinitum. In conclusion, I'd like to express some thoughts along these lines.

Don't undertake to do a training job unless you're thoroughly sold on its benefits and merits. If you initiate a training program give it stature and look upon it as equally important as an audit engagement. If it is just a device for absorbing lost time, the quality and effectiveness will be questionable and the results will be discouraging. Training costs will seem high as they are incurred but they represent an investment in the future of your firm, a kind of insurance that men are being developed to replace your top personnel today. A bit of ingenuity will reveal ways of meeting the problem of training your staff men even though their out-of-town assignments are frequent and of long duration. Where there's a will, there's a way. The degree of success which will accrue from any training effort is definitely tied to the enthusiasm and planning behind it, not just to the details of how it is carried out.

# What Can a State Society Do To Cooperate With Schools of Business Administration?

by Henry J. Lee, CPA

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IT IS THE PURPOSE of the Institute, in the best interests of the profession, that future employees and clients be authoritatively and accurately informed regarding the profession, and that students of college grade have made known to them the nature of the work of the public accountant and the character of academic and other preparation essential to success.

The student studying accountancy as a major subject does not need a sales talk on the selection of a career—he has made his choice—but he does need inspiration and guidance over and above that so well given by his teachers. Enthusiasm and greater effort can be engendered by contacts with accountants who are willing to give of their time and experience, and there are many such men. It is the purpose of this paper to outline very briefly what can and has been done in many states by the local certified public accountant societies in activating the aims of the Institute with college-grade students.

Probably the most essential step is to establish cordial relationships with the local colleges; in Rhode Island, for example, we found that the college officials were just as interested in proposed projects as we were. There are several methods then available to activate plans, both from the standpoint of the faculty members and the student.

Many state societies have special an-

nual meetings with bankers, credit men, and tax authorities. This practice can be extended to include a special annual meeting with educators, at which time subjects of mutual interest can be informally discussed.

Again, the committee on education can meet with faculty members, hold discussions, and bring the results of such meetings to the attention of the state society for necessary action. Many questions arise concerning local and current practice, which may often differ somewhat from the theory, and these can be factually answered by questionnaires. It is also possible to arrange informal meetings of the faculty members of the many institutions of a state and provide speakers to bring them the ideas of the Institute on such mutually vital matters as courses of study, staff turnover reasons, etc.

There are so many subjects in which the accountant should be proficient—from speedy addition and fast shuffling of papers to knowledge of law, economics, and administration—that it is extremely difficult to select the subject matter of an accounting course and evaluate the many subjects thought necessary to teach in a limited time. Local accountants can aid the colleges in such determinations by being willing and prepared to answer questionnaires on specific items. Some institutions already send out such questionnaires, and others could be encouraged to circularize the local practitioners.

Now, how about the student? All our endeavors become humdrum and laborious unless new incentives are provided,

or unless new vistas are discovered. This can be especially true with a student. Accounting can become a dry, day-to-day drudge. Local accountants can help here also by bringing to the student live daily experiences that picturize techniques and procedures, bringing new angles to old subjects, and bringing in the mundane problems such as how to get a job, or how clients are discovered, which are always of great interest to students.

Several plans can be followed in arranging interesting addresses and discussions. The state society may furnish speakers for dinner meetings of accounting major groups, or for evening gatherings of interested accounting students. The subjects discussed, depending on the group size, may be general (as "Professional Ethics", or "Is the Accounting Profession a Closed Group?"), or specific technical discussions of some current classroom phase of accounting. Some colleges have formed professional accounting societies which meet once a month, with limited enrollments dependent on grades attained in class work. These societies are addressed by members of the state CPA society and also by members of local chapters of National Association of Cost Accountants and like professional groups.

An invaluable source of information about accounting and the profession is the literature of the Institute which, in my experience, does not get the student distribution it merits. This distribution can be improved, and interest in constant reading of new material engendered, by using pertinent literature at

the group meetings of students and by interesting the faculty members so that such material is used either as reference material or as classroom supplementary reading, a part of the prescribed course of study. Local state societies can finance initial distributions to school libraries.

Last but not least, incentives can be offered through regular school channels to promote research, debates, and papers on selected accounting subjects. There is, I presume, plenty of material available, pro and con, on all the topics discussed in the Institute bulletins to keep debates lively for a whole academic year. A good incentive, other than the normal awards of medals and money, is the knowledge that winners will receive first consideration for positions with accounting firms of the state society. Projects of this type, to be successful, must be well planned, with plenty of enthusiastic support from the donors and the assured cooperation of an interested college faculty.

These are some of the things members of a state society can do, are doing, or have done, to promote the aims of the Institute, to get better trained young people in the profession and, incidentally, to get a lot of personal pleasure themselves, and very often new knowledge, new ideas and ideals. If we want young students to know the profession, its work and its aims, let's bring the information to them personally at every opportunity through the helpful channels of the schools of business administration and their faculty members.

# Study Groups at the CPA Level

by Thomas W. Leland, CPA

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THE PREVIOUS SPEAKERS on this program have made it clear that formal schooling only starts a man on the rugged path to an education. Perhaps some of the criticism of college training can be traced to the belief that an education is an easily attained objective. Regardless of its origin, the criticism loses force if we consider education as a never-to-be-reached objective and the educated man as one who is making satisfactory progress in the direction of an education.

John Milton in his *Tractate on Education* offers this description of education:

I call it a complete and generous education, that fits a man to perform justly, skillfully and magnanimously, all the offices, both public and private, of peace and war.

Certainly an education of this type is a never-ending process. The chief responsibility for progress toward it would seem to lie with the individual desiring an education.

Another feature of Milton's statement is the emphasis on professional and vocational training. It was in conformity with his concept of education that colleges established curriculums combining general and technical studies in preparation for the varied pursuits of life. The business curriculum in accounting offers such a combination for the student preparing for a career in public accounting.

Leaders in the accounting profession have outlined with considerable clarity the qualifications expected of the college graduate. Some of them express satisfaction with the product of the schools but many of them are critical of the knowledge and abilities of accounting graduates. It is not the function of this paper to answer these criticisms and they are mentioned only for the purpose of supporting a recommendation for continued study at the CPA level as a further step toward an education.

Advanced technical education is available in medical schools for doctors; special courses for lawyers in taxation, accounting, finance, commerce, and law are provided by the Practising Law Institute under the sponsorship of the American Bar Association. It should be equally appropriate for our profession to provide courses which will help practicing accountants improve their knowledge and skills.

The American Institute of Accountants and the profession generally are meeting this responsibility in a number of activities. The annual meetings of the Institute and state societies and the meetings of local chapters provide speakers on technical and professional subjects and contribute greatly to the development of the abilities of public accountants. The regional conferences sponsored by the Institute and the accounting conferences conducted by schools in cooperation with state and local groups of accountants serve this same purpose.

The committee on education of the Institute and its chairman, John W. McEachern, are to be commended on the sponsorship of study groups this year. The classroom and the small discussion

group are effective instruments in the learning process and it is important that they be used in instruction of accountants who have attained the CPA level.

A graduate study conference for accountants was held in June at the University of Michigan under the auspices of the American Institute of Accountants and the School of Business Administration of the University of Michigan. The conference afforded CPAs an opportunity for intensive study and discussion of current technical and professional problems. Participants lived, ate, and studied together in an academic atmosphere conducive to thorough consideration and interchange of ideas. Seventy-five CPAs attended the conference. In the interest of effective operation a limit was set of four representatives from any one firm.

Each half-day of technical sessions began with a lecture by a prominent practitioner especially selected for his particular competence in the subject. The lectures were presented to the entire conference group and were followed by a brief general discussion period during which questions were asked from the floor. After the general discussion period, the conference was broken up into four discussion sections. These small sections were led by men chosen from university faculties and accounting practice. Two hours were assigned for thorough-going discussion of the material of the preceding lecture. Each member of the conference was provided with a copy of the lecture for use in the discussion sections. The lecturer visited the discussion groups to answer questions and give advice. Members of the conference were assigned to specific discussion sections and remained in the same sections throughout the conference.

The following subjects were presented and discussed: auditing standards, inventory pricing, the accountant's place in tax practice, and new developments in accounting.

A registration fee of \$25 was charged for admission to the conference. This registration fee covered out-of-pocket costs for the conference, such as traveling expenses of lecturers and discussion

leaders, and printing costs. The University of Michigan donated its classroom facilities and personnel to the conference. Room charges at the dormitory were at the rate of \$2 per night for single occupancy and \$1.50 per night for double occupancy. Meals for the entire conference period were \$15.

The general impression of those attending was highly favorable and the group voted to make the conference an annual event at Michigan. The conference sought to reach especially the individual practitioner and the moderate sized firms. The program was of definite benefit to all who participated.

The second study conference was held at the Harvard Graduate School of Business Administration September 15th-17th under the sponsorship of the school, the Massachusetts Society of CPAs and the American Institute of Accountants. Residence at the school was required throughout the conference. This conference consisted of the presentation of a series of top-level papers by outstanding accountants followed by organized roundtable critiques of these papers and discussion of the respective subjects. It provided an opportunity for serious uninterrupted deliberation on those problems of theory and practice which are currently confronting the profession. The program included the following: Problems of Accounting and Financial Reporting in an Inflationary Period; A New Look at Basic Auditing Technique; Current Tax Problems; Accounting Services to Management.

In an address presented in 1944 your speaker made this statement:

The accounting profession needs a very definite program to keep accountants abreast of new knowledge, new methods and new ideas. It has not yet committed itself to the type of organization through which the program of continuing education should be conducted but there is need for accounting seminars sponsored by the professional organizations or cooperatively by professional organizations and educational institutions.



The study conference meets some of the need and we should have more of them. However, it is very doubtful that they can be regarded as the ultimate solution of training at the CPA level because the time devoted to the study groups seems insufficient to fill the gap between the qualifications of the young CPA working on examination of books and accounts and that of the supervising accountant, junior partner or partner who directs the work of others. Your speaker believes that a longer post-graduate course in an educational institution can contribute to this upgrading of young men who have shown promise of attaining advanced levels in their previous work as juniors, semi-seniors, and seniors.

The executive program of the University of Chicago and the Advanced Management Program of the Harvard Business School are examples of longer courses of study designed to develop business executives. The University of Chicago course is set up as an intensive two-year evening program of six hours per week. It has enrolled industrial accountants, controllers, public accountants, auditors, production men, marketing men, and engineers. The course relies chiefly on the case method and discussion groups to accomplish its objectives.

The Harvard course is 13 weeks in length. Classes meet from 8:30 a.m. to 5 p.m. The study includes the following subjects: Management controls; cost and financial administration; production organization and engineering; marketing problems; the supervisor and union labor; corporate organization and administration.

The objectives of the program are stated as follows in an announcement of the program:

A primary objective of the program is to make the man who participates in it a better man in his job, whether in supervision or production, sales management, direction of personnel relations, or any other staff or line function. Another, and perhaps even more significant objective is the develop-

ment of men for advancement into positions of wider responsibility.

Both these objectives, which naturally complement each other, are implemented by (1) the general influence of an approach that demands a broad view of business problems, a view which goes beyond the specific departmental or functional aspects of an individual man's interests and functions; and (2) specific training in administrative practices and procedures, designed to make each man a more effective executive in *any* position.

In this way, many forces—the subject matter of the course, the teaching technique of the “case method” used at the School, the wide variety of companies and functional responsibilities represented by the men attending the course, and an atmosphere which makes it possible to acquire a fresh point of view and an attitude of objectivity—all combine to increase the capacities of each man.

It would indeed be an interesting experiment to see a program for adult public accountants fashioned after the programs of the University of Chicago and Harvard. A well prepared program would serve these specific purposes:

1. Improve ability in speaking and writing.
2. Give knowledge of source material.
3. Build reading habits.
4. Refresh technical knowledge and skill.
5. Give familiarity with current developments in accounting and related fields such as statistics, finance, economics, production management, purchasing, and selling.
6. Improve ability to handle personnel problems.
7. Present management, stockholder, investor, and creditor viewpoints.
8. Encourage willingness to exchange ideas.
9. Build confidence in ability to make decisions.

As a concluding comment on the type

of training which I have outlined, I wish to emphasize its possibilities in contributing to a more liberal education of the accountants who participate. It would be a grave mistake to limit the objectives to imparting knowledge and developing skill in accounting technics. The instruction must give attention to personal attitudes. It should build the attitude of the scientist and strengthen attributes such as curiosity, respect for facts, open-mindedness, objectivity, and precision. It should develop a sense of ethics and social responsibility, power of discrimination between right and wrong, integrity, a willingness to stand for principle. It should develop qualities such as imagination, enthusiasm, confidence, and respect for self and others and build a desire to grow. The classroom discussions of advanced students directed by competent leaders is difficult to match as an agency for the development of men for creative service in our profession.

Some of our large public accounting firms have developed very satisfactory training programs for CPA seniors. These programs make use of the small discussion group and the other procedures which were outlined for us in the discussion of "In-Service Training of Staff Members" by Richard S. Claire. At least one firm has an additional program for its supervisory group.

The more successful staff programs at these CPA levels, make use of study outlines and provide for discussions of auditing and accounting subjects in small

groups led by qualified experienced leaders. One firm uses meetings of the round-table type at which each member of the group presents a paper which is discussed by all members of the group. The author of each paper is expected to consider the comments and suggestions which are offered and to rewrite his paper giving effect to such changes as he deems appropriate. The final paper is reviewed by a partner and placed in the library of the firm. A program of this type improves the technical knowledge of the participants and provides an important urge for continued study and development.

The establishment of both short and long study conferences would naturally follow the publication of course material appropriate for the use of advanced students. There is a considerable amount of appropriate material available in the accounting research bulletins, accounting texts and references, the accounting series releases of the Securities and Exchange Commission, articles in *The Journal of Accountancy* and the *Accounting Review* and other accounting magazines, but these materials need to be consolidated and brought into a comprehensive and coordinated course of study at the CPA level. Your speaker believes that the American Institute of Accountants should take the lead in the publication of an outline for such a course. It has made an excellent start this year in pointing the way to improved training at the CPA level.

# The Development of a Professional Consciousness

by James L. Dohr, CPA

[James L. Dohr, CPA, professor of accounting at Columbia University, is a member of the American Institute of Accountants and chairman of its committee on terminology.]

IN ADDING this subject to today's program on accounting education, the committee has performed a very real service. In the teaching of accounting I think we have all had the problem in the back of our minds, and there can be no question as to its importance to the individual practitioner, to the profession and to society at large. The explicit statement of the objective should serve to focus our attention, and to lead us to adopt more effective methods of achieving the desired end.

In the assignment of the topic, it was indicated to me that attention might be directed to the development of a professional consciousness on the part of the student from the beginning of the accounting curriculum. In times past, we at Columbia would have experienced difficulty in this, because our accounting majors have not been segregated at the outset. Beginning in September 1949 we expect to provide for that segregation. As a result we will be in a better position to comply with the suggestion that we "begin at the beginning."

The professional character of a career in accounting is, of course, a factor to be considered in the initial selection from candidates for admission. Through the medium of aptitude tests, and a careful consideration of all observable characteristics and traits, it should not be difficult to constitute the student body in such a

way as to insure, so far as possible, the development of the desired professional consciousness. No process of selection is perfect, however, so that there must be a continuous process of weeding out on the basis of periodic achievement tests and other observations during the course of training.

It is not difficult to outline generally the descriptive material by means of which the student may be introduced to the professional character of a career in accounting. The initial lectures, supplemented by text material, would cover the following:

1. *The organization and functions of the profession.* This would include a consideration of such matters as the organization of the Institute and the state societies; the operations of the various committees of the Institute and its staff organization; the procedures and requisites of admission to the profession; the regulation of professional conduct; and the various kinds of services performed by the profession, not only in the management of business, but in the administration and control of the economy as well.

2. *The matter of professional standards.* It is obvious, of course, that a fairly detailed consideration of the Institute's code of ethics, and the "official" codes of ethics as they exist in some of the states, is of prime importance. This area can be covered by lectures, by assigned reading of Mr. Carey's book, and by consideration of the activities of the Committee on Professional Ethics. If an institution is lucky, as we at Colum-

bia have been on occasion, it can get Mr. Carey to deliver a lecture on professional ethics.

3. *The matter of professional traditions.* As a relatively new profession, accounting has not as yet fully developed its historical background, but there is an ever-increasing amount of material available, including such things as the recent brochure issued by Arthur Young & Co., on the career of Arthur Young. The growth of professional traditions, such as the traditions with respect to independence, attitude toward fellow practitioners, competitive bidding, etc., are important to the profession; a study of their development is most effective in inculcating in the student an awareness of professional dignity.

4. *The matter of preparation for admission to the profession.* Apart from various courses of the curriculum, and apart from the study of various accounting techniques, there is the necessity of developing appropriate mental attitudes on the part of students. Preparation for the examinations which must be passed is not adequate unless the student is instilled with the spirit of the profession as well as its techniques. Much can be done by adequate counseling to the end that the student may appreciate the importance of professional conduct to himself, and what is perhaps more important, to the public which relies on that conduct.

As a matter of theory, developed by lectures, readings and counseling, the foregoing introductory program is not a particularly difficult one. There remains, however, the problem of developing this material throughout the student's career and, more particularly, the necessity of convincing the student of the fact as well as the theory. The professional character of his career is not an academic matter; it is something he must be made to feel as well as to visualize. I suppose that many people would describe this phase of the matter as one involving a requisite of "realism," or as a proposition which should be made "realistic." I like to avoid the use of

these much abused terms because I am not sure what they mean, or because they at least imply the exclusion of idealism—a suggestion which I am sure we all agree would be most unfortunate. I think what I mean is that the student should be made to recognize that technical ability in accounting is not worth while in the absence of a deep-rooted sincerity of purpose under a framework of professional standards and traditions.

There are a number of things which can be done throughout the student's career to develop the introductory program, and to achieve the desired consciousness—some on the campus (in the classroom or as a part of extra-curricular activity)—others involving off-campus activities. In this development it should be noted, of course, that the problem cannot, for the most part, be isolated—it is an integral part of an accounting education which must be dealt with in connection with a variety of accounting and auditing procedures. Some of the things which I am about to suggest may be intended for other purposes—perhaps even primarily so—but they can be presented in such a way as to contribute something along the lines we are considering.

The campus activities would include consideration of such matters as the following:

1. *The auditor's certificate.* Corporate reports should be made available, and should be studied for a variety of purposes. In the development of a professional attitude the appended certificate should be presented as the crux of the relationship between the accountant and the public. The professional aspects of certification and the reliance of the public on the observance of professional standards, are the essential background to an appreciation and understanding of professional conduct and responsibility.

2. *The current literature of the profession.* Students should be encouraged to become subscribers to, and "cover to cover" readers of *The Journal of Accountancy*; over the years it has become an organ in which the profession may

take great pride. The purposes of its various sections and departments, and particularly its editorial pages, should be brought to the student's attention. If possible other professional publications should be made available, including the "house organs" of the large professional firms. Where adequate newspapers are available, daily reading should be encouraged. I have found it very helpful to permit short oral reports by students on current accounting developments including matters which have a bearing on professional conduct.

3. *The current problems of the profession.* This includes a consideration of the Bulletins of the Accounting Procedure and Auditing Procedure Committees and, so far as possible, the projects pending before those committees. This material is, of course, dealt with primarily as a matter of accounting and auditing techniques. It can, however, be presented in such a way as to further the development of a professional consciousness in so far as it illustrates the collective efforts of a profession to solve its problems with due regard for its standards, traditions, ideals and responsibilities.

4. *The decisions in litigated cases.* This material, including court decisions and rulings of various state and federal bureaus with respect to accounting matters, is peculiarly effective. For instance, a consideration of the litigation with respect to the so-called "unauthorized" practice of law is very apt to arouse the student's interest. The decided cases involve statements of fact—no amount of hypothetical material is as convincing. They indicate the practical differences resulting from various courses of conduct thereby demonstrating the importance of accounting rules and their application on a professional basis. On occasion, at least, they bring to light the necessity, importance and value of the professional attitude.

5. *Lectures by graduates of the school.* These may be scheduled in the classroom or before student organizations, particularly student accounting organizations.

I have observed over and over again that the student is very apt to be impressed by the words of his predecessors for whom he feels some sort of an affinity. As a result the opinions and convictions of the graduates with respect to professional conduct are apt to be readily accepted by the student.

6. *Lectures by accounting practitioners and businessmen.* In so far as these lectures cover matters of professional standards, ethics and conduct, they are, like the lectures of graduates, peculiarly convincing. It is particularly helpful if the importance of the professional attitude is emphasized by persons who are not members of the profession i.e., business administrators, stockholders and investment counselors.

7. *The auditing laboratory.* In dealing with records and books of account which have actually been used in the conduct of business, rather than with hypothetical material, the student becomes aware of the manner in which men have, in times past, dealt with their accounting problems, and he is much more likely to become convinced as to the nature of the accounting function, including again its professional aspects. We find that this material can be used very effectively in dealing with problems of ethics and professional standards.

Under the heading of off-campus activities reference may be made to activities such as the following:

1. *Visits to professional accounting offices, or to business offices where audits are being made.* It is surprising how far a relatively brief observation of the professional office, or of the professional accountant in action, will go in improving and clarifying the student's views with respect to the profession. Those of you who have cooperated with us in this connection should be assured that the results, from our standpoint, were well worth the time and energy you gave to it.

2. *Week-end assignments on the staffs of public accountants.* We have experimented, for instance, in placing a number of men on an audit over the week-

end, and have been amazed at the effectiveness of the assignment in the development of the student's attitude.

3. *Part-time employment in public accounting.* I am inclined to think that when all is said and done, a plan of part-time employment is probably the best means of making any part of an accounting education effective. I sometimes think we ought to shift our academic year in order to leave the most appropriate part of the student's annual time period available for part-time assignments.

4. *Attendance at professional accounting meetings.* In a place like New York City many opportunities exist for such attendance, and some of the organizations have been extremely cooperative in extending invitations to our students. The invitations make the student feel that the profession is interested in him, and I observe that he generally returns from these meetings with an added stimulus for the achievement of his objectives.

In all of the foregoing I have tacitly assumed that professional accounting is synonymous with public accounting, and I have used the latter term largely in the sense of the certified practitioner. This is a natural approach because the student of accounting, whatever his ultimate objective may be, is very likely to plan for at least a temporary career in that area in order to round out his education by qualifying for the certificate. There is, in addition, the area of non-

certified practice in which I hope that the same kind of professional consciousness is desirable and in which its development should be encouraged. It goes without saying that in both of these areas the newly employed junior should find, in the office of his employment, the same emphasis on professional conduct as that which was a part of his academic career. This is a matter for which the practitioner must assume responsibility so that your cooperation in the development of professional conduct is an important factor. Beyond these areas there is a question as to the extent to which the professional attitude is appropriate, or desirable, in the field of private practice. Business organizations are increasing their efforts to interest college graduates in positions on their accounting staffs; they are beginning to urge that the student go directly to their staffs instead of via the public accounting firm. I would very much like to have your views on the extent to which a professional consciousness is possible or desirable under these circumstances.

In concluding, I would like to express my firm conviction that the place which accountants will eventually achieve in the economy, depends to a very large extent on the establishment and maintenance of professional standards and ideals. We are making progress but much remains to be done. It is a hopeful sign that the importance of a professional consciousness is recognized at a convention of professional accountants, and that educators are privileged to express their views in this most important matter.

# Federal Taxation

## Tax Practice Problems

by William M. Black, CPA

*[William M. Black, CPA, is a partner in Peat, Marwick, Mitchell & Co., New York. He is a member of the American Institute of Accountants.]*

**I** F I HAD BEEN SPEAKING to you on tax practice problems ten or fifteen years ago, you would probably have expected to hear a somewhat technical discussion of the various complications and difficulties in preparing a tax return. Today, unfortunately, our first consideration must be whether accountants will continue to occupy the position which they have long held in the tax field.

As you all know, the Treasury Department turned to accountants to help set up the basic regulations when the first modern corporation income-tax law was adopted in 1909. For thirty years after that, income-tax practice belonged largely to the accounting profession because no one else was thoroughly equipped to handle it, and comparatively few non-accountants were interested in becoming trained specialists in the tax field. The preparation of tax returns, especially for corporations, was a natural function of those whose business it was to prepare and audit income figures.

I suppose the chief reason accountants were left so long undisturbed in this field was because income taxes were comparatively low and, consequently, there did not seem to be any tremendous amount of profit to be made from tax practice. This situation began to change when income taxes were raised during the 1930's and it changed radically with the imposition of high taxes just before and during the recent war. Today, income taxes are a major factor for both individuals and corporations, and the importance of tax practice has increased accordingly.

In all fairness, we should recognize that there has been a growing number of legal problems in the preparation of tax returns, and the discussion or handling of tax cases with the Bureau of Internal Revenue and the United States Tax Court. The need for lawyers in the tax field has, therefore, undoubtedly increased. In many instances, accountants and lawyers have worked together amiably and successfully in tax cases. But there are, unfortunately, some lawyers who would like to go much further and take over the lion's share of the tax field for their profession.

That is why the right to continue in tax practice has become a major concern of certified public accountants.

I am sure most of you are familiar with the background of this situation, and I will not attempt to repeat the details of all of the instances in which the rights of the accounting profession in the tax field have been attacked by representatives of the legal profession. I should like to remind you at the outset, however, that as long ago as 1944, the American Institute of Accountants helped to set up a national conference of lawyers and certified public accountants in the hope of working out an amicable settlement of the problems affecting the two professions. This hope has not been justified by the event. But we are still ready to resume friendly discussions whenever there is any indication that they might prove fruitful.

### The Bercu Case

One of the first and most serious of the lawyers' attacks on accountants was the *Bercu* case in New York City. This case was initiated by the New York County Lawyers' Association, and it went considerably beyond an attack on a particular individual, in the apparent intention of establishing a precedent which would drastically curtail the right of accountants to give tax advice. Consequently, the New York State Society of Certified Public Accountants, with the aid and encouragement of the American Institute of Accountants, associated itself with Bercu's defense and, in the New York State Supreme Court, won a thorough-going vindication of the accountant's position.

Last winter, this Supreme Court decision was unhappily modified by the Appellate Division and the case will probably be taken to New York State's highest court. However, the Appellate Division decision reaffirmed the right of a certified public accountant to prepare tax returns and offer advice on tax matters to his clients. But in a distinction which seems rather illogical to me, the Court held that the certified public accountant

could not properly give this tax advice to anyone who was not a regular client. Fine distinctions of this kind are apparently perfectly clear and the most natural thing in the world to the legal mind. But to me, as a layman, looking at the case from the point of view of the public interest, rather than as a refinement of legal doctrine, it would seem that if a certified public accountant's advice is good for his client, it should be equally good for anyone else. Some of my legal friends assure me that the argument is much more complicated than this, but I still hope that the higher court will take a common-sense view of the situation.

In Kentucky, last December, an outgoing attorney general rendered a sweeping opinion to the effect that the preparation of tax returns by a non-lawyer in itself constituted the unauthorized practice of law. The new Kentucky attorney general apparently does not intend to make any attempt to enforce his predecessor's opinion, but it has not been possible to obtain a clear reversal of the opinion, and the situation remains unsatisfactory.

### The Conway Case

In Minnesota, what may be another *Bercu* case is in the making. Several members of the unauthorized practice committee of the Minnesota Bar Association have instituted suit against a non-certified public accountant named Conway, charging him with the unauthorized practice of law in the giving of tax advice. The case itself is not entirely clear-cut, but the brief filed by the members of the unauthorized practice committee again goes beyond the immediate case, and constitutes a general and drastic attack on the rights of accountants to give tax advice. The Minnesota Society of Certified Public Accountants has, therefore, decided to retain counsel and present a brief *amicus curiae* if the case comes to trial.

The most serious threat to the accounting profession in these cases is that the loss of any one might establish precedents which would be the occasion for



similar lawsuits all over the country. While I think we could win most of them, the expense might be very serious indeed.

## Legislation

What the unauthorized practice committee of the Bar have thus far failed to accomplish in the courts, they have also attempted by legislation. Two bills in the 80th Congress which might have jeopardized the accountants' position in tax practice were actively sponsored by representatives of the bar associations and unauthorized practice committees.

### HR 3214

HR 3214 was a lengthy bill whose primary purpose was a re-codification of the United States Judiciary Code. No one disagreed with the desirability of the re-codification, and it was, therefore, impossible to attack the whole bill. However, a strenuous attempt was made to use this bill as a vehicle for pushing certified public accountants out of the Tax Court.

The proposal was to make the United States Tax Court a court of record. As you know, certified public accountants have been admitted to practice before this court ever since it was established as the Board of Tax Appeals in 1924. When the name of the Board of Tax Appeals was changed to Tax Court in 1942, Congress specifically provided that the change would not interfere with the right of any qualified non-lawyer to practice before it. At the request of the American Institute, this same provision was inserted in HR 3214 when that bill was before the Judiciary Committee of the House of Representatives in 1947. But during extended hearings this year before the Senate Judiciary Committee, the unauthorized practice committee representatives strongly urged that this provision should be taken out. The lawyers graciously proposed a "grandfather clause," under which those accountants now admitted to practice would continue to enjoy that privilege, but no one except

lawyers would be admitted hereafter. Maurice Austin, representing the Institute, said that this proposal was not acceptable to the accounting profession, and he asked very reasonably why certified public accountants should not be admitted to practice before the Tax Court in the future if they were now qualified to do so. The lawyers, however, maintained that, generally speaking, only lawyers are qualified to handle cases in the Tax Court.

The final outcome in connection with this bill had more to do with timing than with principle. An active campaign of letter-writing and personal calls suggested by the Institute evidently convinced the members of the Senate Judiciary Committee that there would be a fight on the floor of the Senate, if the bill were reported without the provision protecting the right of certified public accountants to practice. Senator Robertson, of Virginia, notified the Chairman of the Judiciary Committee that if the bill were reported without the protective clause, he would introduce on the floor of the Senate an amendment to strike out of the bill the provision relating to the Tax Court.

Since the regular session was drawing to a close, and the Senate Judiciary Committee was anxious to obtain passage of the principal and non-controversial codification provisions of the bill, the committee itself decided to take out the Tax Court sections. The bill was then passed by the Senate and accepted in this form by the House of Representatives. However, members of the House Judiciary Committee stated specifically that they intended to introduce a new bill to make the Tax Court a court of record, early in the 81st Congress. We must be prepared, therefore, to go through the same fight all over again. Still, we shall have the advantage that the case will have to be argued on its merits, and not as a minor section of a major bill whose other provisions were generally approved. When the Tax Court section had been removed, HR 3214 was passed by unanimous consent in both Houses of Congress. We can at least be sure that there

will be no unanimous consent to a new bill embodying the Tax Court provisions.

### **HR 2657**

The so-called Gwynne bill, HR 2657, was an even more direct attempt to obtain special privileges for lawyers in practice before federal agencies, and to make such practice more difficult for everyone else.

This bill, also known as the Administrative Practitioners Bill, was supposed to be companion legislation to the Administrative Procedures Act which was passed a few years ago. In essence, the bill proposed to set up a central bar for lawyers through which they could obtain admission to practice before all federal agencies almost automatically. At the same time, the bill proposed to set up a committee, a majority of whose members would be lawyers, to pass on the qualifications of non-lawyers to practice before any federal agency. In addition, the bill would have required non-lawyers to seek admission to practice before each federal agency separately and, in some cases, would have barred practice by non-lawyers, whether the agency considered that desirable or not.

The Sub-Committee of the House Judiciary Committee, headed by Representative Gwynne of Iowa, author of the bill, held hearings in July, 1947. At those hearings, the only detailed testimony was in favor of the bill, by Judge John D. Randall, chairman of the unauthorized practice committee of the American Bar Association.

At the urgent request of the American Institute and other interested organizations, hearings were reopened in January, 1948. At that time, representatives of a large number of organizations appeared in opposition to the bill. Spencer Gordon, counsel, and John L. Carey appeared for the American Institute, and Mathias F. Correa appeared as a representative of the New York State Society of Certified Public Accountants. The Honorable Norris Poulson, a Representative in Congress, spoke against the bill in behalf of the California Society of

Certified Public Accountants. In addition, eleven other state societies sent statements, letters, or telegrams.

The certified public accountants were joined in their opposition to this bill by such organizations as state chambers of commerce; the Association of Interstate Commerce Commission Practitioners; the National Grange; the Controllors Institute; the Brotherhood of Railroad Trainmen; the American National Livestock Association; the National Cooperative Milk Producers Federation, and several others. In addition, several departments of the federal government indicated their opposition to the bill and none supported it, although a few federal agencies said that it would make little difference to them, one way or another.

The basic arguments against the bill were that no one had been able to show any compelling need for additional regulations of practice before federal agencies, and that it would set up an unnecessary federal bureau to create useless red tape. There was also, naturally, considerable opposition to the bill's discrimination in favor of lawyers, although several witnesses, including those representing the American Institute, testified that they would have no opposition to a simple bill setting up a central federal registry of lawyers which left the situation otherwise unchanged.

The intention of the Bar Association representatives to use this bill as a means of restricting the rights of practice of certified public accountants and others was clearly revealed by one illuminating development. As a result of the hearings and the substantial opposition to the bill which they brought out, Representative Gwynne himself proposed a number of amendments which constituted a considerable revision of the original bill. Among these amendments was one allowing agencies to admit qualified individuals to practice before them if they had done so "by rule requiring investigation and examination of applicants for more than seven years prior to the adoption of this act." The joker in this amendment is that it would protect non-

lawyer applicants for admission to practice before the Interstate Commerce Commission and other agencies which had had such rules for a long time, but would not apply to the Tax Court, which adopted its rules for admission to practice in 1943. The Institute suggested that this provision be changed from seven years to four years so it would apply to the Tax Court, but in a still later version of the bill, the seven year limitation remained.

Another objectionable feature of the bill was a provision that only lawyers could appear as representatives before any agency in proceedings under Sections 7 and 8 of the Administrative Procedure Act. The precise meaning of this provision was not clear, and was the subject of considerable discussion at the hearings. Counsel for the Institute felt and still feels that it might apply to any agency procedure when a written record was made which might later be used in an appeal to the courts. This could conceivably include cases before the Bureau of Internal Revenue.

### HR 7100

During the special session of Congress in August, Representative Gwynne introduced a new bill, HR 7100, which was practically HR 2657 with the amendments he had previously proposed.

According to Congressional custom, a bill introduced in the closing days of Congress is a notice of intent to introduce the same bill at the beginning of the next Congress. It happens that Representative Gwynne was defeated in the Iowa primary last spring—I am afraid we cannot say that the accountants had anything to do with that—and so he will not be back in the 81st Congress. However, there is no doubt that the unauthorized practice committee of the Bar Association can find somebody else to handle their bill for them and it will probably be more or less identical with HR 7100.

This new bill does not meet our objections either to the original HR 2657, or to the amendments first proposed by Representative Gwynne. Without going into

details, I might point out that it still requires that agency rules must have been in effect for seven years to be subject to exception and, therefore, it would still supersede the present rules of the Tax Court for admission to practice.

According to the explanation placed in the *Congressional Record* by Representative Gwynne when he introduced this new bill, it no longer applies to representatives of veterans groups, labor organizations, chambers of commerce, and others who joined us in opposition to HR 2657. It is quite possible, therefore, that when and if this bill comes up for consideration in the next Congress, certified public accountants will find themselves deprived of some of the support which helped us to keep HR 2657 bottled up in committee during the 80th Congress.

### HR 5732

On the other side of the picture is a bill introduced by Representative Gregory McMahon, himself a certified public accountant, but not a member of the American Institute, which would virtually limit all income-tax practice to lawyers and certified public accountants.

While this bill, if enacted into law, might offer some purely selfish advantages to certified public accountants, the Institute committee dealing with this subject has not felt that such a bill could be justified in the public interest, and the president of the Institute, therefore, notified the chairman of the House Ways and Means Committee that the Institute had not sponsored the bill, but would like to be heard if hearings were scheduled. As a practical matter, we knew that the bill had no chance of passage, and it did not even become a subject of hearings.

Quite naturally, there has been vehement opposition to this bill from organized non-certified public accountants throughout the United States, and it has, in fact, been used as a justification for membership drives on the part of organizations of non-certified public accountants. We have, however, informed their national organization that the In-

stitute did not sponsor this bill, and that fact has been noted in some of their literature on the subject.

Representative McMahon, himself, has now distributed an open letter indicating that he thinks the bill should be modified to protect the legitimate rights of public accountants, and that he will revise it substantially before it is introduced in the next Congress.

The appropriate committees of the Institute are exploring this touchy subject of regulation of tax practice but are not yet prepared to make concrete proposals. Among other things, we have in mind the fact that there are probably not enough certified public accountants and qualified lawyers in the United States to handle all the tax returns of small businesses and individuals who need some assistance in filling out their forms. On the other hand, if a practicable means can be found, we feel that something should be done to eliminate so-called "tax experts" who are unscrupulous or completely unqualified.

## Conclusion

Looking over the whole situation, we can say that except for a partial set-back in the *Bercu* case, which is still subject to appeal, we have been successful during the past year in combating a number of concentrated and serious attacks on the rights of certified public accountants in tax practice. However, we must expect that these attacks will be renewed.

It is, therefore, of the utmost importance that we should continue to strengthen our defenses, and use every legitimate means to get our side of the story before the public and the Congress. (Among other things, every member of the Institute who knows a Congressman or a candidate for Congress should try to talk to him *before* election, while he is in a receptive mood.)

At the same time, I am far from reconciled to the prospect of a long-continued battle between certified public accountants and lawyers. As I have said before, individual certified public accountants and attorneys have got along very

well, not only personally, but in specific cooperation in tax cases. I am convinced that the effort to drive certified public accountants out of tax practice is led by a very small group of lawyers, chiefly the members of the unauthorized practice committees, and that they do not represent the real sentiments of the Bar as a whole.

Thoughtful members of both professions must recognize that a jurisdictional dispute provides an unedifying spectacle which is bound to leave an unpleasant impression in the public mind, regardless of which side is right or which side is wrong.

At the same time, we must recognize that efforts to resolve these differences by friendly discussion over a period of years have not been very successful. Ten years ago the unauthorized practice committee of the American Bar Association drew up a list of seven activities sometimes engaged in by accountants, which the committee held to be the unauthorized practice of law. This list was as follows:

1. To give advice regarding the validity of tax statutes or regulations or the effect thereof in respect of matters outside of accounting procedure;
2. To determine legal questions preliminary or prerequisite to the making of a lawful return in a lawful manner;
3. To prepare protests against tax adjustments, deficiencies, or assessments;
4. To represent a taxpayer at a conference with administrative authorities in relation to matters outside of accounting procedure;
5. To prepare claims for refund of taxes;
6. To prepare petitions, stipulations, or orders incident to the review of assessments by the United States Board of Tax Appeals or any like administrative tribunal;
7. To conduct the trial of issues before the United States Board of Tax Appeals or any like administrative tribunal.

The American Institute of Accountants promptly filed a memorandum with

the Bar Association outlining in some detail the reasons why the Institute could not accept the conclusion that these activities were out of bounds for certified public accountants.

The intervening years have seen both the creation and the virtual suspension of the National Conference of Lawyers and Certified Public Accountants. The seven points originally set forth by the unauthorized practice committee remain a stumbling block to cooperation which we have not been able to remove from the path.

I think it fair to say that despite the strong protest filed at the time by the American Institute of Accountants, and despite the professed willingness of the Bar Association to reach an amicable agreement, the unauthorized practice committee has, in fact, proceeded on the assumption that its original premises were correct, and has steadily increased its efforts to bar certified public accountants from these activities.

The position of the New York State Supreme Court in the *Bercu* case was directly contrary to the position taken by the unauthorized practice committee, and even this year's unfavorable decision by the Appellate Division of the New York State Supreme Court, expressly allowed to accountants several of the activities which would be prohibited if the position of the unauthorized practice committee were correct.

The proper way out of this apparently irreconcilable conflict has been indicated by resolutions adopted by the National Conference of Lawyers and Certified Public Accountants in 1944. In these

resolutions, the following statement was included:

"In modern times, more and more, the average citizen is required to seek the professional services of accountants and lawyers, or both. He is entitled to receive the most competent advice, and to be served by men of the highest character, aware of their public responsibility. Harm and injury are suffered by the public whenever such services are rendered by unqualified, incompetent, or unprincipled persons. Whatever can be done by both national organizations to improve the public service of their members will be of great and lasting benefit to the public, as well as to the professions involved."

So far as taxes are concerned, there will always be some overlapping between the functions of the lawyer and the functions of the accountant. It is not difficult to define areas which by common agreement should belong exclusively to the lawyer—such as the preparation of legal documents—and areas which belong exclusively to the accountant. The difficulty is the area in between.

If we look to the public interest, rather than to the narrow self-interest of either profession, it seems to me that for services falling between these clearly defined areas, the client should be free to choose the services of a lawyer or a certified public accountant, or both, in accordance with his own best judgment.

This is all the accounting profession has ever asked. It still seems to me a reasonable approach to the problem.

# Fiscal Policy and the Present

## Economic Situation

by the Honorable Edward H. Foley, Jr.

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[The Honorable Edward H. Foley, Jr. is Under Secretary of the Treasury.]

**D**URING the recent war, and particularly in the immediate postwar period in connection with the settlement of canceled war contracts, I had an opportunity to work closely with many of the members of the American Institute of Accountants, some of whom are present today. Your president George D. Bailey, your vice president J. Harold Stewart, Paul Grady, George O. May, John McEachren and Coleman Andrews, to mention only a few whose names come most readily to mind, all performed patriotic yeoman services on behalf of the government in connection with the swift solution of some of the most complicated and baffling problems ever to confound accountants and lawyers. Every lawyer who was privileged to work with them was impressed with their competence, skill, and cooperation. And that's a lot for a lawyer to say about an accountant. The government owes them much for their sacrifices and help.

I was delighted when George Bailey and Hal Stewart invited me to come here today, not only because it affords me an opportunity to renew acquaintances, but also because it provides an occasion to tell you about some of our problems in the Treasury and bespeak your help in solving them.

One of the principal responsibilities of the Treasury is the management of the public debt. The very size of the public debt is in itself a real challenge—253 billion dollars is a tremendous sum. While you should not be overwhelmed

by the magnitude of the public debt, nonetheless you cannot prudently underestimate its far-reaching effect upon the national economy.

The public debt today makes up about 55 per cent of all the debt in the United States. Federal obligations are the principal investments of millions of individuals, and of thousands of banks, other financial institutions, and corporations. Individuals directly own 67 billion dollars of federal securities. In addition, they have an indirect stake in the larger portion of the public debt owned by banks, insurance companies and other financial institutions which hold their savings and deposits and underwrite their policies. Federal securities constitute about 55 per cent of the earning assets of commercial banks, about 40 per cent of the assets of insurance companies, and about 60 per cent of the assets of mutual savings banks. The Treasury, therefore, has a responsibility for what happens to its obligations such as no private financial organization could have.

In the Treasury we work constantly at the problems of public debt management and we try to mold our debt-management objectives to the needs of the country as the fiscal and economic conditions change from day to day. Each decision must be weighed carefully in the light of its swift and chain-like ramifications.

Before telling you how we are attempting to shape—and have shaped—our fiscal policy to the needs of the economy, I should like to first review briefly our economic situation.

The United States is enjoying a prosperity never before equaled in peacetime. It is a prosperity so great in its proportions that hardly anyone would have dared forecast it three years ago. The reconversion slump, which so many persons then were so certain we could not avoid, simply has not materialized.

In July, employment reached an all-time record of nearly 62 million jobs. Most of you will recall that only three years ago a goal of 60 million jobs for the peacetime economy was considered over-optimistic. Unemployment has fluctuated between  $1\frac{3}{4}$  and  $2\frac{3}{4}$  million since VJ Day. This represents pretty close to maximum employment in a dynamic economy such as ours, where you always find workers who are changing from one job to another or are looking for new and better job opportunities.

According to the figures compiled by the Federal Reserve Board, industrial production early this year reached a peacetime record of 194 per cent of the 1935-39 average—far above any level reached in the prewar years.

This prosperity is distributed broadly throughout the economy. All sectors share in it. Wages and salaries, farm income, and business profits have all reached new peak levels.

The standard of living of the American people, measured in terms of goods and services, is higher than ever before.

This record prosperity is in sharp contrast to the situation which existed at a similar period after the end of World War I. Many of you will recall that by the end of 1921 this country had already experienced, and was just beginning to recover from, a severe postwar recession. Early in 1921, industrial production had reached a level one-third below the postwar peak. Wholesale prices—as measured by the Bureau of Labor Statistics index—had dropped nearly 45 per cent from their 1920 peak.

Our present prosperity is not, however, without a very serious danger. This danger is the persistent upward pressure on prices which has existed throughout most of the postwar period. Wholesale prices have risen almost without inter-

ruption since shortly after VJ Day. They rose 12 per cent in the 12-month period ending last July—the latest month for which figures are available. Consumer prices have followed a similar course; the rise in the same 12-month period amounting to 10 per cent, according to the Bureau of Labor Statistics Consumer Price Index. Both of these indexes reached all-time highs this summer.

It was to deal with this serious problem of inflationary pressures that President Truman called Congress into special session last November and again last July. He laid before Congress a comprehensive anti-inflation program, which Congress chose not to enact. I will not go into the details of that program or why President Truman considered that it was essential to have all of it. I merely want to point out that the program contained specific measures for remedying specific instances of excessively high prices, which cannot be reached by the general anti-inflationary weapons at the disposal of the administration today.

Fiscal policy can be employed against inflation, for example, by cutting down the total purchasing power of the economy. It is not, however, a suitable weapon for bringing under control the price of any one specific item which is seriously out of line. It could be used for this purpose only at the risk of a drastic deflation in the entire economy. In the main, fiscal policy can deal only with general excesses or deficiencies of purchasing power.

Before I began to talk about the way we have tried to direct our policies toward combating inflationary pressures, I wanted to make that clear.

In the field of fiscal policy, a surplus of government receipts over expenditures—which can be used for debt retirement—is the most effective instrument. The fact that the federal government has been able to operate at a substantial surplus during the past two years has been a factor of significant anti-inflationary importance.

As you know, the public debt reached a peak of 280 billion dollars in February, 1946, just after the close of the Victory

Loan. At the same time, the Treasury cash balance, swollen by the proceeds of the loan, also was at its record level. Because federal expenditures were then being cut more rapidly than had at first seemed possible, we no longer needed a Treasury cash balance as large as had been required to meet the contingencies of the preceding war years.

Consequently, a debt pay-off program was inaugurated on March 1, 1946. This program, carried on over the last two and a half years, has brought the debt down to the present level of a little under 253 billion dollars.

From March 1st to the close of 1946, the debt was reduced 20 billion dollars through the application of cash balance funds. By this time, the cash left over from the Victory Loan had been expended, so that subsequent debt reduction had to come from a budget surplus. During 1947 and the first four months of 1948, by the use of the budget surplus, we were able to cut the debt by over 7 billion dollars. Two thirds of this reduction was concentrated in the first four months of 1948.

The money for this concentrated program in the early months of the current calendar year came from a budget surplus of approximately 6 billion dollars accumulated in the first quarter of the year. The rest of the surplus was used to build up the cash balance—partially to meet expenditures in the latter part of the year when current expenditures exceed current receipts. Some of the remainder, however, is still available for debt reduction—for example, a bond maturity of 451 million dollars was paid off only last week.

While the total debt is now down 27 billion dollars from its peak, it is significant to point out that the debt held by the commercial banking system is 30 billion dollars less than it was at the peak two and one-half years ago. And the volume of securities owned by individuals and other nonbank investors is larger than it was in February, 1946. This transfer of government securities from banks to nonbank investors was a direct consequence of the public debt

management policies of the Treasury. These policies have contributed to the fight against inflation, and will be continued as long as they are appropriate.

Unfortunately, however, the federal government no longer has a budget surplus; with the battle against inflation not yet won we have lost our most powerful fiscal weapon. As a result of the combined impact of increased expenditures for foreign aid and national defense, brought about by the tense international situation, and decreased tax revenues, brought about by an ill-timed tax reduction, the Federal government will this year have an operating deficit estimated by the President at approximately 1½ billion dollars, as contrasted with an operating surplus of nearly 8½ billion dollars last year.

You will note that I say *operating* deficit and *operating* surplus. In seeking for a government surplus we must be sure that we have a real surplus, and not one that appears only on paper. We should be careful that we do not get mixed up by our bookkeeping. I don't have to tell you accountants that the government should keep its records so that a CPA could certify to them without putting embarrassing qualifications in his certificate. What I have in mind, of course, is the law passed by the last Congress which directed that 3 billion dollars spent during this fiscal year for the Economic Cooperation Program be treated for the purpose of reporting government expenditures as if it had been spent in the preceding fiscal year. Keeping the books that way does not make it so. This bookkeeping operation, directed by the Congress, does not change the timing of the impact on the economy of a single dollar of government receipts or expenditures. This transaction is irrelevant as far as the problem of inflation is concerned. You accountants are in a better position to realize that than any other group in the country.

The federal government has, of course, other—but less effective—anti-inflationary fiscal instruments, and is using them to the greatest possible extent. For example, the Treasury, during the past



year, has increased substantially the interest rates which it pays on short-term government securities. This, of course, results in higher interest rates on private borrowing and, so, has a restraining effect on such borrowing. The Federal Reserve System has followed with increased rediscount rates; and has recently announced increases in reserve requirements against demand and time deposits of all member banks, pursuant to the new authority granted by Congress last August.

In addition, the government has asked private bankers to re-examine their lending policies, with a view to cutting down lending which does not result in an increase in the production of goods and services. The American Bankers Association carried out a special program to cooperate with the government in this respect; and I should like to take this occasion to repeat the thanks which Secretary Snyder has already expressed for the Association's cooperation.

The task is far from complete, however; and, as Secretary Snyder and President Dodge of the American Bankers Association each commented in an exchange of correspondence last July, now that the federal government is no longer able to operate at a surplus, a heavy and added responsibility is placed upon the banks to reintensify their efforts to reduce nonessential lending. When one bastion is put out of action, the remaining bastion must double its fire. The bankers of the country, I am happy to say, are accepting the challenge in this spirit.

In your capacity as professional accountants you can be very helpful in this connection. By counseling your clients not to borrow money for purposes which do not increase production, you can join the ranks of those actively engaged against the forces of inflation. You know better than any other group in the community the dangers of over-extension—over-extension of credit, over-extension of inventories, and over-extension of plant and equipment. By carrying to your clients a message both of optimism and conservatism, you can make your

influence felt in the battle against high prices. Both are needed, for it is only by maintaining a balance between the two that we can avoid the boom-and-bust cycle characteristic of so much of our past history.

So much for fiscal policy. Now I want to talk briefly about another matter on which the Treasury would like to have your help and cooperation. As I indicated, for the full fiscal year 1949, we will not be able to effect a net reduction in the debt. We will, however, be able to continue in some degree our anti-inflationary policy of cutting down the amount of bank-held debt. But the only funds available for this purpose will be the cash receipts from trust funds and the receipts from the sales of savings bonds. It is, therefore, highly important that a maximum effort should be devoted to the sale of savings bonds to nonbank holders.

The heart of the savings bond program, as you know, is the payroll savings plan. It is in firms like those with which you come in daily contact that the payroll savings plan can be the most effective. During the war, business and industrial firms throughout the country cooperated wholeheartedly in promoting participation in this plan. At its peak, about 27 million people were purchasing bonds through payroll deductions. After the war, there was a substantial decline in the number of participants in the payroll savings plan, which was, of course, to be expected. No need in peacetime can equal the need of actual war, nor can any peacetime appeal be as effective as the patriotic one which was made during the war, when most purchasers of bonds had sons, husbands, fathers and loved ones on the fighting fronts.

The low point of participation in the payroll savings plan was reached about a year ago, and the trend has been upward since. This upward trend has been due, in large part, to the cooperation and activity of business executives throughout the country. Hundreds of companies have re-established the plan, or have revitalized it; and important increases in

participation are reported everywhere. We hope in your capacity as financial advisers and consultants to business, that you will look upon the plan from the viewpoint of its economic and financial benefits to the employer, the employee, and the country as a whole, and disregard the small cost involved in its operation. As you know, each dollar of debt which is transferred from the banks to the general public cuts down the money supply and relieves the pressure upon prices. That is why emphasis on that phase of our anti-inflation program is more important now than ever before.

You can help greatly in our fight against inflation by using your influence with your clients to see that the payroll savings plan is put into effect in those companies which do not now have it and is maintained and strengthened in those companies where it is now in operation, to the end that it be made available to

every worker in the country who wants to participate in it. That's good for management because it benefits from the effects of a more stable economy. It's good for the worker who saves a portion of his earnings against the day when they are really needed. And it's good for you and me and the country as a whole because it puts the brakes on inflation and brings down living costs.

I have enjoyed talking to you about these problems which we, as citizens, hold in common. In asking for your cooperation and assistance in our struggle to cut down inflationary pressures, I know I am appealing to a sympathetic and responsive organization whose members have never turned away when there was a legitimate public service to be performed. No other group has a greater understanding of government and its financial problems. I know we in the Treasury can count on you.