

1954

## 1954 Annual meeting, complete text of papers presented at the 67th annual meeting in New York City, October 16-21

American Institute of Accountants

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AMERICAN INSTITUTE OF ACCOUNTANTS

1954  
Annual  
Meeting  
Papers



Complete Text of  
Papers Presented at  
The 67th Annual Meeting  
In New York City, October 17-21

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# Voluntary Compliance With the Tax Laws

T. Coleman Andrews

*Commissioner of Internal Revenue; Past president, vice president, and executive committee member, American Institute of Accountants*

I know that some of you want to hear some stories from me this morning. But I am not going to tell you any stories this morning, because I have serious business on my mind. Besides, I have found it a bit difficult to be funny this early in the day.

Before I begin my remarks, I should like to make a request, because this is for the benefit of some of our friends from abroad. It is not a part of the speech. I would like to know whether District Director Ahern of the Upper Manhattan District is in the audience. (Mr. Ahern arose.) There is a gentleman on the outside who would like you to do what you can to speed the tax clearances of our foreign guests, and I should ask you to cooperate with him as much as you can.

**DISTRICT DIRECTOR AHERN:** It is already taken care of, Commissioner.

**COMMISSIONER ANDREWS:** Thank you. That is what I call efficiency, ladies and gentlemen, but I assure you that it was not staged; it was spontaneous, and needless to say it was very gratifying to me. I was told that some of our foreign guests were anxious to get away, and they wanted to avoid the red tape of clearance with Internal Revenue. Well, of course, I said there was no red tape in getting out of the United States now, as far as we are concerned, but perhaps we could do something to make it more convenient, and I don't know what they did, but I rather imagine that they brought the mountain to Mohammed and arranged to take care of the clearances here at the hotel.

When we took over, tax clearance for visitors from abroad was taking from three to four hours. As soon as we found this out we did something about it, and now it takes only fifteen or twenty minutes. I think that is speeding it up a bit, don't you? So there would not have been much difficulty anyhow, but I am glad to know that our people have taken care of the situation.

It was a little difficult for me to decide what to talk to you about this morning, because so many of you have heard me speak during the past year that I know many of those present would be bored by a reiteration of our aims and ideals and even the things that we have accomplished. So I decided to take a different approach, and leave these distinguished experts all around me here to talk about the technical things that you are interested in. I shall not even mention too much our administrative and organizational problems.

But first I should like to refer here to a recent event at which the well-known Seidman humor was so delightfully exemplified. We were down at the College of William and Mary, which, if you will permit me, being a Virginian, I will brag about as being the second school or college in the English-speaking world to establish a law school—the first having been Oxford, in England.

The first student of this law school at William and Mary was the illustrious John Marshall, the man who brought alive the Constitution of our country, and his professor was one John Wythe, one of the early lawyers of the Colonies in the days just before they became independent.

During the past year, the College of William and Mary decided upon a bold move. Things are moving pretty fast, you know, down in the southern part of the country; we are growing pretty rapidly down there in many ways, and the College wanted to be up to date with everybody else, so it decided to do something new and different, and they established another “first”: they established a chair of taxation in the law school, leading to the degree of master of law in taxation, with the idea, of course, of extending it to master of business science in taxation, with perhaps some day a combination of the two.

In my opinion, this is an extremely important development in the field of business education and education for law, because it was, I believe, the first step towards the strong probability that sooner or later we will see integrated professional practices. I know that this might seem like heresy to some people, particularly the members of the legal profession. Some of our friends of that profession probably would look with horror on the idea of being in partnership with accountants. But I can imagine worse things, from both sides, incidentally.

I think that this chair of taxation in the law school of the College of William and Mary is the beginning, the first step, in the development of integrated practice, that is, the type of professional practice that business has to use. Many businessmen have told me they are getting awfully tired of having to pay so many different professional people for the services that they need.

Assembled for the inauguration of the Chair of Taxation was a great delegation of people, including the Chief Justice of the United States, the



Lord Chief Justice of England, and the Master of the University College of Oxford. The Chief Justice of the United States unveiled a bust of John Marshall; the Chief Justice of the Court of Appeals of Virginia unveiled one to Wythe; and the Lord Chief Justice of England unveiled one to Blackstone.

I might say the Lord Chief Justice was an entertaining speaker on such an important occasion, but there was another gentleman there, the Master of the University College at Oxford, an American, by the way, the first one who had ever achieved that distinction. Parenthetically, I discovered yesterday, in addressing a meeting over at the Harvard Club, that he was the uncle of a young man who was there at the meeting and with whom I served in the Pacific. His name was Dr. Goodhart, and Dr. Goodhart brought the greetings of Oxford and the University of Oxford, to this meeting: and it was in Latin, five pages of it. I understand the translation is a very delightful sort of thing, but, of course, nobody understood it. The gentleman read it, however, with learning and obvious knowledge of it himself. But the Lord Chief Justice came to our rescue in his remarks by saying that while he, of course, had studied Latin and there are many Latin phrases in the law, he confessed he didn't understand a word that the good doctor had said.

At this Jack Seidman said to me, "Why have this tax panel that is set up? It doesn't seem to me now to be necessary to say anything about the new Code." Later on, at the panel meeting, I think Jack got off probably the best story of the day, or the best quip, when he observed to his audience: "In this atmosphere I have been thinking what a tremendous part Patrick Henry had in the great fight against taxation without representation; and yet," he said, "I wonder what Mr. Henry would do if he could come across the green today and have a look at the present situation and see the magnitude and the complexity and the burden of what we have acquired with representation."

A very apt expression, and very appropriate to what I want to say to you this morning. I know that most of you are interested in the technical aspects of taxation. That is what you want to hear this morning. But, my friends, having occupied the position of Commissioner for almost two years now—a good twenty months—I get a different point of view from the one you have. I get the point of view of the administrator, the one charged with the responsibility for making the revenue laws of this great country work, and don't forget that the income tax law is not the only tax law we administer; we are concerned with about 70 or 80 different kinds of taxes.

We even have to chase moonshiners and bootleggers—a pursuit which is sometimes rather hazardous and even, on occasion, romantic and venture-some; so much so that not too long ago we came here on one of the great television programs and decorated a gentleman who had singlehandedly

gone up into the hills of one of the states down our way and brought in seven armed moonshiners all by himself, even after two of them had taken him and bound him up and stuck his head in the creek and left him to drown. He still brought them in.

Unfortunately, there is no such adventure and romance in the administration of the income tax laws; so there are no decorations of that kind for our people in that part of the Service. But you know, without my having to stress the point, that the administration of the income tax now is, nevertheless, powerfully important.

You have heard me say a lot about the organization and management of the Service since I have been in office, first talking about what we wanted to do, and hoped we could do; and, more recently, talking about some of the things that we have actually accomplished, though guardedly, of course, because we realize that we still have quite a long way to go before we have achieved all of the reform and adjustment that the situation deserved.

The burden of taxation is enormous; let us not make any mistake about it, it is great. The problems of administration are in proportion. The tax burden has been greatly reduced this year; it has been reduced to a greater extent than ever before in all the history of the country in one year—\$3.5 billion of personal income taxes, \$1.1 billion of excise taxes, and so on, a total of \$7.4 billion. But the base is still as broad as before the reductions were made. So we still have the same number of taxpayers, the same amount of administration; and some of the problems of administration are very difficult.

Let me give you just one illustration. Recently I began to be concerned about the question whether the withholding taxes and the Social Security taxes that had been deducted from the paychecks and pay envelopes of the workers of the country were being promptly paid in, and I found some rather disturbing things. I found situations, quite a few of them—and I am speaking relatively—where employers were as much as three to four years in arrears in paying these deductions over to us.

Now, these were not taxes, mind you, that had been levied against the persons who were required to pay them over; but rather were levied against the employees of those people. They represented money held in trust by the people who withheld them, and money which, therefore, should not have been used by the employers; and yet there were many cases of as much as three and four years delinquency.

I need not tell you that a situation of that kind is intolerable. There was over \$140,000,000 of such taxes outstanding and, as I recall it, over 250,000 business organizations and other taxpayers who owed them. We cannot permit that sort of thing to continue.

Recently we had one of these cases where the taxpayer felt greatly

aggrieved that we had invoked the sanction of law to get the money in. He owed four years' taxes, and he said he thought we were pretty harsh about it.

I said, "Now, let's analyze it. You happen to be in the transportation business. This money was taken from the pay checks of your employees. But," I said, "your employees didn't pay these taxes in the final analysis; the people who did pay them were the people who rode your vehicles, because the fare that you charged them covers every element of expense, including the salaries and wages you paid to your employees, which in turn, of course, include these taxes."

"Now," I said, "if we do not collect this money from you, we are going to be asking the people of this country, including those who rode your vehicles, to pay these taxes again. And," I said, "we can't run the Revenue system of America on that basis."

The gentleman said, "Well, I came here thinking you were a pretty tough customer. I go out feeling that I am a heel."

I said, "I have no intention of making you feel that way, but if I have made you realize your responsibility in this situation, then, of course, I have accomplished a constructive session with you." I wish I could do as well with all of them, but I can't, of course. But I might say that that gentleman has somehow contrived to pay us now half of what he owes us, and we gave him five years to pay the balance.

I might say that one of the reasons why we went after this taxpayer so strongly was that he not only had not shown any interest in paying us but he wouldn't even come in to talk about an extended settlement. Of course, that sort of attitude doesn't sit well with a tax collector, and I think you would understand why.

Now, where do you come into this picture? I'll tell you where you come in. The accountant who had audited the books of that company annually had never once called attention to the fact that those taxes represented trust funds or even to the fact that they were delinquent to the extent of one, two, three, four years. That, I submit to you, was a very serious omission. This didn't worry us, of course, because we didn't issue the reports, but as an accountant I suggest to you that the omission was serious.

Another reason that I am discussing this matter with you is that, whether you like it or not, my friends, you and every other tax practitioner in America are an extension of our Revenue Service. We aren't just a group of 52,500 people engaged in administering the Revenue laws, but rather we are a group of 52,500 people, plus all the people of America who make tax returns and who take part in the handling of disputes with us on behalf of taxpayers in order to get the liabilities of taxpayers honestly and fairly settled.

That is why I have said on numerous occasions that no Commissioner of Internal Revenue, and no Treasury Department having the responsibility for the Commissioner's activities, could ever for one minute agree to any limitation upon the right of taxpayers to choose qualified people, whatever their profession, to help them with the settlement of their disputes with their government over their tax returns.

Now I realize, of course, that there may be some who will call that a prejudiced attitude. If so, they'll just have to make the most of it, because it simply states the situation as I honestly see it from the position of the official who has to make the Revenue system work or else.

I am interested in the success of the Revenue laws of this country, because I think that the success of those laws is a key to the success of our economy and that that in turn is a key to the continuity of the success of the kind of government that you and I think is best for free people. And I do not believe that any public official could for one minute limit and proscribe the right of taxpayers to seek assistance in discharging this obligation to compute and pay in their respective shares of the cost of government without unleashing upon the Congress, and upon his own head, a storm of protest from the people that would soon bring reversing action.

Therefore, I have never been too disturbed about the activities of those who would institute such limitation, and I think that sound reason will prevail in due time and the whole matter will blow over and we will be moving on again shoulder to shoulder in the administration of this high responsibility—the Revenue people, with their primary responsibility, supplemented by the great army of lawyers and accountants and others who assist in the preparation of tax returns, and the other phases of the taxpayers' obligation to make his contribution to the welfare of the nation. I believe that harmony will come and in the not too distant future. We will get these unpleasant disturbances behind us.

In the meantime, of course, I find myself in a very unhappy position, though one that I suppose I can stand. I have been attacked by critics other than those who don't like the fact that I am an accountant. I have even made the pages of the *Daily Worker*, which, I am assured by others who have weathered the fury of the commies and their fellow travelers, is the best recommendation that I could hope for.

Now, I should like to say just a few words, if I may, about the question of evasion, because you have a responsibility here, my friends, that is equal to mine. Just remember that it has been the evasion of taxes that has destroyed the tax systems of nation after nation, and ultimately destroyed the economies of those nations and upset their political structures.

Let me read you some examples to show how public opinion changes on this question of evasion. Here is a rather disturbing statement. It is a letter

that went to the President. The gentleman wrote the President at some length, complaining that the Revenue agents were running wild in his area, harassing taxpayers, making them produce records, as he put it, four, six, eight, and ten years old, and that everybody in that area was just about ready to revolt. Well, that disturbed me, because that was just exactly what the situation was in many places when we took over, and when anybody tells me that that is happening again, I get concerned about it. So I began to look around.

In the meantime, I read his letter again, and listen to this. He said, "We all know that since your election and with the return of dignity and fair dealing to the office of President a change has been brought about in the attitude of people toward the Government." Now get that, "the attitude of the people toward the Government." Who is the Government but the people, if you please? But anyhow, that is the way the gentleman put it. To continue, "We all know that many of us skirted pretty close to the law in past administrations, because it seemed to be in keeping with the times."

Well, in my simple and naive way, I must confess that that was the first time that I ever knew that people took their morals, principles, and standards from corrupt politicians.

You might be interested to know that that gentleman was on the verge of becoming an involuntary guest of the United States Government. He wrote the President on the theory, I suppose, that "the best defense is a good offense." Needless to say, he didn't get away with it.

As you know, I am frequently criticized and even abused because I have taken a firm attitude toward the question of evasion. I have held that an evader is, in my book, no better when he comes from the so-called upper strata of society, a man not previously in trouble, one never caught at wrong-doing before, than a racketeer with a long criminal record; and I have insisted that, when people deliberately try to cheat the Government and their fellow taxpayers, then they ought to be put in jail.

I have been accused by some of my friends of the bar of making criminals of these people. It has never been quite clear to me how I could make a criminal of any man who has already made a criminal of himself.

Then I find a rather remarkable statement among the writings of one of my distinguished critics in which he says of the practitioners' relationship to the Revenue Service, "Advocacy requires a certain capacity for insincerity." Drink in those seven words, my friends, and consider, if you will, what would happen to the administration of the Revenue laws of this country if those enrolled to practice before the Treasury Department decided to operate upon the basis that "advocacy requires a certain capacity for insincerity."

When that day comes, I am quite certain that you will find enough Revenue agents to audit everybody and enough determination on the part

of the Revenue Service to pay no attention to any person enrolled to practice before the Treasury Department—if, indeed, there are any there to practice—because when you get to that point, then you are asking for autocratic and dictatorial government, and I did not go to Washington to aid in the institution of that kind of government in this country.

Now listen to this one. This is a report on a member of a profession and his wife who cheated you and your fellow citizens out of \$81,495 of taxes in four years and in the midst of his trial changed their plea from not guilty to *nolo contendere*, and then were sentenced to eight months and ten months, respectively. I don't know why such leniency to such people. Just listen. This man and his wife operated a hospital as a convalescent home to cover up illegal performance of abortions. Eight months for the man and ten months for his wife! And yet I am accused of making criminals out of people of that kind. Goodness knows I didn't make a criminal out of either of them. I don't know what happened to justice in that case.

Here is another. This man, over a period of three years, cheated us out of \$52,000. In the course of the examination of his returns it was found that he had kept inadequate books and records. Therefore it was necessary to make vigorous and extensive examinations of the records of numerous railroad companies, insurance companies, and product service companies involved in damage suits in which this man appeared as attorney. When first interviewed, he said he didn't have any books. We later found some, and we found that even those were faked. In other words, we were dealing with a man of bad character, a man who had no business associating with, or having the benefit of the friendship and favor of, decent people.

What happened? He got 90 days, and wasn't even fined a dollar. Did I make a criminal out of him? What happened to justice there?

Well, finally, my friends, and on this theme of your being a part of an extension of the Revenue Service administration, let me read you what the beloved Justice Jackson, who recently left us, had to say about our system and how important a part it can be shown that you play in this system, you and all your fellow practitioners.

He said, "that the United States has a system of taxation by confession"—that is an interesting way of putting it, and very apt—"where the people, so numerous and so scattered and individualistic, annually are assessed with a tax liability often in highly burdensome amounts, is a reassuring sign of the stability and the vitality of our system of self-government. What surprised me," he said, "in trying to help to administer these laws,"—you remember he was chief counsel of the Revenue Service at one time—"was not to discover examples of fraud or self-serving mistakes in reporting"—I like that; maybe we ought to publish that one, so we don't speak of it so harshly again—"but to discover that such derelictions were so few." And he said then, which I will not discuss this morning, but which

I should like to mention, because it is a part of this statement, "It would be a sad thing for the revenues if the good will of the people toward their taxing system were frittered away in efforts to accomplish by taxation moral reforms that cannot be accomplished by direct legislation."

That is kindred to the problem that we have of having to get rid of so much "legislation by regulation." (Incidentally, I understand there is at least one group who wants to ascertain, even before we release our regulations and the Treasury Department has approved them, whether or not we are writing them in the spirit of the new law.)

Then I should like to read to you what was said in a book called *Taxation in the United States*. Interestingly enough, this statement emanated from an old study of taxation in my own state, where I have always thought we had a pretty good tax system. When I read this, it came to me as a surprise, but it is very apropos of the problem dealt with.

"A large segment of the taxpaying public had become acutely tax-conscious, more so than it had ever been, and a substantial minority seemed more determined than ever to avoid taxes.

"This determination on the part of taxpayers had reached shocking proportions and the point at times of bitter defiance and recrimination. Foreign editors spoke of the problem of the United States to 'make its laws proof against evasion.' Tax avoidance had developed into a fine art."

The gentlemen who are going to follow me here as experts on this panel are going to talk to you about the problems of framing this new law, about the business of drafting regulations, and so forth under the law, but there is one observation that I would like to make concerning one aspect of the matter.

The other day I was asked by a group of newspaper people if our tax forms this year were going to be more simple than they were last year. Actually, the 1040-A is going to be quite simple; it is going to be a punch card about the size of a check. Form 1040 is going to be a little more complicated in the sense that we have had to take the tax chart off the return itself and move it over to the instruction booklet in order to make way for formulas, statements, and schedules necessary to enable people to calculate some of the new credit allowances by the new laws. But, you see, that is because of things done to *benefit* the taxpayer. It has been my observation, unfortunately, that whenever you set out to plug loopholes, achieve more equity, or simplify, you frequently make the end-product more complicated, and I don't know any way to avoid doing so.

You have here this morning a man who worked on the developments of our new law. I personally think that he made one of the greatest contributions to government service of any man of my knowledge, past or present. I know they tried to make it simple, and I think they did simplify the law a great deal, but I am sure he would be the last to claim that it is possible to

avoid complications when you throw in new provisions to bring new benefits, or when you try to close this loophole or that. It just seems unavoidable, no matter how hard you work at it. And, of course, there is nothing that any of these gentlemen can do to minimize the problem of evasion.

We believe that 97 to 98 per cent of the people of this country try to disclose their true income and pay their taxes: but, of course, we must recognize one thing: that a great deal of petty larceny is probably going on. Almost every one seems to enjoy trying it to some extent. But it can be carried too far, as in my own case when I was a kid, I hopped the steps of an ice wagon to snatch a piece of ice when there was plenty in the ice box at home, fell off in the path of a street car, and nearly lost a leg.

However, we are not worried too much about petty larceny. It is the greater kind that worries me—grand larceny, the sort that destroys the fiber of the taxpayers' character. And why do we worry? I'll tell you. Because we know that when compliance goes out the window, as it has elsewhere in the world, revenue systems fail and national economies falter and collapse.

Seeing and knowing this, we of the Revenue Service realize that we are not just tax collectors and you are not just tax practitioners. You and we are engaged, in the final analysis, in making the Revenue system of our country work, in maintaining the high level of voluntary compliance that enables us to accomplish the great things that we do for ourselves within our country, and to assume those obligations of assistance abroad that enable us to keep the light of freedom burning brightly in this uneasy world.

That, my friends, is the challenge, not only to us of the Internal Revenue Service, but to you as tax practitioners, and to you and all your fellow citizens as taxpayers of the last great stronghold of freedom as you and I understand it. And so, with a challenge of that kind, we—all of us, you and you and you, and all of the people of the country—must realize that we have to meet it, because there won't be any Marshall Plan to save us if our revenue system fails and our economy collapses.

Thus, there rests upon you as tax practitioners, and upon us of the Internal Revenue Service as administrators of the tax laws, a solemn obligation to discharge our respective and very closely related duties in a manner that will raise even the present high level of voluntary compliance, build an effective roadblock against social acceptance of evasion and those who make themselves guilty of it, and make the great experiment in liberty that our forefathers embarked upon in the closing days of 1787 secure against the erosion of time and circumstance and impregnable to the mightiest attacks of those who would assume the political domination of the world and put all people under their feet.



# The Regulation of the Issue And Marketing of Securities

Ralph H. Demmler

*Chairman, Securities and Exchange Commission*

I am honored indeed to be addressing outstanding accountants of many nations. The gracious invitation from Mr. Foye and Mr. Carey last April informed me that prominent accountants from Brazil, Canada, Cuba, England, Germany, Holland, Mexico, Puerto Rico, Scotland, and other countries would constitute approximately half of this distinguished audience. Let me hasten to tell you that it is my official position as Chairman of the Securities and Exchange Commission, and not my learning, that entitles me to address you. My training and experience, prior to becoming Chairman of the Commission in June, 1953, was that of a lawyer. I had, however, engaged in some corporate and financial practice and have acquired enough knowledge of this field to be cognizant of the wisdom of the classical couplet:

“A little knowledge is a dangerous thing;  
Drink deep or taste not the Pierian Spring.”

It is fitting that this visit of yours is timed to follow the recent meeting of the Board of Governors of the International Monetary Fund and the International Bank for Reconstruction and Development. At a public forum during that meeting, I had the pleasure of listening to a panel discussion concerning international investments, participated in by our own Secretary of the Treasury, the Chancellor of the Exchequer of Great Britain, the Finance Minister of Brazil, and the Finance Minister of India. They outlined, with some particularity, the problems which confront capital exporting countries and capital importing countries. You know them: remittance of income; repatriation of capital; risk of expropriation; double taxation of earnings; legitimate aspiration for local control; exchange risks, etc.

As you know, in recent years, movement of American capital to foreign countries (other than Canada) has been represented in great measure, not by acquisition of foreign securities by individual investors, but rather by government grants, by government loans, and by investment in subsidiaries by American corporations. The Securities and Exchange Com-

mission has nothing to do with inter-governmental relations. The Commission's jurisdiction with respect to capital advances by parent corporations to subsidiaries is quite limited. However, if the world develops as we hope it will, its economic progress will be based upon a substantial flow of private investment across international boundaries, and with that we do have something to do.

The United States, which emerged as a creditor nation after World War I, has perhaps less experience in international investment than have many of our Western European friends. The complex processes, the varying languages, the multiple laws, the differing customs, the involved techniques, call for skill and experience. The intelligent direction of foreign investment calls for a certain amount of what is suggested by a popular song entitled "Getting to Know You."

It is to be hoped and expected that over the years the international movement of capital required to raise the standards of living of the world will be less by inter-governmental loans and investments and more by private investment. It would be normal, also, to expect that a source of capital for such private investment would be the United States.

The aggregate outflow of private capital from the United States in the last six years has been approximately \$5,004,000,000, or an average of \$900,000,000 per year. In addition, the subsidiaries abroad of United States companies have reinvested earnings at an average of \$600,000,000 per year during this six year period.

It is also significant to note the important change that has taken place in our balance of payments position. During the years 1946 through 1948 the transactions of the rest of the world with the United States resulted in a net collection by us of \$4,500,000,000 in gold and in dollar balances and investments from foreign countries; that is, they paid us that amount to settle their accounts. In 1949, we were in approximate balance and there were no net payments either way. But in the last four years, from 1950 through 1953, the reversal was pronounced, and our transactions with the rest of the world added about \$7,700,000 to foreign countries' assets in gold and dollars. Based upon present available figures, the outgoing trend is continuing and the calendar year 1954 will witness another \$1,500,000,000 flowing to foreign countries to settle our accounts.

The outflow of investment capital, plus the balance of payments position would seem to indicate the validity of two conclusions: (1) That American capital is seeking investment abroad, and (2) That our net payments abroad are in such amount as to assist substantially in solving problems relating to remittance of profits and repatriation of capital.

The Securities and Exchange Commission is an agency of the government charged with the responsibility of administering several federal

statutes which seek to provide protection for investors and the public in their security transactions.

We have set up in this country a federal system regulating the sale of securities based generally on the furnishing to investors of information with respect to the security and its issuer. Legal sanctions, both penal and civil, are imposed for misrepresentation or concealment. Under that philosophy the investor is free to select either a wise or an unwise investment. The law merely assures that he has adequate opportunity to find out what he is buying.

Since the basic philosophy of our federal securities regulations is one of disclosure, the importance of accurate accounting information, furnished under generally accepted principles, is readily apparent. It is only a statement of the obvious to say that the information most determinative of the value or potential value of a security, and the progress of its issuer, is the financial condition of a business and the financial results of its operations. Such information can only be derived from the issuer's financial statements, accurately prepared, and presented in such a manner as to be informative, but concise; candid and uncolored; and disclosing every material fact necessary to make the statements not misleading.

Public offerings of securities by either the issuer or by persons in control of an issuer, and the obligations of issuers of securities listed on our national securities exchanges are governed respectively by the Securities Act of 1933 and the Securities Exchange Act of 1934.

The Securities Act of 1933, the so-called "truth-in-securities law," requires the disclosure of certain information in the sale of new securities, and prescribes standards for such information, so that the investor will know what he is getting when he buys securities. Any issuer registering securities under the Act also undertakes to file annual financial reports with the Securities and Exchange Commission. The Securities Exchange Act of 1934 provides for the filing with the Commission of basic information when a security is listed on an exchange and for periodic reports by the issuers of listed securities.

In complying with the Securities Act of 1933, the issuer files with the Securities and Exchange Commission a registration statement which is examined by our staff to determine whether it complies with applicable disclosure requirements, including the requirements with respect to financial statements. If it appears to be incomplete or inaccurate, the Commission has authority to refuse to permit the statement to become effective. The Commission does not, however, approve the securities, nor does the Commission make any representation as to the accuracy or completeness of the information.

Securities offered for exchange by an issuer with its existing security

holders exclusively where no remuneration is paid or given directly or indirectly for soliciting such exchange are exempt from registration procedures. However, such offerings are not exempt from the application of Section 17 of the Securities Act, and Section 10 of the Securities Exchange Act, which deal generally with fraud and concealment in securities, and the disclosure standards previously discussed would provide analogies in determining questions of civil liability or violation.

I mention this matter of exchanges of securities because we anticipate that from time to time foreign issues will be making offers to exchange new securities for outstanding securities.

Financial statements of issuers, filed with the Securities and Exchange Commission under the Securities Act of 1933 and the Securities Exchange Act of 1934 are, with minor exceptions, required to be certified by independent public or certified public accountants. The Commission's requirements, pertaining to the qualification of certifying accountants, are rigorous. Such an accountant must be in good standing and entitled to practice under the laws of the place of his residence or principal office. Moreover, any such certifying accountant must be, in fact, independent—that is, he may not have any financial interest direct or indirect in the organization whose accounts he certifies. Nor may he be a promoter, underwriter, voting trustee, director, officer or employee.

With respect to accounts filed with it, the Commission is given broad authority. Both the Securities Act and the Securities Exchange Act authorize the Commission to prescribe the items or details to be shown in the balance sheet and earnings statement, the methods to be followed in the preparation of accounts, in the appraisal or evaluation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation of consolidated balance sheets and income accounts.

Despite the broad power conferred upon it with relation to accounting matters, the Commission has not, except in the case of certain companies subject to the Public Utility Holding Company Act, adopted general rules prescribing principles of accounting.

We have adopted a set of rules, identified as Regulation S-X, which specify the *form and content* of the financial statements required to be filed. Included in this regulation are the Accounting Series Releases which are composed mainly of opinions on specific accounting questions.

With respect to the accounting *principles* underlying the financial statements filed with the Commission, our approach has been to review statements as filed, to determine whether the accounting principles reflected therein and the methods followed in their preparation are sound and

generally recognized as such; if not, to suggest that the statements should be amended in order to avoid stop-order or delisting proceedings. This policy is stated in Accounting Series Release No. 4, April 25, 1938, as follows:

“In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the account or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant.”

The application of the principle stated in Release No. 4 naturally gives rise to the possibility of disagreement and uncertainty with respect to particular statements and specific problems. If a registrant makes a filing stating accounts based upon principles for which it claims there is substantial authoritative support, there can readily arise arguments as to whether the claim for support is well founded.

The great variety of problems, which come to the attention of the Commission almost daily, demonstrates quite clearly that accounting is not a branch of mathematics like arithmetic or geometry and, consequently, as a practical matter, cannot be made the subject of rigid rules. It is apparent that there are a number of matters concerning which not all of the accountants in this country agree as to treatment in financial statements. During the short period—some 15 months—that I have been chairman of the Commission, some of these matters have been brought to our attention. For example, we have seen reflected in financial statements a variety of methods of accounting for stock options issued by corporations to their officers and employees; we have listened to arguments concerning accounting for emergency facilities, part of the cost of which under our tax laws may be amortized over a five year period; we have had discussions—some practical and some academic—on departures from cost in the handling of depreciation, and have declined a formal application to adopt a requirement that economic depreciation (based on replacement at cur-

rent prices) be reflected either in the accounts or by other appropriate disclosures; and, more often than one would expect, we have found it necessary to comment critically upon balance sheet write-ups, especially when made concurrently with a public offering of securities.

We have also had to give consideration to filings of foreign companies offering securities for sale in the United States. The financial statements contained in such filings, for the most part, have been certified by independent accountants located in their respective countries. Here again, the certifying accountants have not always agreed, either among themselves or with the accountants in this country, as to the basic principles underlying the preparation and presentation of the financial statements.

While it appears that, to some extent, accounting principles upon which financial statements of foreign issuers are based are derived from specific governmental requirements, usually involving tax considerations, it appears that some concepts of accounting which are not recognized in the United States are generally accepted abroad. For example, it has been represented to us that it is acceptable practice in the Netherlands, in determining net income, to base depreciation provisions on estimated replacement value, rather than on historical cost.

Very real questions are frequently posed by the arithmetical impossibility of converting the result achieved by one method of accounting into the result which would have been achieved by the application of another method.

Differences of opinion among certifying accountants are not confined to the preparation and presentation of financial statements, but are reflected as well in the procedures followed by them in auditing the accounts and records which form the basis of the financial statements. In this country, compliance with generally accepted auditing standards requires that the auditor shall, whenever practicable and reasonable, be present at the inventory taking and, by suitable observation and inquiry, satisfy himself as to the methods followed, and shall confirm accounts and notes receivable by direct communication with the debtors. It is my understanding that these procedures are not mandatory in England or Germany, or perhaps in other countries. I understand, however, that in those countries the independent accountant will not certify financial statements without having satisfied himself in some manner as to the credibility of the amounts shown for inventories and receivables. In this connection, there was brought to my attention, recently, the following abstract from the "Diary of A Chartered Accountant" published in *The Chartered Accountant in Australia*.<sup>1</sup>

<sup>1</sup>Volume XXIV, No. 10, April 20, 1954, p. 727.

' . . . a letter came in the other day from English associates covering the required audit of an Australian subsidiary. It was interesting to see the emphasis they placed on stock [inventory] verification at balance date and on the movement of stocks during the year . . . it is interesting to note how insistent they were on observation of physical stocktaking. My impression is that English practice is veering inevitably towards the American view on the point, though not to the extreme followed in the McKesson and Robbins case.'

From the foregoing partial list of accounting and auditing problems with which the Commission is confronted, it is apparent that some degree of turmoil exists with respect to the financial reporting of domestic issuers, a situation which is present in somewhat greater degree when statements of foreign issuers become involved. As one prominent Netherlands accountant has summarized it, "When in a particular case one has to deal with a great number of countries the obstacles mount to such an extent that, in consolidating or compiling the various data, you feel as if you mix a cocktail of 'good old Scotch' and water from the canals of Venice."<sup>2</sup> However, when one considers the vast complexity presented by the problems of industry, it is some comfort that the areas of controversy are relatively so small.

You can see that questions are presented to us in specific cases. Consequently, it is difficult to be specific in stating over-all policy.

The legitimate mutual interest of our people and the peoples of other lands in encouraging American investment abroad naturally suggests removal of needless barriers to the access of foreign issues to American capital markets. On the other hand, in view of the availability to American investors of relatively attractive investment opportunities at home, they are in position to insist upon receiving, with respect to foreign issues, information similar to that which they receive with respect to domestic issues. Moreover, from our standpoint as a regulatory agency, an imposition of less complete disclosure requirements on foreign issues would lead to demand for a similar relaxation of requirements with respect to domestic issues. In other words, it is normal to expect that American companies will demand "most favored nation treatment" in their own country. This would be retrogression for which our Commission should not be asked to take responsibility.

Our legal requirements for disclosure, our high standards for independent accountants, our insistence upon sound accounting principles, and the requirement for the furnishing of the relatively voluminous statements and schedules have, over a period of twenty-one years, materially raised

<sup>2</sup>The Accountant, Volume CXXVIII, No. 4082, March 14, 1953, p. 299 (J. Kraayenhof).

American accounting standards, and have afforded a very real degree of protection to American investors. There was no absence of complaint about the inconvenience of all this. But the over-all result has been good. Consequently, the accounting standards which we have helped to evolve have, in a sense, become a part of the mores of the American capital markets. And, I think it fair to suggest that this fact is one which must be recognized by foreign enterprises which seek capital funds from private investors.

There are no magic formulas to solve the perplexing questions which I have mentioned tonight nor many of the questions which you will hear discussed next week. It may be that at some future date there will be debates on the same subjects at an International Institute of Accountants.

Accounting is basically a technique of reflecting financial facts. The traditional free press in this country testifies to the belief that an organization of people does best when the people who compose it know the facts. Our Commission has loaned, and will continue to lend, its knowledge and legal support to those who help to develop better and more informative corporate accounting practices. It has goaded a good many stragglers into falling into line.

As we contemplate the place of sound accounting as a medium of information in the international movement of capital, I hope that there is general agreement with the philosophy of adequate disclosure which I have tried to espouse in these remarks.



# Accounting for The Taxpayer's Dollar

Norris Poulson

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I want you to know that I am sincerely grateful to you for your invitation to say a few words to such a group as yours and, too, for enabling me to discuss with you some things which I feel merit your attention and consideration.

While I am a certified public accountant by profession, I have the rather unusual background of having served in two legislative branches of government—first, as a member of the California State Legislature, then as a member of Congress in Washington and now, in the executive branch of government, the mayor being, of course, the chief executive of the city of Los Angeles. I have found an alarming lack of accounting and financial knowledge and understanding at the top level in both the state legislature and Congress. For one thing, they have been saturated too long with legalistic attitudes and techniques. I have a full regard and appreciation of the need for adequate legal knowledge in the conduct of government, but in the management of our public affairs, just as in business, there is also a vital need for an understanding and use of the professional accountant's knowledge and abilities.

One thing has been glaringly apparent to me, namely, the failure of most legislators to take full advantage of, and make effective use of, this management tool of accounting. Two instances come immediately to my mind. In the state legislature, I found it almost impossible to get the facts on what was being done with various monies. I am very gratified and proud to have been the one who sponsored the establishment of the office of "legislative auditor." While, as can happen, this did not accomplish all we intended, it did serve the purpose of providing the state legislature with an auditing branch that kept the legislature informed on what actually happened to the money and made it possible to plan for the future. To give the other instance—while I was a member of the 80th Congress, I know that the most effective cuts ever made in the budget were made possible by utilizing the assistance and knowledge of accountants from

the American Institute. These professionally trained and qualified men were able to study the budgets of each department of the federal government and from these studies produce facts and figures which provided the solid bases for larger cuts than we could ever have hoped for otherwise.

You know, it is the common practice of department heads, at any level of government, to seek far more money than is really needed for their department. They expect their requests to be reduced, and they prepare cleverly for such action. Often, their bluff is so effective that, despite cuts, they still receive more money than is required. Sometimes, in fact, they run into extreme difficulties in finding ways to spend all of their appropriation. I know from personal experience that their records for the final month of the year often indicate reckless spending—their way of using up the appropriation and thereby trying to avoid any decrease in their next budget.

Let me turn now to the role accounting is playing in my present work at the city hall in Los Angeles. When I became mayor 15 months ago, I immediately proceeded to take full advantage of the fact that I was an accountant, and a firm believer in the effective use of accounting as a management tool. I am sure you recognize that I am citing this not to boast, but to bring out the values and benefits to be realized from a greater use of professional accounting facilities in government.

When I became mayor, I was already familiar with the way in which legislators could spend weeks quibbling over item after item when preparing state and federal budgets, and then show an absurd disregard, once the money was appropriated, for how it was really spent. This spending could be done, and was done, in almost any way, so long as it could be interpreted as a legal use of public funds. In effect, lump sums were allocated without any but this general restriction on their expenditure. I knew that if we were to have business-like city government in Los Angeles, we would have to start with a knowledge of the facts—the facts as to the present fiscal condition of the city and the present and future needs of the community. Only secondly could we turn to the question of providing the funds to finance these needs while maintaining a sound and stable financial position for the city. Accordingly, I requested an advance financial planning survey in order to evaluate the city's financial status; to explore deficiencies in our present facilities and services; to forecast future operating costs and foreseeable capital improvements; and to develop a financial plan for the future, based upon probable trends in population, industrial growth, and other economic conditions.

Armed with these facts and figures when preparing the budget, I was able to make a virtually irrefutable presentation to the city council, and enable it, thereby, to recognize and know the true conditions. Together then, we faced up realistically and confidently to our responsibilities and

took decisive action to put our city on a sound operating basis. For the first time in many, many years in the history of Los Angeles municipal government, the mayor's proposed budget was adopted by the City Council without the change of a single appropriation. And why was this? It was because this budget rested firmly on the facts, the supporting data, and the work programs. In short, full and effective use had been made of the management tool, accounting, throughout the budget's preparation.

Let me relate, briefly, a few details of how this budget was drawn up. First, the determinations were made as to what would be needed to continue the current services to the community at the same level for the ensuing year. These determinations were based upon detailed work programs for each department, setting forth the man-hours, the units of production, and the expense and equipment needed, not only for the department as a whole, but for each activity of each department. These determinations were carefully and thoroughly investigated, meticulously probed and revised, until we were satisfied that they represented a program for carrying on at current level. Then, the facts as to added needs, services, and facilities were reviewed and analyzed in relation to the funds expected to be available. In a similarly painstaking and thorough manner, provisions were made for service betterments within the limits of these funds, department by department, activity by activity. Then, for the first time in our budget history, provisions were made for a capital improvements expenditure program, with item by item appropriations in the budget. In this manner, we came up with a balanced budget program assuring continuation of the current level of service to the public, the establishment of urgently needed service betterments, and a budgeted capital improvements program for the public. With respect to these capital improvements, I might say a few words here about our tremendous population growth about which I realize you have heard. However, to show graphically how this has compounded our problems, let me point out that since 1950 the population increase in the city of Los Angeles has been equivalent to the population of Albany, the capital of this state of New York. For these new citizens, we must provide new streets, new sewers, new public buildings, and so on. The urgency of a capital improvements program as a part of the budget is overwhelmingly apparent.

Now, we have also set up a strict policy on budgetary control. This provides for monthly reporting, analysis, and management action to bring about adherence to and fulfillment of the budgeted program. This doesn't stop with satisfying ourselves that monies are being spent legally. It goes much further, and determines that funds are being spent in fulfillment of the budget commitments to the public for the accomplishment and performance of the work and services regarded as essential to the public's welfare and safety.

Let me give you an example of what our tactics have been. The experts tell us that we have the best police department in the country. Nevertheless, this is a military organization, fundamentally and, for that reason, it sometimes gets the idea that it is untouchable, irreproachable, and needs no advice or suggestions from anyone. A few months back a very bad incident occurred right in downtown Los Angeles; some juvenile delinquents beat a man up so badly that he died right there on the sidewalk. As a result of the headlines, the police department was blamed for not having more officers patrolling the downtown area. The department immediately countered with the claim that it was undermanned, intimating that the budget did not provide sufficient funds for an adequate number of officers.

There was only one way to settle this—right then and there—and that was on the basis of the facts, which I immediately obtained. I found out the department had 28 vacancies in fully authorized and financed positions at the time of this incident and, further, that there were 283 officers assigned to such non-police activities as public information, planning and research, supply and transportation, records, personnel and training work. Many of these men could and should have been assigned to field duty, since a lot of the work they were doing could be performed by civilian employees. We put our finger on the facts and figures, retained administrative control in a difficult situation, and have taken steps to correct this condition—all as a result of effective use of accounting know-how. I did not do all this personally, but I did know the tools to use.

It sums up this way, to use a simile; governmental management today calls for full use of the technical instruments available for its guidance and control, just as the pilots of today's huge planes rely upon so many electronic devices as distinguished from the old days when they took up their "Jennies," and, as the expression goes, "flew by the seat of their pants."

Before I close, there's one more thing I feel called upon to discuss with you, and about which I am sure you are concerned. We have talked here about the vital need for making every possible effective use of the talents, knowledge and abilities of the professional accountant. It is no overstatement to say that the great commercial and industrial growth of this nation could not have been realized without the contributions accounting has made. It has played a key role in this development. Government has only recently begun to appreciate and take advantage of these same contributions—and government must be given every opportunity to make the fullest use of them. Any movement which will tend to stifle or hamper the further and greater use of the specialized technical attributes of the qualified professional accountant can only be to the detriment of our country.

# The Profession of Accounting: It's Past, Present and Future

Maurice H. Stans

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As your new president, I would like to talk to you about some perspectives on the *art* of accounting. That will lead, of course, to some thoughts on the *profession* of accounting as it stands today—thoughts that have come to me as I have considered the great responsibilities of this office.

I am especially glad that the ladies are included in my audience and that I can speak to them on this subject. Sometimes I think they know too little about what accounting is and what we do. For example, if their knowledge of accounting is limited to experiences with checkbooks—as I am sure is often the case—they may think of us as spending all our time struggling with colossal checkbooks.

Whatever their ideas about accounting, they try to understand us, they trust us, they sympathize with us when we are tired and overworked—but I doubt that many of them appreciate why we burden ourselves as seriously as we do with the problems of others.

For that reason, I want to try, with these few quick perspectives, to give them some feeling of the significance of accounting in today's world of things—and of how important we are, you and I, in what we do.

I want to stake some claims for the CPA. I want to point out how great a part the art of accounting has had in the economic advances of the last half century. I want to prove how much accounting has contributed to the improvement of our standard of living. I want, too, to point out some paradoxes in our present status in the eyes of the public and suggest what we must do about them. And I want, finally, to make some predictions—predictions about where accounting and accountants can go from here.

## **The Past**

For our starting point, we have to take just a quick look back about 50 years, to the beginning of the century. There wasn't much need for accounting at all then—mainly for three reasons:

1. Society was primarily agricultural. Industry as we know it today was only in low gear.
2. Government taxation and regulation were virtually negligible.
3. Mass production had not even been coined as a phrase.

Now look where society is today. The industrial revolution has converted us, in rapid steps, from an agricultural society to the scientific, mass production, chemical, electronic, aerodynamic, atomic age we now live in. Hours of work are almost halved and standards of living have gained tenfold. Productivity, gross national product, savings, building, almost annually reach new highs. Today we talk of automation, atomic power, synthetic foods, mining the seas, and hundreds of developments undreamed of a half century ago.

What caused this tremendous acceleration in the pace of history? No one would say that it just happened. There must have been powerful factors at work that can be credited—and they must have been new factors that never before existed. Man has always wanted better things—has sought them and has fought for them in all the years of recorded time. How did he suddenly attain them—in our short lifetime?

These are intriguing questions. It is my view that two new ingredients were added to make all these aims of human ambition so dramatically possible—ingredients which had lain dormant for centuries.

One of these additions was applied scientific research on a continuously growing scale. The other was accounting with continually improving techniques. The two together became the great tools of business growth and expansion. Combined, they converted the slow-paced industrial revolution to a fast-moving new kind of revolution. In the last half century we have had a scientific revolution by an intensive development of research—and we have had a managerial revolution by the tremendous expansion of the accounting arts.

This partnership of scientific research and accounting engineering—working together under the great American spirit of free enterprise and individual initiative—tells the story of the gains in living standards since 1900.

Do you think I claim too much? Then let me analyze the processes by which this all occurred.

As each new product was invented and each new business came into existence, the accounting art took over. Business management meant making decisions; decisions needed information; the information came from records; the better the records the better the information.

Bringing new developments to the public under competitive conditions required accurate knowledge of costs; cost measurement and cost reduction became the goals; accounting produced the facts and demanded more

engineering for still lower costs; and with lower costs more people benefited.

Business planning became budgeting. Financial management became controllership and that meant management by accounting. Improvements in accounting were necessary—to aid management and to protect lenders and investors—and this became the responsibility of a new profession.

Can we prove a relationship of cause and effect between these contributions of accounting and the new advances in living? I think we can, by evidence that goes beyond mere coincidence.

In the last few years there have been several teams of European business men that have come to the United States to study management accountancy methods. They found no real differences here in accounting theory, but tremendous differences in the *use* of accounting by business. Cost accounting here, they said in surprise, was less to find out what costs were than what they ought to be. Budgeting in this country provided close business planning and control; it was almost nonexistent elsewhere, where the function of accounting was historical and the attitude was "let's get by." Most of all, interpretative accounting at the management level, and controllership, were strictly American developments.

In reporting these findings one member of the British team conceded that a parallel development was that productivity in Britain since 1920 had increased at a rate less than half that of the United States and was steadily losing more ground.

I don't claim that accounting did the job alone for us. There was a favorable political climate here, and an aggressive philosophy of life. Capital, research, and management were important factors. But I do say that accounting was a major tool, and that without it the great progress in this country could never have been gained.

## **The Present**

When we come to the present, we find some strange paradoxes. They lie in the perspective others have of us. We find ourselves, for example, forced to defend our right to do—in the tax field—what we believe to be accounting. We often find our capacity, our work, and our stature insufficiently recognized when we deal with lawyers, courts, legislative bodies and other outside groups.

Professions grow up and mature, just as people do. It's easy to see how a profession can reach maturity almost without that fact being observed. It's much like the little girl in pigtails next door, who all of a sudden becomes grown up and sends you a wedding invitation. Or the little boy you last remembered shooting marbles, across the street, who amazes you one day by coming home in an army uniform.

That's what has happened to our accounting profession. We've matured and we've grown so fast that the folks next door and across the street haven't quite realized it.

I don't mean growth in numbers. They are impressive, of course: from 243 CPAs in 1900 to over 50,000 today; from a few thousand accountants in industry in 1900 to perhaps half a million today. The growth I mean is the growth in techniques, in responsibilities, in contributions to the accounting art and to business progress.

I really think that's what is at the root of our misunderstandings with the legal profession. They think of us as "glorified bookkeepers", as glum-faced auditors like the one once described by Elbert Hubbard, as arithmeticians who see that figures always come out in balanced columns. They don't see us as professionals, practicing an advanced art, dealing daily with principles, rules, regulations, laws, a large body of professional literature, and handling complex problems of interpretation and judgment. If they did, they would see that what we do in the tax field is what we do daily in our other work.

Part of this is due to the humble source from which we grew—book-keeping. Part of this is due to the fact that we have to ask the public to distinguish between a CPA, a PA, an accountant, and any bookkeeper or clerk who calls himself an accountant.

But these are growing pains, which we will overcome in time. The first real sign that we are important is the fact that we have something that others now want.

### **The Future**

And now a few words for the future. We have come a long way—but we have barely started.

I see the time, not far off, when there will be as many CPAs as there are now practitioners in the professions of medicine and law. I foresee a much wider range of service, as we take on counseling qualities to a far greater degree than at present. Our opinions will count in all places where economic data is basic to a solution of public problems. That means we will not only do our usual chores, but will, more and more, provide business advice, will counsel governments, will assist in settling industrial disputes and in creating economic peace. The CPA's stature will be imposing, his place will be secure, his value will be significant. He will have, not merely a niche in business, but a superior place in society. He will be the custodian of what may well become known as the Age of Accounting, in the rest of this century.

I see coming, and very soon, a demand that skilled accountants replace political favorites in all government positions dealing with economic



factors. I look forward to a continuation and widening of the trend in industry whereby more and more accountants are attaining top executive positions. I believe that soon accounting will be the best road leading to the highest positions in management—whether in manufacturing, insurance, banking, or whatever the line of commerce. Do you know that there were 3500 members of the Institute in 1953 holding positions of executive rank in business, government and teaching—compared with fewer than 300 twenty years ago?

### **Conclusion**

Why do I have such confidence in the part we will play in the future? The answer is evident in our present status—in the long way we have already come. But it is most evident in the service we—and only we—can perform in meeting the demands of our civilization.

Do I exaggerate? I don't believe so, but if you think perhaps I do, then I urge you to consider these words of the great liberal, Oliver Wendell Holmes:

“If we would guide by the light of reason, we must let our minds be bold.”



# Staff Training Problems Of Small Local Firms

Harold L. Child

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This paper was prepared at the behest of the Institute's advisory committee of local practitioners and it attempts to give special attention to the staff training and continuing education problems of small local firms. It is my belief that the best staff training can only be attained when there is a continuing education program for everyone in the accounting organization, including the practitioner principals.

## MEANS OF STAFF TRAINING

Staff training can be attained through any or all of the following means:

1. Individual study
2. On the job training through personal performance of assigned work, supplemented by instruction and assistance from senior accountants, other supervisors and the CPA practitioner
3. Instruction classes conducted within the accountant's own organization or with other groups or participants

### Individual Study

For individual study the following texts, all published by the American Institute of Accountants, are especially recommended:

*Duties of the Junior and Senior Accountant*

*Audits by Certified Public Accountants*

*Rules of Professional Conduct of the American Institute of Accountants*

*Restatement and Revision of Accounting Research Bulletins  
Codification of Statements on Auditing Procedure*

For continuing study and constant reference, the following publications are also recommended:

*Long Form Report Practice*

*Accounting Trends and Techniques* (published annually)

*The Journal of Accountancy*

It is assumed that beginning staff members have already studied basic texts dealing with the theory of accounts and principles of auditing and that they have some knowledge of federal income tax laws and regulations. Usually such beginners are not familiar with the special problems and techniques of the certified public accountant which are dealt with in publications of the Institute.

If a staff manual has been prepared by the practitioner, it should be carefully studied and adhered to. An example of a manual used for staff instruction and guidance is presented as Appendix C in Chapter 9 of the *CPA Handbook*. Local practitioners could readily adapt this manual example to meet their own situation.

The text material in the accountant's library, current information bulletins, and other publications should be identified, located, and explained as being available for study by staff accountants within the rules prescribed for their use.

### **On the Job Training**

Certain basic information relating to the confidential nature of his work and his behavior in the client's office should be taught to every accountant when he begins his service with a CPA to properly indoctrinate him as to his responsibilities. Such information may be taught through assigning the reading of a staff manual, by discussions with the CPA practitioner, or by other methods.

It must be firmly impressed on a new staff member that the relationship between the firm and client is of an extremely confidential nature, and that the client's affairs and problems may not be discussed with anyone except the senior accountant in charge of the engagement, partners of his firm, the client himself, or someone authoritatively representing the client. To safeguard this relationship, the staff member should be cautioned not to discuss his work or the business of clients at home, in restaurants, on elevators, or in any public place. Some thoughtless remark within the hearing of others may divulge confidential information to the detriment of the client. He must be careful about revealing information to the client's office employees or "thinking out loud" with respect to suggestions or criticism of a client's affairs. It may be that certain employees are critical of management or jealous of other employees and are seeking information to be used for fault finding. Errors and differences need not be discussed with subordinate employees except to get information, and certainly should

not be discussed with those not involved. Frequently, department heads are inquisitive about the earnings of their departments. This kind of information should come from the management and should not be volunteered or given by the auditor.

A partner of my firm was reviewing an audit report with a client when he was asked:

"How do my operating results compare with those of X Company, I understand you audit their accounts, how much did they make last year?"

This query was parried by asking the client:

"Would you like me to tell them how much your company earned last year?"

The client recognized the value of the confidential relationship with his auditor and agreed that his question was improper.

The Institute's rule of professional conduct No. 16 recites:

"A member shall not violate the confidential relationship between himself and his client."

This rule is applicable to all members of the practicing accountant's organization.

The staff assistant will receive his instructions from the senior in charge of an engagement. Anything related to the assignment which might involve taking exception to the accounting transactions as recorded by the client, or criticism of existing conditions in the office should be referred to the senior supervisor and should not be taken up directly with personnel of the client by the junior. The staff accountant is usually regarded by the client and by employees of the client as one well informed in accounting and tax matters because he is a representative of the CPA. His opinions may be sought concerning matters of accounting, income tax, office procedures, system revision, progress of the audit, efficiency of personnel, or any other problem. Statements made by the junior accountant are usually accepted by employees of the client as authoritative; if not correct they may cause embarrassment to the staff member and the firm. A guidance rule taken from a paper on staff training submitted to me (with which I fully agree) is as follows:

"Under no circumstances should a staff assistant institute changes in the accounting system or instruct the client's employees to make changes in their work routine."

When a junior accountant begins his service, he should recognize that by his act of joining the staff of a CPA he has enrolled in a profession which requires certain standards of conduct. To the extent that the responsibility for carrying out certain procedures of the examination has been assigned to a junior accountant, the junior's work furnishes the information and justification needed by his employer to enable the expression of a profes-

sional opinion, or denial of an opinion, on the financial statements being examined. Any work performed by the junior accountant is done as the agent of his employer and consequently the junior should be cognizant that it must be performed in a professional manner.

A new staff member, who commences his work with a reasonable amount of academic training and a fairly good knowledge of the theory of accounting and auditing nevertheless has quite a bridge to cross in the transition from the theoretical to the practical. Often he doesn't recognize the particular record or procedure as being like the one he studied in school, possibly because of the different form the record takes or some difference in the way of outlining a procedure from that which he was taught. It is here that his supervisor can be of material help by explaining the mechanics of the client's bookkeeping system, the procedures to be followed, their purpose, and the form of working papers to be prepared. If there is to be any deviation from what might be considered standard procedure, the reason therefor should be explained, to clear up any question in the junior's mind as to why something isn't being done the way the textbook said it should be done.

Probably the best training for a junior accountant is obtained when he works with a senior from start to finish on an auditing engagement. This training should include explaining to the junior the nature and purpose of the examination and a review of the audit program, including the work done by the senior and others. If practicable, the junior should assist in preparing the financial statements and tax returns. He should be encouraged to read the report and to ask questions concerning it.

A difficult lesson to teach staff accountants is the necessity of being inquisitive without being suspicious; and that they may, as individuals, believe representations of the client concerning certain items in the financial statements, and yet have no right to express an independent public accountant's opinion concerning such statements because these items have not been confirmed in accordance with generally accepted auditing procedures. The controller of a company whose accounts I was examining once said to me: "You don't believe anything I tell you, do you?" And I replied: "I believe everything you tell me, but it is my responsibility as a CPA to obtain objective proof of the correctness of the items in your financial statements."

There is often a tendency to assume that, when financial statements are prepared without audit, professional standards are not required to be observed in their preparation. Auditing Statements Numbers 1 and 23 are urged for special study. The beginner should be impressed that his employer is judged by every product issued, including letters sent to obtain confirmation of information needed in examining financial statements. The

practicing accountant needs to remind himself constantly that excellence of work must be maintained in all circumstances.

New employees, who may have recently graduated from colleges where they majored in accounting, frequently lack practice and experience in the routines of bookkeeping and office procedure. Our firm has a few engagements which involve bookkeeping write-up work and preparing monthly financial statements. The work on such engagements is often performed in our own office, and those who need bookkeeping experience are assigned to do it.

Accountants should write legibly and clearly on working papers, drafts of financial statements and reports, and especially on any of the client's records. Although no special penmanship instruction has been given in the study classes conducted by my firm, a few text tablets obtained from a school supply house were distributed to the staff with the admonition to practice the writing exercises recommended therein. Some improvement in writing legibility has resulted.

An auditor must be taught to refrain from forming hasty judgments or jumping to conclusions. Often he will find errors in accounting records that could have serious implications. His inclination is to raise a question immediately with the bookkeeper or whomever is concerned. Nearly every time he does this he will find that the errors have already been corrected and that if he had carried on with his work, he would have readily found the answers to his questions. When questions arise, they should be recorded on a query or audit note sheet. Questions of serious implication should be brought to the attention of the supervisor for follow-up.

### **Instruction Classes**

It is possible to become, and continue to be, well informed in technical knowledge and auditing procedures through individual study, but there is a tendency for practicing accountants and seniors who have passed the CPA examination to be occupied with the problems and work of each day to the exclusion of such study. The impetus of a special class or an organized program of training is needed to supplement and give direction to individual study.

In my firm, we hold a one-hour weekly class which is attended by all accountants in the organization, including beginners and members of the firm. These classes are conducted during regular office hours each Friday morning. Usually the class session is conducted by a partner or senior accountant who is considered to be well qualified to discuss the subject being considered. Questions are solicited and the discussions resulting from these questions afford an opportunity for partners and senior accountants to supplement the lecture presentation and possibly cite examples obtained in actual experience.

Subjects which have been discussed in these weekly classes include the following: Federal and state income and miscellaneous taxes; working papers and auditing procedures; municipal auditing; office machines (classes conducted at the sales offices of machine manufacturer's representatives); Auditing Statement No. 23; report writing.

In our organization, all accountants have some responsibility in connection with preparation of income tax returns. For the past eight years we have held weekly classes dealing with the subject of federal and state income taxes which have usually extended for a period of approximately six weeks. We are currently conducting a class on the new Internal Revenue Code, and have already held several weekly class meetings. These tax classes have been conducted by a CPA who is also a professor of accounting at our local university. Simple requirements for filing of returns and complex problems related to insurance annuities have been discussed in our classes.

Much of the information discussed is already familiar to some, but the laws, regulations, and requirements are more firmly fixed in their minds through the class review, so that returns are prepared and information furnished to clients without the necessity of checking and confirming with text sources.

At least one public accounting firm holds regular staff training classes in which accounting and other selected subjects are presented in speeches by employees of the firm. The meetings are conducted in a formal manner. After an employee has delivered his speech, a forum discussion follows in which the speaker may be asked questions. This is followed by an evaluation of the talk from the standpoint of its presentation, audience interest, the English used, grammar, and other factors. This program stresses the proper use of the English language, and has resulted in better report and letter writing. It provides enlightenment on accounting and tax matters developed and presented by staff members. I was informed that partners and staff accountants of the firm using this method believe they have the best arranged training program that anyone has yet devised. Mr. Louis K. Bell, a member of that firm, is a member of our discussion panel.

One firm presents indoctrination, information, and instruction to beginner employees through tape recordings dictated by a partner. After listening to the recordings, the new staff man is invited to discuss any matters, which require clarification or amplification, with one of the partners. This procedure permits the imparting of basic information to each new employee without the partner taking any additional time to do so, once the tape has been recorded.

The California Society of CPAs has collaborated with the Extension Division of the University of California in carrying out a "continuing edu-



cation" program for public accountants of that state. Regular extension classes sponsored by the California society, open only to members of the association and their staffs, are conducted under the auspices of the university. A committee on continuing education of the California society selects topics and courses to be offered, and nominates those who will perform special research and prepare detailed course outlines.

Under the guidance of the American Institute of Accountants, and with the sponsorship of state CPA societies, and the cooperation of a college or university in each state, I believe that the California plan could be effectively used throughout the nation.

In a report to the 1954 spring meeting of the Council, we were told that the Institute's committee on accounting personnel plans to proceed with the development and promotion of a continuing education program for members and their staffs which could be sponsored by the state societies. In general, the proposal is that the Institute, working through this committee, would provide course materials and suggestions on methods of administration and operation. The committee reported that "obviously the courses offered should not duplicate areas already dealt with by existing educational institutions." Considerable study has already been given to the problem by this committee, and we can anticipate that carefully prepared study courses may be available in the future.

### **CONTINUING EDUCATION**

It is usually assumed that every staff accountant wishes to become a CPA, and in our firm we try to encourage the accomplishment of this objective. After an accountant has passed the CPA examination, it seems to be more difficult for him to continue his studies. Senior staff men are not so much concerned about the latest accounting and auditing bulletin releases of the Institute as are those who are preparing for the CPA examination.

I believe that, if a continuing education program for members of the Institute and their staff is developed under the guidance of the committee on accounting personnel, everyone in the accounting organization will be stimulated to become better informed on new concepts and developments of interest and concern to the profession.

# Practical Application of the Rules On Advertising and Solicitation

Alvin R. Jennings

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Member, Council of the Institute, executive  
committee, and committee on budget and finance*

Advertising and solicitation have no proper place in a profession. With negligible exception, every state board which has adopted a code of ethics supports our Institute in its position on this question. Doorbell ringing is out.

We did not attain professional stature by proclamation, and we do not achieve an ethical standard by adopting a code. Neither position can be reached by mere association. Joining an institute and paying dues does not make a professional man. The wolf in sheep's clothing may run with the flock; he may even fool some of the sheep, but he is nevertheless a wolf.

Ethical conduct, like independence, is primarily a frame of mind—a matter of conscience in the individual. Codes of ethics are formal statements of standards. It is important that we recognize that all standards, by their nature, are minimum requirements.

## SOLICITATION

Solicitation is the subject of our Rule 7. That rule states that a member shall not solicit clients, and that he shall not encroach upon the practice of another accountant. The committee on professional ethics has not been called upon as frequently for interpretations of Rule 7 as it has for Rule 10 which treats with advertising. There is little that can be ambiguous about solicitation, and misunderstanding can seldom constitute a valid defense for wrong conduct.

Every accountant, sooner or later, will find among his clientele some who feel they can do better by shopping around. Likewise, he will occasionally be asked to consider doing work for businesses already being served

by other accountants. It does not take much experience to distinguish those who have a bona fide reason for changing auditors from those who would like to pit one of us against another in senseless competition which serves no one well — least of all the public interest. I am sure you agree we should avoid these traps, however baited.

If we do find ourselves in such a situation, what should be our course of conduct? After all, doesn't Rule 7 specifically say we can serve those who request our service? Yes, it does, and in pretty plain language. If you want to live by the letter you can probably get the job away from your fellow practitioner and leave him without formal grounds for complaint. Very few such prospective clients are apt to volunteer that they have invited others to the party too. If you are careful not to inquire you won't expose yourself to a charge of competitive bidding if you quote a price, will you? Probably not, and if that's your goal you are likely to achieve it. Think about it for a minute. Not an appealing prospect, is it?

While clearly not called for by Rule 7, it is my conviction that we should refuse to quote fixed fees or maximum fees in any such situation unless and until the incumbent accountant has been notified that his services have been terminated. It has been argued that a business may have valid reasons for wanting to change CPAs but may be reluctant to commit itself without some assurance that it is not letting itself in for substantially higher fees. This sounds plausible and, in some cases, even may be sincerely argued. Nevertheless a quoted fee has often been the instrument of injustice, and I would like to see us set our sights above Rule 7 and insist that we be selected solely on the quality of our service.

## ADVERTISING

It is only natural that we should desire to be well and favorably known by the business community. We need not apologize for that ambition, but we must be sure our means of achieving this conform to good taste. A passion for anonymity may be a requisite for a secretaryship in the White House but it is no hallmark of professional conduct.

Rule 10, as you know, approves announcements and listings that meet prescribed standards. The committee's conclusions on the most frequently raised questions are worth repeating.

### Announcements

A newly-formed firm stated that it intended to publish announcements of its establishment in all local newspapers. The members of the firm inquired whether, in conjunction with such announcements, it would be permissible to have a news item appear in their local newspapers, containing their pictures and a story of their backgrounds and stating that they had opened an office.

The committee, in reply, pointed out that the rule against advertising is intended to deal with self-advertising. If such publicity is in the nature of gratuitous recognition of something done by an accountant which is of public interest, it is not considered advertising.

The committee has held that a member may not accomplish through a third party what the rules of professional conduct provide he may not do himself. For example, a bank placed a small pamphlet in the hands of its customers during the tax season suggesting that a certain CPA with offices in the bank building was prepared to give assistance on tax matters. This was held to be in violation of the Institute's rules of professional conduct, even though the offer was solely a goodwill gesture on the part of the bank officials and was not a promotion effort on the part of the accountant concerned.

On another occasion, a fraternal organization, in order to show its appreciation for services rendered by its accountant, placed a card in its magazine showing the name and address of the accounting firm. The member concerned was requested to have the fraternal organization discontinue publication of the card.

### **Directory Listings**

Another perplexing problem arises when a member receives a request for a biographical sketch from a publication of the "Who's Who" type. One inquiry was received from a member who had received a request to write his own biographical sketch for a local "Who's Who" of people "who have devoted a measurable part of their life to civic, social or cultural development . . . of the locality." In this instance, the member's local society of accountants arranged with the publisher to supervise the propriety of material to be published.

A similar inquiry was received with respect to a member being listed in *Who's Who in Commerce and Industry*. A member was requested to prepare a biographical sketch as an individual selected by the publishers as being worthy of inclusion in its publication. The committee responded that the rule against advertising would not be violated by such a listing, but cautioned the member that his biographical sketch should be prepared in such a manner that any implication that he was taking advantage of the listing in order to advertise his professional attainments would be avoided.

The subject of paid directory listings under special headings such as "business consultant" is often before the committee.

In past rulings, the committee disapproved the practice of a member listing himself as a "systems analyst" under the classification of "certified public accountant" in a telephone directory as constituting a violation of Rule 10(b) of the rules of professional conduct. At the same time, the

committee has ruled that a member may list his name in a telephone directory under a separate classification of "systems analyst" provided such a listing is available in the directory.

It has been observed by the committee that the statement of principles promulgated by the National Conference of Lawyers and CPAs, prohibits a member from designating himself as "tax consultant" or "tax expert." Also, the committee indicated that it felt much progress had been made toward the elimination of such gingerbread on members' letterheads as "audits, systems, taxes, etc."

The committee further observed that matters had not yet reached the stage where the committee felt it could adopt a provision, at the national policy level, against the designation of specialties such as "management consultant" or "business consultant." While the committee favored eventual elimination of the use of special designations by Institute members, it nevertheless recognized that local conditions in many areas permit members to use such designations.

The extent to which a member may identify himself with published material, community projects and the like, brings many inquiries before the committee. Some of the more commonly asked questions are typified by the following material summarized from the files of the committee.

### **Canned Newsletters**

From time to time the committee on professional ethics has considered the propriety of members of the Institute furnishing clients and others with newsletters, tax booklets, and similar publications prepared by others and imprinted with the firm name of the member.

In a release which was published in the August, 1953, issue of *The CPA*, the committee said:

"In the opinion of the Committee, imprinting the name of the accountant on newsletters, tax booklets or other similar publications which are prepared by others and distributed by a member of the Institute does not add to the usefulness of the material to the reader. Use of the imprint, in the Committee's opinion, is objectionable in that it tends to suggest (and has been interpreted by many as a means of) circumventing Rule 10 of the Rules of Professional Conduct, which says that a member shall not advertise his services.

Since the imprint of the accountant's name serves no useful purpose and since it may be misconstrued to the detriment of the profession, it is the conclusion of this Committee that the distribution of newsletters, tax booklets or similar publications, prepared by others is not in the interest of the public or the

profession when such material is imprinted with the name of the accountant furnishing the material.

“The Committee sees no grounds for objections to furnishing material of the type indicated to clients or others provided that such material does not carry the imprint described and provided that such distribution is limited in a manner consistent with Rule 7.”

In reply to a recent inquiry the committee has gone one step further in suggesting that “canned” material distributed by members should be accompanied by a covering letter or memorandum containing an express disclaimer of authorship.

The committee was asked whether, in view of its disapproval of the imprinting of members’ names on canned newsletters, a member could nevertheless send such material to clients with his business card clipped or otherwise fastened to the canned material. The committee replied that there was some danger that even this mode of identification by the accountant might give rise to the inference that the printed matter had been prepared by the sender. However, the committee continued, the fact that the sender’s name was not imprinted directly on the material satisfied the letter of the rule, and the committee took the position that the distribution of material in such manner could not be objected to. At the same time, in order to avoid any possible criticism, the committee suggested that it would be best to distribute canned newsletters under a covering letter or memorandum with an express disclaimer of authorship.

A related problem arises in connection with a member writing material for publication (tax booklets, tax material), being paid for it, and leaving distribution of the printed material to the publisher.

A recent inquiry asked whether it was proper for a member to prepare a tax bulletin for compensation, distribution of which was to be made by someone other than the accountant. The committee replied that there is nothing in the Institute’s rules of professional conduct to prohibit a member from performing this type of work as distinguished from a straight auditing engagement. If the Institute were to forbid its members to express themselves in print for compensation, then such material that is being circularized for newspaper columns, tax services and so forth — and which is written by members of the Institute — would also have to be curtailed, the committee observed.

A similar ruling was made regarding publication and advertisement of accounting forms designed by a member for a publisher. The committee held that the advertising of such forms by the publisher does not necessarily constitute a violation of the rules against advertising and solicitation on the part of the member, provided the accountant has no financial interest in the

publishing firm, and has designed the forms for the publisher for compensation. On the other hand, the committee observed, if the accountant is financing the publishing venture and reserving a royalty for profit, or if the accountant furnished the forms to the printer outlining an advertising campaign for their sale, agreeing to underwrite any deficit incurred, then there would be little doubt that the entire operation was unethical.

### **Entertainment Program**

A member inquired whether the listing of an AIA member's name in an entertainment program without any designation as to his profession was a violation of Rule 10 (a).

It was the committee's conclusion that the display of a CPA's name in an entertainment program, even without any designation as to profession, might appear to be an advertisement of services in a case where long contact with the public had made the CPA's name well known. Even in cases where the individual is not well known, subscription by CPAs to advertisements in an entertainment program is not strictly in accordance with the rules of professional conduct. Stated in another way, the committee concluded that, although no positive breach of conduct occurred, such practice borders on impropriety.

### **TELEVISION APPEARANCES**

The question has been raised whether it is proper for a member of the AIA to appear on a television program and, during the commercial announcement, certify to financial data such as units sold, dollar value, etc., of one of his clients. The committee held that such a television appearance would not constitute *per se* a violation of the rules of professional conduct. Care should be taken however, the committee noted, to see that such an appearance would in no way impair the dignity of the profession. The committee stated that it would dislike seeing a rash of appearances on television of CPAs reaffirming statements that do not require the performance of some auditing or other technical work. On the other hand, the committee stated that it would have no objection to a member appearing on a television program such as a televised annual stockholders meeting of a corporation of which he had served as auditor, or to appearing on a television program sponsored by a professional society in connection with presenting tax information or other matters of general interest.

Apart from such situations as those outlined above, the committee felt that there are very few other instances of television appearances for which approval could be given.

### **Conclusion**

It is regrettable, even though perhaps unavoidable, that discussions such as we are having here today feature the negative rather than the positive.

There are many legitimate ways in which the newly established CPA can become better known. Robert Witschey's chapter on "Building and Keeping a Clientele" in the *CPA Handbook* is practical, specific, and well worth careful study.

When I was serving on the ethics committee, I facetiously suggested we urge the membership to add a new rule reading "if you have to look it up — don't do it." I still think it was good advice!



# Ethical Problems Encountered Within the Accounting Firm

**John D. Morrison**

*Partner, John D. Morrison and Company, Marquette,  
Michigan; Member, committee on membership*

Our rules of professional conduct have grown out of many years of experience on the part of many practitioners. As the profession has grown, so have our concepts of what is ethically sound expanded to meet new circumstances. Because our profession is relatively young as compared to others, we are still in the process of developing our formal code. The amount of time required by our committee on professional ethics to consider the problems presented to it by our membership, and the time devoted to such problems by the Council and by ourselves at our annual meetings, is evidence of this fact.

To one who has served on the committee on professional ethics of the Institute, it becomes quite apparent that, although stated rules are a most useful and necessary guide to proper conduct, we must realize two facts: (1) that because of the rapid growth of public accountancy and our membership, our code of ethics must be constantly reviewed in the light of new experience, and (2), that our present code, or the code we may have twenty years from now, can at best be only a statement of minimum requirements.

Older members of the profession will have no difficulty in recognizing in our present code certain proscriptions which formerly were matters of common occurrence. New rules will undoubtedly be added from time to time as our experience indicates their need, and when the majority opinion of members makes their acceptance possible.

No matter what our code of ethics may be at any point of time, it is important that we recognize the code for what it is: a useful guide for all of us, particularly for new members of the profession, and a statement of principles to govern the relations of members with each other, with clients,

and with the public. Nevertheless, the stated rules should be looked upon as the minimum, and not the maximum, measure of what constitutes ethical behavior. No code can be all inclusive. There will always be situations to which the answers as to what is ethically sound will not be found in the printed code. The practitioner, therefore, should not feel overly righteous because he lives up to the letter of the code only. There is also a spirit of ethical thinking and behavior that is equally important, in which printed rules play little, if any, part. Many of the replies to problems and questions submitted by our members to the committee on ethics include the statement "there is nothing in the code of ethics which would preclude your contemplated action"; or "the rules of professional conduct are not specific on the matter about which you inquire." This should not deter members from presenting specific problems to the committee on ethics, because the committee is often able to give the inquirer the benefit of the consensus of its members and the committee is often assisted by such presentation in judging wherein the rules may need clarification or strengthening.

These specific problems do, however, indicate that our professional approach to ethics in our day to day activities should not be of a negative nature. The question should not be, "How close may I come to the line which divides good practices from bad without offending?" Advances in ethical standards can never come from the negative approach, and the practitioner who so plots his ethical course is destined to run a poor race.

Most of our rules of conduct deal with our relations with each other, our clients, and the public. These were the areas where the need for regulation was most obvious.

The ethical problems encountered *within* the accounting firm are perhaps as numerous and important as those encountered in any other phase of public accounting practice, but they have not required as much of our attention.

Our rules of professional conduct are specific on only two groups of problems in this field, the first group being covered by, or related to, Rule No. 1, which pertains to the use of the designation, "Members of the American Institute of Accountants."

### **Rule No. 1**

This rule merely specifies the circumstances under which the designation "Members [or associates] of the American Institution of Accountants" may and may not be used in conjunction with a firm name. It parallels closely the provisions in most state accountancy laws relating to a firm's use of the designation "certified public accountants," that is, the designation may not be used unless all members of the partnership are certified public accountants. Similarly, the Institute designation is restricted to firms all the members of which are members of the Institute.

Actually, most of the questions raised do not relate directly to the designation, but more frequently to the style of the name of the individual practice or partnership. The rule denies the use of the designation to an individual practicing under a style denoting a partnership when, in fact, there are no partners. John Jones, a member of the Institute, may use the designation if he carries on a practice in his own name. He may not use the designation if his personal practice is styled in any manner which implies the existence of a partnership, such as John Jones & Company. If a member is in partnership with a CPA who is not a member, or with a non-CPA, the designation is denied. All members of a partnership must be members of the Institute (or associates) to use the designation.

At present, there is nothing in Rule No. 1 which prohibits a member who practices alone from using a name implying a partnership or firm; nor are there restrictions on the style of name that may be used by a partnership. Perhaps there should be, and the time may come when such a rule will be appropriate. In October, 1945, the committee on professional ethics issued a memorandum on ethical considerations respecting choice of names, which stated in part as follows: "The name of a firm of practicing accountants should denote a personal association. Such a firm should not adopt for its name any nonpersonal or misleading title." Here is where the positive approach to ethics can be recommended.

The following are some of the pronouncements of the committee on ethics pertaining to firm names and Institute membership designation:

The inclusion in the firm name of a former partner or partners is entirely appropriate.

It would be improper for an individual CPA to practice under the name of a deceased CPA. It was suggested in such a case, where the goodwill had been purchased from the estate, that the purchaser, who would practice in his own name, might show on his letterhead that he was successor to the deceased accountant.

It was also suggested that, if a deceased partner had been a member of the American Institute of Accountants, and all continuing partners were participants, the firm might properly continue to describe itself as "Members of the American Institute of Accountants."

Within the last year, a member who was a candidate for election to a school board inquired if it was appropriate to use the designation "Member of the American Institute of Accountants" in connection with his campaign advertising. The committee's opinion was that it was a legitimate method of substantiating the candidate's claim of worthiness to public office.

There is nothing in our rules of conduct, or in most CPA laws, which prevents a member from participating in a mixed partnership with one or more accountants who are not CPAs. However, the committee on ethics has consistently held that in this type of partnership the CPA is ethically responsible for all the acts of the partnership. That means that such a partnership must conform to our rules of conduct, and our member would be held accountable for the violation thereof of his noncertified partner.

Can a CPA practice public accounting in partnership with a member of another profession who is not a CPA? The laws of some states may preclude such an arrangement, but our rules of conduct do not prevent it. Generally, this practice is frowned upon as one not promoting the best interests of the profession. Again, it should be noted that the CPA would be responsible for any violation of our rules by his non-accountant partner.

There is nothing in our rules to prevent part-time practice, or the combining of the practice of accounting with another profession if the member is also licensed or qualified to practice the other profession. There are, however, definite restrictions as to certain occupations, as stated in Rule No. 4: "A member shall not engage in any business or occupation conjointly with that of public accountant, which is incompatible or inconsistent therewith." Any occupation which would cast doubt on the independence of a practitioner would probably be held incompatible.

In connection with partnership agreements, the question has been asked if the agreement may provide for the payment to the estate of a deceased partner of a share of the profits of the partnership over an agreed period. Rule No. 3 states, in part: "Commissions, brokerage, or other participation in the fees of professional work shall not be allowed directly or indirectly to the laity by a member." The committee on professional ethics has held that payments to a widow or the estate of a former partner would not be considered a violation of that rule. A widow or other heir, unless professionally qualified, could not properly be included as a partner.

### **Rule No. 2**

Rule No. 2 states "A member shall not allow any person to practice in his name who is not in partnership with him or in his employ." This rule has implications pertaining to ethical problems encountered within the firm as well as to relationships with other practitioners and the public. The purpose of this rule is to prevent the use by an unqualified person of the name and attendant prestige of a qualified accountant. The circumstances which prompt such an unauthorized use may lie with either party to an arrangement, or both, but in any event it is obviously a practice which should not be permitted. The following will illustrate the type of questions coming to the committee on ethics under this rule:

*Question:* "May a CPA who is employed by a non-CPA practice his profession without restriction?"

*Answer:* "There would be restriction inasmuch as financial statements based on audits made by the CPA could not be signed by him on behalf of the non-CPA firm. If the CPA became a partner, however, he would then be able to sign as a member of the firm and as a CPA."

*Question:* "Would it be improper for an accounting partnership to purchase a member's practice and use the designation 'Successors to—(name of member)'?"

*Answer:* "No. The partnership would not be practicing in the name of the member."

The committee questioned the right of a member entering the armed forces to have his practice continued in his name by a noncertified assistant. Other suitable arrangements were suggested.

More frequently than not, questions relating to Rule No. 2 stem from mixed partnerships, multiple partnerships, pseudo partnerships, and other working arrangements wherein representations on letterheads or otherwise may indicate relationships and responsibility not merited by the facts. The profession of public accounting, like most other professions, inherently has some aspects of commercial enterprises, and that is one reason why it is necessary to stress the professional approach as contrasted with the commercial. When the emphasis is misplaced, it usually gives rise to problems in ethics. Rule No. 2 cautions us to avoid relationships in practice that are not on a sound professional basis.

### **Other Problems**

Thus far our discussion has concerned those problems encountered within the accounting firm which are covered by Rules No. 1 and No. 2, and it must be realized that even these have directly or indirectly a public or client significance in many instances. There is always the very human inclination, as well as the real necessity, to regulate our outward points of contact, leaving the internal or family affairs of a firm to our individual consciences and judgment. Do rules of professional conduct apply here? Perhaps not printed rules, but certainly it is no less a field for the application of sound ethical thinking and practice.

Are partners carefully chosen with a complete knowledge of their ethical background and behavior? To endure, let alone prosper, a professional partnership requires that the relationships between partners be on a high ethical plane. Like the proverbial chain, a firm of accountants is no stronger ethically than its weakest partner link.

Are there ethical concepts involved in the responsibility of an accountant to be informed, to be familiar with the pronouncements of the Institute on

auditing procedures and standards of reporting? Undoubtedly there are, even beyond what we may find in our code.

What about our attitude toward staff? Are they people to be used for our gain only? We can probably never have stated rules governing this relationship, but here is a field in which ethical considerations are most vital. We do have a duty to instruct and train them in the skills of the profession. There are often ethical concepts involved in the advice we are asked for, or, occasionally, the advice we should feel compelled to volunteer, to staff. Do we have a sincere concern for their professional advancement, or is our counsel colored unduly by our own desires and needs? Can we maintain right attitudes when there are disappointments in our relations with staff, particularly on severance?

How much time and energy does the individual practitioner or the partner of a firm owe to his profession and professional societies? You will find no answer in the printed code. Participation in the activities of state societies and chapters, their committees, programs and educational endeavors involves a professional responsibility beyond that of personal satisfaction. We all recognize the debt we owe to those who have unselfishly contributed to the general welfare of all.

The final problem in ethics within the accounting firm is that of training our staff in ethics. This is just as important as any other part of the training program. Recently, a brand new CPA was invited by his employer to apply for membership in the Institute. He replied: "Perhaps someday, but not now. I have access here in the office to all of the publications and pronouncements of the Institute without cost." Needless to say, here was an opportunity to set a promising young man straight in his thinking, or, in other words, in his ethics. It was pointed out that, even as a newcomer in the profession, he owed a debt to those who preceded him, and to the organization which had done so much to make the profession today sufficiently attractive to induce him to enter it. He saw the point, and agreed he didn't want a "free ride."

Yes, a code of conduct is essential. Our code has served us well and merits our wholehearted support, but we should strive to interpret and apply it in the spirit of ethical conduct as well as the letter of the law. It is the minimum of what is expected of us ethically, not the maximum.

# Ethical Relationships With Fellow Practitioners

John H. Zebley, Jr.

*Partner, Turner, Crook and Zebley, Philadelphia;  
Member, Council and Trial Board of the Institute*

As a starting point in any discussion of one's relationships with fellow practitioners with whom one is not in partnership, perhaps the Golden Rule should be paraphrased somewhat in this manner: Treat your fellow practitioner as you would have him treat you.

However, having had some experience at both the state and national levels with the interpretation of rules of professional conduct and the determination of whether a particular course of action represents a breach or a violation of the ethics of the accounting profession, I realize that such a generalization will not contribute much to the solving of the ethical problems of the CPA as he rubs elbows with others in his day to day practice.

So I am going to try to be specific about a few types of situations with which some practitioners have been confronted, and indicate what may or may not be done if one is to avoid being called to answer for his actions by the committee on professional ethics.

## **Staff Accountants**

It seems that all too frequently an assistant on a fellow practitioner's staff appears to have just that little something that is lacking in the personnel of one's own staff. Under such circumstances, the temptation is great to approach the man with an offer of employment. I'm sure that all of you know that to do so would be a violation of Rule 8 unless you first discussed the matter with the man's present employer. I'm equally sure that the members understand and carefully observe this rule, because there are hardly ever any inquiries concerning its application to a set of given circumstances or complaints thereunder.

The rule clearly indicates that you may discuss employment with any person who makes application for a position with you, whether or not he

may be employed by a fellow practitioner at the time, provided you have not initiated the interview. Generally, you will also want to discuss the situation with the present employer in order to ascertain the capabilities of the applicant and to check on the circumstances given as the reason for making a change.

Collaboration between fellow practitioners in trying to keep staff personnel happy in the accounting profession can go a long way toward preventing a move to private industry by some promising individuals.

In an endeavor to make certain that the time devoted to training staff assistants is not lost by having them leave after they have been developed to a high degree of usefulness, some firms have asked new employees to sign employment contracts for a specified period, and to agree not to engage locally in public accounting for a limited time after leaving. There are some practical limitations to the success of such employment contracts. Usually, a few clients will give their work to a former staff assistant who has satisfactorily served them when he opens his own office. However, he may not solicit, or even send cards to, clients of his former employer without running foul of the American Institute's Rule 10. He may not be a member of the Institute at the time of soliciting or sending advertising matter to clients of his former employer and thus think to avoid prosecution. But some person will be almost sure to remember the incident with unfavorable results some years later when his name does come before the membership for admission.

Incidentally, the Treasury Department has recently adopted a new procedure with regard to the application by staff accountants for cards to practice before it. A letter is now required from the employer, stating whether or not there is any objection to the use of the card, if granted, for representation of persons not clients of the applicant's employer. The reply by the employer to this particular question will have no effect upon the decision of the committee on enrollment to grant the card.

### **New Clients**

Generally speaking, a certified public accountant has a feeling of well-being and all's right with the world when a new client approaches him to undertake some accounting work. But the well-advised practitioner will usually want to know the circumstances which led the new client to his door, particularly if there was no previous acquaintanceship.

Where a new business venture is being established, there would seem to be no problem except to arrive at rates and manner of compensation. But when the prospective client indicates that he has previously utilized the services of a fellow practitioner, you will surely want to learn not only the fact that the relationship with the other CPA has been severed, but the reasons for discontinuance.



Obtaining an answer to this question from the prospective client is not usually generated by a desire to save the work for the other accountant. Instead, one is interested to learn at the outset whether the prospective client is one who fails to accept the concept of independence which is the hallmark of the professional accountant.

If auditing procedures had been restricted to the end that the former accountant's qualified opinion or disclaimer had been a matter of dissatisfaction to the prospective client, the chances are that he will be no more pleased with your report; and the time to find that out is before you have expended any efforts on the engagement.

Sometimes the reason given for changing accountants is the fact that the service received has been unsatisfactory. You may want to check on this with the former accountant if for no other reason than to make sure that you are not getting a client who will make unreasonable demands on your time and not be willing to pay accordingly.

After satisfying yourself that you would like to undertake the work offered by the prospective client and that price-cutting is not primarily the cause of the desire to change accountants, there is no requirement of the rules of professional ethics of the Institute that would prevent you from undertaking the engagement. It would be optional whether you would even discuss the matter with the former CPA.

But suppose your interview developed the fact that the real reason for the prospective client coming to you was to get the same work done for less money. What then should be your attitude? My suggestion is that you tell your prospective client that your office could not be expected to do the work for less money than he previously paid—with the possible exception of the elimination of traveling, hotel, and subsistence expenses which might be a factor if the prospective client had previously engaged accountants from out of town and your office was locally situated with regard to the engagement.

If you should offer to do the same work for less money, and you get the engagement, you may well find that next year your new client will be shopping around again for some one else to make a further reduction in the amount of the accounting fee.

Sometimes new clients are obtained by the acquisition of the practice of one who desires to retire, or from the estate of a deceased practitioner. A point which should be fully covered between the parties to such a transaction is the transfer of the working papers. The accountant acquiring the practice should have no difficulty in obtaining permission to receive all working papers for prior years of the clients who agree to engage him for future work. But the practitioner who sells his practice would be violating

the confidence of his former clients were he to turn over their working papers to the purchaser of his practice without obtaining their permission.

### **Collaboration by Fellow Practitioners**

At the 1949 session of the General Assembly of Pennsylvania, the Joint State Government Commission (a continuing agency for the development of facts and recommendations on all phases of government for the use of the General Assembly; and composed of members of the House and Senate of the Commonwealth) was authorized "to study and investigate the accounting systems used by the several departments, agencies, and commissions of the Commonwealth with a view of developing adequate and uniform accounting systems and complete analyses of the Commonwealth's fiscal condition including a statement and analysis of assets exclusive of physical assets and liabilities of the Commonwealth."

The magnitude of the undertaking might be better understood by stating that the budgeted expenditures for the 1949-51 biennium, exclusive of federal monies, were in excess of \$1,028,000,000, and were distributed among 40 departments, agencies, and commissions. Representatives of the Joint State Government Commission called on the Pennsylvania Institute of Certified Public Accountants for help on the project.

Fifteen accounting firms represented in the membership of the Pennsylvania Institute contributed, without charge, the services of their organizations in making a survey of the accounting systems of eighteen departments. Separate reports were submitted by each firm and the Pennsylvania Institute's committee on Commonwealth Government Accounting, after further study and consultation, made recommendations to the Joint State Government Commission for far reaching changes in the Commonwealth's accounting practices and procedures.

There may be some who will say that such altruism on the part of the Pennsylvania certified public accountants should be unnecessary, and that the Commonwealth should have been required to pay for the services rendered. Perhaps that is so, but it seemed to be good public relations at the time.

Some years ago (1937), a number of accounting firms were engaged to make a simultaneous examination of the records maintained, and a survey of the general conditions under which operations were being carried on, at various relief offices under the Pennsylvania Department of Public Assistance. Those examinations were paid for at an agreed upon average daily rate for all firms.

This type of joint undertaking has found a counterpart within the year where a number of public accounting firms were engaged to reorganize the property accounting system and methods of the federal government, as reported recently in *The CPA*.

With business tending to decentralize and to establish subsidiaries or branch plants at strategic locations away from large cities, opportunities are being presented for local CPAs to collaborate in the examination of the accounts of such branches as assistants to the accounting firms serving the main plant or the parent corporation.

Operating expenses of many large corporations, to say nothing of their smaller counterparts, are being scrutinized more thoroughly than ever to find spots susceptible to savings. Perhaps fees for auditing may be selected by some for possible reduction. Cooperation with a client to this end might be accomplished through the use of local accounting firms for such purposes as branch inventory observations, verification of accounts receivable, and other auditing procedures, with the elimination at least of traveling, hotel, and subsistence expenses of staff accountants sent out from the main office.

### **Competition in Bidding by Fellow Practitioners**

About 20 years ago our firm replied to a request for a bid on a school district audit in Pennsylvania. When the bids were opened it was found that they ranged, approximately, from \$350 to \$3,500. Now it is obvious to us as certified public accountants that the work contemplated by the low bidder had to be vastly different from the scope of work in the mind of the highest bidder. In other words, no difference in rates could possibly account for the difference between the total prices of the lowest and the highest bidders.

You might think that such a disparity could not exist today, and yet just a few weeks ago one of the technical services of the federal government entered into a contract with a firm of certified public accountants that was the low bidder, as the result of proposals submitted which ranged from a low of \$49,000 to a high of \$200,000, with ten firms in between.

Again, it can hardly be said that differences in per diem rates would cause the variations in the estimated overall cost submitted in the proposals. There must have been a substantial difference in the conception of the work to be done.

These two examples merely illustrate the futility of a prospective client endeavoring to measure the ability and judgment of a certified public accountant by the number of dollars for which he offers to undertake a more or less accurately described engagement.

### **Proposals for Government Work**

Interest on the part of public accounting firms, management consultants, and industrial engineers in obtaining contracts with the federal government has expanded in recent years, no doubt as knowledge of the steps being taken to install more business-like controls and accounting practices has become more wide spread.

An example of such interest is the fact that as many as 46 such concerns were invited to submit proposals to the Treasury Department on a phase of the reorganization work for which about \$40,000 had been allocated.

When there is no compulsion for a procurement officer to accept the lowest dollar bid, and no emergency involved, who can say that the enlargement of the number of professional persons, be they CPAs, management consultants, industrial engineers, or others with similar abilities who might be consulted, would not be helpful in ultimately getting the proposed work accomplished more efficiently and probably more economically.

But the completion of proposals for government work, whether federal, state, or local, is a time consuming job and costs each proposer a considerable sum to prepare—in time and, often, expenses of partners, managers, and others who might be involved in the work should the proposal be accepted.

Public accounting firms, generally, have no estimating departments whose cost is included in general overhead and prorated to, or paid for, by all accepted jobs, such as is the case with contractors or manufacturing concerns doing a custom business. Productive time is the stock in trade of professional persons, and whenever time, which could be productive, is required to duplicate the efforts of representatives of as many as 46 other firms, there is an economic waste of no small proportions.

So it would seem necessary to weigh the possibility of excessive charges being paid by the government for work given out other than after consideration of proposals against the unrecovered expenses for preparation of proposals by all unsuccessful bidders, plus the additional expense to the government in handling and processing the extra proposals.

It seems incredible that officials of the government, charged with the assignment of engagements involving management controls and accounting practices, could be deceived for long, either with regard to the capabilities of those selected for a particular assignment or to the fairness of the charges made for the work done. Certainly a firm that failed in either respect would properly be excluded from any future consideration for work.

### **Competitive Bidding**

Under the rules of professional conduct of the American Institute of Accountants, is the submission of information (which is often requested by a prospective client—government or otherwise) regarding the qualifications of firm and key personnel, a form of discreditable advertising; is the request to have one's firm listed with banks or with various governmental agencies who may have need for the services of a CPA, a form of discreditable solicitation; is the submission of a proposal, when requested, with knowledge that similar inquiries have been made of others, an unprofessional and discreditable act?

I hope you will agree with me when I say that my answer to all three questions is in the negative under the letter of the rules of professional conduct of the Institute as presently worded.

But let me hasten to add that I do not believe that fixed price bids for audit engagements, when the overall price is the determining factor in awarding the work, are generally in the public interest in the case of government work, or in the client's interest in the case of private engagements. I would like to see such bidding discouraged to the point of complete elimination, and I salute the CPAs of those states which have taken appropriate action, either through their boards of accountancy or the rules of ethics of their societies, to prohibit such practice.

In May, 1946, the executive committee of the American Institute expressed very clearly, its reasons for recommending the elimination of competitive bidding for audit engagements. The official text of that statement was published in the August, 1946 issue of *The Journal of Accountancy* and a copy is appended to this paper.

As an example of what may be done in states which prohibit competitive bidding when proposals are solicited by a municipality, there is also appended a letter drafted by the committee on professional ethics of the Texas Society of Certified Public Accountants in 1953, and sent to the officials of a county in Texas who had requested competitive bids for an audit of the accounts of the county.

The American Institute's rule on competitive bidding is as follows:

*Rule 14.* A member shall not make a competitive bid for professional engagements in any state, territory or the District of Columbia, if such bid would constitute a violation of any rule of the recognized society of certified public accountants or the official board of accountancy in that state, territory or district.

It would seem that any question of violation of this rule would depend on the location of the engagement, and the rules of the society or board of accountancy having local jurisdiction. If a member should make "a competitive bid" in a state having no rule against such bidding, he could not be found guilty of a violation of Rule 14. If, on the other hand, a member should make "a competitive bid" in a state having such a rule, an interpretation of the definition of competitive bidding under the rules of that state would have to be made.

No case has ever come to trial under Rule 14 of the Institute. Any violation which should be reported would undoubtedly be referred to the state level for initial consideration. But can it be possible that the states which have rules prohibiting competitive bidding have been so successful in discouraging this practice that no member has sought to violate the rule,

and the public in those states has accepted it? If public acceptance has been so complete, why don't the CPAs of other states strengthen their rules on this subject, and thus broaden the area over which Rule 14 of the Institute may assume jurisdiction?

Eight state societies and two boards of accountancy have quite strictly worded rules against competitive bidding. Sixteen others have a rule similar to the American Institute rule. Thirteen have merely a rule admonishing members not to engage in competitive bidding or minimize the value of their services, or a resolution in discouragement of competitive bidding. There are only ten states in which neither the board nor the society has adopted some rule or resolution indicating an unfavorable attitude toward competitive bidding. Those states, according to a compilation of the American Institute staff are California, Indiana, Nebraska, Nevada, New Hampshire, New York, Oklahoma, Rhode Island, Tennessee and Washington.

In recent years the committee on professional ethics and the executive committee of the council of the American Institute have discussed, on several occasions, the desirability of taking steps which might strengthen the prohibition against competitive bidding by members of the Institute. One deterrent to such action has been a feeling that greater uniformity should be indicated by the state society members in strengthening the local rules before an overall prohibition should be adopted at the national level. Another cause for delay is the uncertainty which exists regarding the type of restriction which could be placed on competitive bidding without subjecting members to the likelihood of being asked to explain why their activities should not be considered to be in restraint of trade. Such criticism might be raised if minimum daily or hourly rates were established and all members adhered to them, or if interference with the right of a client to change accountants were shown.

Actually, the question of whether or not the anti-trust laws apply to the professions has not been directly submitted to the courts for adjudication according to information received from counsel for the Institute. This despite the fact that in an early decision the conclusion was reached that the term "trade" included "all occupations in which men are engaged for a livelihood."

Those in favor of strengthening the rules against competitive bidding will find comfort in the fact that the Supreme Court went on to say in the case against the National Association of Real Estate Boards:

"We do not intimate an opinion on the correctness of the application of the term to the professions. We have said enough to indicate we would be contracting the scope of the concept of "trade" as used in the phrase "restraint of trade"

in a precedent-breaking manner if we carved out an exemption for real estate brokers. Their activity is commercial and carried on for profit.”

In a later decision of the Supreme Court, involving the Oregon Medical Society, Mr. Justice Jackson intimated that the competition which the Sherman Act tries to foster in the commercial world might be demoralizing to the ethical standards of the medical profession. Unfortunately, the opinion does not set forth the form which the suggested demoralization might take and, consequently, it is not possible to make an analogy therefrom with the ethical standards of the accounting profession.

### **Conclusion**

From personal experience let me state that the best way to improve ethical relationships with fellow practitioners is to get to know as many of them as you can. You won't take a client away from a friend and your friend won't take your client. Go to your state society meetings and take an active part in professional matters at the local level. Attend the regional conferences that are held from time to time in the general area in which you live and get to know CPAs from neighboring states. Finally, become a regular attendant at the annual meeting of the American Institute of Accountants wherever it is held in order to maintain through the years your personal acquaintance with those who are currently active in the affairs of the profession of accountancy.

## Appendix I

### **Pro forma Letter to the Judge and Members of the Commissioners' Court of a County which Requested Submission of Bids for Auditing Engagement**

Gentlemen:

Several copies of your notice of January 19, 1953 advising that proposals for an audit of the County Officers of \_\_\_\_\_ County would be received on February 13, 1953 have been forwarded to the Committee on Professional Ethics of the Texas Society of Certified Public Accountants. Since I am Chairman of that committee, it is my duty to advise you that any certified public accountant or public accountant who engages in competitive bidding or submits a competitive bid in an effort to secure a professional engagement is in violation of Item No. 14 of the rules of professional conduct which have been promulgated by the Texas State Board of Public Accountancy under authority of Sec. 5 of the Public Accountancy Act of 1945 as amended by the Fifty-second Legislature of the State of Texas. This act is designated as Article 41-A of Vernon's Annotated Civil Statutes, to which your attention is respectfully invited.

Any certified public accountant or public accountant who violates any of the rules promulgated under authority of the Act cited above is subject to disciplinary action and could lose his right to practice. Submission of a competitive bid by a Certified Public Accountant constitutes such a violation. It is doubted that an engagement undertaken under such circumstances would result in the professional type of service that you and the people of \_\_\_\_\_ County are entitled to receive from an independent auditor.

The reason for prohibition of competitive bidding in our professional rules of ethics and in the State law regulating the practice of public accountancy is the belief that competitive bidding for audit engagements is not in the best interests of the client or the general public who must rely on the report of the auditor. It is not inspired by a desire to restrict free and fair competition, nor an effort to monopolize accounting practice.

A comparison of fees or rates quoted by two or more accountants is worthless since there is no means of measuring the relative value of the services rendered. With price competition there is a strong temptation to the less scrupulous accountant to submit a lower bid than is justified by the requirements of adequate performance. When the work is awarded to him he then finds himself in a position where, if he is to make a profit, or avoid losing money, he must curtail the scope of the examination, or employ assistants at lower than customary salaries.

Just as an individual would employ a physician in whom he had confidence those requiring accounting services should employ a certified public accountant in whom they have confidence, rather than one who offers to perform the work at a lower price. In the long run the client must depend upon the accountant's judgment.



There is no way in which a client can check the accountant's mental processes and those of his assistants to determine that an adequate examination has been made.

Even detailed specifications of the work to be done serve as no protection, because it is impossible to specify the exercise of good judgment. Laying down rules of procedure to be followed by an accountant by no means assures a good audit. A competent accountant, after commencing an engagement, might find many things in the specifications which were unnecessary in the given case, and many steps not mentioned in the specifications which should be taken.

Opposition to competitive bidding does not indicate any intention to seek uniformity in fees or rates for accounting services, nor to interfere in any way with arrangements as to fees, rates, or scope of work which may properly be made between the client and his accountant. The propriety of settling and completing such arrangements before or after the accountant is engaged is unquestioned. Nor is it suggested that clients or prospective clients may not properly inquire and be informed as to the amount or basis of an accountant's fee for services under discussion.

Experience has shown beyond any doubt, however, that selection of accountants on a competitive price basis leads to poor quality of work. Often audits undertaken on the basis of competitive bids are not worth even the relatively small amount paid for them. Competitive bidding is incompatible with service of a proper professional standard.

May I suggest therefore that you select an accountant or a firm of accountants in the same manner in which you would select a physician or an attorney — choose one in whom you have complete confidence, discuss the work you want done, and agree on a basis for his fee.

Very truly yours,

COMMITTEE ON PROFESSIONAL ETHICS,  
TEXAS SOCIETY OF CERTIFIED PUBLIC  
ACCOUNTANTS

By:

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William E. Ponder, Chairman

## Appendix II

### COMPETITIVE BIDDING FOR AUDIT ENGAGEMENTS

#### American Institute of Accountants

#### Statement by the Executive Committee

May 5, 1946

#### OFFICIAL TEXT

Competitive bidding for engagements to render professional service is unsound and illogical. Certified public accountants and their professional societies have long endeavored to discourage, or even forbid, the practice, on the ground that it is harmful both to those who receive the service and to those who render it.

The reason for opposition to competitive bidding is a belief that competitive bidding for audit engagements is not in the best interest either of the public or of the accountancy profession: it is not inspired by a desire to restrict free and fair competition, nor an effort to monopolize accounting practice.

An audit consists of an examination of accounting records and underlying data in conjunction with independent confirmation of certain items which are susceptible to that kind of check. The extent of the examination, that is, the number of records of actual transactions which will be scrutinized, and the number of items which will be independently confirmed, must rest largely on the judgment of the auditor. It is his duty to make sufficiently extensive investigations and tests to satisfy himself that the records and financial statements reflect fairly the financial position of the enterprise and the results of its operations. The cost of such an examination depends largely upon the time spent by the certified public accountant and his assistants in doing the work described. The final product is the accountant's opinion as to whether the financial statements as submitted do present fairly the position and the results of operations, with perhaps further detailed comment on various items for the information of those requiring additional information. The opinion may be valueless if offered by an incompetent person, or if offered on the basis of an examination which is inadequate to enable the accountant to form a valid opinion. The client, however, cannot know whether the opinion he has received is of value unless something later occurs to prove the contrary.

The accountant's opinion is far from being a mere intellectual abstraction. The readiness with which bankers, creditors, federal and state governmental agencies and taxing authorities, and all other third parties who must rely on accounting statements accept them is a definite and concrete matter on which the success or failure of important business transactions may depend. Decisions may be taken by the owners or managers of enterprises on the strength of an accountant's opinion and statements which may have serious and far-reaching results. There is no comparative measure of such results either on a qualitative or quantitative basis.

A comparison of fees or rates quoted by two or more accountants is worthless since there is no means of measuring the relative value of the services rendered. With price competition there is a strong temptation to the less scrupulous accountant to submit a lower bid than is justified by the requirements of adequate performance. When the work is awarded to him, he then finds himself in a position where, if he is to make a profit, or avoid losing money, he must curtail the scope of the examination, or employ assistants at lower than customary salaries.

Just as an individual would employ a physician in whom he had confidence, those requiring accounting services should employ a certified public accountant in whom they have confidence, rather than one who offers to perform the work at a lower price. In the long run the client must depend upon the accountant's judgment. There is no way in which a client can check the accountant's mental processes and those of his assistants to determine that an adequate examination has been made.

Even detailed specifications of the work to be done serve as no protection, because it is impossible to specify the exercise of good judgment. Laying down rules of procedure to be followed by an accountant by no means assures a good audit. A competent accountant, after commencing an engagement, might find many things in the specifications which were unnecessary in the given case and many steps not mentioned in the specifications which should be taken.

Opposition to competitive bidding does not indicate any intention to seek uniformity in fees or rates for accounting services, nor to interfere in any way with arrangements as to fees, rates, or scope of work which may properly be made between the client and his accountant. The propriety of settling and completing such arrangements before or after the accountant is engaged is unquestioned. Nor is it suggested that clients or prospective clients may not properly inquire and be informed as to the amount or basis of an accountant's fee for services under discussion.

Experience has shown beyond any doubt, however, that selection of accountants on a competitive price basis leads to poor quality of work. Often audits undertaken on the basis of competitive bids are not worth even the relatively small amount paid for them. Competitive bidding is incompatible with service of a proper professional standard.

*The Journal of Accountancy,*  
August, 1946

# Ethical Considerations in Relations With the Public and the Client

S. W. Eskew

*Chairman, committee on interstate practice;  
Partner, Eskew, Gresham & Diersen, Louisville*

As you know, rules of professional ethics are necessary.

It has never been my understanding that the rules of professional ethics of the accounting profession were intended to force a man to be ethical in his dealings either with his fellow practitioners, his clients, or the public. It is my understanding that these rules were originally designed to assist those members of the profession who were already ethical in following the proper course of conduct in the practice of their profession.

I remember a few years ago I was delivering a paper on the subject of ethics in the accounting profession at a meeting of one of the state societies. The program chairman had arranged for the dean of one of the accounting colleges to discuss my paper. After I had delivered the paper, he started off by saying that, in his opinion, the rules of professional ethics of the American Institute of Accountants stressed too much the negative side rather than the positive side. After he had completed his discussion of my paper I asked for permission to answer some of his comments. I stated then that, in my opinion, the positive side of the ethics of the profession had to be taught in the colleges, rather than by the American Institute, or any professional society.

I am quite sure all of you present know that of the Ten Commandments, seven of them begin with the statement, "Thou shalt not."

I have felt for a number of years that it would be desirable to include professional ethics as one of the subjects of instruction for students who are preparing for a career in public accounting. Many teachers of accounting agree with this theory. Today, there is much talk about public relations and

public information. However, it does not seem to be widely recognized that the codes of professional ethics and their enforcement are an essential part of good public relations.

It is my purpose to discuss those rules of professional ethics which deal with the relations between the practicing accountant and the public, and those dealing with the ethical relations between the practicing accountant and his client.

The first of the rules dealing with this subject is Rule No. 3.

“Commissions, brokerage, or other participation in the fees or profits of professional work shall not be allowed directly or indirectly to the laity by a member.

“Commissions, brokerage, or other participation in the fees, charges, or profits of work recommended or turned over to the laity as incident to services for clients shall not be accepted directly or indirectly by a member.”

Now, simply stated, the first part of this rule means that it is unethical for a practicing certified public accountant to split his fee with some person not engaged in the accounting profession in consideration for being recommended for the job.

The second part of the rule prohibits the certified public accountant from accepting a fee or commission for work done by a person other than a member of the accounting profession, which work was done as a result of the recommendation of the certified public accountant. For example, an accountant might recommend an investment banker or broker to handle a bond issue; but the accountant could not properly accept a commission from the banker or broker for having recommended him to handle this work.

During the past two years or so, the committee on professional ethics has received numerous inquiries concerning a corporation's offer to pay public accountants a referral fee for amounts of money placed in certain savings institutions.

The corporation was advised that participation by members of the Institute in such an arrangement would be a violation of Rule 3.

A few years ago, the committee received the following inquiry:

“I have been approached by a salesman of a bookkeeping service, not an accountant, to act as his professional adviser when technical problems arise. This person will make all contacts to complete sales, and will call me in to assist his customer in installing the system. He will no doubt inform his prospective customers that he has a CPA assisting him and available for special problems. This party would be another client to me. I would have no investment in the business nor would I be considered a partner. My fee might be based on a percentage of gross income or might be based on an hourly rate. Would this sort of arrangement violate any of the rules of professional conduct?”

The committee answered that inquiry as follows:

"The arrangements proposed might place you in the position of having the bookkeeping service indirectly solicit business for you, and might therefore be a violation of the rules of professional conduct. Your attention is directed to Rules 3, 7, and 15."

I think the illustrations which I have given will clearly demonstrate to you the purpose of Rule 3 with reference to commissions and brokerage fees.

The next rule which has to do with this subject is Rule No. 4, which reads as follows:

"A member shall not engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith."

Undoubtedly, this rule was adopted by the American Institute many years ago because of a similar rule then in existence in the rules of professional ethics of the Institute of Chartered Accountants in England and Wales.

While this is considered a sound rule, it apparently was of far greater importance in the early days of the profession than it is now.

As an illustration of how the committee on professional ethics feels about this rule, I will give you the following question and answer.

"Would solicitation or advertising for insurance business while simultaneously engaged in the practice of public accounting lead to violation of the Institute's rules of professional conduct?"

The committee answered as follows:

"In the event that complaints of advertising or solicitation were received against a member engaged simultaneously in the practice of public accounting and the insurance business, the Institute's committee on professional ethics would be in a position to invoke Rule 4 . . . ."

While most of the inquiries and complaints with reference to the application of Rule 4 have to do with a practicing accountant engaging in the insurance field, I would like to read to you another inquiry with reference to another subject.

The committee received the following inquiry and made the following answer:

"Is it proper for an accounting firm listing itself in the telephone directory and practicing as 'Certified Public Accountants' to own and operate an 'Industrial Engineering Department,' and as such to render industrial engineering services to the clients of other certified public accountants not owning and operating a like 'Industrial Engineering Department'? Is the practicing of industrial engineering simultaneously with the practice of public accounting, under the same name and within the same office, contrary to Rule 4 of the Institute rules of professional conduct? In

consideration of the fact that the state has established a State Board of Registration for Professional Engineers, which requires the licensing of all engineers engaged in public practice within the state, can it therefore be interpreted that the owning and operating of an industrial engineering department is compatible and consistent with the practice of public accounting?"

Answer: "An engineering or systems department in an accounting firm is not an activity that is incompatible with public accounting. Such departments in an accounting firm represented in the Institute must, under Rule 15 of the rules of professional conduct, observe the by-laws and rules of conduct. Rules 7 and 10, concerning solicitation and advertising, would have to be strictly adhered to."

Of course it can, I think, be stated unequivocally that the most important rule of professional conduct in so far as an accountant's dealing with the public is concerned is Rule 5.

Rule 5 reads as follows:

"In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if

(a) he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or

(b) he fails to report any material misstatement known to him to appear in the financial statement; or

(c) he is materially negligent in the conduct of his examination or in making his report thereon; or

(d) he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

(e) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances."

Now, of course, strictly speaking this is not a rule of ethics at all. This is a direct statement to the effect that dishonesty or carelessness will not be countenanced by the profession. Further, it is a statement that members of the Institute in their capacity as independent auditors must be governed by generally accepted accounting principles and generally accepted auditing procedures.

Prior to 1941 the Institute did not undertake to hold a member to any technical standard of performance either in the scope or quality of his examination or in the presentation of the financial statements on which he

expressed his professional opinion. In other words, it was more or less a question of judgment on the part of each accountant to determine what was a sufficient audit.

As early as 1917 the Institute recognized that some standard of auditing procedure was desirable.

In 1936 the Institute issued a bulletin entitled, *Examination of Financial Statements by Independent Public Accountants* in which it undertook to outline certain requirements with reference to auditing procedure.

In 1939 the Institute's committee on auditing procedure began the publication of a series of Statements on Auditing Procedure, outlining in detail the manner in which an auditor may properly satisfy himself as to the validity of various items in financial statements.

A similar development has taken place in the field of accounting. In this connection there is also considerable latitude for individual judgment.

Now as you will recall, Rule 5 provides that, in expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if, first, he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading.

This statement is clear and unequivocal. Deliberate omission of a material fact known to the accountant is inexcusable.

Subsection (b) of this rule says that the member may be held guilty of an act discreditable to the profession if he fails to report any material misstatement known to him to appear in the financial statement. This subsection is also clear and direct. In other words, if there is a material misstatement in the financial statement on which the accountant issues his certificate, it is his duty to call that to the attention of those to whom the report is addressed.

The third subsection says that a member may be held guilty of an act discreditable to the profession if he is materially negligent in the conduct of his examination or in making his report thereon.

This subsection says that a member cannot expect to conduct a negligent examination.

Subsection (d) says that a member may be held guilty of an act discreditable to the profession if he fails to acquire sufficient information to warrant expression of an opinion, or if his exceptions are sufficiently material to negative the expression of an opinion.

Instances are known where qualifications or exceptions related to such important items in financial statements that an auditor's opinion on the fairness of the statement had no value. If an accountant is going to express



an opinion, he must acquire sufficient information to warrant the expression of that opinion.

Subsection (e) says that a member may be held guilty of an act discreditable to the profession if he fails to direct attention to any material departure from generally accepted accounting principles, or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.

Under this subsection, an auditor cannot claim that he has done his duty even when he sees to it that there is full disclosure of all material transactions in the financial statements.

The matters covered by Rule 5 properly fall within the area of professional conduct, but they are of even greater significance than other questions generally associated with the term "ethics." It is more than likely that public accountants in questions involving civil liability will be measured by similar standards. It would not be unreasonable to assume that courts would hold that the responsibility of auditors under the law was no less than that prescribed by the organized profession.

Another rule of the Institute which has to do with the relationship between the accountant and the public is Rule 9, which reads as follows:

"Professional service shall not be rendered or offered for a fee which shall be contingent upon the findings or results of such service. This rule does not apply to cases involving federal, state, or other taxes, in which the findings are those of the taxing authorities and not those of the accountant. Fees to be fixed by courts or other public authorities, which are therefore of an indeterminate amount at the time when an engagement is undertaken, are not regarded as contingent fees within the meaning of this rule."

The public accountant must be on guard against the impairment of the independence of his judgment. Accountants must avoid positions in which their independence of judgment might be questioned by the public.

Your attention is called to the fact that Rule 9 excludes from its prohibitions contingent fees in connection with tax matters. While this is true, it is well known that the rules of practice before the Treasury Department require that an accountant handling a case on a contingent fee basis must disclose that fact.

The committee on professional ethics recently received the following inquiry with reference to the application of Rule 9:

"Where an accountant is to appear as an expert witness in a suit for damages and will testify in plaintiff's behalf as to the amount of damages sustained, is it proper that he shall receive, in addition to a per diem charge, a fee contingent upon the outcome of the trial?"

The committee answered as follows:

"Any agreement between a plaintiff and an expert witness that the witness

shall receive compensation based upon the amount of damages awarded the plaintiff, would be highly improper. Further, if such arrangements were to be discovered upon cross-examination, the effect of the expert witness' testimony would be severely weakened, thus prejudicing the client's case.

"Compensation paid an accountant for expert testimony given at a trial must be fixed at a per diem rate or at a fixed sum prior to the giving of such testimony."

Another rule which has to do with the relations of public accountants with the public is Rule 13, which reads as follows:

"A member shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise. A member shall not express his opinion on financial statements which are used as a basis of credit if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise, unless in his report he discloses such interest."

You will notice that this rule covers two different subjects. The first part prohibits a member from expressing an opinion on a financial statement of an enterprise financed in whole or in part by public distribution of securities, if he owns or is committed to acquire certain financial interests in the enterprise. The second part of the rule provides that he shall not express his opinion on financial statements which are used as a basis for credit if he owns certain financial interests in the enterprise, unless in his report he discloses such interests.

I think practically all members of the accounting profession recognize that it would be improper for an accountant who owned a substantial interest in a corporation to certify to the financial statement of that corporation. Probably the ownership of an interest in a corporation would in no way influence the public accountant in rendering a certificate. However, there is a more important angle to this matter. It is of the utmost importance that the profession safeguard its reputation for independence. What the public might think of a public accountant is as important as what the accountant actually is. The public could not be expected to accept the opinion of any accountant if it knew that the accountant owned a large block of the securities of the company whose statement he had certified.

The committee on professional ethics has received numerous inquiries with reference to this rule.

As illustrative of the feeling of the committee on professional ethics, the following is a condensation of a ruling issued a few years ago on the question of "substantial".

"The question is asked, what percentage of stock is considered a substantial financial interest in interpreting Rule 13, and whether this rule refers to nonvoting preferred as well as to common stock. Rule 13 covers common and preferred stock, voting and nonvoting, as well as bonds and any other type of financial interest. There is no fixed percentage which is considered as representing a substantial financial interest. What is substantial will be determined in the light of all the circumstances, including cost, value, and relationship to the total stock of the company and to the personal fortune of the holder. The chief purpose of the word 'substantial' is to indicate the spirit of the rule and to prevent its being applied literally to trivial situations. In any case, an accountant would be well advised to have no financial interest in an enterprise which he is auditing."

There is another rule which is closely related to Rule 4, which I have already discussed, and that is Rule No. 15, which reads as follows:

"A member of the American Institute of Accountants engaged in an occupation in which he renders services of a type commonly rendered by public accountants, must observe the bylaws and rules of professional conduct of the Institute in the conduct of that occupation."

You will recall that Rule 4 does not prohibit an accountant from following some other occupation conjointly with that of a public accountant.

Rule 15 provides that if he does follow some other occupation conjointly with the practice of public accounting, he must observe the rules of professional conduct of the Institute in the conduct of that other business or profession.

In interpreting this rule, the question most frequently involved is the question of advertising.

The committee has ruled that there is no objection to a certified public accountant practicing as a partner with a noncertified accountant. It has, however, called attention to the fact that the certified public accountant, in engaging in such a partnership, assumes responsibility for the actions of all members of the firm for conducting the practice in conformity with the Institute's rules of professional conduct.

The committee on professional ethics has recently issued a ruling on the application of Rule 15. The question was:

"Is it proper for a member to also be a member of a management engineering corporation which does no auditing tax work or system installation?"

Answer: "Yes, such activity constitutes service of a type commonly rendered by public accountants. Therefore, the corporate activity of the member falls within the scope of Rule 15 of the Institute's rules of professional

ethics. In the conduct of such corporate activity, there is always the danger, of course, that complaints may be received charging that the member is using the corporation as a feeder for his accounting practice. Consequently, the member in conducting such corporate business must assume the obligation of seeing that the rules against solicitation and advertising are complied with."

We now come to a rule which deals entirely with the relationship between the accountant and his clients.

Rule 16 is as follows:

"A member shall not violate the confidential relationship between himself and his client."

The confidential relationship between client and accountant cannot be stressed too strongly, because it is the basis of the client's faith and trust in his accountant. In order to perform an audit properly, the client's most personal business and financial affairs must be disclosed to the accountant. If this information, revealed to the auditor, is not held by him in the closest secrecy, the accountant's career is doomed.

The committee on professional ethics was presented with a peculiar situation covered by Rule 16. This is the problem:

"This office was engaged last year by client A, a holder of real estate, to handle his accounting and tax matters. During the year the client disposed of a portion of his holdings for the sum of blank dollars. In the course of working for client A, I met the purchaser of this property and was engaged by him, client B, to prepare his returns for the same year.

"While working on the records of client A, I discovered an error of \$500 in favor of client A on the sale of the property. The error on the settlement sheet was overlooked by both parties.

"I called the matter to the attention to client A, who stated that he had noted the error a week after the settlement but had not revealed it.

"I have not yet reviewed client B's copy of the settlement data, but anticipate doing so. Client B's tax returns were based on a purchase price of blank dollars which should have been \$500 more.

"Inasmuch as I owe confidence to both clients A and B, I am seeking advice on this matter."

Answer: "You should see that client B is informed of the \$500 error. The good will of all parties concerned might be preserved if you could explain the whole problem to client A and persuade him to bring the circumstances to the attention of client B. Client B should by all means be informed of the error which went undisclosed by both clients at the time of the settlement."

The committee on professional ethics has, during the past years, received a number of inquiries as to the proper course of action on the part of an

accountant when he discovers that a tax return, formerly prepared by him from information furnished by a client, was erroneous. The question raised usually is as to whether or not the accountant is under an obligation to report this fact to the Internal Revenue Service.

The committee has issued a number of rulings to the effect that a public accountant is not permitted to disclose this sort of information to anybody other than to his client. The committee has recommended in cases of this kind that the accountant notify the client of the error and advise that correction be made. The committee has advised that, unless the client is willing to make correction, the accountant should withdraw from the case and notify the client in writing that he is withdrawing and setting forth his reasons for taking this action.

Another question which has been presented to the committee for advice concerns privileged communication. Several states now have in their accountancy laws a provision that there is privileged communication on the part of certified public accountants. However, for all practical purposes, these provisions are no protection to the client or to the accountant with reference to federal income tax matters. The federal courts have held that, under the common law, there is no such thing as privileged communication applying to certified public accountants. The committee, however, has recommended that no certified public accountant voluntarily testify in any case, but insist upon being directed to testify by the court.

Professional men are not only regarded as highly skilled in some particular science or art; it is also assumed that they are willing to place service ahead of personal gain. A professional man must be regarded as a man of character. He must display a professional attitude toward his work. A professional attitude must be acquired by self-discipline. The rules of professional ethics of the accounting profession are intended as guides to right action—to action that will develop a professional attitude and thus win public confidence.

# A Survey of Audit Reports Submitted to Banks

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In discussing this subject, it should be understood that it pertains to the recent nationwide survey conducted by the Institute with the cooperation of Robert Morris Associates. A little history may be in order.

A considerable amount of publicity was given to a survey conducted by a fellow member of ours in Detroit some years ago. A similar survey, at least in some respects, was conducted by the Pennsylvania State Society. Preliminary to beginning the present survey, a test survey was made in New York City for the purpose of developing the best form of questionnaire to be used in the proposed nationwide survey. About 25 local banks cooperated in that endeavor and filled out over 100 questionnaires. With the benefit of this experience, and with the assistance of members of Robert Morris Associates, who had cooperated in that endeavor, the questionnaire was revised. When it was deemed satisfactory from every standpoint, the chairman of the committee on auditing procedure wrote to the presidents of all of the state societies of certified public accountants and invited them to conduct this survey in their respective states. An outline of methods to be followed was furnished, and a supply of questionnaires was made available.

The national chairman of Robert Morris Associates wrote to each district chairman and solicited his cooperation with the state societies.

With this background, the questionnaires were distributed in the various states to those banks which agreed to fill them out from selected audit reports contained in their files.

The questionnaires were filled out by the banks without any identification of either the borrower or the accountant, and were sent directly to the American Institute of Accountants.

The team which made this result possible consisted of the 30 cooperating state societies, the national and district organizations of Robert Morris Associates, and more than 300 banks, whose employees or officers filled out the questionnaires. Over 7,200 questionnaires were filled out, representing an equal number of audit reports.

While there must be errors of various kinds contained in the result, these are not believed to be important in relation to the total available information.

This is a significant study. It is believed that Robert Morris Associates could not have initiated, or successfully completed, such a study without the benefit of extensive consultation with state societies and representatives of the American Institute of Accountants. It would, of course, have been completely impossible for the latter to have conducted this survey, as the necessary information rested in the files of the banks. We have, therefore, information resulting from a great cooperative effort by all the interested parties, and we should feel a deep sense of appreciation to all who made this result possible.

The questionnaires were received by the Institute and tabulated through the use of punched cards. (This permits the preparation of the data in many different ways, and much more information is available than has been published or will be referred to in this short paper.)

Now what are the strong points of this survey — from the standpoint of the accumulation of data?

1. It represents a summary of information prepared from reports which were not originally expected to be used for such a purpose.

2. The reports rested in the files of lending banks and therefore supported loans or were made available for what we generally refer to as credit purposes.

3. The basic information was tabulated by the banks from selected reports, and each bank therefore represents only one out of 300 similar institutions.

4. While a basis for selection was suggested, the selection was made by different banks and therefore by different individuals, which would seem to guarantee a fine cross-section of available reports.

5. The information placed on the questionnaire shows the interpretation of skilled credit men and not certified public accountants.

What are the strong points of the survey, as to the use of the data?

1. It permits a reliable assay of the performance by accountants which is basic to an intelligent effort for improvement of the performance.

2. It is the groundwork, of course, for an extensive dual educational program. The effort can be directed toward accountants and their performance, and can also be directed toward bankers to aid them in understanding accountant's reports.

3. It indicates a superiority of performance by members of the American Institute of Accountants and certified public accountants in general as compared with those not enjoying such status.

4. It indicates effective acceptance of technical publications of the American Institute of Accountants, since the publications of the Institute influenced the performance on which the survey was based.

5. It indicates the influence of the leadership of the Institute and its committees. Statement No. 23 of the committee on auditing procedure, which had a major influence on the results shown by the survey, was not issued until 1947 and not formally adopted until 1949. Since this present study was made during 1953, it is probably based on audit reports of 1951 and 1952, so that there is a spread of only three to five years between the issuance of an important influence on these reports and the utilization of this influence by the practicing accountants.

Now what are the possible weaknesses of the survey?

1. The reports were selected by the banks and, although a suggested approach was offered, it is possible that the selection may have inclined toward the worst reports or toward those with qualifications.

2. Questionnaires necessarily involved an interpretation of reports and this interpretation was supplied by bank representatives and not accountants. Classification of data may therefore have been influenced by acceptability of the data to the bank as a basis for credit rather than as an indication of compliance with generally accepted auditing standards.

Careful consideration has been given to the tabulation made, and it is the belief of the research department and of the committee on auditing procedure of our Institute that on balance the conclusions expressed are entirely reliable.

Some of the results may be summarized as follows:

*Opinions:* about  $\frac{1}{2}$  are clean or unqualified; about  $\frac{1}{5}$  are qualified; about  $\frac{1}{10}$  disclaim the expression of any opinion; and about  $\frac{1}{5}$  neither express an opinion nor disclaim the ability to furnish one.

The last group should be the first area of our attack. Reports in this group, which represent one out of each five tabulated, fail to conform to standards of reporting. They fail to make clear the relation between the accountant's name and the accompanying financial statements. The relation cannot be clear when the accountant's opinion is not expressed and when he also fails to state that he disclaims any opinion and accompanies such disclaimer with the reasons therefor.

This entire result is quite good when the time element of adoption of publicized standards is considered. In my opinion, the facts show a high standard of performance.

However, it is also my opinion, that we should have a higher percentage



of clean certificates. The fact that only half of the reports contain unqualified opinions indicates the need of a broad educational effort applied to three fields:

First, a particular effort should be made to get certified public accountants to remove the one report out of five which fails to conform to proper standards, and also to improve the entire area approximating 50 per cent not represented by unqualified certificates;

Second, an effort should be made to get bankers to further the unqualified opinion as the proper basis for credit reliance. Their extensive reliance, if such is the case, on reports in which there is no expression of opinion by the accountant, should be brought clearly to their attention.

Third, clients should be educated gradually to more nearly complete acceptance of the fact that, as bankers' understanding of our qualifications tends to equal that of accountants, then the half of the reports which do not give an unqualified opinion will fail to serve the purpose of the borrower, and thus will be, to some extent, a partial waste of funds.

A few comments on specific results may be interesting:

*Observance of extended auditing procedures in connection with accounts receivable:* In 2/3 of the reports extended procedures as outlined were followed; in 1/10 of the cases the accountant stated that he satisfied himself by procedures other than those of confirmation; in 1/4 of the cases the extended procedures were not followed and the accountant either stated specifically that he had not satisfied himself by other procedures or made no statement.

The following conclusions seem appropriate:

1. The absence of the acceptance and use of the extended procedures in one out of each four reports should have been unsatisfactory to the banks.

2. It should not represent an adequate performance for the protection of clients.

3. Whether the extended procedures were followed or not is not of specific concern to the accountant provided his reporting standards are observed in relation thereto.

*Extent of the observance of extended auditing procedures in the case of inventories:* The extended procedures were observed in 56 per cent of the cases. This is 10 per cent less than in the case of receivables.

A little over 1/10 of the reports indicate that the accountants obtained satisfaction as to the existence of the inventories by other auditing procedures.

Where the inventories were definitely not observed, which was in one case out of three, the accountant indicated that he did not satisfy himself by other auditing procedures in 1/2 of the cases, and made no statement

in the other half. It is reasonable to assume that he was not so satisfied in this last group.

Again it is my opinion that the figure of 56 per cent for observance is not a high enough figure for the protection of clients, and should not be satisfactory to banks. The other 44 per cent remain areas for our educational efforts.

The committee on auditing procedure does not agree that inventories can be satisfactorily verified in 12 per cent of all cases. Eight hundred and nineteen reports contain the expression that although extended procedures (that is, observation as to inventories) were not followed the accountants satisfied themselves by other auditing procedures. It is my opinion that these accountants were too easily satisfied. It seems appropriate to remind you that the committee on auditing procedure previously expressed itself as believing that such cases were so rare as to be almost nonexistent.

In the final analysis, the opinion of the certified public accountant must stand investigation. Whenever such an investigation is made, it will be a study which will have the benefit of hindsight. If these 819 instances were investigated, would the opinion of the accountant be supported as having an adequate basis? It, of course, remains the responsibility of the signatory accountant, but the following comments regarding adequate performance should be kept in mind.

Of the reports examined, 73 per cent, or nearly three out of four, were by members of the American Institute, and an additional 14 per cent were by certified public accountants who were not members of the Institute. A total of 87 per cent of the reports in this test therefore supports the belief that reports made by CPAs are more acceptable to banks. These percentages are greater than the percentage of total certified public accountants to total practicing accountants. It seems safe to accept the statement that this is an indication that banks attach value to the certificate and particularly to membership in our Institute. If it is not the banks who are selective then it is our clients. In the case of the five states from which the largest number of questionnaires was obtained, four of the five showed an even larger percentage than the 87 per cent just expressed, namely; California 88 per cent, Pennsylvania 91 per cent, Florida 92 per cent, and New York 95 per cent. The other one of the five largest states, Connecticut, showed a smaller figure—84 per cent.

It is my opinion that the conduct of the survey itself has furnished two almost automatic results. It has made the members of Robert Morris Associates, and particularly the specific 300 cooperating banks, conscious of the reports accepted by them in the selected instances; it has directed the glare of investigation to reports some of which are deficient when

considered in the light of information available to the lender of funds; and it has made it apparent that many of the deficiencies developed are the responsibility of the bank, by making clear that the accountant can go no further than to state appropriately what he has done and give his opinion—either clean or qualified—or disclaim any opinion.

Another result is that, when greater knowledge of the survey has been disseminated, accountants will realize that full compliance with reporting standards is necessary as well as desirable; that the increasing ability of bank credit officials to determine responsibility for deficiencies in reports requires the certified public accountant to make clear that any deficiency is in the scope of his work which he does not control and not in his performance either in standards of field work or of reporting.

The survey has made a basis for educational work available to all of us, and we must accept the duty of utilizing this valuable information to the fullest extent.

# Some Historical Notes on Extensions of Auditing Procedure

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That hereafter, wherever practicable and reasonable, these shall be generally accepted auditing procedures: that the auditor be present at the inventory-taking; and that he confirm notes and accounts receivable by direct communication with the debtors.

The foregoing is of course a paraphrase from *Extensions of Auditing Procedure*, adopted by the Council and then by the Institute membership in 1939. It was not the first word said on the subjects of observation and confirmation; nor, for that matter, was it the last. It is the purpose of this paper to review some of the trends before and after adoption of the Extensions and to appraise the present position regarding them in the light of the most recent pronouncements on auditing standards and procedures.

## PERIOD 1917-1938

### **Inventories**

The *Federal Reserve Bulletin* of 1917 took a direct approach to the entire matter of audit programs. Its announced purpose was to remedy the lack of uniformity as to the extent of verification of balance sheet statements; emphasis upon the judgment required of the auditor in selecting his procedures is entirely lacking. Physical contact by the auditor with inventories occupies a prominent place in this document. In fact, a large part of the introduction is devoted to a distinction between balance sheets drawn up on an appraisal basis, which would include the auditor's personal supervision of inventories, and those based on an examination

of the books "without personal supervision of inventories and independent appraisal of all assets with the aid of technical appraisers."<sup>1</sup>

The statement then lists the following program steps:

- (5) Where stock records are kept and no physical inventory is taken at the time of the audit, ascertain when the last physical inventory was taken and compare it with the book records. If no recent comparison is possible, select a few book items of importance and personally compare with the actual stock on hand.
- (6) Where no stock records are kept, a physical inventory should be taken preferably under the general direction of the auditor. After the inventory is completed, he should apply the same tests to verify its accuracy as if the inventory had been taken before his arrival upon the scene."<sup>2</sup>

The 1929 bulletin of the Federal Reserve Board, *Verification of Financial Statements*, modified the auditor's approach to the inventories considerably and introduced the thought that the auditor's procedures would be adapted to the circumstances and be determined out of his skill and experience. It emphasized that "the auditor is not a valuer and can not have intimate knowledge of many classes of business."<sup>3</sup> It also advanced the view that the auditor's responsibility for quantities, quality and condition was greater when the verification thereof did not call for technical knowledge and presented no substantial difficulties than when such factors were present. This bulletin also suggested that the accountant participate in the planning phase for physical inventories, as follows:

"If the accountant can come into contact with the situation before the stock taking, it is very desirable that he should take part in determining the methods to be followed or at least that he should understand them and have the opportunity to make any criticisms of them beforehand."<sup>4</sup>

This bulletin continues the instruction from the 1917 pamphlet as to the auditor's procedure when stock records are kept and no physical inventory is taken at the time of the examination.

The 1936 pamphlet *Examination of Financial Statements*, the first audit program guide issued under the name of the Institute, withdrew the auditor a little farther from physical contact with the inventories. Whereas the 1929 pamphlet stated that the auditor must "generally

<sup>1</sup> *Approved Methods for the Preparation of Balance Sheet Statements, A Tentative Proposal Submitted by the Federal Reserve Board* (1918) — Page 5.

<sup>2</sup> *Ibid* — Page 12.

<sup>3</sup> *Verification of Financial Statements* (1929) — Page 8.

<sup>4</sup> *Ibid* — Page 8.

rely" upon the responsible officers and employees of the client for information as to quantities, quality and condition, the 1936 pamphlet stated that he must "rely principally" upon them in these respects. The full quotation from the 1936 pamphlet is as follows:

"3. The duties and responsibilities of the accountant in the case of quantities, quality and condition of stock vary with the circumstances; but he must rely principally for information as to quantities, quality and condition upon the responsible officers and employees of the company. In the case of a business which does not call for technical knowledge and presents no substantial difficulties, the accountant, by special arrangement with his client, may be justified in assuming a greater degree of responsibility than in cases where expert knowledge is essential. Make reasonable inquiries and tests to ascertain that quantities have been carefully determined and that quality and condition have received due consideration."<sup>5</sup>

The foregoing audit programs and program guides would indicate that in the pre-McKesson period there was a trend toward taking the auditor away from physical inventory contact and relying more upon corporate officials for determinations on these matters, and this was undoubtedly a reflection of majority practice. At the same time, more and more emphasis was being placed upon the auditor's judgment in the determination of the audit program for the specific case and in the light of existing internal controls. The connection between the two is indicated by the paragraph in the 1936 pamphlet on adapting the inventory program to the conditions obtaining in a large company, as follows:

"Many large companies maintain comprehensive continuous inventory records which are subject to periodic and independent physical stocktaking. In such cases the accountant should use his best judgment in determining the extent of the examination required, but the various points mentioned in the program regarding inventories given in Section II should be considered."<sup>6</sup>

During this same period, however, several individual authorities were recommending that the auditor's physical contact with inventories be increased. One of the Institute's committees also seemed to be drawing closer to the subject.

It might be well to review at this point the manner in which the Institute was organized prior to 1939 to handle matters of auditing procedure. The pamphlets of 1917, 1929, and 1936 had been originated by special

<sup>5</sup> *Examination of Financial Statements* (1936) — Pages 17 and 18.

<sup>6</sup> *Ibid* — Page 34.

committees each of which was discharged when its task was accomplished. There was no counterpart on auditing to the Institute's standing committee on accounting procedure. However, there had been in existence since 1937 a special committee on inventories which, the record indicates, was originally formed primarily to consult with representatives of the American Petroleum Institute on questions of *accounting* for inventories.

The reports of this committee for the years 1937 and 1938 indicate that accounting matters occupied a large part of its attention, although in a questionnaire mostly directed at other areas it did undertake to ascertain from a cross-section of practitioners the current views with regard to attendance or observation at inventory taking. In the latter connection, the 1938 report indicates that about one-half of the responding accountants considered that work on inventory records need not be supplemented by physical tests whereas the other half considered such tests desirable. One respondent felt that it was a necessary additional procedure. Whether this subject might have been pursued further and among other industries, had it not been for the happenings in *McKesson*, can only be a matter for speculation.

### Accounts Receivable

In the audit program for accounts receivable, the 1917 pamphlet laid strong emphasis upon subsequent payments, in the following words:

“. . . payment is the best proof that an account was good at the date of the audit.”<sup>7</sup>

With regard to an open balance, the pamphlet referred to confirmation as an “optional” procedure, but seemed even to discourage this step for the large concerns, as follows:

“Optional.—The best verification of an open balance is a confirmation by the customer; therefore, if time permits and the client does not object, it is advisable to circularize the customers . . .

“In large concerns the system of accounting is generally so arranged that it would be almost impossible for accounts to be paid and not correctly credited on the accounts receivable ledgers, but in small concerns, with imperfect systems, such occurrences are quite possible, so much so, in fact, that it is generally admitted that the risk of errors and omissions decreases in direct proportion to an increase in bookkeeping.”<sup>8</sup>

The 1929 bulletin continued the emphasis on subsequent payment as “clear proof” that the account was good at the date of the audit but

<sup>7</sup> *Approved Methods for the Preparation of Balance Sheet Statements, A Tentative Proposal Submitted by the Federal Reserve Board (1917)* — Page 9.

<sup>8</sup> *Ibid* — Page 10.

strengthened somewhat the wording with regard to confirmation of open balances by deleting both the word "optional" and the phrase "if time permits and the client does not object." The position is succinctly stated thus: "It is best to verify open balances by confirmation from customers."<sup>9</sup> However, this bulletin continued the faith in the system of accounting in large concerns in much the same language as in the 1917 bulletin.

The 1936 pamphlet sharply de-emphasized the subsequent payment by merely suggesting that the auditor "note on the lists any amounts paid since the date of closing" without any characterization of the validity of this information as evidence, or without stating for what purpose the information would be used. This pamphlet raised the status of the confirmation as evidence but suggested that it was still optional with the client and possibly unnecessary for companies with an adequate system of internal check. The instruction in this pamphlet is as follows:

"7. The best verification of accounts receivable is to communicate directly with the debtor regarding the existence of the debt, and this course may be taken after arrangement with the client. While such confirmation is frequently considered unnecessary in the case of companies having an adequate system of internal check, it is one of the most effective means of disclosing irregularities."<sup>10</sup>

With regard to circularization of accounts receivable then, the period from 1917 to 1938 saw a gradual de-emphasis of subsequent payment as evidence of the validity of accounts receivable and a concurrent increase in emphasis on circularization of customers. It would appear that the trend was such that in due course confirmation of receivables might have become recognized as a generally accepted auditing procedure although one may speculate as to how soon this might have come about had it not been for the *McKesson* case.

### PERIOD 1939-1942

Although the practices of observing physical inventories and circularizing receivables were far from widespread at the close of 1938, we have seen from a review of earlier program guides that they had already been given a great deal of attention. In the short space of six months, their status was entirely changed.

Immediately after the *McKesson* disclosures in December, 1938, a special committee on auditing procedure was appointed to recommend the measures which the Institute should take in the interest of the public and of the profession. This special committee consulted with the Committee

<sup>9</sup> *Verification of Financial Statements* (1929) — Page 5.

<sup>10</sup> *Examination of Financial Statements* (1936) — Pages 14 and 15.



on Inventories and with members who had participated in writing earlier pamphlets on auditing procedure. The committee recommended the *Extensions of Auditing Procedure*,<sup>11</sup> which were approved at the 1939 spring meeting of Council and, with modifications, by the membership of the Institute at the fall meeting. Adoption of the extended procedures was commended by the Securities and Exchange Commission at the time and in its subsequent report on the investigation in *McKesson*. The latest pronouncements of the committee on auditing procedure, *Codification of Statements of Procedure* (1951) and *Generally Accepted Auditing Standards* (1954), indicate that the audit steps outlined in the first statement on extensions have been carried down without substantive change to the present day. This is not so true of the reporting requirements regarding them.

The decision to adopt the physical contact and confirmation procedures generated the question of what disclosure should be made in the accountant's report if the procedures were not carried out. The statement on extensions approved at the spring meeting of the Council in 1939 specified that such disclosure should be made, in the following words:

"Your committee is of the opinion that recognition should be given to the widespread demand for an extension of auditing procedures with regard to inventories and receivables. However, it should be noted that additional expense to business will be involved in the added procedures, and business con-

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<sup>11</sup> The paragraphs pertinent to this discussion, oft-quoted, are:

**Inventories —**

"That hereafter, where the independent certified public accountant intends to report over his signature on the financial statement of a concern in which inventories are a material factor, it should be generally accepted auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified public accountant may require physical tests of inventories to be made under his observation."

**Receivables —**

"That hereafter, wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent and time of confirming receivables in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment."

(Statement No. 1 of committee on auditing procedure.)

cerns which do not have them undertaken must recognize the necessity of disclosure of their omission." <sup>12</sup>

The revised statement adopted by the membership at the fall meeting, however, modified this position to state that no reference to omission of the procedures need be made if, in the opinion of the accountant, they were not practicable and reasonable and he had satisfied himself by other methods.

Although the SEC commended the Institute on its action in adopting the extended procedures, the disposition of the subject of disclosure was not so satisfactory to them. It will be remembered that they remained under pressure to take all possible steps to protect the investor and they held to the view that disclosure of the omission of the extended procedures, regardless of the reason and notwithstanding that the auditor had satisfied himself by other means, was necessary in order that the reader could judge for himself the reasonableness of the departure.

Rule 2.02 was amended in 1941 to require disclosure of the omission of any generally accepted auditing procedure regardless of the circumstances. The Institute conformed its position to that of the SEC by adopting at the 1942 fall meeting an amendment to Extensions which was released as Statement No. 12. This action was taken, according to the Statement, in order to avoid any appearance of different standards as between listed and unlisted companies.

### PERIOD 1943 TO DATE

The twelve years since the adoption of Statement No. 12 have seen considerable discussion, both in the organized committees of the Institute and in the literature and on the platforms of the profession, of the extended procedures and the reporting requirements regarding them. This was entirely natural, since for the first time in the history of the profession two auditing procedures had been "legislated" into existence. An abrupt transition of two auditing procedures from minor usage to recommended universal usage was entirely new to a profession which had developed and adopted new techniques gradually through education and the exchange of ideas. Moreover, the extended procedures were virtually singled out for comment in the auditor's report despite the fact that they were only two out of the many which an auditor may apply (Broad listed twenty-six basic procedures at one point.<sup>13</sup>) The discussion regarding extensions since their adoption might be divided into two broad areas: (1) an exchange of ideas as to how to put them into effect and (2) an attempt to put them into proper perspective in relation to the audit as a whole. The

<sup>12</sup> *The Journal of Accountancy* (June 1939) — Page 344.

<sup>13</sup> "Auditing Standards" by Samuel J. Broad — *The Journal of Accountancy* (November 1941).

Institute's committee on auditing procedure played a most important part throughout the period and was a wise and stabilizing influence.

This committee was changed from a special to a standing committee in 1940. The initial task assigned to it after the extensions were adopted was that of revising the 1936 pamphlet *Examination of Financial Statements* so as to bring it up to date. The committee wrestled with this for some time but soon concluded that the complexities of auditing were now such that no one document could satisfactorily serve as a guide to the auditor and as information regarding procedures to third parties. Therefore, it set about to devise other means of developing guide lines on auditing procedure for the profession.

Its first step was to draw the distinction between "auditing standards" and "auditing procedures," which had often, theretofore, been overlooked. In the committee's words:

"Auditing standards may be said to be differentiated from auditing procedures in that the latter relate to acts to be performed, whereas the former deal with measures of the quality of the performance of those acts, and the objectives to be attained in the employment of the procedures undertaken. *Auditing standards* as thus distinct from *auditing procedures* concern themselves not only with the auditor's professional qualities but also with his judgment exercised in the conduct of his examination and in his reporting thereon."<sup>14</sup>

Having thus distinguished between standards which prevail in all circumstances, and procedures which vary with the circumstances, the committee then set about to define the standards. Its efforts resulted in the publication of the very significant document, at first tentative and later definitive, *Generally Accepted Auditing Standards*.

As regards procedures, the committee issued bulletins and statements, not of the sweeping type but each in the light of a given set of circumstances. In issuing the latter, the committee emphasized time and time again the importance of the auditor's judgment in selecting the procedures which he would apply in a given case and the effect on these procedures of the internal control of his client. The publications issued under the responsibility of the Committee with regard to auditing procedures and internal control have been the following:

*Statements of Auditing Procedure.* A series of statements setting forth opinions of the committee on auditing procedure as to certain auditing principles and procedures.

*Case Studies in Auditing Procedure.* A series of case

<sup>14</sup> *Generally Accepted Auditing Standards, Their Significance and Scope* — (1954) Page 11.

studies illustrating the auditing procedures applied in actual examinations.

*Internal Control.* An analytical study of internal control.

*Case Studies in Internal Control.* A series of case studies illustrating the accountant's evaluation of internal control and the application of his findings in actual examinations.

*Codification of Statements on Auditing Procedures.*

Out of the foregoing literature and the hundreds of articles which have been written since the adoption of extensions, it is hard to select what might be considered the most important developments. Perhaps the best approach would be to select a few of the major questions which were raised during the period as to application of the extended procedures or reporting on them along with a brief, general comment on how the matter was resolved.

### **SOME EARLY QUESTIONS REGARDING THE EXTENSIONS**

*Is not the auditor assuming a greater responsibility for the technical aspects of physical inventory than his layman's knowledge warrants?*

This early fear apparently arose in the minds of many from the misconception that the extended procedures required the auditor to "take" the inventory. Discussion developed that this was far from the case and that the responsibility for taking the inventory remained with the client. Similarly, it soon became clear that the company retained the major responsibility for the quantity, quality and condition of the inventory. Basically, what the extended procedures required was that the auditor familiarize himself with the plans and organization of the client for taking inventory and that he then be on the scene of the physical inventory sufficiently to satisfy himself that the plans were effectively carried out. Thus, physical contact work on the part of the auditor was properly relegated to that of checking on the effectiveness of the client's methods and procedures in order to form an opinion as to the accuracy of its representations.

*Would not the extended procedures be too costly to the client?*

The question of relative cost and benefit has been and will continue to be a pertinent one in the application of any audit procedure. It would appear in retrospect that many of the early fears on the part of both auditors and clients were based upon misconception as to the nature and extent of the work required by the auditor under the extended procedures.

If, for example, it was thought that the auditor *would* be required to *take* the inventory, or must send requests for confirmations to a vast number of debtors regardless of distribution of risk, then the cost of the extensions would undoubtedly have been too great. Subsequent discussions on the nature of the auditor's work with regard to physical inventory, and of the extent of his tests of receivables through circularization, the latter of which could be quite small where the risk in receivables was widely scattered, satisfied most clients and auditors that cost and benefits could be placed in a proper relationship.

One of the early reservations as to the ability of auditors to observe inventories and confirm receivables was apparently based upon an assumption that virtually all of this work would have to be carried out near the balance sheet date. Since most companies close their accounts as of December 31, the additional work would have increased the peak of the auditor's work to the point where the burden would have been intolerable. However, it soon became clear that the auditor could frequently carry out a major portion of the extended procedures at interim dates as a phase of checking on the effectiveness of the internal controls. The fear that large numbers of positive requests for confirmation would be required was largely dissipated by common agreement that the negative form of confirmation was reasonable and acceptable in large areas. The negative form, of course, is considerably less costly to carry out and also causes less trouble to the debtor. Adaptations such as the foregoing went a long way toward making the extended procedures practicable.

As to benefits, clients found, to the surprise of many, that the auditor who participated in the planning phase of physical inventories was able to offer many helpful and constructive suggestions and to point out places where procedures had theretofore been ineffective. The same was true as to the auditor's observations on the premises: he was often able to detect and point out careless and ineffective work. Experience has shown, in other words, that the auditor's participation in the physical inventory work has resulted in a better inventory for the company. A final benefit, appreciated no less by the client than the auditor, was found to be that the auditor's knowledge of his client's business and his ability to examine the records in practical terms was enhanced by his inventory work. Therefore, at this date, it would appear that only a minority of companies continued to object to the extended procedures and it seems fair to say that many of these might well change their minds with education.

*Is not the effectiveness of  
extended procedures exaggerated?*

The point that new auditing procedures may be oversold is well taken.

It seems probable, in retrospect, that the observation and circularization procedures received more emphasis than is appropriate in the entire auditing scheme. However, subsequent discussion has largely served to develop a proper perspective.

It is true, of course, that the technical nature of much merchandise is such that the auditor by mere observation could not categorically identify it or check its quality and condition. Likewise, the stacking and packaging of merchandise often is such that an inflation of inventory through empty packages, hollow centers, or the like, might well go undetected. Nevertheless, subsequent discussion as indicated above has largely clarified the extent of the auditor's responsibility as well as the fact that his work, while not assuring that all errors will be detected, would go far toward minimizing them.

It will be recalled that the 1936 pamphlet *Examination of Financial Statements* stated that confirmation is one of the most effective means of disclosing irregularities. After the adoption of Extensions, many auditors pointed out that confirmation is by no means a guarantee against irregularities since the defaulter can, and has many times, arranged that an apparently bona fide confirmation be returned to the auditor. This of course must be acknowledged, as must the fact that no auditing procedure will necessarily disclose irregularities. What must be borne in mind again, is that the extensions are basically additional procedures designed to confirm the validity of the client's records and of their representations. The discussion of the last ten years seems to me to have made clear that circularization of receivables affords to the auditor an important means of evidence which he will take into account along with all the other evidence which he has collected in forming his opinion as to the accounts.

*Are there any instances in which  
carrying out the extended procedures  
is not practicable and reasonable?*

Experience has shown that there are not nearly so many instances in which observation or circularization is not practicable or reasonable as was originally feared. In fact, such cases have been found to be rare. What is not quite so rare is an opinion on the part of a client that the extended procedures are objectionable from some standpoint or another. It is these cases which present the greatest test of the auditor's ability to persuade and educate, but it is important that he do so, for the alternative of accepting without challenge a client's opinion as to any audit procedure is dangerous indeed.

Inability to carry out the extended procedures is of course encountered. Physical contact with inventories is least effective in dealing with certain

types of work in progress and, if a company's inventories consist almost entirely of such, he is still confined largely to work on the accounting records. However, even in these cases, ingenuity has developed many effective physical contact steps. With regard to confirmation or receivables, the policy of certain debtors or their manner of keeping records has precluded the receiving of confirmation as, for example, from some of the United States Government departments or companies that do not maintain accounts payable records. Use of the latter system appears to be increasing and it is possible that the ultimate introduction of electronic data processing methods will further increase the number of debtors who do not or cannot reply to confirmation requests. In all these cases, the auditor must resort to substitute means.

*Are not the requirements for reference  
to the extended procedures in the  
auditor's report unnecessarily emphasized?*

This seems to me to be a valid question when the reference is to the omission of the extended procedures in those rare cases where they were not practicable and reasonable. While I appreciate fully the emphasis which was required in order to have the extensions carried into effect quickly when they were first introduced, I should think that the period of education in this respect has about come to an end. If the auditor cannot carry out any one of the numerous generally accepted auditing procedures, but can satisfy himself by other means, it would seem to be unnecessarily confusing to the lay reader that he specifically refer to the omission in his report.

The foregoing refers only to cases in which an auditing procedure is not practicable and reasonable in the circumstances and the burden is always on the auditor, (particularly so for the extended procedures) for justifying an omission. I do not see how an auditor can run the risk of failing to carry out one of the extensions when it is reasonable to do so, and where the asset involved is relatively important, without qualifying his opinion as well as his statement of scope. He runs a grave risk if he does not do so.

The auditor is even more poorly advised who does not carry out the extensions when they are practicable and reasonable and when he makes no reference whatever to the omission in his report. Such a person, if discovered, can receive little comfort from either the public or the profession, since he is supposed to have knowledge and skill in the application of auditing procedures. He might well read the quotation from *Cooley on Torts* which appears in *Generally Accepted Auditing Standards* (1954; page 32) and reads, in part, as follows:

"Every man who offers his services to another and is em-

ployed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is prerequisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and, if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession."



# Long-Form Audit Reports: Selection and Presentation of Material

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For many years, accounting practitioners have reported on the financial position and operations of their clients in reports which were sometimes long-form and sometimes short-form. There is now little mystery about the short-form. It has been widely distributed through the common practice of publishing such reports for stockholders and others. Reader reaction and client approval have been measured and professional standards developed until short-form report practice has reached the point of general acceptability; but until recently, there were no criteria by which the individual practitioner could measure his own long-form reports in comparison with others. The need for a yardstick, and the probability that standards of reporting should be raised, were generally recognized. Very good texts have been written about long-form reports from time to time, but no writer has had the advantage of knowing what the effect of reader reaction and client approval has been on general practice in long-form reporting.

This was changed when the *CPA Handbook* was issued in 1953. Appropriately, Chapter 19 on report writing was initially assigned to the late I. B. McGladrey, although another writer completed it. The chapter is based upon information obtained by means of questionnaires regarding common report practices. Examples are given of two good long-form reports which do not purport to be actual, and of two report-writing manuals which are reproductions of manuals in actual use.

In 1953, also, the research department of the Institute published the results of a study which they made of a sample of 52 long-form reports. The booklet is called *Long-Form Report Practice*. Unlike the *Handbook* which illustrates a model and attempts to provide a guide to good reports, this study illustrates examples of actual practice which the department warns us *not* to consider as a model. A combination of the two publications furnishes

us with a real yardstick to measure our own reports, and authoritative information regarding current practice.

I hope that you have read Chapter 19 of the *CPA Handbook* and considered the technique of writing and presentation which it outlines. I hope that you have studied the booklet *Long-Form Report Practice* with its illustrations, and I hope that, if you didn't hear the paper on current practices in long-form report preparation given by Carl M. Esenoff before the annual meeting last year, you have since read it.

In his paper, Mr. Esenoff drew on materials from the *Handbook* and the research study from which he developed the outline of a typical long-form audit report. I, too, will draw heavily on these sources of authentic information about current practice, and I will draw on the practices of my own firm in an attempt to explore the possibilities for improvements.

I understand that the extent of usage of long-form reports varies. Even national firms of accountants vary their practice in different localities in recognition of local customs and the attitude of the personnel in their branches. It seems to me that the long-form audit report should be used more in reporting for small and medium-sized business than in reporting for big business. It seems logical that the accounting departments for larger firms are geared to produce much of the material contained in the audit report and get it to management earlier than the practitioner can. We recognize this in our own reports on examination of bigger businesses.

On the other hand, the practitioner serving smaller business may render his greatest service by a long-form report on the financial position and operations of his client. Here we have inadequate accounting staffs, limited in ability or in number, and consequently unable to supply financial analyses, comparisons, and yardsticks needed, leaving that field open to the auditor. Therefore when we talk about long-form reports we are really addressing practitioners who serve small and medium-sized businesses.

How then can we fill the need of smaller business in a manner which fulfills our promise of service? I think of our responsibility as threefold:

1. Performance:

- (a) Make our examinations in accordance with generally accepted auditing standards, particularly those promulgated by the Institute's auditing committee;<sup>1</sup>
- (b) See that financial statements conform to generally accepted accounting principles, particularly those promulgated by the Institute's accounting procedures committees;<sup>2</sup>

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<sup>1</sup> *Codification of Statements on Accounting Procedure* published by the American Institute of Accountants.

<sup>2</sup> *Restatement and Revision of Accounting Research Bulletins* published by the American Institute of Accountants.

- (c) Make adequate disclosures of material facts.
2. Furnish data helpful to client and credit men.
  3. Present our information with clarity.

The standards of performance are familiar to us all and need not be restated now. Instead, we will consider the selection of material and its presentation to our clients and their credit men in our long-form audit reports. First, we must find out what information will appeal to our intended reader. This will vary from client to client; but credit men, speaking through Robert Morris Associates, tell us clearly what they want.

The pamphlet entitled *Financial Statements for Bank Credit Purposes* issued by Robert Morris Associates in 1951, is reprinted in Appendix A of Mr. McGladrey's chapter in the *Handbook*. If you haven't read it already, don't postpone it. Here is an organization beating the drums for the services of our profession and at the same time telling us that they want to find a lot of information in an audit report that we may not be giving them.

They want financial history, comparisons and analyses. They want descriptions of practically every balance sheet account. For instance the desired information on receivables is broken down into three sections; notes, accounts, and provision for doubtful accounts. As to accounts receivable alone they want the trade accounts segregated from others; they want them aged by charge dates or by maturities, such as not due, 30 days past due and so on; they want selling terms and deviations from terms; any concentration of sales outlets, accounts pledged, and credit insurance if carried. Similar detail of information is requested for all accounts. Speaking for ourselves, I may say that we supply a great deal of such information, but not all of it at present. I wonder how many of us do?

After considering the information which is helpful to the banker, we must find out: how much is useful to the client? We will have to answer that question on an individual client basis. As a matter of fact, we have clients who are not interested in analysis and comments of any kind. These are the exception and, even in such cases, if a long-form report is called for, we supply certain comparisons and data, hoping to educate the client as to their value, and bearing in mind that eventually the report may fall into the hands of other interests.

What, then, should be the content of the average report? What should be the extent of information furnished? Turning to the five specimens of long-form reports illustrated in the analysis of 52 reports made by the research department of the Institute, we find a common practice which may lead us to a conclusion regarding the essentials and the minimum content of our report.

In every case there is a condensed comparison of operations for two years, showing per cent relationship to sales, or increases and decreases, or

both. This is a basic requirement for our own reports. In addition, as illustrated, operating income is analyzed by products, or the familiar textbook statement is employed, showing the factors which cause the increase or decrease in net income. We use this analysis in a few of our reports, but only where the client-management does not receive the information from its own staff, and where it is certain to be useful. Someday we hope to educate all of our clients to the usefulness of such data, as you presumably have already done.

The research department indicates that, generally, the principal balance sheet is not compared, and is presented in the conventional manner, with assets on one side and liabilities and stockholders' equity on the other. In a preponderance of the reports there are secondary comparative statements — often in the comments. In our practice, we show the two year balance sheet among the other financial statements, but secondarily to the principal balance sheet. We condense it a little and show the increases and decreases. Then in the comments we show a skeleton comparison with one amount of current assets, deducting in one amount the current liabilities to show the working capital and the increase or decrease from the preceding year. To the working capital we add other assets and deduct the long-term liabilities to reach the shareholders' equity. Since we show our comments before the financial statements, this gives a quick look at the financial position at the outset, leaving details for the financial statements.

In three of the five long-form reports illustrated in the Institute's study the current liabilities are deducted from the current assets to show the working capital. But in all of the illustrations the accounts are listed in nearly as much detail as the balance sheet itself. We like our practice because in the condensed statement we first show the overall picture. Then we follow it with an analysis of the changes in working capital in a text schedule which we call "summary of financial operations." Here we may also give essential elements of the current assets and the current liabilities.

I was a little surprised to note how prevalent the use of the funds statement has become. The study indicates that it is being used in between 70 and 80 per cent of the reports. We use it in all of our reports with the exception of a few where we know it will not be appreciated. The study shows that in most cases the financial operations are stated in terms of working capital, and the analysis ends most frequently with the increase and decrease in working capital. This seems to me to be the best treatment. This working capital analysis answers the age old question of "where did all of the profits go, I am still broke."

The variety of names given to this statement — hardly two firms use the same — suggests a topic for terminology study. If you do not agree with our "summary of financial operations" you might do well to include a reference

to "working capital" in the title rather than "fund." But whatever name you use, it is a valuable statement.

The principal feature of the long-form report is the comment section. Because little has been known about the practice of other practitioners in this area, each of us has developed his own pattern of disclosure.

In practically all of our reports we include a "history and organization" section and I am surprised that this is not general practice. There were only 17 reports (out of 52) that carried this section, and the only item common to all of the 17 was the inclusion of the date and state of incorporation. Only 12 described the stock issues, and 11 described the major business activity; other items less frequently used include names of officers and sometimes directors, terms of charter, charter amendments and capital stock changes. It seems to me that this section is good background for your financial position and operations and should always be included.

We always include a section on insurance coverage in our long-form audit reports. The study indicates that frequently the absence of liability, casualty and surety bond coverage is pointed out. I am glad to see this. We follow that practice except where there is any obvious deficiency in coverage. In this case we discuss the matter with the client or make it the subject of a supplementary letter.

Another schedule that I think is invaluable is the statement of property and equipment together with the accumulated depreciation for the year. The complete picture is given in the statement which shows opening balances, additions, disposals, and closing balances as to each class of asset and corresponding depreciation. To me, this seems essential in all cases where there has been much activity in the accounts during the year.

How much description of auditing procedures should you include in your long-form reports and should you segregate it from comments on balance sheet accounts? The committee report of Robert Morris Associates mentions the desirability of disclosing audit procedures for receivables and inventories. In the 52 reports studied these procedures are commonly described. Other procedures were not emphasized by bank loan credit men and are usually not too important to the client, except as you may want to impress him with the vast amount of work you have done. It seems, then, that we may keep our description of audit procedures to a minimum. Specimen No. 4 of the long-form report illustrated, indicates that the recital of audit procedures should be omitted except in cases where it is desired for the use of credit grantors. In this case, they say it should be segregated. But in three of the specimens, the procedures were outlined briefly in the comments regarding the various balance sheet accounts. We use this method in most of our reports, but occasionally, having in mind the particular interest of the client, we place them in a separate section of

the report. I think the practice should be tailored to the preferences of the client in most cases.

The comments we make on balance sheet accounts furnish a real opportunity to make ourselves valuable to the reader of the audit report. And it is in this field that it is useless to try to establish a formula, for here is where the boys are separated from the men. Full and complete disclosure of the content of and facts behind each major item in the balance sheet is certainly required. But the pertinence of the comments and the clarity of the presentation will measure its value to the reader.

Certainly we should include a comment as to the last year in which federal income tax returns have been examined, what additional taxes were imposed, and, if appropriate, the improbability that similar issues will be raised for later years. Of course, we should always comment on leases, pension plans, construction commitments, renegotiation, and matters of this kind.

After we have translated all of the financial information into accepted forms and have made lucid analyses and comparisons, and after we have assembled information whereby we are in a position to disclose important information concerning the assets and liabilities and different phases of operations, we may still produce a report that will fall flat on its face.

Our profession has accumulated all kinds of stilted, outmoded terminology, borrowed from textbook writers of another day and from legalistic circles, which does little to encourage the reader to explore the content of our report. The paper cover of Robert Gunning's *The Technique of Clear Writing* enjoins us: "Write to *express* not to *impress*." (McGraw Hill Book Company, Inc.)

What does a client think who reads an audit report with phrases such as these: "The foregoing amount, so classified, was verified by test checks"; "there is set forth below"; "requests for confirmations were mailed by us"; "reflect the amounts due from customers contacted by us." We may be impressing our readers, but I doubt if we are expressing our meaning by accounting jargon and stilted phrases such as these. We will do better to use ordinary words which will be understood by everyone. We are writing to inform the reader, but if we cannot hold his interest long enough for him to read our report, our time has been wasted.

I urge you to read Robert Gunning's book to which I just referred, as well as W. H. Bell's *Accountants' Reports*, J. M. Clapp's *Accountants' Writing*, and Frank H. Vizetelli's *A Desk Book of Errors in English*, which are recommended in the report writing chapter of the *CPA Handbook*. Let's make our reports readable as well as factual.

There isn't much to say about the opinion paragraph. The antiquated "subject to the foregoing comments" went out with the acceptance of the auditing committee's Bulletin No. 23. We now name our exceptions if they

affect our opinion, or we deny an opinion and state why. There must be no exceptions to this standard which has been adopted by our membership.

Let us assume now that the long-form audit report which we have discussed is completed. We have used generally accepted auditing standards<sup>3</sup> in our examination. We have observed that the financial statements are in conformity with generally accepted accounting principles promulgated by the Institute's accounting procedure committee,<sup>4</sup> such as (1) a proper classification of accounts as current assets and current liabilities, (2) a proper handling of intangibles, (3) classification of general purpose contingency reserves as a part of the shareholders' equity, (4) proper determination of income for the year, and (5) proper recognition of the receivable for refundable income taxes from carry-back of unused excess profits taxes and operating losses. We have made disclosures of all material facts such as:

1. Commitments for construction, stock options, leases and pension plans.
2. Contingent liabilities connected with income tax examinations, renegotiations and litigation.
3. Pledged assets.
4. Post balance sheet date events which may have a bearing on the statements.

We have used terminology recommended by the committee on terminology<sup>5</sup> such as "statement of financial position," "statement of earnings or income," "allowance for doubtful accounts," "accumulated depreciation," "shareholders' or stockholders' equity," "retained or accumulated earnings," "capital contributed in excess of par value of capital stock."

Our financial statements have been designed to state clearly the financial position and operations of the client; we have made analyses and schedules which we believe interpret the statements; we have written comments in clear, concise language; and we have expressed the responsibility that we have been willing to assume regarding the report.

There is just one thing left to do and that is to persuade the client to read it. Traditionally he is supposed to be interested in one amount only — net income. Unless you find some means of persuading him to read your report, you may as well join the many who stop with short-form reports. We do not intend to give up that easily and will continue to write long-form audit reports, and make them interesting and informative to the reader.

<sup>3</sup> See *Codification of Statements on Accounting Procedure* published by the American Institute of Accountants.

<sup>4</sup> See *Restatement and Revision of Accounting Research Bulletins* published by the American Institute of Accountants.

<sup>5</sup> *Accounting Terminology Bulletins No. 1 Review and Resume* prepared by committee on terminology, American Institute of Accountants.

# The Accounting Firm's Own Records and Accounting Procedures

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Have you ever considered the advisability of engaging an independent public accounting firm to review the records and procedures of your own practice? When a doctor or some member of his family is seriously ill, it is not unusual for him to seek the services of a fellow practitioner. In what way does the medical profession benefit from this practice? The greatest benefit is, of course, the completely objective analysis of the problem at hand. While the public accounting profession probably will never exchange services to any great extent with respect to their own office problems, they can exchange ideas and thus attain a greater degree of objectivity in the analysis of their own records and office procedures.

The length of this paper will not permit a detailed discussion of the mechanics of time reporting and recording. The *CPA Handbook* and many other excellent publications contain a wealth of information on this subject. A careful analysis of this information, along with discussions with fellow practitioners, leads one to the conclusion that we have many different ideas about our own records and procedures.

## **Basis of Accounting**

The very basic question of whether to use the cash or accrual basis of accounting will find many proponents on both sides of the discussion. While most practitioners have adopted the accrual basis for reasons which are quite obvious, many of us find it difficult to explain why we have been unable to persuade our clients in other professions to do the same. Probably one very



important reason is that on the cash basis it is so much easier to have funds available with which to pay income taxes when they become due. Another is the simplicity of the cash basis. Don't these arguments which our doctor and lawyer clients use so persuasively apply equally to the conduct of our own practices? After all, we are all selling professional services and it would seem that the basic principles involved are the same regardless of the professional practice to which they are applied.

Apparently it is the generally accepted practice in our profession not only to use the accrual basis of accounting but also to apply a so-called standard billing rate to our work in process, thus recognizing the profit derived from our work as it progresses. In most cases we are not entitled to our fees unless and until we complete an assignment. Perhaps the "completed job" basis of accounting is a more nearly correct method, but the *CPA Handbook* says, "Very few maintain records of time accumulation on the basis of salary costs incurred." The nature of our work is probably the reason for our placing more emphasis than our professional clients on stable gross incomes which are comparable with the same periods of prior years without taking into account the variations from year to year of cash collections or the time when assignments are completed.

### **Time-Only vs. Time-and-Dollar Amounts**

There probably are very few of us who have even attempted to persuade our professional clients that they should use a time sheet which accounts for all of the time in a standard work week, plus any overtime which may have been worked. However, in our own practices we go even much farther. We maintain a time ledger with a control sheet and a section for nonproductive time with a separate account for each individual. From the data contained in the time ledger we prepare not only a complete analysis of the time charged to the client but also comprehensive summaries of our non-productive time by individuals and by classification.

In our profession there is very little difference of opinion about the necessity for such a time ledger, but we are about equally divided on the question of whether it should contain only time or also dollar amounts.

The "time only" advocates maintain that it is unnecessary to convert time to dollar amounts within the time ledger itself. They say that the entire ledger, including a control to which is posted totals from the time sheets, can be maintained with less expenditure of time and no loss in accuracy. Of course, they recognize the necessity of converting to dollar amounts in the preparation of periodical reports.

The "dollar amount" proponents maintain that the extra effort in converting to dollars in the time ledger is justified by the ease of determining at a glance the fees accumulated for each client.

### **Should Each Engagement Be Costed?**

It is surprising to find that there is such a wide divergence of opinion on the benefits to be derived from determining the cost of each engagement. The following excerpts from Chapter 7 of the *CPA Handbook* are illustrative:

“The cost is determined at the close of each month by applying the per-hour salary rate of each employee involved to the hours worked on each engagement, and adding to this amount the expenses incurred.”

“No costing is done, the office manager-partner of the firm holding that costing is theoretical and of limited, if any, value.”

“Mayo, in emphasizing the importance of cost records, suggests that fees produced by each man, as well as the cost of each engagement, should be determined.”

“Most of the large - and medium-sized firms visited, as well as a few of the small ones, have work-in-progress ledgers in which standard billing rates are applied to accrue work performed but not yet billed. More and more firms are beginning to charge by the hour instead of by the day. Very few maintain records of time accumulation on the basis of salary costs incurred.”

With so many different ways of solving a common problem, perhaps the employment of an independent public accounting firm to review the records and procedures of our own practice wasn't such a good idea after all. Or maybe it would be helpful to attempt to reconcile the opposing views and determine which method is most suitable for our own practice.

Perhaps those who employ the “costing” procedure are only doing more precisely on each engagement just about the same thing as the “standard rate” proponents are doing with respect to their entire practice. The cost of operations plus a provision for profit determines the standard rates and by maintaining them in the proper relationship to salary and overhead costs it is possible to exercise the requisite degree of control over the practice. Since many factors other than actual cost of the engagement are taken into account in fixing the amount of the fee, there is a question of whether the expense of maintaining a cost system is justified.

Even the most elaborate cost system cannot provide accurately for the fluctuations in nonproductive time which is usually the largest item of overhead. Judging from the published articles and books relating to this problem, it can safely be said that we are rugged individualists with respect to our own records and procedures.

### **Group Rates vs. Individual Rates**

Where standard rates are used, should there be a different rate for each individual or should all individuals in the same classification be billed at

the same rate?

Group classification is preferred by many practitioners because:

1. When a client inquires about the basis for his fee, he will more readily accept an explanation of differences in rates based on graduated levels of experience and responsibility than those based on the qualifications of one individual as compared to another.
2. The proper relationship between fees and salaries with less deviation in the rates of fees can be maintained.
3. The records relating to time accumulation are simplified.

Others prefer different rates for each individual because:

1. Fees and salaries should both be based on the capabilities of the individual so the same relationship should always be maintained between them.
2. The problem of constantly maintaining a balance between the individuals in each of the salary brackets within a group is minimized.

### **Description of One Firm's Procedures**

The literature now available indicates that each firm has developed its own procedures of time recording and that, while the procedures vary substantially, there are many principles common to most of them. This literature has been developed largely by authors who have explained the procedures employed in their own practice and so a brief description of those of our firm may be of some benefit.

The general ledger contains only a minimum of accounts which relate to the time recording function such as "fees earned" under the income section and "accounts receivable" and "work in process" under the asset section. In the general ledger the work in process balance is adjusted only once each year, but it is adjusted monthly through the fees earned account on a trial balance work sheet which is used in connection with the preparation of the monthly financial statements.

"Time only" is contained in the time ledger in a separate column for each of four "group classifications." The time ledger has two sections—one in which an account for each client is maintained and another in which the nonproductive time of each principal and staff member is recorded. In the front of the time ledger a control account is maintained to which the totals of all time sheets are posted.

Time sheets are kept and posted on a weekly basis and are designed so that productive and nonproductive time are separated. The nonproductive section has a separate line for each of eight different classifications.

After all weekly time sheets for one month have been posted to the time ledger and the totals of all columns in each account brought down and

reconciled with the control, a list of the jobs completed during the month is prepared on a work sheet. By referring to the time ledger, the hours applicable to each completed job is entered on the work sheet and at the same time subtracted from the time ledger account. The totals of each of the four columns on the billing work sheet is then deducted from the control account.

The billing work sheet is then converted to dollar amounts by application of standard rates to the hours applicable to each completed job. The amount of the fee applicable to each job is then entered in the next column to the right and the differences between the fee and the time at standard rates is extended into another column headed "fee variations."

In the case of all of the larger engagements the time is recapped by use of key numbers into standard classifications on separate work sheets and extended at the standard rates. On these work sheets entries are also made of the prior years time by the same standard classifications and any unusual circumstances relating to the engagement are noted.

After the billing procedure is completed, a statement is prepared analyzing the fees earned for the month by starting with "gross potential income" which is the total of all time from the time sheets at the standard billing rates. The nonproductive time is deducted to arrive at "net potential income" and by the addition or subtraction of the "fee variation" amount from the billing work sheet the gross income for the month is computed. By the addition of the work in process at the beginning of the month and the subtraction of the total of the fees invoiced during the month, the work in process at the end of the month is computed. This amount is then verified by deducting from the total hours on the control sheet of the time ledger the nonproductive time and extending the remainders at the standard billing rates. This statement also shows the same analysis for the same month of the prior year along with a notation of the number of productive personnel for both periods.

The nonproductive time item is supported by a schedule which lists the names of each principal and staff member in the left column with one column provided from left to right for each of the following classifications:

- |               |                     |
|---------------|---------------------|
| 1. Unassigned | 5. Holidays         |
| 2. Personal   | 6. Public Relations |
| 3. Illness    | 7. Administrative   |
| 4. Vacations  | 8. Routine          |

A total column is provided to the extreme right. Thus this schedule presents a comprehensive analysis of the nonproductive time by individuals and by classification.

Once each six months the foregoing schedules are summarized and a supporting schedule is prepared showing the amount of the gross potential

income, the nonproductive time, and the net potential income by individuals. Although our firm has never done so, the fee variations could also be allocated to individuals.

No effort is made to determine the cost of each job but we do always try to maintain the same relationship between salaries and standard billing rates by each of the group classifications.

### **Organizing the Billing Procedures**

One of the most perplexing problems to practitioners is that of organizing the billing procedures so that the invoices are rendered promptly with a minimum of time consumed by productive personnel. Even where the mechanical phases of the process have been designed so that clerical personnel can be entrusted almost wholly with it, the problem is not eliminated. It sometimes seems that each individual invoice requires consultation between principal and supervisor and, in many cases, with several of the staff members to determine why there are deviations from estimates or prior years fees. At the time the invoice should be rendered some one of them is sure to be either out of town or working against a deadline.

In some cases the basic cause of such a problem may be that clerical employees have either not been given — or they refuse to accept — the responsibility of anticipating a few days in advance, the necessity of several individuals reviewing the time and making a decision about the amount of the fee. In other cases a principal of the firm may be unwilling to make definite plans in advance in any matter which relates to internal affairs of the firm. Many offices have fallen into the bad habit of leaving such matters for a time when their clients' problems do not demand their immediate attention. It is a great aid to definitely establish a certain day of the month or week when all data relating to billing is to be ready for review and discussion by the various individuals. Some practitioners maintain that this problem can be minimized by keeping with the work paper files a record of the accumulation of time and expenses and then prepare the invoice upon completion of the work. They point out that supervisor and principal can thus discuss with each other and also the staff personnel any abnormalities in time at the same time they are discussing other phases of the work.

### **Possibilities of Machine Bookkeeping**

A closely related problem is the value of machine bookkeeping not only in accumulating the time and billing the fees but also in other internal functions of the accountants' practice. Some practitioners point out that such machines can do no more than speed up the mechanical functions of assembly and tabulation and that they do not pay their way in any except a large office. They do not solve the problem of giving careful

consideration to the determination of the amount of the fees after the mechanical functions of time accumulation have been performed.

The *CPA Handbook* reports that:

“Not many CPA firms use bookkeeping machines for their general bookkeeping; but Burroughs, Remington Rand and National Cash Register machines are found in use, the latter particularly for payroll and time recording purposes.”

There also is a section describing the use of punch-card accounting which concludes that dispatch in obtaining results is the principal advantage and that the omission of the nature of the work in the end-result tabulation is the principal disadvantage.

In the discussion period we can exchange ideas not only about our records but also about many of our procedural problems, such as the determination of what time should be chargeable and non-chargeable. Perhaps such an exchange of ideas will be an acceptable substitute for the employment of an independent public accounting firm to review our records and procedures.

# Assisting Small Businesses With Management Advisory Services

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This discussion might well begin with consideration of some basic principles involved in certified public accountants extending the scope of their services to our economy. One of these fundamental principles is that competition demands a more efficient and more acceptable product at a reasonable price. The accounting profession is not outside that law and can never be exempted, so long as our economy remains free. As has been said many times, we must face competition; not as to price, but as to quality of product — our services.

Price, of course, must have a reasonable relation to quality of service. Another very important principle is that the public know about the product. Too long we have been teaching the public to think of our services as covering only a few elements in the field of our potential.

## **Economic Need for Advisory Services**

Probably the most important of the many underlying principles is, that for any product or service to succeed there must be an economic need for it. Our economy is so constituted that when a need for a product or service is recognized, that product or service is soon produced.

The complex economy in which businesses operate today imposes many and serious problems for management. Numerous businessmen, particularly owners and operators of small businesses, find themselves short in education, training in management techniques, and time for solution of their problems. Thus, the need for supplementary assistance arises with them. Many busi-

nesses have been searching for sources to fill that need. For quite some time our profession has modestly sat by and watched that search go on. *Fortune* magazine in the May and June issues of 1954 presents positive proof of the frantic search that management has made to fill that need. However, fortunately for our profession, quite a number of businesses have instinctively turned to the logical source of supply — the accounting profession — for this service. The probable major cause of management not turning to this local source of supply in much greater numbers for their needs is that the accountants have been dodging the issue of extending the scope of services — services which rightfully fit into their profession.

### **Client's and Advisor's Attitudes**

In undertaking the services to management, there is that important facet of attitudes — the client's attitude and the advisor's attitude. It follows that the advisor's attitude or philosophy should be one wherein he feels prepared and able to render the service on an independent, but sympathetic basis; that he knows the boundaries of the field and knows his own working limitations.

As to the client's attitude toward their service, the advisor can do little about that, except to be circumspect and diplomatic in dealing with the client. In keeping prudent in meeting certain client-attitudes the following case illustration is briefed:

An operator of a small contracting business having trouble meeting his bills was advised by one of his suppliers of materials to seek an accountant's help with his problems. This advice was accepted and he contacted an accounting firm. The prospective client's concern over what the service would cost him was almost pathetic.

As a practical matter, that attitude on the part of a client is probably the hardest nut that certified public accountants have to crack. In the beginning you were reminded that in this field there is no price competition. On outset of engagements of the sort being described, one cannot tell or even estimate what time and effort will be involved in the assignment. This means the accountant must be a good salesman and work toward establishing the client's confidence in his fairness in charging for the service. At the same time he must be adroit and make no commitment that may later hamper relations.

To continue the case illustration — the engagement was undertaken on a mutual trust basis. The performance of the assignment turned out to be rather simple, in that it required only revision of the accounting system and some pointers in billing and collecting for the client's services. Final results of those changes and advice were that his financing is no longer critical. However, in frankness it must be stated that these results were not altogether due to the advisory assistance — some part of it was due to other favorable influences that would have happened whether the accountants had been



engaged or not. Later it was demonstrated that this client was no "tightwad," or "chiseler," and that he had a fair sense of values for professional services.

As we progress further in the extension of the scope of these services we must rationalize such attitudes as just described. Certainly, there are underlying causes for initial attitudes of this type. Some of those causes may be very important to us.

That caution has been encountered many times where clients are not already users of one or more conventional accounting services, and that extreme caution prevails in committing for any type of accounting services — many times the very services they seriously need. What is the basis of their apparent fears?

On the other hand, where the accountant has been serving the client in some of the more conventional types of service, the client's attitude is generally entirely different. He isn't at all worried about the cost. His main concern seems to be one of getting the accountant's attention directed to his particular problems. A client not long ago stated to his accountant that he felt there was considerable saving in using regular accountants to furnish the needed management service to his company, and in that way the accountant's intimate knowledge of the company's affairs was, in effect, reused — similar to the further use of a manufacturing by-product.

What about the client's attitude after the management services have been more or less in successful use for some time? Don't be too surprised if it turns out that he pretends the ideas were his in the first place and that he was merely checking them with his advisor before putting them into effect. Many times that may really be true. However, in cases where it is not true, this attitude can, with safety, be ignored so long as the client continues to "check ideas" and pay the fees billed for the service.

### **Human Relations and Attitudes**

There are many ranges of client-attitudes toward management accounting services — in this area there are numerous deep human relations problems. The accountant should be constantly on the alert to these relations. The problem of management attitudes toward management services cannot be and should not be ignored.

To illustrate one particular phase of relations, suppose that in your visitation to the client's office, after you have served his enterprise for some-time, and in this service had pointed out a host of ills. His business was really sick, but the patient is recovering. He starts coming up with remarks somewhat along this line, but in different language: "What are you going to raise . . . about now?" If he is not kidding (and most business men don't kid), stop, look, and listen. It is quite possible that the supply of service is going beyond the wants of that management.

The purpose of this discussion of attitudes on the part of the client and

the accountant is to stress the point that practice of human relations is a primary requisite to the application of techniques in the management services field.

### **Tools Available to the CPA**

There is no dark area today in sources of information on sound management and business practices. Literature of business is almost limitless. The *CPA Handbook* details a basic bookshelf on page 13 of Chapter 25. In addition to that list, the monthly publication *Management Methods* is recommended. This publication is a source of specific cases of solutions to special management accounting problems. Presently one of the Institute's committees, the committee on management services by CPAs, is working on a project in management accounting. Undoubtedly much good information and valuable guides will soon be forthcoming from that committee's work.

Techniques result from know-how and that attribute is acquired from study, observation, and experience. Thus, the subject should be pursued daily by those wishing to acquire proficiency in their chosen field. CPAs would do well to attend seminars on management subjects whenever it is at all possible. They should join, attend, and take part in meetings of organizations that deal with management problems.

One cannot acquire the necessary proficiency and technique through study alone. Study and observation must be supplemented by experiences of oneself or others. Therefore, some citation of cases in experiences appear to be in order.

### **Case of an Unwise Dividend Policy**

The client — a distributor of industrial mill supplies — had been established for some years and had achieved considerable success. The strong cash position of the company was causing concern about Section 102. As a result, dividends had been paid for several years at extremely high rates. The majority owner-executive's compensation was also in relatively high figures. These two circumstances plus income from other securities caused a very deep tax bite in that executive's income. The organizational set up of the company made it a natural for a good stiff pension and profit-sharing trust plan. Such a plan was brought under consideration in collaboration with pension trust consultants. The results were that a considerable portion of the dividend payments will be diverted into the plan, thereby becoming deductible for tax purposes and at the same time building up the young executive's estate faster than would be possible under the previous policy.

### **Case of the Too Busy Contractor**

Mr. X, who had operated a contracting business for three or four years, complained bitterly to his principal trade creditor about his lack of getting any finances ahead, notwithstanding the fact that he was extremely busy

with plenty of work. The trade creditor who had had experience with accountants in management services recommended to him the employment of accountants. He acted upon that advice by employing an accounting firm. The client thought he had an accounting system sufficient for his purpose. However, the accountants found the records were not current; there were no job cost records; billings were not timely; and no follow-up statements on accounts receivable were being sent out because the bookkeeper did not have the accounts in balance. Results are as follows: bookkeeper, who was unable to correct these deficiencies, has been replaced and record keeping established to accomplish those objectives. Almost immediately the tightness in finances began to decrease. If the present trend continues for six months, the pressing problem in financing will be solved. Relieved of those worries, he, with the help of his CPA advisor, can concentrate on improving the estimating, bidding, and job cost controls in his business.

In the experience just related there is a good example leading to the conclusion that where many problems exist, changes and solutions should be carried out in an orderly manner. In other words, observe the old maxim, "To do many things well, do them one at a time."

### **Recognition of One's Own Limitations**

Lest the idea get abroad that only the management side is weak and the accountant is always strong, the following case at point is cited.

Accountant A had been serving a client for sometime. The client was floundering in heavy losses and financial difficulties. A forward looking bank executive kept counseling his borrower to find the causes for his problems. The client sought assistance from Accountant A who was young and inexperienced. His advice to the client was to get a certified audit report which could be taken to the bank to get additional bank credit. A short form audit report was submitted. The banker turned the credit extension down and suggested to the borrower that he should ascertain the causes for needing additional credit. About that time a supplier to the company closed in by filing court action. Again Accountant A faltered in his service and became very indignant about that supplier's actions. Accountant B was called in to assist and advise with the client and Accountant A. Accountant A refused to cooperate and suggested that Accountant B, who was fairly well established, was pirating Accountant A's clients. The client for a time was willing to put up with Accountant A's attitude; however, after awhile he got tired of his antics and dispensed with his service. This, however, did not happen until things had gone so far as to seriously damage the firm's credit position and considerably delay remedial measures. The causes underlying the firm's financial condition were ferreted out and corrected. The client is now able to pay its bill, but the damage to

its credit position has not been fully repaired. Much of that damage could have been avoided if Accountant A had recognized his limitations and collaborated with Accountant B. Also, he would, in all probability, have retained a client that he does not have today.

That example can be carried one step further with fully experienced accountants where collaboration is needed with other more specialized consultants in such fields as industrial engineering, advertising, market research, pension trust, and several other specialized activities. In those fields no ordinary accountant or small firm of accountants could be expected to be proficient. In general, these remarks do not apply to the large or highly specialized firms of accountants that are organized and departmentalized to handle all or some of that type of service.

### **Attitudes Toward New Problems**

A frequent mistake made by both management and management advisors is holding the belief that a new problem is clothed in some deep mystery, and believing that some "high-powered" expert should be brought in from the outside to solve the alleged mystery.

Many times the light dawns—only after considerable cost—and management finds that operational know-how can be profitably built upon the garden variety of personnel having extended service in the organization. Here is a striking example of that truism. An executive of a thriving business acquired another related line of business—processing of concrete products. The newly acquired business was fairly well staffed with experienced personnel. Because that executive thought there was some great mystery in the operation of that business, he assigned his vice-president to be the plant manager. That trial did not work out. Then he went outside of the organization and hired a new expensive plant manager.

The accountant somewhat timidly advised against this procedure. Perhaps some of the timidity was due to the accountant feeling that personnel problems were not in the scope of management accounting.

The new manager turned out to be an "empire builder". Production went completely "haywire," with no regard to inventory or sales requirements. Finally, top management took a good "look," and found there was no deep mystery; that common sense and fundamentals of management were all that was needed. The imported "hot-shot" manager was replaced with one of the old employees who had been capable all the time of doing the job. The plant is now operating satisfactorily with half the direct labor formerly employed and is operating in coordination with inventory and sales requirements.

In this case, if the accountant had fully analyzed his stand and forcefully presented that analysis to management, perhaps several thousand

dollars in loss of potential profit and much anxiety could have been avoided.

### **Giving Constructive Advice**

The foregoing case points up the question of what attitude the accountant should take toward advising management in staffing key positions, other than strictly accounting functions. Unquestionably, there will be more than one school of thought on this subject. For the purpose at hand, it is submitted that every person in an organization causes or generates accounting problems of some sort. It is with those causes that management must deal.

In many cases, but not all, the accountant can furnish management with an independent constructive viewpoint in personnel matters. Whenever a client wants or asks for that viewpoint the accountant should not be so restrictive as not to give it; provided, of course, that his knowledge of the personnel and the functional requirements of the position will fully support that advice.

### **The Challenge to the Profession**

There is no doubt that specific case experiences provide local practitioners with the most helpful material for their guidance. The few examples cited in this paper were presented to help meet this need for sharing experiences. It should be recognized, however, that the wide variety of management problems has made it impossible to cover even a fraction of them in this paper.

We have indicated that local practitioners are facing up to the hard job of shifting their professional horizon over and beyond the mere fulfillment of their conventional services. We must pool our knowledge and experiences to meet this challenge.

# The Electronic Industry: Its Present and Its Future

Alfred N. Goldsmith

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Any opportunity to address the American Institute of Accountants is both pleasant and stimulating. Accordingly I am appreciative of your invitation to present to you, necessarily in outline and in nontechnical form, something concerning an industry which is essential to our country in war-time and even more helpful in the years of peace.

Electronics is a branch of electrical engineering and manufacture which uses rather novel devices such as vacuum tubes, crystal devices (for example, transistors), and similar apparatus. There is no agreement on an exact definition but all of you who know about television and radio receivers or electronic computers have a good idea of what is meant.

There are three principal capabilities of electronics which are of practical interest. Firstly, electronics can extend or improve the senses of man. Secondly, it may supply an electric substitute for physical or mental processes of the human individual. And thirdly, it can handle operations which the human brain or hand cannot carry out, at least in a reasonable period of time. That is, electronics is a remarkable way of speeding up some simple or difficult processes.

Electronics is already widely used in a variety of highly diverse fashions and in various industries. Airplane designing, guided missile development, activities of the Government Census Bureau, high-speed bookkeeping and date tabulation by insurance companies, store room inventorying in factories, study and prediction of markets—all these and many other applications of electronics are already known. And many more will follow.

Considering first the applications of electronics as an extension or an expansion of the senses of man, these are mainly based on the availability of electronic amplifiers. These amplifiers, whether of the tube or transistor type, can utilize a small and feeble input and convert it into a far larger

and accurate copy of the input. Thus the output of an amplifier closely resembles its input, but contains considerably more energy. This at once enables us, in effect, to amplify both sound and light. We are of course all acquainted with the public-address systems which produce sound that may cover many acres, or even square miles in the case of the battle systems used for propaganda from airplanes. We also know how a brilliant picture can be produced on the screen of a television receiver from the feeble incoming energy even though the picture was originally picked up on a dimly lit football field in the late afternoon.

On a more prosaic, but humanly valuable basis, the modern hearing aid has brought enormous comfort to numerous persons whose hearing has become impaired. Electronic techniques enable the accurate recording of sound on phonograph discs or magnetic tape, and permit as well the reproduction of this sound with excellent quality and any desired volume. Possibly pictures may similarly be recorded and reproduced commercially in the near future.

A more abstruse but humanly valuable application of electronics is the electron microscope. This has extended the vision of man far toward the realm of the infinitely little. By its means, the intimate details of human cell structure can be studied, and bacteria and viruses can be made visible in such detail as to afford many valuable medical clues.

Possibly the electronic telescope will also reach a stage of usefulness one of these days, and will permit far distant stars and galaxies to be examined more readily by the naked eye, thus extending our knowledge of the universe. Indeed, the radio telescope is already proving very valuable along these lines. It would be possible to prolong this list indefinitely but the preceding instances sufficiently indicate the astounding versatility of electronic methods and the likelihood that they will be ever-increasingly useful in the realms of industry, entertainment, and science.

In the second place, electronic methods may substitute for the individual procedures, both physical and mental, of human beings. It is obviously uneconomical to use a man to do a job if an economic and versatile electronic device can rapidly and flawlessly perform his tasks. Human beings are too slow and variable—and too costly—to be used except where there is no effective substitute. Among the electronic methods falling into this class are the controlling devices. They cover an enormous range from automatic door openers to precision means for registering the color impressions on high-speed printing presses. One important application of electronic controls is found in the atomic reactor piles for power production. Here cadmium rods, for example, are automatically slid into and out of the pile in such fashion as to prevent the atomic-fission split-up from getting out of control and resulting in the well-known and destructive atomic

explosions. Broadly, wherever a given control is required to maintain an operation or to avoid an undesirable result, electronic methods may properly be considered. Some prove economical and useful; others do not.

Electronic devices also enable unfailing and ever-vigilant supervision. The messages of the supervisory equipment can be carried to remote points where the coordinating personnel can determine whether anything has gone wrong. In some cases automatic devices can even rectify mistakes without any human intervention.

One important supervisory capability of electronics is the watching or control of processes in locations which are either too hazardous or uncomfortable for human beings. For example, the inspection of furnaces is better carried out by a small television camera or other electronic device than by human personnel. The dangers of operation of an explosive-manufacturing plant can be minimized by remote inspection. In the military field, there are locations where an observer cannot be feasibly installed—for example, in the tail of an airplane. However, electronic cameras or measuring devices can be placed in such locations and can carry their messages back to a convenient observation point.

Another instance of the inspection of a remote effect of similar nature is the location of an electronic camera at or near the top of a smoke stack to watch the control of combustion. Telemetering—the reading of measurement indications at a distance—is another obvious use for electronics.

There are many operations in manufacture where electronic supervision will ultimately relieve much of the tedium or reduce the necessary number of persons involved in an inspection job. Actual or impending failure of equipment can thus be supervised, or even predicted and avoided.

Still another useful application of electronic methods is the guarding of plants or installations against unauthorized intrusion. Light beams and photocells, with associated amplifiers, warning circuits, or alarms can surround any area with an open and yet impenetrable barrier. In such cases intrusion automatically gives the necessary alarm.

One of the most startling successes of electronic devices, and of particular interest to you, has been in the realm of the computing machines. It has been found possible to build machines which, in the flash of a second, will carry out, with a high degree of accuracy, a calculation which might take many skilled mathematicians weeks or even years. These electronic computers are today rather large and complex mechanisms. However, their capabilities are astonishing. They are used, for example, to calculate the ephemeris—that is, the navigational tables issued by the government for the use of *marine and air navigators*. Computers can similarly be used in normal business and industrial operations, for bookkeeping, inventory control, and a myriad of other necessary applications.



They are already used by manufacturers of abrasives, aircraft, automobiles, electrical equipment, petroleum, and steel and by such concerns as bankers, product distributors, and public utilities.

Data originated in a governmental military department indicates the economics resulting from electronic computation in the preparation of some 120 complex actuarial tables. The electronic computer used 1443 man-hours of human labor in all the incidental and auxiliary operations, and 104 hours of computer time in actually preparing the tables and checking them. It was estimated by experts that human calculators would have required a total of about 28,000 man-hours for the same job. The project cost on the electronic basis was \$15,000; if carried out by human labor it would have been \$200,000—or 14 times as much. It is permissible to say that the electronic computer is a permanent part of our civilization in peace and war—and a most valuable one.

In the third place, it has been indicated that there are numerous conceivable future applications of electronics, some of great human significance and others of less basic nature. Only a few among the many of these can be here mentioned. And, in any case, any such crystal-ball commentary must be accepted mainly in a broad sense.

It is likely that automatic shops and factories will some day be evolved. We already have automats where the customer deals with rather simple machinery to secure his necessary nutrition. The principles of the automat can likely be developed further in the direction of comfortable and satisfactory automatic restaurants. Similarly, the flow of materials through a manufacturing plant, and the processing of such material may in time be increasingly simplified and rendered automatic by electronic machinery and controls.

In the military realm electronics is playing an increasing, and almost alarming role. Its uses in the production of the atomic explosives are myriad. In the case of the modern long-range bomber, the electronic equipment which is installed may cost more than the remainder of the bomber. When guided or homing missiles are considered, their entire functioning depends primarily on electronic apparatus.

One interesting possible future application of electronics is in the realm of precise prediction of future weather at a given location. In order to determine with a high degree of certainty just what the weather will be at a given time and place an enormous number of variables must be automatically measured, coordinated at a central point, and utilized in many and complex computations. In fact, the computation of tomorrow's weather on a reasonably exact basis might involve tens or hundreds of millions of calculations. It is obviously useless to gather the necessary information for the prediction of tomorrow's weather if it will take years to carry out the

necessary calculations. The weather computer of the future may carry out many millions of computations in an hour or less and thus bring precise weather prediction into the realm of possibility. This would be a great boon to the farmer, and even to the city dweller.

A study of electronic circuits and their behavior has shown certain curious and significant resemblances to the behavior of the human brain and the controlled nerves and muscles. The study of animals having mechanisms resembling those of electronic devices has been termed "cybernetics." This new science has already been carefully studied by advanced mathematicians, physicists, and electricians. Its findings may go far to explain normal mental and physical processes in animals, and even the peculiar mental aberrations which are sometimes found in man and also, oddly enough, in faulty electronic devices such as computers.

On the lighter side—though with a serious background—it is now possible to build an electronic chess player which can take on the average human opponent and at least hold him to a draw. Perhaps the future electronic chess player will prove invincible even to human world champions in that field.

Of human value would be an effective and simple electronic device for guiding the blind. One approach to this has involved using sounds to give warning of obstacles. That is, the blind man carries the device which, for example, throws an interrupted light beam ahead of him. If it strikes an obstacle and is reflected, the blind man hears a sound in his headphone and is accordingly warned. Such devices may ultimately be developed to full practicality.

Only recently, a major industrial leader proposed that electronic air conditioners be devised. These would permit direct cooling by some electronic means. Since the comfort in homes and working places is important to human beings, this may ultimately constitute a major field of manufacture.

I have not mentioned such applications of electronics as communication over wires, submarine cables, land cables, and radio-relay stations. Nor has mention been made of such other applications as radar, radio broadcasting, and television broadcasting in monochrome and color. Much time might also have been devoted to that interesting and promising device, the transistor—a crystal contact assembly which can already carry out effectively a limited number of functions of the vacuum tube and may accomplish much more after further development. However, I believe that even my brief summary of the electronics field should prove adequate to clinch the thought that this field is indeed of major importance and bids fair to be one of the most valuable assets of mankind.

Oddly enough, it has been found that the study of human and com-

mercial problems, using elaborate electronic computers, is far more difficult than the electronic analysis of scientific or technical matters. Many more and very complex factors affect human behavior. The laws governing these factors are extremely hard to determine. Random disturbances in human affairs must be allowed for lest the results become undependable. And many rules affecting human responses have numerous and serious exceptions. Thus it will be a long time before political, sociological, and commercial problems can be as satisfactorily handled as can the simpler fields of science. This leads to the pleasant conclusion that the human statisticians, accountants, and analysts will long be the sole masters of their professions and that, in the foreseeable future, the electronic machine will be no substitute for them but only their convenient and reliable servant.

On this reassuring and happy note, and with my renewed thanks to the Institute for the privilege of addressing you, I can *non*-electronically conclude my remarks.

# How Electronic Systems Will Affect Accounting

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Strange things are happening in the accounting profession. One example is that advertisements have appeared offering employment in accounting firms to electronics engineers, mathematicians, and others with unusual technical and scientific training.

What is going on? There is no secret about it. These specialized skills — on the surface quite alien to the accounting profession—are being combined with those of the accountant and industrial engineer to form a team to study accounting systems and a wide variety of business problems. The prospective use of new electronics equipment in business is one of the most significant developments responsible for this trend.

## **A New Language**

Accountants are attempting to understand a new language which includes strange words—among them “binary numbers,” “electrostatic memories,” “Boolean algebra,” “statistical sampling,” “linear programing,” and “operations research.” Not all of these terms, it should be noted, necessarily relate directly to this new field of electronics, but they all relate to faster or better ways of doing things in the office.

## **Research**

Much of the current work on the application of electronic devices to accounting systems is quite experimental in nature. Certain electronics equipment has been rather extensively used for several years in connection with conventional punched-card systems. However, accounting systems are now being designed and used which are pioneering in the elimination of at least some of the traditional written records and original documents.

For example, accounting data are recorded on magnetic tape or mag-

netic drums. The capacity of magnetic tape is so great that the information formerly recorded on two or three punched cards can be recorded on one inch of tape not greatly different from that used in the home tape recorder. A reel of tape ten inches in diameter and less than an inch thick can hold as much information as can be recorded on 25,000 punched cards.

### **Variety of Devices and Applications**

Although much of this activity involves the large-scale electronic digital computers or "magic brains" that can perform a variety of operations using both numeric and alphabetic information at a high rate of speed, the potential improvements involve not just one new device but numerous machines and many manufacturers. Most of the familiar names of accounting machine manufacturers are involved—for example IBM, Remington Rand, National Cash Register, Burroughs, Underwood, and Monroe—as well as many others who have not previously been identified with this field. Some of this new electronics "hardware"—to use the jargon of this field—is not intended to replace existing accounting machines but may be related, for example, to new methods of communication, new methods for obtaining production counts, the solution of engineering or mathematical formulas, or the control of machine tools and manufacturing processes.

### **Processing of Information**

The terms "computer" and "electronic computer" suggest to the accountant a device for performing arithmetical operations. Electronic computers can add, subtract, multiply, and divide numbers faster than any other medium yet devised. Much of their usefulness, however, is not that they can do arithmetic rapidly, but rather that they can receive information and data of many kinds—alphabetical or numerical—and sort it out, rearrange it, add to it, compare it, store it, look it up quickly, and write it out as required. Large-scale electronic computers have considerable capability, for instance, in maintaining records related to magazine subscriptions and preparing address labels for mailing. The variety of basic things that they can do gives rise to the name "electronic data processing machine," which is also commonly used in referring to electronic computers.

Questions such as these are frequently asked: "Isn't an electronic computer just a new and faster punched-card accounting machine?" "Even when punched cards are not used, isn't it true that input information must still be manually recorded by use of some keyboard device?" The similarities suggested by these questions are real within certain limits, but there are also very important fundamental differences.

Conventional punched-card systems usually require manual handling of cards in and out of various separate pieces of equipment. Even though a large-scale electronic computer may consist of a group of machines, they

are interconnected and are capable of performing a complex series of operations without manual intervention.

It is also practicable for the machine to choose alternative courses of action depending upon the answers obtained as steps in a series of operations or computations are completed. The ability of electronic computers to make "logical decisions" in processing data has much to do with their usefulness.

While data still must generally be recorded initially by manual operation of some keyboard device, routine manual effort can be minimized by proper design of the system. Moreover, machines are being developed that can actually read printed material.

Experimental work is being done on the automatic processing of bank checks by use of machines that can read coding printed on the checks. It is conceivable that future developments of machines and techniques may eventually make practicable some form of electronic sorting of mail by post offices.

### **Early Emphasis on Speed**

Initial discussions in the accounting profession of these electronics devices were often directed to their amazing speed—the fact that they could perform hundreds of arithmetical computations and type thousands of numeric and alphabetic characters per second. Questions were asked as to their cost, reliability, and practicability.

It soon became apparent that reduction of clerical costs by the use of electronic computers was also dependent upon many factors other than the internal speed of the machines. Electronic computers are complex, and they are expensive. Much is yet to be learned with respect to their effective use.

Electronic computers have been used for scientific, engineering, and mathematical purposes for a period of several years. Their reliability is now fairly well accepted. Initial studies and installations for business applications promise important net savings in clerical costs sufficient to justify the present cost of equipment. It is expected that improvements in equipment will continue and that cost of the equipment can be reduced.

### **Learning to Use Computers**

Discussions in the accounting profession and in business are now turning to the question of how to best use these new machines and how to live with them. There is ample evidence that they will be widely used in business.

The accountant who undertakes to study this subject finds a veritable flood of literature. Most of the early work on electronic computers was directed to their application on engineering, scientific, and mathematical problems not related to accounting or perhaps even to business. However,

the scientists, engineers, and mathematicians who developed these devices for the first applications were early aware that they offered possibilities in business and in accounting. They have been eager to try out these new methods in areas more directly related to our own field of accounting.

Some of the scientists who have not had extensive contact with accounting and business systems have been somewhat surprised at the difficulty of defining the requirements of the business system and determining from business executives and accountants the real nature of the problem that this new equipment is expected to handle. The complexity of the devices and the fact that many of the methods for processing data represent new approaches in business do not make the problem any easier.

### **Communication**

Accountants are aware that many of the words used in their profession frequently have quite different meanings to others. This problem of communication exists in all technical and scientific fields. It can be particularly observed now in the contacts between the various groups working on business problems. The only solution that has been offered is for all concerned to learn something of the language, the technology, and the approach of the others.

### **Problems of Automation**

There has been a parallel interest in the possibilities of automation in manufacturing facilities. Automation is easiest to apply in mass-producton industries. The cost of facilities and special tooling is high, and improvements in products may require expensive changes in the automatic machines. Despite these difficulties, a definite and growing trend toward automation of manufacturing facilities certainly exists.

Somewhat similar problems exist in developing automation in accounting and business systems. More perhaps than in some other fields, accountants have tended to rely heavily on established precedents and proven policies and principles. Accounting systems in business are heavily flavored with custom and precedent. It has been necessary that these systems be able to handle or accommodate numerous exceptions to general rules and principles. These exceptions have often been taken care of by what has been thought of as the application of judgment rather than by application of standard rules and formulas. There is often a variety of practices on a particular point or policy, the treatment followed being the result of some subtle differentiation.

This by no means should lead one to the conclusion that very considerable steps cannot be taken toward what we can call automation in accounting systems; rather it means that some changes in thinking may be required and that new methods must justify their usefulness.

Most of the initial applications of electronic computers to accounting systems are in the areas where there is a large volume of transactions which generally can be catalogued and processed in accordance with a defined set of rules. These situations are numerous in business. There are also many clerical operations in business which consist of innumerable bits and pieces. Automation will be more difficult to apply in these areas.

Some of the more promising applications in business are in insurance companies, for policy and premium records; department stores—perhaps for recording all transactions from point of sale through accounts receivable and stock control records; public utilities, for billing customers; and in manufacturing, for payroll, inventory control, and billing.

### **Nature of Office Clerical Work**

There has been a very marked increase in office clerical work over the years, and much of this involves accounting. Despite the increasing use of constantly improving office equipment, the trend has continued. It has been reported that the ratio of office to factory workers in 1900 was roughly one to ten, and that today it is about one to four. It is possible that some of the developments in electronics equipment may make a dent in this problem.

When office clerical work, including that related to accounting, is analyzed, much of it can be catalogued and described as the transcribing of information from one record to another, sorting of information, and filing of information. Computation—addition, subtraction, multiplication, and division—is usually a relatively minor portion of the total.

Much of the effort of the accounting-systems designer is directed toward the elimination of unnecessary rewriting of the same information and to the simplification of sorting and filing of information. Selecting the best machines and equipment for each task is an important part of this work. It is obviously more productive, however, to find some means of eliminating an unnecessary operation than to find a faster means of performing it.

In analyzing the details of office and accounting clerical work in almost any business, it is usually found that a large number of things are done which are either of questionable value or clearly need not be done at all. On the other hand, many perplexing business problems could be solved if data and information not now available could be obtained economically.

### **Special-Purpose Machines**

In designing electronic computers, the engineer has a choice. On the one hand, a piece of equipment can be designed with considerable flexibility so that it can handle a variety of problems. It is often better engineering practice, however, to design a piece of equipment to handle a single problem. Since a specialized machine can frequently do a better job than



the all-purpose machine (and at less cost), some engineers have sought to find applications in accounting systems where the requirements are sufficiently narrow that a machine can be designed specifically for a particular problem. Others have concentrated on general-purpose equipment. We are likely to see continuing discussion of these two alternative methods of approach.

American Airlines, in the New York area, utilizes a single-purpose machine located at La Guardia Airport to control reservations. Ticket offices in the vicinity have a small instrument not greatly different in appearance from an adding machine. Reservations for any one of 10,000 flights are requested by inserting a metal plate and depressing a few keys. The answer as to availability of space is signaled by a light about a quarter of a second after the keys are depressed. The recording of orders for tickets is handled in a similar fashion. This is an example of a single-purpose machine designed for a particular application.

### **Punched-Card Systems**

Punched-card accounting systems are now widely used in business. Many of these systems are complex, as are the business problems with which they are concerned. A reasonable understanding of how to most effectively use existing equipment of this character requires specialized training and experience.

Nevertheless accountants have not had any particular difficulty in auditing punched-card accounting records. It has not been necessary for the auditor to be a specialist in punched-card methods—certainly not, for example, to the point of knowing how to set up the machines or wire the control boards. The elimination of many written records by the use of electronics equipment is not likely to result in serious audit difficulties for the accounting profession.

### **Punched-Card Computers**

Many of the electronic computers and related equipment now being considered for use in business were designed by manufacturers of punched-card equipment and are likely to be used in conjunction with their other equipment.

Among the smaller electronic computers are the Remington Rand Type 409 and the IBM Model 604, which have been in use now for several years. Their cost or rental is relatively modest and they are designed to be used with other punched-card equipment. While described as "small," it is interesting to note that even these machines make use of more than 1,000 vacuum tubes similar to those used in a radio or television set.

The IBM Card Programmed Calculator (CPC) and the IBM Magnetic Drum Calculator, Model 650, are somewhat similar electronic computers,

with increased capacity, designed to work with other punched-card equipment. The monthly rental of this equipment is in the \$2,000 to \$4,000 range.

### **Large-Scale Computers**

Much interest currently centers around the large-scale computers known as the UNIVAC and the Model 702, also manufactured by Remington Rand and IBM respectively. These large-scale general-purpose computers are designed to perform a variety of tasks. The complexity of large-scale computers such as these is evidenced by the fact that they use as many as 15,000 vacuum tubes. They are actually made up of a coordinated group of several pieces of equipment. The number of input devices, such as magnetic tape units, and the output devices, which may consist of magnetic tape units as well as line printers, can be varied within quite wide limits to meet the requirements of a particular installation. The internal capacity of the machines in the sense of the amount of information that can be stored in a particular installation is also flexible within certain limits. While not basically punched-card machines, they will frequently be used in conjunction with other punched-card equipment.

A typical installation involves equipment costing perhaps \$1,000,000 to \$2,000,000 or, on a rental basis, monthly rentals in the general range of \$20,000 to \$40,000 per month.

These figures might seem to indicate that only a very limited number of situations could afford such equipment. There are, however, many installations of conventional punched-card equipment involving equipment costing considerably more than this.

Initial studies of the use of these large-scale electronic computers in business indicate possible savings, in suitable applications, after considering all factors, of perhaps several hundred thousand dollars per year. It seems likely that one of these machines may be able to take care of the work formerly done by as many as 100 to 300 office employees.

The initial installations of these machines in business are taking place this year and next. These include two in large insurance companies, Metropolitan Life and Franklin Life; General Electric at Louisville; Monsanto Chemical in St. Louis; and Chrysler in Detroit. Accountants, systems people, and electronics engineers are watching these initial installations with considerable interest.

It would not be surprising to find that some difficulties are encountered. The initial use of any new and complex device usually presents problems. How soon and to what extent the expected benefits will be realized is a matter of conjecture. There is certainly every evidence at this time that the equipment and related systems will ultimately work quite satisfactorily.

It should be pointed out that in none of these initial installations will

the machine take over all accounting and office clerical activities. As might be expected, the plans involve selecting some of the most promising operations at first with the expectation that additional uses and operations, perhaps requiring additional equipment, will be explored as soon as the initial task is operating smoothly.

## **STAFF REQUIREMENTS**

The number of people required for the operation of a large-scale computer (once the system is established) is not large. The best information available at this time indicates that the number of staff people directly related to computer operation in accounting systems applications is likely to range from about 12 to 25. This should permit two-shift operation. There has been a tendency, in the past, to operate large electronic computers on a two- or three-shift basis. Processing of input data which requires keyboard operation is not covered in these figures.

Three to five full-time maintenance engineers and technicians are included in these totals. The complexity of the machines requires more or less continuous maintenance work—partly of a preventive nature.

Five or six programmers—individuals trained in the preparation of step-by-step instructions which the machines require in order to perform desired operations—are also included in these totals. Programming is also sometimes referred to as coding, or the preparation of instructions or commands.

The operation of the machine itself requires only three to six people per shift. While the machine operation is highly automatic, attention must be given to a master control panel which, among other functions, signals errors as they occur. Reels of magnetic tape or other input and output media must be loaded and unloaded, output units printing paper forms require attention, and so on.

## **Systems Design and Programming**

Preparation for use of a large-scale electronics computer in business is a major project. Estimates of the time required for preparatory work are generally in the range of 25 to 35 man years. Some study is first required to determine whether the particular situation is appropriate for the use of this equipment at all. It is necessary to integrate the operations or sections of work to be taken care of by the computer with other operations in the over-all system which may be manual or which use some other type of equipment. A decision must be made as to the particular new equipment to be purchased or leased.

The accounting systems work can be broken down into several segments. It is usually necessary to determine in some detail how the existing system operates, what the existing requirements of the system are, and the nature of the various problems that the existing system must cope with. Seldom

is it clear that the existing system fulfills the requirements of the particular situation. It is therefore necessary to give consideration to desirable changes in existing requirements, to define what the new operation is expected to accomplish, and to outline the detailed steps that are required to accomplish the desired result. Much of this portion of the study does not involve consideration of the prospective new equipment at all but is rather a re-examination of the accounting and business policies and practices which are inherent in the operation of the existing system. Agreement must be reached as to what should be changed and how the changes are expected to operate.

Detailed flow charts graphically illustrating the old and new systems have been found to be exceedingly useful in preparation for the use of a large-scale electronics computer. The sources of input information to the over-all system are outlined, as well as step-by-step details of the transactions as they are processed and the end requirements as to records, reports, and other paper work.

It is only after these many points have been considered and decided that the actual layout of the work for the new computer can commence. The various steps in the proposed new system are then analyzed and a determination made as to how the available equipment can be best utilized to obtain the desired results. The step-by-step machine operations are determined and a detailed program prepared for the machine which consists of a series of code numbers (or alphabetical characters). Programming at present requires considerable time. Separate programs are likely to be required for each of the principal phases of the operation—for example, processing of vendors' invoices and payment, preparation of payrolls and related reports, inventory control, or billings to customers and accounts-receivable records. The principal phases may be divided into subroutines in certain instances, particularly where certain types of exceptions must be processed.

The scope of the work required for these several steps presently results in a preparatory period which may be as long as one or two years from the time that serious consideration is given to the use of a large-scale computer to the time when it is actually in operation. While this can be discouraging on first thought, changes in accounting systems and data processing must of necessity be planned far in advance in any large business enterprise.

The fact that orders for such equipment must be placed a considerable time in advance of delivery should also be taken into consideration. However, the equipment can usually be obtained as soon as the groundwork can be completed for its use.

### **Public Accounting Firms**

It seems probable that a number of groups will be working on systems

problems involving the use of electronics devices. Many business firms have well-organized systems departments. The equipment manufacturers will generally participate in surveys and details of systems planning as they have in the past. A number of consulting firms outside the accounting profession are also directing attention to accounting systems and the applications of electronics equipment. Much work needs to be done in the entire field of accounting and data processing systems in business and in government.

A continuing trend toward specialization can be observed in the internal staff organization of public accounting firms. It is becoming increasingly difficult for the professional accountant to be well informed in all aspects of auditing, taxation, and the various specialized services, including systems work. Public accounting firms can make important contributions to the improvement of systems and the design of methods to effectively utilize the newer developments in machines and equipment. Their success in this field will be dependent, in part, upon the effort and talent directed to staff development, training, and supervision.

# A Good Public Relations Program On a Small Budget

Elliott C. Serotta

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and public relations committee, Georgia Society of CPAs*

During the past five years the public relations program of our profession has become extremely important. Within the past year the need for an enlightening public relations program has been the demand of every state society. Such demands have also had their impact upon our national public relations program.

There are today approximately 52,000 CPAs in this country. Each one of the 52,000 CPAs should be concerned with out public relations program. The responsibility for a good public relations program rests *as much* upon the shoulders of the one-man CPA firm as it does upon the shoulders of the chief of any of our large national firms. Each must in some manner contribute to our public relations program. We are now aware through the *Agran* decision that a major portion of our practice is being challenged. We must fight to preserve our tax practice. In addition, the individual practitioner must overcome many obstacles in order to have his services appreciated by businessmen. He cannot advertise—so he must become known by his presence and activities in community affairs. Thus, the individual practitioner too has a share in our public relations program.

We have now established the basis for a common participation by all CPAs in our public relations program. What then is our first step in having a public relations program on a small budget? I am reminded of the story of the young college graduate who came to a large city in search of a Good Job. After having been in the city for several weeks, unsuccessful in his search, and with his financial reserve dwindling away, our hero sent this telegram to his father, *collect*: “Dear Dad—all alone in the city—no job, no money, no friends—what shall I do?” The father, a businessman of the old school, immediately wired back: “Make friends.”

The outline of the past three years' public relations program of the Georgia CPA Society is as follows:

1. Increased items in newspaper publicity.
  - (a) Greater publicity of chapter programs
  - (b) Publicity of speakers on chapter programs
  - (c) Closer coordination with editors of local newspapers
  - (d) Publicity in local papers concerning state and national activities of accountants
2. Radio and Television.
  - (a) Planned programs before tax season
  - (b) Arrangements for presentation of AIA tax transcription record on radio stations during tax season
  - (c) Joint programs with internal revenue agents on income tax information
  - (d) News items on local TV and radio stations
  - (e) Showing of AIA film *Accounting, The Language of Business* on TV
3. Talks by accountants before civic and business groups.
  - (a) Speakers on taxes and accounting programs
  - (b) Question and answer programs
  - (c) Specialized groups—such as farmers, business groups, manufacturers
  - (d) Appearances before bankers, and loan and credit associations
  - (e) With cooperation of education committee, talks before high school students on phases of "Accounting as a Profession", and showing of AIA films
4. Participation by accountants in civic, community, and religious activities.
  - (a) Community Chest advisory activities
  - (b) Audits of small civic groups
  - (c) Serving as officers and directors of civic groups
  - (d) Serving on budget and finance committees
  - (e) Installation of accounting systems for civic, community, and religious groups.
5. At all times in all manners and methods, publicize the professional dignity and ethics of the Certified Public Accountant.
  - (a) Integrity
  - (b) Education
  - (c) Knowledge and intelligence
  - (d) Independence

As I unfold our method of successfully conducting this program, you will readily understand the necessity to "make friends."

Insofar as newspaper publicity is concerned, I have found this to be the most standard medium of publicity in cities under 100,000 population. Although it is a standard medium, I find that for some unknown reason we have been neglecting this source of publicity. Let me tell you two ways to improve your newspaper publicity.

First, make the acquaintanceship of the newspaper reporters and editors who will handle your articles. This can be done easily through social channels or in civic or business clubs.

Second, improve newspaper publicity by writing your own articles. To many CPAs this seems most difficult. However, it is not as difficult as writing an auditor's report. A study of various newspaper articles, or a conference with your local newspaper reporter or editor, will soon have you on the right track. Just as there should be a proper choice of words in writing a report, so should there be in writing a newspaper article. Don't attempt to write the headlines for your newspaper articles—the newspaper will do that. For most local papers the article should not be over three to five inches long when it appears in print—ranging from 125 to 250 words in length. Sometimes, you may find it difficult to have your article 125 words in length. Have plenty to say but don't repeat yourself.

The public relations department of the American Institute of Accountants is planning to release a series of short newspaper articles dealing with problems of the average taxpayer in filing his federal income tax return. In order to widen the distribution of these articles and as a public service offering by our profession, a letter will be sent to each newspaper in Georgia advising of the availability of these articles. A detailed listing and description of every member of the Georgia Press Association has been furnished us by a Friend!

We have not *touched* the potentialities of the TV and radio fields. I could write pages on the various types of programs which an aggressive group could present, but first, let me tell you what others are doing. In many cities in Georgia, the TV stations are presenting a *weekly* program entitled *This is the Law* in which individual members of the local bar association participate. Enough said—the pace has been set.

During this past tax season a number of our chapters presented income tax information programs over TV—usually 30 minutes in length. Others offered information on live radio programs. On some of these programs, Internal Revenue agents appeared. One CPA appeared several times on a TV program which was in the nature of a general news and commentary program. All appeared under the sponsorship of the Georgia CPA Society and their local CPA chapter. It was very easy to have the AIA radio



transcriptions and spots broadcast on radio stations in our state. We sold the stations on the idea that we were offering a *public service*—not selling accounting. Because of our limited budget in Georgia for 1953–1954, we requested many of the stations to tape record the AIA transcription, which enabled us to get better coverage with fewer records, and to permit the station to use the transcription more than once. Incidentally, the stations used their own tape recorders and tapes. Within a very short period, a letter will be sent to *each* radio station in the state, advising them of the availability of both the AIA transcription and the local radio programs. Each chapter chairman and publicity committeeman has been furnished a list of radio stations so that he can pick out the stations within his area to be contacted.

The TV spot films were given a warm reception by the stations. It was discovered that this same film in 35 m/m size could be used in movie theatres. The manager of a chain of five theatres was “persuaded” to rotate the spot films around his theatres. During the 1954–1955 season, the Atlanta CPA chapter will furnish a number of five minute scripts beamed at housewives for telecast on the largest TV station in Georgia—WSB-TV. The Atlanta chapter has also been promised the assistance of the production staff of WSB-TV.

We also have a number of 15 and 30 minute scripts in production for TV and radio broadcasts for other chapters. In one area, the local chapter is planning to prepare a series of scripts for radio broadcast. In order to have broadcasts made over several stations, the groups plan to tape record the programs and *lend* the tapes to the radio stations. Usually, the station will re-tape the program and thus have available a program which can be used before and during tax season.

Scripts are being planned for broadcasts beamed at farmers and for use on “farm and home hour” programs, and for broadcasts on rural radio stations. At this point, let me warn you about “beaming” your programs too high. Many members of our profession thought that the AIA transcribed tax records were childish. However, they failed to recognize the fact that these records were “beamed” at a group of taxpayers who have never seen the interior of a CPA’s office. These transcriptions have become good public relations because they inform the “grass roots” taxpayers at a “grass roots” level of the services of the CPA.

We have also found another source of news publicity in TV and radio, and with our contacts we are now able to publicize individual members of our profession. Each time a news article is submitted to our two local newspapers, a copy goes to the local news editor of five stations and two TV stations. Pictures taken by the TV station photographers are telecast with the news items.

I now come to the area of participation in which the CPA can display his best public relations talent—talks before civic and business groups. This is the area where participation has been the weakest. The program of public appearances and talks by CPAs before civic and business groups appears to me to have the greatest and strongest public relations potential because of one factor—*direct contact*. We cannot neglect this area of participation because success therein can bring the greatest results. The CPA, bringing his message to his audience face to face, can level his appeal directly to the caliber of his audience, thus making the fullest use of this method of public relations. Talks to bankers and credit and loan associations should have a range of discussion different from that directed to small businessmen or junior executives.

There are a number of banking and credit groups to reach. I have heard a talk delivered to the National Association of Bank Auditors and Controllers—"NABAC" for short. Other banker groups are the Robert Morris Associates and the local clearing house associations. Credit groups range from the national credit rating firms (*i.e.*, Dun and Bradstreet), down to the local retail credit bureaus. In many areas, there are state or regional industrial groups, such as roofing and sheet metal contractors' associations, garment manufacturers, building supply dealers, automobile dealers, auto parts dealers, furniture manufacturers, and others too numerous to name. Talks before the banking and credit groups and industrial groups may take the theme of "the services the CPA can render to business"—emphasizing how such services are reflected in better credit reporting.

Talks before trade groups may be divided into two categories: (1) Services of the CPA to that particular business or trade group, including tax accounting; and (2) How the 1954 Revenue Act will affect the tax accounting program of their respective groups. For any data needed on category (1) (services of the CPA), I refer you to the public relations department of AIA, which has prepared numerous articles for publication in trade journals and magazines. Recently, they have also contacted numerous trade associations offering to furnish articles on the 1954 Revenue Act and its effect upon their specific trade groups.

The American Institute of Accountants has produced the film *Accounting—The Language of Business* for showings to high school students. This film, 20 minutes long, should also be shown to civic, business and trade groups with a short talk on the services of the CPA. We have several copies of this film in circulation in Georgia. It has also been shown on TV stations.

I have saved for last the activity of the group that I consider an outstanding opportunity in public relations. Millions of American men and women are members of numerous civic groups, such as business and pro-

essional women's clubs, garden clubs, Civitan, Kiwanis, Exchange, Lions, Optimist, and Rotary. Each one of these taxpayers is thirsting for information on the 1954 Revenue Act. Most of these club members are small businessmen, sales representatives or junior executives. A great percentage prepare their own tax returns or utilize the services of someone other than a CPA to prepare their returns. Opportunity is knocking at the doors of our profession and begging us to offer a public service to the aforementioned taxpayers in a program of income tax publicity. Although these taxpayers are not our clients, they are voters, employees of businessmen—and potentially future small business clients.

Several state societies are contacting the civic groups in their regions on such programs. In Georgia, we have elaborated on this program by making our income tax information program a coordinated CPA-Internal Revenue Service presentation. During this past tax season, one CPA group presented 16 such coordinated programs before civic groups within a 75 mile radius. These income tax information programs were a tremendous success. The participants found the program easy to present, especially when they threw the floor open to questions. Programs ran overtime on many occasions. What was most pleasing was the realization that we were creating good public relations for the Internal Revenue Service as well as for the CPA. We received personal commendation from the Director of Internal Revenue for the District of Georgia, the Regional Commissioner of Internal Revenue, and the Honorable T. Coleman Andrews, Commissioner of Internal Revenue. A scrapbook of the activities of this program was assembled and presented to each of the aforementioned officials. We plan to continue this coordinated CPA-IRS income tax information program during the months of November and December.

In the April, 1954, issue of *The Journal of Accountancy* there was an article which listed the characteristics of the CPA entitled "What Manner of Man is the Average Accountant." I was amazed to read that the CPA was deemed weakest in participation in community activities. Some CPAs have created ill will for our profession by their refusal to participate in community, civic, and religious activities. Their excuse is that they're too busy. I do not know of a greater fallacy than that we are too busy to work with, and help, our fellow man. The CPA, by training and educational background is well qualified as a civic leader; or to advise civic or religious groups on financial and budgetary activities. Many CPA chapters are now working with Community Chest groups in audits of the Chest funds soliciting campaigns. Others are doing audits of Chest member agencies. I know of one CPA who is auditor for a regional Baptist association; another is fiscal advisor on a municipal hospital board. Many CPAs have volunteered their services as auditors of the civic groups in which they are

members; others audit church records or serve on finance committees. Other groups which receive such assistance are the USO, boys clubs, veterans councils, etc. The Georgia Society, in cooperation with the State Health Service, completed during the last year a program of accounting for small hospitals in rural counties. This program has now been utilized by similar hospitals in Texas.

The potential public relations program of the CPA in this field is amazing. The factor of direct contact with his fellow man, his capacity to assist those less qualified, and the contacts with other civic, community, and religious leaders can result in a fine public relations program.

Our last commentary is as obvious as it is important. We must exhibit at all times professional dignity, a high standard of ethics, and integrity. We must also emphasize these traits to our clients, friends, and acquaintances.

In closing this paper I want to stress that a public relations program is only a reflection of the activities of each of you. No one person or group can possibly shoulder the burden of a good public relations program alone.

Above all, to have a good public relations program on a small or a large budget, each of us must "*make friends.*"

# How to Combat Legislation Unfavorable to the Profession

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In approaching the matter of state legislation, it may be expedient to review the background of this problem. The special report of the executive committee on the subject of regulatory legislation is an excellent source for this purpose. Accounting laws of the permissive type which apply only to the certified public accountant have been in effect in many of the states for fifty years or more. The regulatory type of legislation came some time later, the first such law being passed in Maryland in 1924. There are presently 21 states and 2 territories operating under regulatory acts.

The National Society of Public Accountants made a request in the summer of 1953 for a conference with Institute representatives for the purpose of exploring the possibility of substituting cooperation for conflict between CPAs and public accountants in the state legislatures.

It seemed clear that registration or licensing of public accountants in some manner was the basic objective of the National Society. The executive committee felt that the Institute should not refuse to discuss its policies and activities with any outside group which had a legitimate interest in the field of accountancy. The executive committee also felt that regardless of the meeting with PAs, the Institute's position on regulatory legislation should be reviewed periodically in the light of changing conditions.

The conference with the National Society of Public Accountants was held January 15, 1954. No official minutes were kept as the meeting was simply a means of exchanging viewpoints. It was agreed that no specific opinions would be ascribed to any particular individual. Both sides agreed that no commitments could be made by either. The result of the meeting was a better understanding by each group of the viewpoint of the other.

One fact which we must not overlook is that the public accountants

will go on striving indefinitely for some kind of recognition in the form of registration or licensing which is in itself regulatory legislation.

Where the CPAs have not accepted this approach and will not accept it as a desirable objective, there seems no possibility of substituting cooperation for conflict between the two groups. This is not necessarily unfortunate in itself. Conflict cannot always be avoided on terms consistent with the public interest—and the public interest must be the governing consideration in all professional regulation. As was previously stated, nearly one-half of the states have adopted regulatory measures which in many instances may reflect an acceptable result achieved by cooperative effort in contrast with conflict that could well be wasteful and expensive.

It is evident from the various state laws that there is a lack of consistency among the several states. Changing conditions during the relatively short history of our profession has brought about varying degrees of opposition from the PAs.

In 1945, the Institute issued a form of regulatory accounting bill in which one fundamental change was suggested from the prior bills. Instead of defining the area of public accounting practice which was to be restricted to licensed public accountants and certified public accountants, the Institute's bill simply prohibited persons who were neither registered public accountants nor certified public accountants from doing two things:

1. Signing financial statements or reports in such a manner as to add to their credibility.
2. Using the title Public Accountant or Certified Public Accountant.

Laws following this line of reasoning have been passed in Kentucky, Texas, Missouri, Oregon and Washington. This type of bill was much less strict than the older regulatory measures which, in effect, had prohibited any unlicensed person from earning a living doing work of a nature commonly performed by public accountants. In the newer laws, there is nothing to prohibit anyone from doing public bookkeeping, write-ups, preparation of income-tax returns, or from performing any accounting services for management, so long as he does not use the title Public Accountant or sign his name in such a way as to add credibility to a financial statement or report. It is believed that the more modern bills are less vulnerable to attack on constitutional grounds.

Regulatory legislation was one of the subjects which sharply divided the Institute and the American Society of Certified Public Accountants. The Society actively promoted regulatory legislation, whereas the Institute generally opposed it. In 1934, the Council of the Institute adopted a resolution which declared that regulatory legislation was not compatible with the interests of the certified public accountant and the business public.

Following the merger of the American Society and the Institute, the council in 1940 changed its position and stated that the National organization neither opposed nor advocated regulatory legislation, but left the matter for the states to decide.

In 1946, the committee on state legislation sent a questionnaire on the subject to all members of the Institute. The results indicated such a preponderance of opinion in favor of regulatory legislation, that the council adopted a resolution that legislation of the regulatory type should be encouraged, and that the Institute should render all possible assistance to state societies considering this form of legislation.

This position, however, was immediately attacked by members who disapproved of regulatory legislation, and after further extensive discussion, the council in 1948 again resolved to withdraw its approval of regulatory legislation and to adopt a position of neutrality on the subject.

Our present situation has resulted from economic and social changes in the past few decades creating a sudden demand for accounting services. Additional CPAs have not been created rapidly enough to satisfy this demand. Consequently, persons with varied training in accounting have found that they can make a good living by entering the so-called public accounting practice without obtaining a CPA certificate.

Once established in practice, these men naturally begin to feel the human desire for fellowship, organization and recognition. Many of those who have ambition and ability further their studies and pass the CPA examinations, thus partly satisfying the need for additional CPAs.

On the other hand, many others do not or can not pass the CPA examinations. Some of these are content to go along with their normal practice and have not participated in any organization of public accountants. Others seek to satisfy the desire for fellowship and recognition by joining societies of public accountants, and many of these societies have made it their business to seek legislation providing for the registration and licensing of public accountants.

The motivation of public accountants to seek registration or licensing is largely the desire for "status," partly a desire to eliminate unethical competition by subjecting all practitioners to disciplinary control; partly a desire for some protection against the possibility that, as a result of the activities of the Bar Associations, the field of tax work would be closed to Public Accountants. This latter element of fear has been greatly increased, due to the current conflict with the Bar which is being carried to Congress.

There are now estimated to be about 50,000 public accountants in the United States, which is roughly the same as the number of certified public accountants. Since the number of CPAs has been growing very rapidly, it may be reasonable to assume that the number of public accountants

may be declining or at least is relatively static. As time passes, the CPAs will probably outnumber the PAs.

It has also been estimated that about half of the public accountants are in states which have already adopted regulatory legislation.

In most of these states, where the regulatory type of law was adopted before the war, the PAs now represented in the National Society of Public Accountants are practicing outside of the law, often under some title other than public accountant, such as public bookkeeper, accountant, independent accountant or tax consultant. They strive to reopen registration provisions of the regulatory law or to enact an entirely separate law which will give them status as registered or licensed public accountants.

In the states which have adopted regulatory public accounting legislation since the war, the PAs represented in the National Society are for the most part registered or licensed. They generally oppose reopening registration provisions in their own states, since they presently enjoy official status and there is no particular reason why they should wish to make it available to others.

The half of public accountants who are in the non-regulatory states generally desire regulation or registration of one sort or another.

The attitudes of the certified public accountants in the various states are naturally quite different.

In general, certified public accountants have not sought any particular protection against competition. They have enjoyed a half-century of uninterrupted growth and prosperity, and have been more concerned with raising standards and improving their own ability to serve the public than with seeking any legislative advantages. Their concern with regulatory legislation is generally actuated by the questions of what will best serve the public interest and what is best to do about the public accountants.

The majority of the certified public accountants in other permissive states appear to be opposed to regulatory legislation and generally have defeated efforts of public accountant groups to enact it, though in some cases the PAs have won the victory, and in other cases the CPAs averted defeat by narrow margins.

The subject is extremely complex and it may be that the solution will be found only through the evolutionary process of trial and error.

It is generally conceded that no two states or territories have the same problem, due to the human element reflected in the legislatures and the public accountant groups. It is felt that the foregoing comments explain the "why" of the problem.

It is suggested that the legislative matter be approached on a continuous basis. This approach will improve the position of the state society when



the matter resolves itself to a specific legislative problem. Following are suggested procedures for such a plan:

1. *Maintain a Strong Legislative Committee*

Careful consideration should be given the appointment of a qualified legislative committee composed of members who have indicated interest and have the background of experience to understand the problem. Such a committee may be supplemented as necessary when undesirable legislation is actually introduced in the legislature.

2. *Educate Your Membership*

The Institute has many valuable papers on legislative problems. Among these are the following:

- a. The executive committee's report to Council on regulatory legislation.
- b. *Legislative Problems and How to Meet Them*. See especially the statement entitled "The Function of the Certified Public Accountant."
- c. The Institute's *Form of a Regulatory Public Accounting Law*. This no longer represents the AIA's official position, which, on the subject of regulatory vs. permissive laws, is neutral.
- d. Spencer Gordon's opinion on the constitutionality of this bill.
- e. The Model Bill of the National Society of Public Accountants.
- f. AIA Brief and Arguments against this bill.
- g. Russell Harrington's statement before the Rhode Island Senate Judiciary Committee.
- h. List of states with regulatory accounting laws.

Fortified with this information, your committee is in a position to present programs at the annual society meetings, local chapter meetings and/or special area group meetings and acquaint the members with the background of the problem, thereby formulating a better understanding of the issues. This procedure should develop a unified position on the part of the membership as a whole, concerning which type of legislation is considered advisable for the particular state. Unity on the part of the society is essential for the sponsorship of good legislation, or for the purpose of combating undesirable bills.

3. *Appointment of Legislative Counsel*

Consideration of someone to act as a representative of the society may differ according to the individual state society organization:

- a. In states where a full time executive secretary is maintained, it may not be desirable to employ legislative counsel unless it is desired to sponsor legislation or an undesirable bill is introduced. The executive secretary may be able in this instance to spend the necessary time to be in constant

contact with legislative matters which may pertain to the profession.

- b. In states where the membership has not yet justified full time executive secretaries, it is probable that consideration should be given the employment of legislative counsel who will be in a position to advise the society on legislative activities having effect on the profession. It is not practical to expect legislative committee members or other society members to spend the necessary time for such a service.

#### 4. *Public Information Service*

Public information, offered by the Institute for the benefit of the profession as a whole, will undoubtedly be our most effective weapon in legislative matters. Increasing emphasis should be made at state levels to train each of the members to act as a public envoy for the profession. This plan will reach legislators, clients, and the general public, and acquaint them with our profession and its responsibility to the public interest.

The state society should initiate contact with the state legislature, offering assistance with committees toward revision of state income tax laws where applicable. The invaluable work of the Institute committee on federal taxation with the Congress is indicative of the professional stature gained at a national level.

Qualified members should be available for participation with bankers and other industrial groups which will further the knowledge and understanding of our profession by the business public.

The society should endeavor to have one or more members acquainted, on a personal basis, with all of your legislators. It is highly desirable to be acquainted with the committee members in the legislature with whom legislation will be introduced. Such an acquaintanceship, if fostered when no problem exists, may be a "port in the storm" if it develops.

If you have an actual legislative problem, you may rest assured that there is no easy formula for its disposal. Usually each one calls for individual treatment. The following, however, suggests a general pattern which may prove useful when, and if, trouble starts:

1. *Notify the Institute.* The Institute is in touch with legislative problems all over the country. Often a problem in one state, or the approach to its solution, will closely resemble a problem in another state. Through the Institute, the state society may be able to tap the experience of other societies.

2. *Take a stand promptly — with the right people.* If a bill is pending before the state legislature, action must usually be taken through legislative channels. There is no point in making a statement to the newspapers and assuming that this will do the job. It will not. It is essential, first of all, that

the legislative committee considering the bill be informed directly and at once that the society objects, and wants to be heard.

3. *See the people who can help.* A battle for the protection of professional standards cannot be fought at long range. Press announcements *might* help, and in some circumstances *certainly* would, but in the beginning it is often best to see what can be accomplished through negotiations — perhaps without publicity at the start. Representatives of the society should certainly see the bill's sponsor, the chairman of the committee considering it, members of that committee, and other key legislators.

Depending on circumstances, it may also be helpful to talk with the governor, with political leaders, and perhaps with leaders in the opposite legislative house who might get the bill for consideration.

4. *Get a hearing.* If a bill is sufficiently controversial, it is usually customary for the committee to grant public hearings to opponents and proponents. Public hearings afford real opportunities to take a vigorous stand, and to put that position on record.

The foregoing suggestions assume that it may be possible to work the situation out through legislative contacts and channels. This is often the case. Should it be necessary, however, to bring public opinion to bear on the question, it will be necessary to put the membership to work developing letters and contacts directly with political leaders in opposition of such legislation. Community support will be necessary from bankers, business organizations, commercial organizations, outstanding community leaders who use the services of accountants, and other groups. It will necessarily be helpful if letters or resolutions indicating their position toward the bill be transmitted to the members of the legislature. This kind of support is particularly strong, as it comes from sources not personally affected.

Press releases may be utilized in carrying the progress of our cause to the public. Every resolution passed, every decision taken by the society, every speech made, and each new development will lend itself to press treatment. Here again, it is valuable to maintain good relations with the press and other media when a need does not exist, in order that full support may be available to meet a crisis.

In conclusion, it is observed that the legislative problem should be reviewed regularly by each state society, giving consideration to the increased standards of the profession, the relationship of the number of CPAs and PAs to meet the accounting demand, and other relevant circumstances for the purpose of developing legislative programs which will best serve the public interest.

# How to Stimulate Effective Committee Work

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The title of this paper has much broader implications than might appear at first reading. Webster's dictionary defines *effective* as "producing a decided, decisive, or desired effect"; more loosely, the subject might be defined as "effective committee operation." Within the compass of the latter definition, this paper will attempt to outline the essentials of successful committee work. Ideal committee activity might be likened to a tasty pie:

The bottom crust represents the soundly created and appointed committee.

The filling represents the subjects studied by the committee members.

The top crust represents the conclusions reported by the committee.

To be successful, committee work must have the attributes of a good pie.

At the present time quite a few state societies of certified public accountants employ an executive director or secretary and possibly additional staff; others operate almost entirely with volunteer help. Because of this, those most interested in this subject can probably be divided into two principal groups — officers of societies which operate entirely on the volunteer basis and paid officials of state societies. While this point is brought out, no implication is intended that there should be a difference in the manner of conducting committee activities in the two situations. To the contrary, provided that the same principles are followed and the same energy is exerted, equally effective committee work should result under either method of operation. However, in all frankness it may have to be conceded that, human nature being what it is, it is easier to accomplish effective committee work with outside help and push. But that might well be the subject of another paper.

Suffice it to say, regardless of whether there is outside push or not, effective committee work can only be accomplished if the committees have worthwhile subjects to study, if they are manned by members willing to work hard, and if the conclusions are reported upon in an orderly and timely manner and given the consideration they deserve by the officers, directors and, where appropriate, the members as a whole.

One of the best definitions of committees to be found is that they are groups of members at work. You cannot escape the conclusions that committees are the lifeblood of an organization and the more members serving on committees the healthier the organization should be.

Committee work gives a member a feeling of participation in the affairs of his society. In conversation, the member unconsciously refers to "our" committee and "our" society rather than "the" society. It is this sense of "belonging" which helps so much to bind the organization together.

### **Formation of Committees**

It is axiomatic that committees should not be formed merely to give members something to do. A committee must have a purpose and that purpose must be clearly defined.

Your organization may or may not have an organization manual. The California Society has a manual and the American Institute of Accountants is understood to be developing one for the help of all societies. Such a manual is almost essential to smooth committee operations and should contain the following material relating to committee operation:

- (1) A general outline of the composition of committees and their functions in relation to the society or chapter.
- (2) General instructions to chairmen for discharging their duties.
- (3) General instructions to committee members regarding their responsibilities.
- (4) General instructions regarding committee minutes, continuity, organization, etc.
- (5) Relationship of committees to staff (when such staff exists).
- (6) A work program for each committee outlining its functions and, where necessary, procedures to be followed, keeping in mind the necessity for simplicity and for tailoring the program to the capacity of the organization.

Amplifying the foregoing, even at the expense of repeating it in part, it is essential that there be delineation of the exact work to be performed, of the scope of the effort, and of the manner in which results are to be made available.

Having decided that there is a necessity for a particular committee, its size must next be determined. There is no one answer to that problem. Because of the work involved in appointing members, the temptation is to

make the committee as small as possible. While this may be desirable in a few special situations, too small a committee can be as ineffectual as too large a one. No flat rule can be stated. The number of members of some committees is established by the by-laws; others are controlled by regional representation. In the California Society, the general rule is that, where appropriate, the members of a state committee are composed of the chairmen of the chapter committees. This means that there are ten members on such committees as accounting and auditing procedures, cooperation with credit grantors, legislation, etc. Such committees as membership, public relations, etc., ordinarily have more members. It is important to emphasize that there should not be too rigid an adherence to a particular number. The proof of the pudding is in the eating; if each committee member carries his share of the load and the work at hand is accomplished in an expeditious manner you will have a healthy organization.

Reference is made in the previous paragraph to chapter committees. It is understood that California is one of the few states having several chapters and that some societies hesitate to encourage a multiple chapter system on the apparent assumption that it will result in a dilution of effort. It has been the experience in California that the reverse is true. With the addition of chapters the organization has been strengthened rather than weakened. Subject to natural restrictions based on size, chapters are encouraged to form committees paralleling those of the parent body. State-wide committee activity is greatly increased and a reservoir of potentially good committee members is created upon which the parent body can and does draw. Concurrently, the increased committee activity in the chapters appears to assist in attracting new members from outlying areas and the organization is thus strengthened through increased membership and better regional representation.

Selecting the personnel for a committee is probably one of the hardest tasks falling on the officers and staff of a society because it requires a wide knowledge of the abilities and interests of its members. The chairman of a committee must be picked for his ability as a leader and be possessed of considerable tact. The committee members must be picked for their ability, their interest in society affairs and their willingness to work. If possible, at least one member of a committee should be potential material for chairmanship the following year so that provision is made for some measure of continuity of knowledge and effort. An invitation to serve as a committee member is a distinct compliment and if the one invited is unable to give the necessary time and effort he should decline the invitation. Upon his appointment, each committee chairman and committee member should be supplied with a copy of the appropriate sections of the organization manual relating to committee operation.

At this point it might be appropriate to comment that the paid secretary can be of tremendous help to active committees through his attendance at all important committee meetings, thereby making available his knowledge of what other committees are currently doing and what committees have done in the past regarding problems similar or related to those under consideration.

### **Committee Meetings**

Except for a few of a special nature, it is essential that all committees have regular meetings. It is the chairman's responsibility to see that meetings are organized, that timely notice is given of the meetings, and that the meetings are conducted properly. The chairman must prepare an agenda which should be adhered to closely and should keep the meeting moving.

Of course, a meeting should be called only if there is a purpose for it. Since it is assumed that the hypothetical committee has worthwhile projects the meeting can be for organizational purposes, to report progress, to report on completed projects, or to take up new matters.

In the interests of orderly work and reporting it is essential that minutes be kept at each meeting. Prompt reproduction of the minutes and circularization thereof to the committee members assures elimination of misunderstandings and tends to expedite the next phase of the effort.

What of the committee meeting places and length of committee meetings? Ordinarily, the California State Society committee meetings are held either at a downtown hotel or at the downtown office of a committee member. If the meeting is held at a hotel there is a tendency to fewer interruptions and the work is more expeditiously accomplished. In a hotel setting it is also possible to provide a pleasant interlude in the form of a coffee break and if, as frequently happens, a meeting carries over into the afternoon, lunch can be arranged for in the meeting room or nearby.

Trite as the statement may be, meetings should last only so long as it is necessary to complete the work at hand. Careful preparation of an agenda well in advance of the meeting date will provide a strong indication of the probable length of the meeting. Whenever possible, and in particular when committee members are coming from other cities, a tentative agenda should accompany the notice of the meeting. It appears desirable to start meetings as early as possible in the morning, taking into consideration the arrival time of out-of-town committee members.

### **Committee Reports**

Since committees are groups of members and their conclusions represent the thinking of a group of members, it is important that their findings be reported on adequately and regularly to the board of directors. It is the committee chairman's responsibility to see that the report, after approval

by his committee members, is presented to the board — in person, if possible. It then becomes the board's responsibility to approve or reject the report and to take such other action as may be appropriate.

In order to permit orderly organization of board meetings it has been found helpful, in the case of the larger societies, if a condensation of the committee report is made available to the president and the staff a few days prior to the meeting. Such a procedure tends to eliminate waste of time and gives advance notice of possible controversial issues.

### **General Considerations**

It goes without saying that the activities of many state society committees should be carefully coordinated with those of similar committees of the American Institute of Accountants. This provides assistance and support to Institute committees and avoids duplication of effort. Many committees of one organization, of course, have no counterpart in the other organization, or if there is a counterpart the activities are unrelated. The areas of mutual and separate activities appear to be quite well defined and state societies should have no difficulty in determining whether or not the efforts of a particular committee supplement or overlap those of the Institute.

In planning the over-all society program and in assigning projects to committees it is important that committees be given too little to do rather than too much. It is much better that a committee comes up with one job well done rather than getting spread so thin that it accomplishes nothing. The old rule of "first things first" must apply.

Perhaps it is in order to sound a brief warning at this point that it is possible to stimulate too much activity. Once a good program has been developed and committees are functioning properly, potential projects begin to appear as if by magic. This is probably the logical result of having enthusiastic volunteer workers.

Budgetary and other considerations require that proposed projects be carefully considered from the standpoint of desirability, cost and time consumption. There is a limit to effective volunteer activity. All new projects should be approved in advance by the board of directors.

It is also advisable from time to time to review all committee activities to the end that a well-balanced program is maintained and unnecessary or unimportant activity is eliminated. It is preferable that this be done at the beginning of each year. In the process of review it may be found that a committee has completed the task for which it was created and that it can be discontinued.

Some organizations have a "committee on committees." One of the important functions of such a committee is to keep the committee activity healthy along the lines just discussed, and on a continuing basis.



## Summary

It should now be abundantly clear that effective committee operation is dependent on many factors. The most important elements which must be present to produce consistently effective work are:

Soundly created and appointed committees.

Worthwhile subjects for study (not just something to keep a committee busy).

Proper reporting of committee conclusions to the board of directors.

Appropriate action by the board of directors.

The most important aid to effective committee work is an up-to-date organization manual. In larger organizations, the staff provides an important assist in activating and coordinating committee work.

The benefits to be obtained from effective committee work are:

An active membership and a feeling of participation.

Attraction of new members.

Accomplishment of worthwhile projects.

A healthy organization.

Do not bewail the fact that there may be considerable waste motion. This is inevitable with volunteer workers. Try, however, to hold the waste motion to a minimum by proper organization.

The writer cannot deny that he is enthusiastic about the benefits to be obtained from properly planned committee work. It is his concluding observation that once a good program has been developed and is in operation the problem is one of controlling the activities rather than finding something to do.

# Organizing the Chapters Of a State Society

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The thought that motivated the establishment of chapters throughout the entire state of New Jersey was one of greater service to the members of the state organization. Several years ago, the first step was taken when the state public relations committee set up subcommittees in many areas of New Jersey. Very soon, however, it was discovered that not only was there a need to bring information concerning the profession to the attention of the business and professional community in each area, but also a need which had not adequately been met by the state organization; *i.e.*, an opportunity for the members to meet locally to discuss common problems and become better acquainted.

The next step seemed logical. Some of the areas, realizing the importance of the local units, requested a more formal status than subcommittee of a state society committee. They were of the opinion that, if they were organized as chapters, with their own elected officers, they would take their rightful place alongside the other county professional organizations such as lawyers and bankers. As a result of these requests, the by-laws of the state society were amended to permit the board of trustees to authorize the organization of chapters at such locations in the state of New Jersey as appeared to them to be necessary or desirable. The amended by-laws state that the organization of the chapters and the manner in which their affairs are conducted shall be governed by such rules and regulations as the board of trustees may prescribe.

The president then appointed a committee of members representing several areas of the state to draft a set of rules and regulations for the organizing and operation of chapters. When the report was presented to the board of trustees, it was reviewed by a special committee of the board before final approval.

As set forth in the rules and regulations, the objectives of the chapter

are "to promote the interests of the Society at the local level; to cultivate professional cooperation and social intercourse among its members; to encourage an interest in accounting and accounting problems among the public; and in general to relate professional accounting standards to everyday living." In order to prevent misunderstanding as to the relationship of chapter and state organization, the rules state that the powers conferred upon the chapters are to be exercised in a manner consistent with the constitution and by-laws of the society and the rules and regulations as well as amendments thereof or supplements thereto, and are limited by any power now or hereafter exercised by the society. Furthermore, it gave the trustees power to amend, alter, or supplement the rules and regulations.

In the event of a violation of the rules by a chapter, the trustees of the state society may hold a hearing upon twenty days' notice, by registered mail, served on the president and secretary-treasurer of the chapter at their last known addresses, setting forth the charge or charges against the chapter. The rules provide that not less than five days prior to the date of holding such a hearing the chapter shall submit a general statement of its answer in writing to the secretary of the state society. The trustees shall hear the charge and the answer and render judgment thereon. If the chapter is guilty of violation, the trustees may decree suspension or forfeiture of the chapter's charter.

During the past fiscal year, charters were granted to ten chapters covering every area of the state. Some chapter areas include one county, while others include two or more, depending upon the location of the counties and the number of members in each county. The trustees have the right to determine the geographical boundaries of a chapter. Although provision was made for the formation of chapters either at the instigation of the trustees or upon application of 15 or more members of the society in good standing in a given area, all were organized at the request of the members. The trustees have the right to dissolve a chapter when its membership falls below ten.

Membership in a chapter is automatic, with the only opportunity for choice being in instances where a member lives in one area and practices in another. When a new member joins the state society, he is immediately assigned to a chapter. Under our present method of operation, just as soon as a man or woman receives a certificate from the state board of public accountants, his or her name and address is placed on file at the state society office and a card containing that information is mailed to a chapter membership chairman. The successful candidate is then invited to attend a chapter meeting, and every effort is made to secure his application for membership in the state society.

The rules and regulations make it mandatory for a chapter to hold four meetings, including the annual meeting, during a fiscal year which ends at

the same time as the fiscal year of the state society. The secretary of the chapter is required to send a copy of all meeting notices and minutes to the secretary of the state society.

One chapter has held a meeting monthly during the past year, including social meetings during July and August. During one of the summer months, they had a dinner and theater party for members and wives, and during the other month a golf outing followed by a dinner with a speaker on a technical subject. Several of the chapters held more than the mandatory limit of four meetings, and plans for the coming year indicate that many of the chapters will have more meetings than the minimum required.

In addition to the membership committee and the program committee, each chapter must have a public relations committee and may have others if they do not conflict with areas reserved for the state society, such as committees on legislation and professional conduct.

When the chapters were first organized, the officers were designated as chairman, vice chairman and secretary-treasurer. At a recent meeting of the board of trustees, the rules were changed to designate the officers as president, vice president, and secretary-treasurer. The board of directors of each chapter, as distinguished from the board of trustees of the state society, consists of seven members, including the three officers and the last retiring president. The board is required to meet at least three times a year and a notice of all meetings and the minutes of such meetings must be sent to the society's secretary.

In order to finance the operations of the chapter, twenty per cent of the dues collected by the society from the members of each chapter is paid to the chapter's treasurer. This section of the rules is being reviewed by the board of trustees, because in some chapters the amount was insufficient to finance an active program while in other chapters there was a sizeable surplus at the close of their fiscal year. There is a specific section of the rules and regulations which prohibits a chapter from levying dues or assessments.

Several of the chapters have been in operation for one year, while others were formed less than a year ago. However, we can definitely say that there is more activity in our state than ever before. Members who have rarely, and some who have never, attended a meeting in Newark, the state society headquarters, are now attending local meetings. There are several reasons for this: First, they are meeting with fellow members who practice in their area of the state. Second, the groups are smaller and therefore lend themselves to more informal discussion. (After a round-table discussion in the southern part of the state, the chapter chairman mentioned how pleased he was that the younger members of the profession took such an active part in the discussion. He said this never would have happened at a larger meeting in Newark.) Third, although New Jersey is a relatively small state, members

in the northern part require at least an hour travel by car to reach Newark, and many of the members in the southern part of the state travel by car for over two hours to reach Newark. The state has no public transportation system which conveniently connects the northern part with the southern part.

There are other reasons why we believe our new chapter organization is successful. For example, last year when we were considering the problem of two-class regulatory legislation, after the trustees mailed a copy of the legislation committee's report, setting forth the historical background as well as the pros and cons of such legislation, the president of the state society requested the chapter presidents to call a meeting of the members of their chapter to thoroughly discuss the question. We are certain that without the chapters we could never have had so many of our members participate in the solution of this question.

Furthermore, our chapter organization enables us to keep in close contact with the membership. The local officers, directors, and committee chairman, who usually come from different areas of the county, find it very easy to contact personally the members who do not attend meetings.

Another reason why our chapter organization is successful is quite evident when you realize that last year, with a membership of approximately 1,200, ten per cent served as officers, trustees, and chairmen of state society committees and officers and directors of the chapters. When you add to this group those who served as members of state and chapter committees, the result is a sizeable number of members directly concerned with the work of our organization.

Probably one of the greatest benefits derived from the chapters is the knowledge and information which a member acquires at the chapter meetings. Round-table discussions on the problems of the local practitioner's accounting and tax practice; and the opportunity to exchange experiences benefits the older as well as the younger members of the profession.

We also found an excellent public relations opportunity when the charters were presented at dinners held in the principal city or town in each chapter area. Many people prominent in business, banking, and the professions, attended the dinners, and the resulting press coverage was excellent in each instance. After all, a new local organization had come into being, and to the local papers this was news because subscribers to their paper were officers, directors, and members of the chapter.

It is possible that eventually we will find some weaknesses in our chapter organization, but we believe they will be minor and easily solved because of our method of operation. Certainly any plan which better serves our members and strengthens our professional organization is of great value and merits the thought and interest of all of us.

# Deferral vs. Charge-Off of Research and Development Costs

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In considering the accounting treatment of research and development costs it seems almost essential to consider separately the problem as it applies to manufacturing companies and as it applies to oil and mining companies. Not only does the nature of expenditure differ but the extractive industries are permitted special deductions for Federal income tax purposes which influence to a great extent the accounting treatment accorded certain expenditures for financial purposes.

## MANUFACTURING INDUSTRIES

### General explanations and definitions

Webster defines research as "studious inquiry; usually, critical and exhaustive investigation or experimentation having for its aim the revision of accepted conclusions, in the light of newly discovered facts." This definition seems appropriate as to both "pure research" and "general research".

Development costs are usually thought of as being the costs of attempting to convert the results of research to a commercial basis. While the terms "research" and "development" are often used interchangeably, it is important to distinguish between the two.

The type of expenditures usually thought of as being research and development costs are such items as salaries of engineers, chemists and other technicians; wages of experimental labor; laboratory supplies; initial patterns, tools and dies; blueprinting; and related indirect expenses.

It is desirable that the accounting system provide for a reasonable segregation of research and development costs, e.g., through the use of work orders to accumulate the costs by projects. The accumulation of costs by projects is not difficult where groups of people are assigned to single projects

and may be assigned separate burden centers in which all the appropriate costs may be accumulated, but somewhat of a problem arises where individuals are merely diverted from time to time from, say, general research to work on specific projects. This problem may be overcome usually by having the individuals so diverted keep some type of time log which is available for the proper distribution of their salaries. Other development costs can usually be segregated by projects without great difficulty. Even though all research and development costs may be expensed by a particular concern, its management may desire to provide for a segregation of them so that they may be properly controlled.

### **Treatment of research costs**

Research in industry today is usually in connection with products currently being produced or with new products and is commonly termed "general research". It includes the study of the suitability of materials for specific purposes, the experimental testing of material, the study of manufacturing processes and techniques and similar research work.

While expenditures for general research may to some extent benefit future sales of existing products, they are usually more closely related to current production and as such appear to be properly classified as current manufacturing expenses. Even though new products may, and frequently do, result from general research, the possibility of the commercial success of any new product at the time of the expenditure is usually so remote that there is no valid basis for deferment.

Research and development departments of many large industrial concerns have had a fairly rapid growth in the past few decades mainly because they have been found necessary for concerns to maintain their competitive positions. In most industries today a company must constantly improve its products to retain its share of the market.

### **Recording of development costs**

#### **(a) Existing products**

The first type of development costs to consider is that in connection with existing products of a manufacturer. After the basic research on improvements has been accomplished, there are usually additional costs incurred in getting the improvement into production. Inasmuch as existing products are generally being improved continuously, these costs are closely related to current production and thus would appear to be current manufacturing overhead.

#### **(b) New products replacing present**

Turning to the development of new products, we have a variety of situations which may exist. First, the new product may merely replace an existing product of the same manufacturer, which presents a situation

little different from the improvement of an existing product. There should not be much argument that such development costs should be charged off when incurred as the manufacturer is usually just maintaining a competitive position. There may be some situations, however, where the manufacturer is really improving his competitive position, and it might be argued that the costs of developing the new product should properly be amortized against future operations. Caution should be exercised in deferring such costs as it may not be by any means certain that the anticipated improvement will take place.

(c) Entirely new products

Next is the development of an entirely new product not presently on the market and not replacing an existing product of the manufacturer who develops the new product. Obviously, if the new product is successful, the development costs benefit future sales and may be properly amortized against them. But during the development period, what assurance is there that the new product will be sold at a profit? This is the big problem that must be confronted at least annually in the preparation of financial statements. If there is reasonable assurance that the development projects in progress will be commercially successful, there appears to be no reason why the accumulated costs should not be deferred. Should there be any doubt as to this, it seems prudent to charge off the accumulated costs in the current period.

(d) Variance between different classes of concerns

Some companies, particularly the larger manufacturers, maintain research and development departments which are concurrently at work on general research, improving the companies' existing products and development of entirely new products. While the costs of each of these may be segregated as mentioned previously, some companies, possibly the majority, prefer to charge off all research and development costs currently even though the costs are segregated for management purposes. Their position is that such costs are of a recurring nature and do not fluctuate substantially from year to year, to cause any distortion in reported net income. They feel that these costs are incurred to keep a company's growth in line with others in the industry and are thus current costs.

Smaller concerns have a somewhat different problem in that development costs may be quite substantial in relation to net income and may fluctuate widely from year to year. In such cases it appears acceptable that the development costs should be deferred if there is a reasonable presumption that the projects in process at the year-end will be successful.

New companies organized to develop a new product have a different problem. It may take several years before the product is ready for the market on any substantial scale. In such cases it is usual to defer all development



costs, including those costs normally thought of as manufacturing overhead or as administrative expenses. This procedure seems justifiable as there is little point in building up an earned surplus deficit during the initial period of a company's existence. There appears to be general agreement that, where development costs are deferred, any income from the project during the development period should be applied as a reduction of the deferred costs rather than being carried into the income accounts. This does not apply, of course, after the development stage is over even though a portion of the deferred costs may be carried forward through a reasonable amortization policy.

(e) Development of equipment

Another category of development costs is the costs incurred by a manufacturer in designing new equipment for its own use. Some companies have departments which do a certain amount of research on the types of tools and machinery in use in their plants and on the improvement of manufacturing processes and methods. As mentioned previously, in most cases this research is more closely allied with current rather than future operations, and the costs thereof would appear to be properly chargeable to current manufacturing overhead.

The cost of developing new equipment for a manufacturer's own use, however, presents a different problem. The cost of manufacturing the equipment (or the purchase price if acquired outside) will be capitalized, and there seems to be sufficient justification for capitalizing normal development costs (i.e., exclusive of duplication of work due to errors, etc.) as a part of the acquisition costs of the new equipment.

The obtaining of a patent, as a result of developing a new product or a new machine for the company's own use, may seem sufficient reason for deferring the development costs and other costs of obtaining it. Usually, however, a period of years exists between the beginning of the project and the obtaining of the patent and the product may have proven to be commercially successful or even unsuccessful in the interim. Thus, it appears that the question of current expense vs. deferment should usually be resolved on grounds other than the obtaining of a patent. The same reasoning holds true with respect to trademarks and other similar intangibles.

It is sometimes argued that development costs should be deferred for financial purposes so that they will not be lost sight of in the determination of selling prices. This is not a valid argument as such costs can easily be accumulated on a statistical basis even though they are charged off currently.

(f) Aircraft industry

Few, if any, other industries have problems similar to those of the aircraft industry. Since that industry's principal customer is the U. S.

Government it has the usual problems encountered in allocation of research and development costs to military contracts in connection with cost reimbursement, price redetermination and renegotiation. A further problem exists with respect to the development of new commercial models. Experience has shown that the costs of developing new commercial models are quite substantial and occur over a fairly long period of years. Due to the relatively few customers available to the several manufacturers of commercial airplanes, the chances of developing a successful model are frequently less than in other industries. Even though a successful commercial model is produced, it is quite difficult to predict the number of units which will eventually be sold, and the unit development costs may be quite substantial due to the relatively few number of units to be produced. Because of these uncertainties there appears to be strong argument for an aircraft company to charge off all commercial research and development costs currently, although sometimes such costs may doubtless be properly deferred.

#### **Disposition of deferred development charges**

Once development costs have been recorded as deferred charges, there logically follows the question as to the proper disposition thereof. If the project to which they relate becomes a successful one, the deferred costs should be amortized over no longer a period than they can be considered to benefit, the objective being to match an appropriate amount of development costs with revenues. New companies in particular should be careful not to be overly optimistic as to such period, as failure to make sufficient write-offs in the earlier years could easily lead to difficulties. Some companies prefer to be conservative and write off the deferred costs in a few years even though it is anticipated that a much longer period will be benefited. Capitalized patent costs are usually written off over no longer a period than that from the date of application for and the date of expiration of the patent.

When costs have been deferred on a particular project and the project is abandoned or it becomes doubtful that the project will be a successful one, the deferred costs should be written off immediately. Care should be exercised not to carry over deferred costs from one project to a similar one as such practice may result in pyramiding the deferred costs to an extent not warranted because of the duplication of experimental expenses, etc.

#### **Financial statement classification**

Where research is going on constantly in all lines of a company's business, these costs are usually considered as manufacturing overhead. If the research and development is applicable to a specific product, the overhead may be allocated only to that product. Some companies prefer to classify research and development costs as general and administrative. There are other cases where such costs are considered to be so significant that they are shown separately in the income statement. In an extreme case there

may be much justification for showing the write-off below the determination of "net income".

A related question is the proper classification of deferred costs in the balance sheet—should they be included in work in process, or some other current asset caption, or in deferred charges? If the product to which they relate is in commercial production and if the deferred costs are to be amortized over a short period of time comparable to the production cycle, there seems to be no objection to the inclusion of the deferred costs in current assets. Correspondingly, costs recoverable from the Government are ordinarily treated as a current asset. Apart from these situations it would appear that in most cases it is preferable to include the development costs carried forward in deferred charges.

### **Tax treatment**

The tax treatment of "research and experimental expenditures", which presumably include development costs of the type under discussion, is outlined in the Senate Finance Committee report on the Internal Revenue Code of 1954 from which the following is quoted:

"No specific treatment is authorized by present law for research and experimental expenditures. To the extent that they are ordinary and necessary they are deductible; to the extent that they are capital in nature they are to be capitalized and amortized over useful life. Losses are permitted where amounts have been capitalized in connection with abandoned projects, and recovery through amortization is provided where the useful life of these capital items is determinable, as in the case of a patent. However, where projects are not abandoned and where a useful life cannot be definitely determined, taxpayers have had no means of amortizing research expenditures.

"To eliminate uncertainty and to encourage taxpayers to carry on research and experimentation the House and your Committee's bill provide that these expenditures, incurred subsequent to December 31, 1953, may, at the option of the taxpayer, be treated as deductible expenses. It also provides that a taxpayer may elect to capitalize such expenditures and if no other means of amortization is provided, may write them off over a period of not less than 60 months, beginning with the month in which benefits are first realized.

"The tax treatment for these expenditures, once adopted, must be adhered to consistently unless approval for a change (with respect to all or a part of such expenditures) has been obtained from the Secretary or his delegate.

"These options do not apply to expenditures for land or for

depreciable property used in experimentation work. Also excluded are exploration expenditures incurred for minerals, oil, or gas which are presently provided for under other provisions."

While it cannot be definitely ascertained, it is probable that in the past most manufacturing companies have followed the same policy for financial purposes as for tax purposes as to the expensing or deferring of development costs.

No doubt the fact that research and development costs are, except under certain circumstances as indicated above, deductible currently for tax purposes has led many companies to follow the same treatment for financial purposes. Well-established companies with relatively high incomes usually seem anxious to obtain tax deductions as early as possible as working capital can be conserved by lower income tax payments. Further, many companies follow the bird-in-hand theory with respect to income tax deductions. On the other hand, companies with losses, particularly new companies, may well wish to defer whatever costs they can against subsequent profitable years. It should be noted, however, that under the new Internal Revenue Code, companies which elect to defer and amortize research and similar expenditures may not change over to an immediate charge-off method without first obtaining the Commissioner's approval.

## OIL AND GAS INDUSTRY

Oil companies have problems in their refining and other manufacturing operations similar to those of other manufacturing industries as to the accounting treatment of research and development costs. The exploration and development of oil and gas properties occasion altogether different problems and it seems appropriate to discuss such expenditures in a certain amount of detail. The main expenditures in this category are Exploration Costs, Leasehold Cost, Lease Rentals, Intangible Drilling and Development Costs, Well Equipment and Dry Holes. All of these costs are more or less inter-related and it seems necessary to have a general understanding of the accounting treatment usually accorded the items included therein.

### **Exploration costs**

Except for new companies which capitalize all development expenses, practically all companies charge off exploration costs (geological and geophysical expenses) as incurred for financial purposes as it is very difficult to allocate such expenses to specific producing properties because of the wide range of activities of geological and geophysical departments of the companies. These expenses are expected to be capitalized as leasehold costs for Federal income tax purposes insofar as they can be related to the acquisition of producing properties, but it is so difficult to allocate the expenses to specific properties that in practice a compromise is usually reached with

the Revenue Service as to what portion of the exploration expenditures must be capitalized. Such capitalized costs may then be recovered through depletion.

### **Leasehold cost**

The initial payment made to the landowner to induce him to grant a lease is commonly termed a "lease bonus." This payment is usually capitalized for financial purposes as the leasehold cost with depletion being taken thereon on a per barrel basis. Leases which prove to be non-producing are charged off when abandoned. The foregoing treatment is mandatory for Federal income tax purposes except that the taxpayer is permitted to deduct the greater of cost or percentage ("statutory") depletion for each individual property. The percentage depletion allowance for oil and gas properties is 27½% of gross income, limited to 50% of net income, from the individual property. Thus, we see that, while for financial purposes a company must not charge more than the total leasehold cost against income, for tax purposes it is possible for a company to more than recover its leasehold cost on a specific property. This may result in material differences between net income for financial and for tax purposes.

Some companies provide for amortization of the "lease bonus" by equal annual charges to income based on the life of the lease. When, in such cases, a lease becomes productive, the balance unamortized becomes subject to depletion; when a lease is surrendered the unamortized cost is expensed.

### **Lease rentals**

Oil and gas leases commonly provide for annual payments to the lessor in the event drilling operations have not been commenced on a lease. These payments are in the nature of penalties and are known as "delay rentals." Such payments are generally charged off currently for both financial and tax purposes, although for the latter there is an annual election which permits the lessee to capitalize the rentals as carrying charges on undeveloped properties. The taxpayer likewise has an option to capitalize ad valorem taxes paid on a lessor's property prior to production.

## **Intangible drilling and development costs and tangible well equipment**

### **Definition**

Intangible drilling and development costs for tax purposes include expenditures for labor, fuel, repairs, hauling, supplies and services incurred (a) in the drilling, shooting and cleaning of wells; (b) in such clearing of ground, draining, road making, surveying and geological works as are necessary in preparation for drilling; and (c) in the construction of such derricks, tanks, pipelines and other physical structures as are necessary for

the drilling of wells and the preparation of wells for production.

It will be noted that expenditures of the type mentioned above generally have no salvage value. The actual costs of materials in any tangible property which may be considered to have a salvage value, including such items as tanks, tubing, casing in the well and compressors, are considered to be tangible well equipment. Such costs are invariably capitalized as depreciable tangible property.

### **Tax treatment**

For Federal income tax purposes a taxpayer has the right to elect to deduct all intangible drilling and development costs incurred in drilling producing wells in the year in which such costs are incurred. This election must be made in the return for the first year in which such costs are incurred or otherwise the intangibles must be capitalized. The election is binding for all future years. This election is also applicable to "turnkey" contracts, under which drilling contractors usually furnish all labor, material and equipment and turn over a completed well for a certain price. If intangibles are capitalized for tax purposes, those applicable to the installation and construction of capitalized materials are recoverable through depreciation and the remainder through depletion.

### **Treatment for financial purposes**

Prior to twenty-five years ago or so the vast majority of oil companies charged off intangible drilling and development costs on their books as incurred. Their reasons for doing so were (1) taxpayers since as early as 1916 had the option of charging off such costs currently for Federal income tax purposes and most companies, at least the larger ones, exercised the option to do so. It seemed to them much more convenient to follow the same policy on the books; (2) conservatism—because of the great margin of error in determining with any degree of exactness the quantity of oil in any particular area there seemed much justification for expensing immediately all intangibles. These costs were incurred close to the time of the flush production from new wells and it was felt that the advantages from this conservative approach more than outweighed the disadvantage of undoubtedly some distortion of income as between years because of not matching costs exactly with revenues. During the 1930's however, many oil companies, while continuing to deduct intangible drilling and development costs currently for tax purposes, changed over to capitalizing them on their books. They reasoned that the so-called intangibles were really no different from other capital costs such as tangible well equipment and the cost of acquiring the lease—admittedly capital expenditures—and to obtain a proper matching of costs and revenues would necessitate spreading all such costs over the period of production. Such period, they pointed out, was

getting very much longer with proration laws barring them from the initial flush production. They also pointed out that while it was difficult to reasonably estimate the ultimate economical production from a given property it differed only by degrees from that of estimating the useful life of a piece of machinery including the questionable factor of obsolescence. Today probably most companies capitalize intangible drilling and development costs although there are still quite a number of companies—some of them very large—that write off such costs as incurred.

Probably most accountants feel that in the great majority of cases spreading intangibles over the productive life of the property gives more accurate operating results. While it may not be quite so important in a large company which maintains a fairly consistent drilling program from year to year, in a small company a variation in drilling activities can affect net income very considerably as between years.

Undoubtedly some of the large companies that expense intangibles would change over to capitalizing them if it were not for the confusion that results from the change-over. Either route taken by a company to effect a change-over seems to result in an awkward situation. Should the company change over by capitalizing all intangibles applicable to producing wells as of a given date, with a corresponding credit to earned surplus (the credit would not be to income as it is bound to be material), it would mean that the same costs would be charged against net income twice. If, on the other hand, the company were to start capitalizing intangibles as from a certain date, there would be a less than normal charge to income for many years, i.e., until the capital sum approached the amount that could produce a normal charge. Those companies that made the change-over during the 1930's mostly followed the second alternative. During the ensuing period of years disclosure was made by them of the extent to which net income had been affected because of the change. With the growing emphasis on the significance of reported "net income" during recent years, however, most companies are reluctant to make a change which will affect the comparability of income for a period of perhaps ten years. A strong argument can be made for effecting the change-over by capitalizing all intangibles as of a given date. The proponents of this point of view state that misleading inferences can be avoided by recasting earnings for the previous five years or so to show what they would have been had the company followed the policy of capitalizing intangibles and depleting them over the lives of the respective properties. The advantage of this course, they point out, is that the full impact is made at one time and from then on reported earnings are on a consistent basis. Despite this, however, it is a serious step for management to undertake to change reported earnings for a number of years, particularly if such earnings have been used in connection with public financing.

**Whether there should be a provision  
for deferred taxes where intangible  
drilling costs are capitalized**

The question has been raised many times as to the application of Chapter 10B of the American Institute of Accountants' Research Bulletin No. 43 to Intangible Drilling Costs. As we know, this bulletin provides that when an item is deferred for financial purposes but deducted for tax purposes in a given year a provision should be made by a charge to income in that year for the amount of the tax reduction and applied as a reduction of the deferred charge to be amortized in future years. The bulletin further states that this section (Chapter 10B) "does not apply where there is a presumption that particular differences between the tax return and the income statement will recur regularly over a comparatively long period of time." While intangible development costs recur regularly they naturally vary in amount from year to year and much can be said for providing for the immediate tax benefit that a company obtains by expensing them for tax purposes. Not only does a company carry a very substantial asset on the books which has no future tax benefit but it can be argued that a company can increase its profits at will, through the tax benefit, merely by spending money on intangibles. At least one large oil company meets this situation by providing through charges to income each year for the tax differential. The main argument against providing for the tax reduction is that the Institute bulletin seems to imply that the committee was thinking of situations where the net income for financial and tax purposes would be practically the same were it not for one or at least only a few non-recurring transactions which were treated differently for the two purposes and not of oil companies which have many continuing differences—some of them quite significant. In addition to the excess of intangibles capitalized over amortization thereof and of statutory depletion over book depletion, there is the inter-relationship of intangibles and statutory depletion. Thus, the non-recurring tax benefit from expensing intangibles recurs in certain properties, to some extent, by increased statutory depletion in subsequent years because of an increase in the 50 per cent net income limitation referred to above. Also, in many cases inventories may be calculated differently and some of the property values may also have a different base for tax purposes. The question of providing for the tax saving resulting from difference in treatment of intangibles is not nearly as important in large companies as in small companies. While the amounts expended on intangibles can vary considerably from year to year in a large company it is probably only in fairly extreme circumstances that the comparability of operating results is seriously affected. So far as a small company is concerned where difference in treatment can affect income materially there is not much justification for providing



for the deferred taxes for the reason that there is no way of telling what years will show profits for tax purposes and what years will show losses principally because of the effect of statutory depletion. It does not make sense to provide for taxes that may never have to be paid. The thinking of most oil accountants appears to be that any misleading inferences that might result from the different handling of certain transactions for tax and book purposes should be met by disclosure rather than by book entries.

### **Amortization of intangible drilling costs**

Let us now consider the amortization of intangible drilling costs. Capitalized intangible drilling costs are usually written off against income over the economic life of the unit of property involved. It is usual to consider each lease a separate unit of property for this and other accounting purposes. Most companies write off intangibles on a unit of production basis, i.e., the ratio of the barrels (42 gallons) produced during the period to the estimated barrels recoverable at the beginning of the period, multiplied by the remaining cost to be written off from the beginning of the period. The estimated barrels recoverable at the beginning of the period are usually adjusted retroactively on the basis of data available at the end of the period. The major oil companies have petroleum geologists in their employ who develop the necessary data for estimating recoverable barrels of oil, but some smaller companies have to rely on outside concerns and, therefore, do not adjust the recoverable barrels as frequently as once each year. The estimated recoverable barrels used in amortizing intangibles are frequently the same as those used for the purpose of computing the depletion of leasehold costs, but some companies use an estimate based only on the anticipated production from wells drilled to date and not from additional wells to be drilled on the lease. Those that follow the latter policy argue that this procedure is more conservative in that a larger portion of the cost is written off in the years before all wells are drilled in the lease. Those companies that use the same estimate of recoverable barrels as used for depletion purposes contend that it is impossible to reasonably estimate the barrels recoverable from an individual well. It appears that both methods are acceptable, the main concern being that a company should follow a consistent policy, both as among all properties and from year to year, in the method used.

A few companies amortize intangibles on the basis of the number of years a property is expected to produce economically. The estimate of the number of years must of necessity be based on an anticipated number of barrels recoverable and on a rate of production. This method appears acceptable, although it is argued that the unit of production method more properly matches costs against revenues because the rate of production changes from year to year.

Where intangible drilling costs are deferred, the unamortized portion is written off at the time a property is sold or abandoned, or when it becomes evident that production is no longer economical. In the latter case it is common to include the unamortized portion of the intangibles on such a property along with the amortization of intangibles on other properties for the period due to the relative insignificance thereof.

### **Dry holes**

The discussion of intangibles so far has related to producing wells, but those applicable to non-producing wells, or "dry holes", must also be considered. In addition to intangibles, dry hole costs include the well equipment costs (net of salvage, if any). For financial purposes the intangible costs of dry holes are usually treated in the same manner as those of producing wells, the capitalized intangibles and the loss in value of material capitalized being charged off when the well is determined to be dry. Some newly-formed companies capitalize all dry hole costs in the earlier years when they are in the development period and when there is little or no income. These capitalized costs are then generally amortized on the per barrel of production method in the case of producing properties and on some straight-line basis in the case of properties which fail to produce.

For Federal income tax purposes, if a taxpayer has elected to capitalize intangible drilling costs, he may elect to deduct in the year in which occurred all intangible costs incurred in drilling dry holes. If an original election to expense all intangibles was made, no election with respect to dry holes is necessary.

### **Financial statement presentation**

In published reports to stockholders many companies show intangible drilling and development costs separately from depreciation and depletion in the income statement, but some of the large companies combine these items. It is more usual to combine the capitalized costs (even if 100% reserved) with other costs of property, plant and equipment and the accumulated amortization with accumulated depreciation and depletion in the balance sheet. Most companies disclose whether intangibles are charged off currently or are deferred.

It would be difficult to set up standard rules of presentation and disclosure because of the diverse situations encountered among the oil companies. It seems best to let the matter of significance in the individual circumstances govern.

## **MINING INDUSTRY**

The accounting problems of the mining industry have many similarities to those in the oil industry. In mining companies we have exploration costs and development costs both having special tax treatments permissible in-

cluding the deduction of development costs as incurred. We also have statutory depletion based on varying percentages of gross income with the possibility of a company recovering for tax purposes more than the cost of the property involved. Since the accounting problems are basically the same in both industries there seems no good purpose served in considering separately the detailed accounting problems pertaining to the mining industry.

### CONCLUSION

It is fitting that this paper is to be discussed in a session entitled "Controversial Areas in Accounting" because, as will be seen from the comments herein, there is a wide divergence of opinion as to the proper accounting treatment of research and development costs and particularly intangible drilling and development costs. Maybe this is an area where no attempt should be made to lay down rigid rules. While, as in other areas of accounting, perhaps the chief virtue is consistency from year to year it might be well to agree on some such broad principles as the following:

#### MANUFACTURING COMPANIES

There should be a general presumption that research expenses—whether pure research or general research—should usually be charged off as incurred.

Development expenses should be deferred only in those cases where they have a reasonable connection with future operations. Their amortization should be over no longer a period than they are expected to benefit and an early charge-off should be encouraged.

#### OIL AND GAS COMPANIES

It should continue to be a generally accepted accounting principle to either capitalize or expense currently, intangible drilling and development costs. It should be understood, however, that under either method disclosure may be necessary in any case where the yearly expenditures fluctuate widely since misleading inferences might otherwise result in comparing one year's operations with another.

Amortization of intangible drilling and development costs should normally be on the unit of production method so that the costs are written off over the life of the individual property. In the case of a new company, or where a company extends its exploratory activities into an entirely new territory (e.g., a foreign country where perhaps no extensive exploratory work has previously taken place), it should be considered acceptable to defer all exploratory and development costs. Amortization should usually commence when commercial production has been reached. Should commercial production never be reached all costs should be written off when the property is abandoned or preferably at such time as a considerable doubt arises as to the outcome of the venture.

# Disclosure and Accounting for Current Value of LIFO Inventories

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## **Introduction:**

The problem of disclosing current market value of LIFO inventories was seriously considered by the American Institute's Committee on Accounting Procedure in 1948 and 1949. This consideration arose in part from suggestions for disclosure that were being made rather generally by the Securities and Exchange Commission at that time and earlier, in respect of financial statements filed with it.

In 1947 the Commission issued a number of letters to registrants suggesting that in succeeding annual reports (Form 10-K) the registrant should disclose the current replacement value of inventories. In the case of registration statements filed under the Securities Act of 1933, where inventories were partly on a LIFO basis, the S.E.C. required that the note to the financial statements setting forth the amounts of the inventories at the end of each year throughout the period be amplified, to indicate the amount of that portion of the latest inventory valued on the LIFO basis and the current replacement cost thereof. The Commission felt that often the difference between the LIFO basis and replacement cost was significant information known only to "insiders" and that it should be furnished to stockholders generally. However, where there was any refusal to furnish this information it is not believed that the S.E.C. insisted on disclosure in many instances.

The draft bulletin circulated by the Committee on Accounting Procedure for comment in 1949 favored disclosure. The replies, however, from corporate officials were virtually all opposed to the bulletin. Carman G. Blough,

director of research, reported that more letters were received from corporate controllers disagreeing with the bulletin than had previously been received from corporate officials with respect to all other bulletins (37 in number) put together. The argument convinced the committee, as the bulletin was not issued. It also carried weight with the S.E.C. and thereafter the commission did not request disclosure of the difference between LIFO valuation and replacement cost in statements filed with it.

**Arguments for and against disclosure:**

Perhaps as good an approach as any to the pros and cons of disclosure, is to present the recommendations of the draft Institute bulletin, the objections by corporation officials and some quotations from the bulletin's philosophy. From this the reader may be able to form his own opinion as to the desirability of disclosure.

The draft bulletin presented the following recommendations:

- “(a) Where practicable, the estimated current value of the inventory should be disclosed in the balance-sheet or in a footnote thereto in cases in which the difference between the carrying value and the estimated current value is material;
  
- (b) Where it is not practicable to make a reasonable estimate of the current value of the inventory without undue effort and expense, there should be disclosed such pertinent information as is available which will give a general indication as to the relationship between carrying value and estimated current value;
  
- (c) When a reader of the financial statement is likely to conclude, because of the method of pricing used, that a substantial difference may exist between the carrying value and the estimated current value of the inventory, the fact that no substantial difference exists should be indicated if that is the case;
  
- (d) Disclosure of any difference between the carrying value and the estimated current value of the inventory should be worded in such a way so as to avoid conveying misleading inferences regarding current or accumulated profits.”

The objections by corporate officials to these recommendations were, to quote Mr. Blough, multitudinous. He attempted to summarize the objections and came up with a list of 14 which he felt were probably the most convincing. Let us compare the bulletin with the objections where such a comparison can be made, and interpolate such comment as seems pertinent. Where the objections appear to be somewhat similar they have been grouped for convenience.

*Objection 1*

In many cases it would necessitate undue effort and expense to obtain reliable data on which such an estimate could be made.

*Bulletin—*

Difficulties are sometimes encountered in estimating the current value of inventories. When, for example, the items in the inventory are numerous, or a complex manufacturing procedure is involved, the problem of even approximating the current value may become a laborious and expensive task. The committee, however, does not consider that standards of meticulous accuracy are necessary for the purpose to be attained. For example, it should not be necessary to maintain duplicate inventory records on two alternative bases when the purpose is primarily to give a reasonable approximation or estimate as to the variation. In a complex situation it may not be possible to do more than give a general indication, such as the relative prices and quantities of the principal raw materials or the best estimate possible of the percentage by which current value exceeds stated cost. The committee believes that in the majority of cases, however, management has available for its own purposes a sufficiently close estimate of current values to serve this purpose.

*Comment—*

While the bulletin may have over simplified the problem, it is apparent that the objection goes beyond the requirements of the bulletin which in essence simply asked management to do its best within reason.

*Objection 2*

If the item is to be included as part of the certified financial statements, the auditor would have to do considerable additional work to satisfy himself that the figure is a fair one.

*Bulletin—*

Not covered.

*Comment—*

The relatively small cost of auditing should not be a determining factor.

*Objection 3*

Widely varying bases for determining current values would tend to make such disclosures misleading.

*Bulletin—*

One of the objectives of the committee on accounting procedure has been to narrow the areas of difference in accounting treatments,

thereby increasing their usefulness and comparability. In some areas this objective is best accomplished by the acceptance of a single method to the exclusion of all others. In the case of inventory pricing, however, the committee indicated in Accounting Research Bulletin No. 29 that several methods produce different inventory figures and affect the profits reported. Accordingly, the committee believes that the usefulness and comparability of published financial figures will be enhanced by the adoption of a recommendation that estimated current value be disclosed when it differs materially from the carrying value of the inventory.

**Comment—**

The bulletin is probably correct in implying that there is less room for variation in arriving at current values of inventories than there is under the usual lower of cost or market method. However, the tenor of the argument is unfortunate in that it casts some doubt on Accounting Research Bulletin No. 29 and on the usefulness of financial statements where inventories are valued on the bases prescribed by that bulletin.

**Objections 4, 5, 7, 12, 13, 14**

4. Readers would be misled into concluding that profits were greater than actually reported.
5. Would cast reflection on validity of the method used. (This was particularly emphasized by users of the LIFO method.)
7. Figure cannot be properly explained and would confuse rather than clarify.
12. Would lead to inevitable implications as to the accuracy of financial statements.
13. Would lead stockholders to conclude that there are additional liquid assets subject to dividends.
14. Figure would have little significance except in case of inventory liquidation.

**Bulletin—**

The committee recognizes the possibility that disclosure of a substantial margin above cost might lead readers of financial statements to conclude that profits were actually greater than those reported. This danger, the committee believes, can largely be avoided by careful selection of suitable wording in conveying the information. It could be made clear, for example, that the amount of the difference could only be realized by partial or complete liquidation of the inventories and that, if realized, it might be subject to income tax. In the opinion of the committee, stockholders and others are less likely to misinterpret the financial statements

when disclosure of pertinent facts is made than when they are left to draw their own conclusions without adequate information.

The argument has been advanced that any comparison of the inventory as priced for balance-sheet purposes with the same inventory priced on some other basis casts an unwarranted reflection on the validity of the method used. This argument, the committee believes, is not convincing and loses much of its force in view of the practice of disclosing estimated current values of other assets, notably marketable securities, when a variation exists between current and stated values.

**Comment—**

To those who believe that LIFO, despite its imperfections, results in a better determination of income, these objections are perhaps the most serious. Maurice Peloubet in opposing disclosure makes the following pertinent argument:

“Many corporations which make every effort to keep their stockholders and the public informed of the significant facts concerning their enterprises, do not, nevertheless, believe that hypothetical figures based on a liquidation of inventories, which is neither possible as an operation of a going concern nor probable as the result of a liquidation, are of any great value to stockholders or investors as a part of a periodical report.

“Companies, which must constantly carry large and substantially unchanged basic inventories, using the first-in, first-out method, have been criticized severely and have even been threatened with legal action because profits have been grossly understated on falling markets. For a corporation to give information which is equivalent to making calculations of such unreal, hypothetical, and unrealizable profits seems to be a very doubtful service to its security holders or to the public. If any requirements for duplicate inventory valuations are to be enforced, it would seem more useful to show figures which would eliminate fictitious profits rather than to force a calculation and display of the hypothetical and unrealizable apparent gains.”

*Objection 6*

Would lead to increased state and local taxes.

**Bulletin—**

Not covered.

**Comment—**

This is a practical objection but by itself would not be convincing.

*Objection 8*

Would lead to difficulties with labor.



**Bulletin—**

Not covered.

**Comment—**

Economists for labor unions tend to read into the figures what suits them. Disclosure, especially when read in conjunction with a bulletin similar to the one which it was proposed to issue, would tend to discredit the reported figures.

**Objections 9 and 10**

9. In general, restatement should include all assets, not only inventories.
10. Current value of fixed assets would be just as significant and difference between current value of fixed assets and book value is more serious.

**Bulletin—**

The question arises whether endorsement of the principle of disclosing estimated current value of inventories would not logically lead to a requirement for disclosure of estimated current value of fixed assets. In the committee's opinion such a conclusion does not follow. Stockholders, analysts, credit grantors and others are interested in the estimated current value of the inventory because of its effect on current and prospective earnings as well as its bearing on the financial position. Fixed assets, on the other hand, are looked upon more as a vehicle for the manufacture or sale of the product, the cost of which is to be spread over their useful lives.

**Comment—**

The bulletin's argument does not sound convincing. Neither basic inventories nor fixed assets are expected to be liquidated and their market value is not readily available to the business. If current values of inventories are shown in corporate reports, and stockholders rightly or wrongly conclude that some significance attaches to such disclosure, then the normal progression would be for stockholders to inquire as to current values of fixed assets.

**Objection 11**

Disclosure might invalidate LIFO for tax purposes.

**Bulletin—**

Not covered.

**Comment—**

The practical answer seems to be that a number of companies are making disclosure without apparently invalidating the use of LIFO for tax purposes.

**Conclusion:**

If the reader has persisted to this point, he might well agree with the Chairman of the Committee on Accounting Procedure who wrote to one of his partners as follows:

“The whole question is a very difficult one, one where the arguments in favor are strong and where many of the arguments against are quite potent. Cumulatively, they reach so close to a balance that one can easily be swayed from a conclusion that the pros outweigh the cons to a position that the cons outweigh the pros”.

There is no doubt that disclosure would simplify the task of the competent analyst in comparing the results of one company with another but as one comptroller puts it:

“A corporate report to stockholders, as a report of stewardship to owners of the business, must be directed toward the average stockholder. Great progress has been made in recent years in evolving corporate reports that are interesting and understandable to the average stockholder—reports that paint the financial and operational picture but are not burdened with technical accounting language or concepts. Sometimes, we, as accountants, may tend to forget that the corporate report is primarily addressed to the average American investor”.

The writer believes that the LIFO basis of determining income is a preferable method and that disclosure of replacement cost would to some extent tend to discredit the reporting and confuse the stockholder. For this reason, he casts one rather hesitant vote against disclosure.

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**Should the carrying value (of LIFO inventories)  
be written down when cost exceeds market**

The second part of this paper is in a much less controversial field than the first. Statement 5 in the chapter on inventory pricing in the Restatement and Revision of Accounting Research Bulletins reads:

“A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as market.”

There was only one objector to this philosophy, Mr. Perry Mason, who argues, with some merit, that a drop in selling price below cost is no more of a realized loss than a rise above cost is a realized gain.

While the statement does not specifically refer to LIFO inventories, it is apparent from Mr. Wellington's dissent to the same bulletin that such inventories were considered. The chapter states that where goods have been written down below cost, such reduced amount should be considered the cost for subsequent accounting purposes. Mr. Wellington felt that where the accounts are kept on a LIFO basis and the market rises in the subsequent period to original (LIFO) cost or higher, the write-down should be restored.

There seems to be little evidence that there is any large group of accountants, in the profession or outside, that objects to writing down LIFO inventories where cost exceeds market. Quite a few, however, feel that the write-down should not go through the income account. They argue that when a company determines income on the basis of charging current costs against current income, the operating results should not be confused by the inclusion of an inventory write-down which, they feel, should be made either against surplus reserves, set up when the LIFO basis was first adopted, or against surplus itself.

# The Applicability Of "Generally Accepted Accounting Principles"

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Do generally accepted accounting principles relate only to commercial and industrial organizations? Or is it appropriate to certify that financial statements are in conformity with generally accepted accounting principles when they reflect rules customary in a particular area, although not throughout business organizations generally? These questions arise most frequently in connection with audits of nonprofit organizations, such as colleges, hospitals, and municipalities, or those under specific regulatory authority, such as public utilities, banks, and insurance companies.

Before seeking answers to these questions it is first necessary to consider what is, or what should be, meant by the term "generally accepted accounting principles". There is an excellent chapter by Carman G. Blough on that subject in the "CPA Handbook". Therein it is pointed out that accounting principles are not fixed and immutable laws of universal applicability, like the laws of nature, but are rather rules of action or behavior designed for the greatest usefulness of those who need to rely upon accounting. They serve as guides in making accounting decisions. Therefore, since accounting principles are not fixed laws, it must follow that there may be alternative guides or rules to be employed under varying circumstances. This is, in fact, one of the areas of the work of a CPA where judgment plays an important role.

This same thought is well expressed by the AIA Committee on Terminology in the discussion of accounting principles appearing in "Accounting Terminology Bulletins—Review and Resume", as follows.

"It is desirable that the accountant conceive of his work as a complex problem to be solved and of his statements as creative

works of art, and that he reserve to himself the freedom to do his work with the canons of the art constantly in mind and as his skill, knowledge, and experience best enable him. Every art must work according to a body of applicable rules, but it also must reserve the right to depart from the rules whenever it can thereby achieve a better result.

"Dictionaries agree in giving at least three orders of definitions of principle. The first is: 'source, origin, or cause,' which is of little help to accountants except as it emphasizes the primary character of some principles. The second is: 'A fundamental truth or proposition on which many others depend; a primary truth comprehending or forming the basis of various subordinate truths.' The third is: 'A general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice. . . .'

"This third definition comes nearest to describing what most accountants, especially practising public accountants, mean by the word principle. Initially, accounting postulates are derived from experience and reason; after postulates so derived have proved useful, they become accepted as principles of accounting. When this acceptance is sufficiently widespread, they become a part of the 'generally accepted accounting principles' which constitute for accountants the canons of their art. It is not convenient, either in conversation or in writing on accounting subjects, to add '(meaning number three)' each time the word principle is used, though that essentially is understood.

"Care should be taken to make it clear that, as applied to accounting practice, the word principle does not connote a rule from which there can be no deviation. An accounting principle is not a principle in the sense that it admits of no conflict with other principles. In many cases the question is which of several partially relevant principles has determining applicability."

Since we are dealing with broad guides or rules of conduct the term "generally accepted" cannot mean "universally accepted", but instead must mean "commonly accepted" or "frequently accepted". Thus alternative sets of principles which are actually conflicting may both be generally accepted. General acceptance arises out of the practices of business, views of authors, recommendations of technical committees, opinions of government officials, and other evidences of informed opinion. When a substantial number of representative organizations consciously and voluntarily employ a particular accounting principle it must be recognized as being generally accepted. This

is just as common sense would lead us to expect. If such principles are to be useful to those who need to rely upon accounting they must serve as satisfactory tools not only for practicing CPAs, but also for management, creditors, investors, governmental agencies, employees, and customers, and they must be applicable to large and small organizations of all types.

There is, of course, a difference between general acceptance and general use. General use alone is not enough, because such use may result from the imposition of arbitrary rules by a governmental or private agency, or from the continued use of archaic or obsolete procedures by a backward industry.

One other necessary characteristic of generally accepted accounting principles should be mentioned. The ultimate objective of using rules for making accounting decisions is to achieve a fair presentation of the information involved. Consequently, any generally accepted accounting principle must be compatible with such a fair presentation.

To summarize, we may conclude that generally accepted accounting principles are rules of action which serve as guides in making accounting decisions and which have the following attributes.

1. Flexibility to meet varying and alternative conditions.
2. Usefulness and intelligibility to all who rely on accounting information.
3. Basis of substantial authoritative support.
4. Compatibility with a fair presentation of the information involved.

Returning now to our basic question of whether such principles relate to other than commercial and industrial organizations, the conclusion seems inescapable that they do. Assuming that financial statements of any nature for any type of organization have been prepared in accordance with principles which meet the criteria described, there would appear to be no valid reason why it should not be appropriate to certify unqualifiedly that they are in conformity with generally accepted accounting principles.

Why, then, has such controversy developed about this question? I believe that the confusion of thought which leads to attempts to narrow the application of the term "generally accepted accounting principles" arises primarily from two causes. First, there is sometimes a failure to recognize that an accounting procedure actually in general use can be a "generally accepted accounting principle" without having been included in a formal codification or published in a pronouncement of the AIA Committee on Accounting Procedure or some other official statement. While it is true that the accounting research bulletins issued by that Committee constitute the single most comprehensive source of authoritative recommendations on generally accepted accounting principles, they are by no means all inclusive. Although the Committee had not originally restricted the applicability

of these bulletins, it did do so in the comprehensive "Restatement and Revision," issued as Bulletin 43, in the following words.

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

It seems clear that this statement is intended to mean that of all the generally accepted accounting principles applicable in many cases and in many fields the Committee, to date at least, has limited its studies and its recommendations to certain important areas. The Committee has made no attempt to seize upon the term "generally accepted accounting principles" as exclusively its own and hence applicable only to its own pronouncements. Such principles existed before the Committee had issued any bulletins. In 1938 Messrs. Sanders, Hatfield, and Moore in "A Statement of Accounting Principles" stated:

"There is, it is believed, a corpus of principles of accounting which are generally accepted. It is true that they are not 'written law'; they have not been codified; they must be sought in accounts and financial statements, in treatises, and in other evidences of professional opinion. It is true that they have not been adopted by vote of the profession. But that they have been accepted is evidenced by the common ways of thought and speech which make communication in accounting matters possible, by the generally uniform practice of all accountants when dealing with some situations, by the general agreement that, among all the possible ways of dealing with other situations, only a few can be used with propriety, by the restrictions of controversy in respect of propriety to a relatively small number of situations out of the innumerable number about which disagreement is possible. So fully is the existence

of a body of accepted accounting principles recognized that accountants commonly state in their reports and certificates that the statements presented have been prepared 'in accordance with accepted principles of accounting'."

It is therefore evident that the Committee, in the introductory statement quoted, merely intended to point out that its attention has been directed primarily to the accounting needs of commercial and industrial organizations, and that as a result its recommendations may not always be applicable in other circumstances. Any attempt to restrict the use of the term "generally accepted accounting principles" to profit organizations, however, would place a narrow special meaning on a phrase which is basically sound English and which is readily understood by those outside of the practicing accounting profession.

Generally accepted accounting principles emerge from reporting practices of many organizations. Often they may be studied, and thus given added authority and clarity, by the American Institute of Accountants, the American Accounting Association, trade associations, or other groups having a recognized standing in a particular area. In other cases they may not have received any such formal recognition, but, if in the auditor's judgment they meet the criteria, then it is certainly appropriate for him to employ the term "generally accepted accounting principles."

Another reason for the attempts to restrict the use of the term seems to arise from the relatively greater difficulty, in fields other than the commercial and industrial, of locating statistics or authoritative pronouncements to determine borderline cases of general acceptance or of fair presentation. The question of fair presentation often leads to the necessity for appraising the materiality of variations in presentation resulting from the use of the cash basis, or of modified or hybrid bases, used in certain industries. In the absence of a study by an authoritative group it is frequently very difficult, without engaging in prohibitive research, for a practicing CPA to determine whether certain accounting practices employed by a client are truly accepted in the related area, or whether they are really compatible with a fair presentation of the information involved from the standpoint of those who may have occasion to use that information.

Possibly due to such difficulties we find the AIA Committee on Terminology advising the Committees on Accounting and Auditing Procedure as follows:

"The members of the committee on terminology agreed that the expression 'generally accepted accounting principles' relates to income determination on an accrual basis and consistently related balance sheets, and should not be used in connection with other



kinds of financial reporting. We feel that the term refers to standards which are not applicable to cash-basis or modified cash- or accrual- basis statements. We believe that the historical development of the term has been directed toward business enterprises in which the measurement of income is paramount and that it would be desirable to restrict its use to such situations."

In my opinion it would be wrong for us to adopt the view here expressed, and would lead us into an absurd and thoroughly untenable position. The historical development of the term has been directed toward profit enterprises in the minds of those engaged in such enterprises. But how about those engaged in other types of organizations or enterprises? To them the historical development of the term has been directed toward the clear and fair presentation of accounting information of various types on which they could rely. It is undoubtedly true that almost always statements on a cash basis do not present accounting information fairly and are therefore not in conformity with generally accepted accounting principles. However, there are many instances of practices which are established in certain industries or types of organizations involving modified cash bases which are generally accepted and which are compatible with fair presentation. In such cases it would be absurd to deny the applicability of the term.

Such a position becomes more and more untenable as the areas of lack of authoritative research diminish. In 1951 the National Committee on Governmental Accounting of the Municipal Finance Officers Association of the United States and Canada published an excellent book entitled "Municipal Accounting and Auditing", which contains recommended accounting principles for governmental organizations. In an entirely different field a similar need is equally well satisfied by the publication in 1952 by the American Council on Education of a work entitled "College and University Business Administration—Volume I". In this latter work the following statement appears.

"The auditor's certificate or opinion should generally follow the standard form recommended by the American Institute of Accountants for the use of its members in reporting on financial statements of commercial enterprises. If the institution maintains its accounts in conformity with generally accepted accounting principles for colleges and universities, the certificate or opinion might read as follows:"

The form which follows is the standard opinion containing the words "in conformity with generally accepted accounting principles" without any qualifying or explanatory language.

When a municipality or a university properly employs the accounting procedures and forms recommended by such authoritative groups in their fields as these, it would be presumptuous, in my opinion, for us to assert that the resultant statements are not in conformity with generally accepted accounting principles. I believe this is true despite the fact that in both of these fields the procedures recommended depart in certain major respects from those applied in regular commercial and industrial fields. Even to suggest that explanatory terms such as "for college and university accounting" or "for governmental accounting" be added to the standard opinion language is unwarranted. It is implicit in the standard unqualified language that the principles employed are, in the opinion of the auditor, appropriate in the circumstances. To add such unnecessary words might be misleading in some cases.

It is significant to note that in the two special fields cited the generally accepted accounting principles recommended in the publications described were not created by the authors of those books. They grew out of practices employed in the field. The fact that they have been studied and are recommended by authoritative groups merely makes it much easier for the practicing CPA to ascertain which practices are generally accepted and are believed by representative authors in the field to result in fair presentation.

In other fields where there may not be any recognized authoritative summary of accounting principles so readily available the task of the practicing CPA is much more difficult. Here he must bring his judgment to bear in arriving at a decision as to whether the practices employed in a particular case reflect generally accepted accounting principles for that area. In doing so he should take into account his knowledge of the particular industry or institutions involved, the availability of opinions of others familiar with the field, the trade practices in use, and the materiality of any departures from the principles employed in other fields. Whenever the available information is insufficient to establish the general acceptance of the principles employed or their compatibility with a fair presentation, then, of course, the unqualified term "generally accepted accounting principles" may not properly be applied. It should be clear, however, that this is because of a lack of required information and not because the term, in itself, is not applicable to special fields.

# Conflicting Methods of Accounting For Construction Contracts

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## **The methods:**

The percentage-of-completion method recognizes that income is realized during the period of construction as work on a contract progresses, whereas the completed-contract method defers all recognition of income until the related contract is completed. A choice between these methods does not necessarily affect the underlying records of the contractor but it does affect the method of closing accounts at the end of fiscal periods, and the preparation of financial statements.

## **The nature of contracting:**

One of the difficulties in discussing any phase of the contracting business and its accounting problems is the wide variety of contracts and the equally wide variety of contractors' organizations. A contract can be almost any kind of an agreement, and we are obviously not talking about contracts of employment, lease contracts, mortgages, or any other kind of agreement which has no relation to construction. In some cases, particularly with respect to the government, manufacturing concerns enter into contracts to make and sell products in their regular lines of manufacture and sometimes products which are entirely foreign to their regular lines. These contracts may be subject to price redetermination or renegotiation, but they are not the things discussed here. Neither are cost-plus-fixed-fee contracts or any other kind of cost-plus contracts. In such cases there can be at least a general presumption that accrual of fees may be properly reflected in income as the work progresses and as costs are incurred. This is also probably true in cases of contracts involving very simple unit operations such as trucking

or earth moving where it can be clearly apparent that the service performed is related to a fee earned on a unit basis closely comparable to manufacture and sale of products.

Even after excluding the various kinds of contracts which are not subject to the problem of the percentage-of-completion method vs. the completed-contract method, there is still a wide variety of contracts to be considered. They include construction of roads, bridges, dams, buildings, subways, airports, pipelines, and ships. They are large and small and involve varying degrees of risks and uncertainties. In general, early stages of contracts seem to involve the greatest risks. Bridge building may encounter white water or defective geological conditions such as quicksand. Excavations and foundations may encounter the same difficulty. Almost all job-site construction is subject in a considerable degree to weather. There is risk of damage to adjacent properties. Work which is done underground such as subway construction is probably the most risky and the least certain of final outcome prior to completion. The smallest risks are apt to be incurred in such types of work as interior plumbing and wiring installation which is usually done as a subcontract. While the subcontractor in many cases may not face exceptional hazards, the general contractor does depend to a considerable extent on the performance of his subcontractors and this dependence constitutes one of his hazards. But typically job-site construction work involves risks which are apt to be greater than those involved in plant manufacture.

In addition to the variety of circumstances, there is considerable variety in contractors' organizations. These must necessarily expand and contract with the varying size of contracts in process. There is generally a central core of permanent organization and a large flexible organization built around each contract. Many contractors are corporations, but a percentage greater than in most other industries is unincorporated, operated as proprietorships or partnerships. When very large jobs are handled it is customary for a group of contractors to join together and form a joint venture along partnership lines. Then the various contractors, whether they are individuals, corporations, or partnerships, are themselves partners in the joint venture. Sometimes instead of such a partnership of contractors' organizations, a special corporation is formed and the various contractors involved are its stockholders. In either case such organizations generally are terminated or liquidated at the end of the contract or series of contracts for which they were formed. In many cases contractors specialize in certain kinds of work and a general contractor will perform the types of work which he prefers to do with his own organization and will sublet other types. Thus the same contractor can be both a prime and subcontractor. Contractors in such fields as electrical, plumbing, and heating installations are generally subcontractors. Those who do excavations, concrete work, and

steel erection are apt to be general contractors, but they can be either or both simultaneously on different jobs.

Typically a contractor who wishes to bid on a job will obtain the specifications and make a detailed estimate of his costs. This estimate may include subcontracts. The prime contractor will then submit a single over-all figure for the entire job, and if he is awarded the contract it will be signed and he will proceed with the work. Typically this contract which he signs will contain provisions for progress payments. Such provisions might say that on or about the tenth of each month the owner shall pay 85% of the value of the work done or materials delivered and secured at the job site based on the contract price and as estimated by the architect representing the owner. As a practical matter these provisions for progress payments would be rather difficult of implementation except in the simplest of circumstances. The custom is for the architect representing the owner to ask the contractor for a breakdown of the bid price into such major classifications as excavation, concrete work, steel erection, various subcontracts, etc. With this breakdown the architect has, for example in the first stage of the work which may be excavation, a figure representing a part of the total bid price which he can relate to the excavation. If he determines that a certain percentage of the excavation is completed he can compute the value of the work done and the amount which may be requisitioned by the contractor under the progress payments provision of the contract. The function of the progress payments is primarily to finance the construction of the project by the owner rather than by the contractor. While it does not wholly accomplish that purpose, it minimizes the financing requirements which are placed on the contractor's organization.

In furnishing the architect with the breakdown, the contractor generally allocates somewhat disproportionately heavy amounts to the portions of the work which are to be performed first. This practice obviously aids the contractor in financing the entire project. It tends to offset the retainage which the progress payments provision of the contract authorizes the owner to withhold in order to insure the final and satisfactory completion of the work. Some contractors regard this retainage as a pernicious practice and consider that the so-called loading of early stages of the contract in the breakdown furnished to the architect is a necessary defense against it. They urge that both practices should be abandoned. Regardless of the merits of such proposals the practices of retainage and loading are fairly well established, and most architects make no objection to the loading so long as it appears to be within reason. Sometimes, however, approved interim billing may be influenced by policy or even political considerations.

With respect to the loading it should be pointed out that the architect is in no position to question the breakdown furnished to him other than on

the grounds of general reasonableness. He will probably know the amount of the bids by subcontractors and for this reason loading of subcontracts is generally kept at a minimum. There is a special situation regarding what are sometimes called general conditions. These are over-all costs of construction such as superintendent's salaries, the erection of sheds and shelters and temporary fencing and lighting, etc. which cannot be specifically allocated to such divisions of the breakdown as excavations, concrete work, steel erection, etc. Some architects require that general conditions be made one of the items of the breakdown. When this is done the progress payments can be made with some relation to the incurring of the related costs. When it is not done these general costs which are apt to be incurred early are an additional reason for the loading and tend to increase the financial burden on the contractor.

Another problem regarding the financing of construction jobs which leads to loading the breakdown arises from the fact that even within a single division of the breakdown there are early or preliminary costs which are not incurred in proportion as the work proceeds. For instance in concrete work, forms and other initial costs which relate to this entire division of the breakdown are apt to be incurred in part at least before any concrete is poured. If the architect approves progress payments in proportion to the amount of concrete poured, the contractor will have to finance the early stages of this particular segment of the work even though the total progress payments for pouring concrete ultimately reimburse him for more than his costs.

Since the financing problems of the contractor are so important, it is possible that he may load the breakdown furnished to the architect so as to bill his entire estimated profit on the total contract considerably before it is completed and even to bill amounts in excess of his total incurred costs and total earned and unearned profit combined. When the contractor bills the owner for an approved drawing, he creates an account receivable on his own books. Presumably it will be paid promptly except for the authorized retainage. However, both the cash and the unpaid portion of the bill are represented in the contractor's assets. If the amount of such assets is exactly equal to the related costs of the work covered plus a proportionate amount of the over-all profit on the contract, the excess of billings over costs could be taken as representing profit earned to date. If due to loading of early stages the billings exceed the cost to date by more than the proportionate amount of the over-all profit, such excess might represent unearned profit on a portion of the work not yet performed. If, however, at any point the billings exceed not only the costs incurred to date plus the entire anticipated profit on the whole contract, that excess is in the nature of a payment by the owner in advance of work performed, and the contractor has a liability

to the extent of such advance payment. It might be argued that this is not in fact an advance payment since the owner has withheld retainage, and this might be true from a cash standpoint. From an accounting standpoint, however, it must be remembered that the retainage is included in the contractor's accounts receivable and is therefore presumed to have been realized by him. On this basis there can be a liability which should be reflected in the contractor's accounts.

A part of the contractor's concern with respect to his finances naturally relates to income taxes. Obviously the completed-contract basis defers the payment of income tax and therefore helps with financing. In view of the carry-back and carry-forward provisions of the tax law, the possibility of losses in some years and profits in others is not generally serious from a tax standpoint. For unincorporated contractors, however, irregular reporting of income may involve higher tax brackets than would be the case if the income were more evenly spread out.

For tax purposes either the percentage-of-completion method or the completed-contract method is available to contractors for contracts running for a period of twelve months or longer. For shorter contracts the taxpayer is required to use the accrual method, although just what this means with respect to construction contracts does not seem to be clearly set forth. In the case of the *Jud Plumbing & Heating Company*, the Tax Court said that the completed-contract method was an accrual method. In another case the court said that the acceptance of a finished well by a customer of a drilling company marked a completed transaction. These cases indicate that the completed-contract method is acceptable for both short and long term contracts. This seems reasonable since with respect to the short term contracts the completed-contract method closely approximates the well established accounting procedure with respect to manufacture and sale of goods, particularly where manufacturing job costs are used. Both inventories in the case of manufacturing, and costs in the case of contracting, are accumulated, and income is recognized at a point of realization marked by a sale of a completed product. In general it appears that any consistent tax method will probably be acceptable. Under prior laws the regulations made special provision permitting a taxpayer under the percentage-of-completion method to recompute his taxes for years not barred by the statute of limitations by using information available when contracts were finished. The present law and regulations are silent on this point, but it may be that the same permission is or will be available. In any case the selection of tax procedures which will minimize taxes and assist in the financing of contracts is an important consideration to most contractors.

As was pointed out earlier in connection with progress payments it is possible that a contractor has realized, either in the form of cash or accounts

receivable, sums which represent unearned profit. Under the percentage-of-completion method the unearned profit would relate to work not done. Under the completed-contract method no portion of the profit is recognized prior to completion of the contract so that any realization in excess of costs incurred except for prepayment liabilities mentioned above would be unearned profit. Since unearned profit is not taken up in income, provision is not normally made for the income taxes on such profit. This is logical with respect to the income statement, but raises a question with respect to the balance sheet. The cash and receivables or part of them are included in current assets, but the portion of these assets which will have to be paid out in income taxes when the profit is taken into account may be included in the item of unearned profit but not set forth as a liability. Thus it is possible during the course of a contract that a balance sheet may indicate a sound financial position which will be seriously impaired when the contract is closed and the liability for taxes is taken into account. This tax situation raises the question as to whether under any method balance sheet figures which represent or include some unearned income should be segregated so as to indicate the portion of it which will become a tax liability at a later date.

This consideration has no effect on the income statement itself, and if we were to be governed by the broadly general consideration that the determination of income is paramount in financial statements it might be regarded as relatively unimportant. However, contractors' financial statements are seldom used primarily as indications of earning power or as reports to shareholders. The nature of contractors' work and its inherent irregularity and discontinuity tend to minimize the significance of income statements as indications of earning power, and the fact that most contractors' organizations are rather closely held diminishes the necessity for reports of stewardship which will furnish guidance to stockholders. It appears therefore that the generality regarding the paramount nature of income determination does not apply to contractors' financial statements.

On the other hand the balance sheet appears to be all important. Contractors' financial statements are most often used for bank loans, performance bonds, and reports to municipalities and credit rating agencies. In all these situations the emphasis is on financial condition. There might appear to be a contradiction here due to the fact that construction is generally financed, not by the contractor but by the owner through progress payments. However, we are talking about different orders of magnitude. A million dollar contractor may build a twenty-million dollar building. He is not expected to finance the entire cost but he must finance the interim periods between his expenditures and the progress payments, and he must be capable of financing a loss and completing the contract if he makes a mistake or



runs into trouble. It is these financial requirements that force him to borrow from banks, to put up performance bonds, and to qualify financially for municipal projects. Thus financing is one of a contractor's major problems, and for this reason primary consideration should probably be given to statements of financial position. Segregations between items representing unearned income and liabilities either to owners or for income taxes are significant, and accounting policies should be chosen which most clearly set forth the financial condition of the contractor.

### **Special problems in the percentage-of-completion method:**

The application of the percentage-of-completion method involves several problems depending on the procedures used. Some accountants have suggested that the progress payments are so carefully checked by the architects that they form a sound basis for measuring profit. The procedure would be to distinguish between costs which relate to the last authorized progress payment and any costs of subsequent work not billed or portions of general costs applicable to work subsequent to that approved by the last architect's certificate. The costs determined as expired would be related to the revenue from billing and the resulting profit would be carried into income. The faults of this proposal are twofold: first, the difficulty of segregating costs that relate to amounts billed from those that do not, and second, the overstatement of income that would result due to the typical loading of the breakdown of contracts for billing purposes.

Another procedure for implementing the percentage-of-completion method is to relate the incurred costs at any balance-sheet date to the total original estimate. The percentage so determined could be applied to the total contract price in order to determine the portion of the revenue earned to date. The principal fault of this procedure is that it gives no consideration to deviations of incurred costs from the corresponding estimates, and the resulting percentage could be materially misleading. Thus if the portion of the work completed had cost considerably more than was estimated, the percentage indicated by the relationship of incurred costs to total estimate would be materially in excess of the percentage of physical completion.

Still a third procedure which has sometimes been suggested is to take into income that portion of the total contract price which bears the same relation to the total as the original estimate of the part of the work completed bears to the total original estimate of cost. This procedure has the merit of ignoring the loaded progress payments and does take into consideration the deviations from estimates which are represented in the incurred costs to date, since it is these incurred costs which are written off against the proportion of revenue taken into account by this procedure. It has, however, one of the disadvantages in the first procedure mentioned above,

namely, that there must be a careful cut-off of costs to correspond to the cut-off used in arriving at the percentage of the original estimate representing completed work.

A fourth procedure is to obtain a new estimate of the cost to complete each contract, at each balance sheet date. This new estimate of cost to complete is then added to the incurred costs to date, resulting in a new total estimated cost and therefore a new estimated profit. The percentage of this profit to total costs according to this latest determination is then applied to the incurred costs to date and the result is the amount carried into income. This procedure avoids some of the difficulties of other procedures, but is subject to the criticism that the determination of cost to complete for purposes of determining income is highly subjective and difficult to verify.

The conflict in rather basic theory between the last two mentioned procedures is particularly interesting. The former appears to regard the original estimate as having special validity and significance. There is an apparent assumption here that the original estimate was made with a view to a uniform profit percentage on every part of it. It follows from this view that any deviation in actual cost from the original estimate will represent an increase or decrease in income in the period when that deviation took place. Thus we might have unexpected costs in excavation due possibly to quicksand, so that under the former procedure we would record a loss at the conclusion of the excavation although the over-all contract might still be believed to be profitable and might actually turn out to be so. It is not entirely clear why the relationship among the items in the original estimate should be endowed with such special significance in the measure of income during construction.

On the other hand the last mentioned procedure apparently is based on a philosophy that the contract should be regarded as a unit even though income is being recognized on a percentage-of-completion method. There are four possible situations which could affect income determination under this procedure: Costs incurred prior to the balance sheet date could be either more or less than original estimates, and revised estimates to complete could be either more or less than original estimates. The last named procedure permits any or all of these situations to affect the anticipated profit from the entire contract, and therefore to affect the income said to be earned either during or before or after the occurrence of events or their anticipation. This unit treatment of the contract may raise a doubt as to the consistency of the philosophy that uses it in determining income according to the percentage-of-completion method.

### **Special problems in the completed-contract method:**

Ordinarily, in accounting for business income it is customary to regard

general and administrative expenses as period costs to be written off as incurred. However in the case of contractors having relatively few long term contracts, the writing off of administrative expenses could result in the reporting of losses for a year in which no contract might be closed, and it therefore appears that the deferring of all general, administrative, and possibly selling expenses, by allocation of these expenses to costs of contracts in process, would be desirable. This is comparable to the capitalization of all costs and expenses of a new company during a period of plant construction. On the other hand in the case of many short term contracts the deferring of general and administrative expenses seems unnecessary, and consideration of both simplicity and conservatism would indicate that it should not be done. Possible inconsistency between different contractors does not appear to be too serious because the difference in treatment would reflect a difference in the nature of the business. When a single contractor has both long and short term contracts the decision should be based on the predominate type of contract as to length, and should be applied consistently to all contracts.

Another problem arises in connection with the completed-contract method when a contractor adopts the policy of charging contract costs with rental of his own equipment. Customarily this rental is credited to a warehouse or rental equipment division which is charged with related costs such as depreciation and maintenance. In order to avoid violating the principle of the completed-contract method by taking up income prior to the completion of the contract, care must be exercised to see that the portion of the warehouse or rental equipment division profit related to uncompleted contracts is not taken into income. Probably the best way to do this is to reverse the portion of the warehouse or rental equipment division profit related to uncompleted contract accounts. This reversal could be made on each balance sheet date and the amounts could be immediately reinstated thereafter. Similar considerations might follow from standard charges for insurance or social security taxes which are sometimes made as accruing contract costs with corresponding credits to other accounts. Quite often these charges are in amounts greater than the actual liabilities for these costs as finally determined.

#### **Losses on contracts in process:**

One problem which both the percentage-of-completion and the completed-contract methods have in common is that of providing for losses on uncompleted contracts. A strict literal following of the percentage-of-completion method would result in taking into income the portion of such a loss incurred at any balance-sheet date but not any portion relating to the uncompleted part of the contract. A similarly strict literal following of the

completed-contract method would not take up any part of such a loss. However, if the circumstances indicate that a loss will result, the fact that the contractor is committed to sustain it indicates that provision should be made for the entire anticipated loss even though this may appear to be inconsistent with the method used for recognition of profits on contracts. The apparent inconsistency is no greater than the widely adopted one between the general practice of providing for all accruing losses, and the principle that income is not recognized until it is realized. It is most nearly comparable to the general situation with respect to firm purchase commitments at fixed prices; losses are recognized when market prices drop but unrealized profits due to rising market prices are not. The difference between the percentage-of-completion method and the completed-contract method in this regard is that the special loss provision required would generally be greater under the latter method than under the former. In either case, since the special provision for losses would not be deductible from taxable income, it should probably be computed net of its tax effect.

#### **Advantages and disadvantages of the two methods:**

The arguments in support of and against the two methods can be grouped under four headings:

1. *Regularity of income:* The chief advantage often claimed for the percentage-of-completion method is that it results in regular recognition of income or at least comparatively more regular recognition, when the income is earned, than does the completed-contract method. The desirability of regular recognition of income is somewhat minimized, however, by the facts that contractors' income, particularly in the case of long term contracts, is by its very nature irregular, however measured, and that their typically useful financial statement is more apt to be the balance sheet than the income statement. Regular recognition of income as an indication of earning power is not generally of great significance to contractors. The thought that income should be recognized as earned raises the entire question of carrying inventories or investments at cost, and the question here is whether or not contractors' accounts should constitute an exception to that general practice. It is sometimes urged that the percentage-of-completion method results in greater fairness to shareholders and possibly to employees under bonus and profit sharing plans, although it is doubtful that any greater fairness to these groups can be achieved than by placing them on the same basis as that which seems sound from the standpoint of the company.

2. *Objectivity:* The principal advantage of the completed-contract method is that the result of each contract can be determined with a satisfactory degree of accuracy and objectivity, and can be made subject to adequate

verification. It is conservative in the desirable sense in that it conforms to the well established realization postulate in accounting. A contract is not final until its completion and the later stages of the work may involve unforeseen costs and possible losses. Any basis on which income is recognized under the percentage-of-completion method necessarily involves subjective elements of judgment which are difficult of verification, and, while subjectivity is unavoidable in accounting, its minimization is always a desirable goal. To a great extent the validity of these considerations depends upon the degree of risk and uncertainty involved, and circumstances will alter cases. However, in general it is safe to say that contracting is a more than ordinarily hazardous business and therefore corresponding conservatism is appropriate. That appears to be the view of many people who are in it and of bankers and bonding companies who have served it. It is significant that bankers generally seem to prefer the completed-contract method.

On the other hand it may be that the completed-contract method permits an element of managerial caprice not possible under the percentage-of-completion method. Income can be manipulated as between years by deliberately hastening or deferring the closing of a contract. This charge is subject to two questions: (1) Whether or not it is undesirable that any business enterprise should have the privilege of timing its actual operations as it wishes, and (2) Whether the opportunities for caprice are really any greater than those existing under the percentage-of-completion method in estimating the status or future of contracts in process. It is obviously of no great importance as far as guidance to management is concerned because management knows more about the status of the contracts than can be learned from financial statements. Neither is it very important from the standpoint of income statements as indications of earning power, since most contractors are closely held and even under percentage-of-completion methods contractors' income is subject to wide fluctuations.

3. *Presentation of assets and liabilities:* One of the arguments advanced in favor of the percentage-of-completion method is that it facilitates a more meaningful presentation of assets and liabilities. The income tax liability on the profit taken into income is reflected in the accounts. Expired costs are written off and there may remain among the assets only an inventory or deferred charge relating to work not done. There may also be reflected an unbilled account receivable representing a portion of the contract price earned but not subject to billing at the balance-sheet date under the progress payments provision of the contract. The basis of computation of income earned under the percentage-of-completion method affords a basis of computing provisions for losses and of segregating any net credit balance as between prepayments by owners, unearned income, and the income tax liability related to unearned income. By comparison the completed-contract

method might be reflected by net debit or credit balances in the nature of suspense items which would not disclose these elements.

It should be pointed out, however, that the usefulness of this balance-sheet information is dependent on the accuracy and dependability of the computations by which it is developed and that similar information can be developed when the completed-contract method is used. This point is particularly significant when, as often is the case, there is difficulty in ascertaining the amount of liabilities to suppliers and subcontractors for work done which should be taken into account. Under the percentage-of-completion method omission of such liabilities results in a misstatement of both income and liabilities; under the completed-contract method the effect is limited to a misclassification of liabilities.

*4. Income tax effect:* An important consideration that influences contractors is the burden of financing construction in process. The fact that the completed-contract method results in deferring the payment of income taxes is therefore a practical advantage, particularly to corporations. Unincorporated contractors, on the other hand, may be penalized by the completed-contract method if it results in such irregular taxable income that excessively high rates are incurred. While this consideration is not an accounting problem it may have considerable weight in a decision between the two methods.

#### **Criteria for selection of method:**

In view of the great difference between various contracts and between various contractors' organizations, it appears that either the percentage-of-completion method or the completed-contract method may be the more appropriate in a given case. It is even conceivable that the same contractor might properly use one method in some cases and the other method in other cases, although in general this would not be desirable.

There seems to be little point in adopting the percentage-of-completion method in the case of a contractor who has many short term contracts. Such a contractor is closely comparable to a job-order manufacturer such as a printer whose inventories of work in process are generally carried at cost. Under either method the contractor's income would be reflected in a fairly regular manner. It is unlikely that such a contractor would be receiving progress payments in material amounts, and he would therefore not be apt to have the problems of asset and liability classification typical of contracts of longer duration. His accounting would be both simpler and sounder under the completed-contract method.

For very different reasons it would be undesirable for a contractor engaged in long term contracts which involved a high degree of risk and uncertainty to adopt the percentage-of-completion method. Such contracts might depend on unfavorable weather or ground or water conditions, or on

hostile surroundings or precarious labor relations, or on judgments without precedent or much guiding experience. Sometimes claims against contractors, even though they arise in early stages of the work, are pending in dispute or litigation throughout the entire term of the contract, and its final result might depend on their outcome. When high degrees of risk are involved the completed-contract method is the part of discretion.

In many cases contractors do not have well developed accounting systems, and reliance on internal methods must be limited. In such cases the accounting methods may be adequate for the application of the completed-contract method but not for the percentage-of-completion method. Then the choice of method should be based on the available evidential matter and that choice would generally be in favor of the completed-contract method.

There remain the cases where the term of contracts is long, generally substantially more than twelve months, the extent of risk and hazard is not excessive, and the internal methods are dependable. A great deal of building construction, some types of bridge and highway construction, and sometimes ship or power plant construction, will meet these requirements. In these cases the percentage-of-completion method is appropriate, and its advantages will outweigh its disadvantages. This is particularly true in circumstances where determination of income and indication of earning power are paramount.

As a practical matter borderline cases will be encountered in which the foregoing criteria are not clear or in which they are conflicting. One difficulty is that the long term contracts which justify the percentage-of-completion method are sometimes the most uncertain of final result. In some cases the nature of the contract may justify the percentage-of-completion method whereas the accounting methods of the contractor may not. When there is doubt the question should be resolved in favor of the completed-contract method so as to avoid the possibility of taking into income unearned profits which may never be realized.