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EXPERIENCES
WITH EXTENSIONS OF
AUDITING PROCEDURE

AND PAPERS ON
OTHER ACCOUNTING SUBJECTS

PRESENTED AT THE FIFTY-THIRD ANNUAL MEETING
AMERICAN INSTITUTE OF ACCOUNTANTS



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1940

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FOREWORD

THIS book contains the papers presented at the fifty-third annual meeting of the American Institute of Accountants, held October 13-18, 1940, at the Peabody Hotel, Memphis, Tennessee. Experiences with extensions of auditing procedure was a principal subject of discussion. This book contains, however, over forty papers delivered on a wide variety of other accounting subjects, such as audit working papers, internal conduct of an accounting practice, professional ethics, accounting education, and auditing and accounting problems of specific industries.

In order to make them available in published form as promptly as possible, three papers by Albert L. Hopkins, J. A. Phillips, and Thomas Tarleau presented at a round-table session on federal tax law and administration were published in the November, 1940, issue of *The Journal of Accountancy*. Likewise, four papers read by Lincoln G. Kelly, John W. Clarke, Willard R. Ginder, and Donald M. Russell at a session on accounting problems under national defense contracts were published in the December, 1940, and January, 1941, issues of *The Journal*. They have not, therefore, been included in this collection.

I

Discussion of Experiences with Extensions of
Auditing Procedure

Leader: SAMUEL J. BROAD

October 17, 1940

Introduction

BY SAMUEL J. BROAD, NEW YORK

Vice president and chairman of committee on auditing procedure, American Institute of Accountants

AUDITING, having perforce to keep pace with the development of business, has probably been in a constant state of development or extension ever since the first audit was made. Generically, the word "auditor" refers to one who hears the evidence in an accounting, and probably in the early stages most of the evidence was of an oral nature. As time went on more evidence was required; books became more elaborate; auditors began to go behind the books and to examine vouchers and other evidence supporting the entries in the books. This was gradually increased until auditors not only looked at data supporting the entries which were on the books, but also sought out information which might not be recorded in them. Books themselves are today regarded as prima-facie evidence of the performance of a transaction or of the existence of an asset or liability, but as little more than prima-facie evidence.

In their auditing function independent public accountants still deal almost entirely with evidence supporting the financial statements, but a great deal of our work now consists in going out for ourselves and searching out the evidence instead of relying upon evidence which may be produced for us.

There are various kinds of evidence, with varying degrees of probative value. Some of the evidence is oral and must necessarily be so. In the standard short form of report included in the bulletin, *Examination of Financial Statements by Independent Public Accountants*, issued in 1936, the statement that we "obtained information and explanations from officers and employees of the company" referred primarily to this oral type of evidence. This statement was

omitted in the later revision of the form, not because such part of the evidence was considered unimportant but, in the words of the report, "Extensions of Auditing Procedure," issued under date of October 18, 1939, because "it is inherent in all auditing procedure to obtain information and explanations from officers and employees concerning the accounts, either as supplementing information obtained from other sources or as constituting the only available information on the subject. In the latter case, the auditor must decide, in view of all the circumstances, whether he should rely upon such information without disclosure of the source. The phrase in question has led to serious misconception as to the degree of reliance on such information and explanations."

A great deal of supporting evidence is of a documentary character and some of it is obtained from independent sources. Confirmations are obtained directly from banks with regard to cash balances and loans; we inspect agreements, minutes, and vouchers, and we make direct confirmation of accounts receivable.

There is another important body of evidence which is neither oral nor documentary and which I regard as more or less circumstantial in character. Primarily, entries on the records can be considered as prima-facie evidence only. The auditor's conclusions as to the reliability or integrity of the accounts and of the supporting details are based, first, upon such tests or sampling as he may make and, second, upon the number of persons who must be involved in order to produce any material inaccuracy or misstatement in the accounts or in the details supporting them. Thus, in

Extensions of Auditing Procedure

large part our reliance upon internal check and control is based upon the belief that if a number of persons take part in initiating, carrying through, recording, and controlling a transaction, the probabilities are very strong that the transaction is a real one and is properly recorded, especially if the individuals are independent of one another.

Today one important purpose of the testing and sampling of transactions which we undertake is to find out whether the system or methods of internal check and control are operating effectively and the extent to which we are justified in relying upon them. It may be an exaggeration to say that this is the primary purpose of the testing and sampling. Nevertheless I believe the trend of our thinking is in that direction in the examination of larger organizations having personnel adequate to provide effective internal check and control. In the examination of a smaller organization more direct reliance for discovery of errors must necessarily be placed on the testing and sampling process.

Similarly in connection with our work on inventories, in the terms of the report, "Extensions of Auditing Procedure," issued under date of October 18, 1939, "the independent auditor is justified in giving consideration to the effectiveness of the internal check and control as applied not only to book records, but also to the procedure of taking physical inventories." Here again the emphasis is placed on methods or procedure by which the client takes the inventories. The auditor is one who by his training is skilled in methods rather than in materials and quite frequently his primary reliance must be on

the methods used. His training and experience do not qualify him as a general appraiser, valuer, or expert in materials, but his attendance at inventory-taking and his observation that adequate procedures which have been established are followed out strengthen the evidence on which he relies, first of all by giving him some physical contact with the assets and perhaps to some degree a layman's knowledge regarding them and, secondly, by satisfying himself that a careful inventory has been taken.

If the conditions are such that there is little in the nature of internal check and control applied in the taking of the inventory, the auditor may of necessity have to substitute his own independent check for that of others and make some test of the quantities himself. This will probably apply more frequently in the case of quite small organizations, and in these organizations such tests are probably more feasible.

Thus recent extensions of auditing procedure have all been in the direction of strengthening the evidence which the auditor examines in order to form an opinion as to the credibility of the representations, or the accounting, made by management. He requires a greater amount of positive evidence; he obtains more definite knowledge as to whether methods which have been adopted are adequate and have been actually carried out; he subjects the indirect or circumstantial evidence to a more searching scrutiny. He does this, however, within the scope of his training and ability as an accountant, thereby avoiding the dangers of undertaking work which carries him outside his proper sphere.

Inventories

BY PRIOR SINCLAIR, NEW YORK

Member of special committee on coöperation with stock exchanges, American Institute of Accountants

FROM time immemorial an important activity of merchants and manufacturers, large and small, has been a periodical "stocktaking." So important was this activity even in early days that to take stock has become an idiom of speech having a far broader application than the purely technical one implied in the taking of a physical inventory in a commercial enterprise.

As our industrial life progressed from the one-man business of local character to the present intricate business structures of nationwide activity, there arose increasing need for independent confirmation to the interested public of the representations of managements with respect to the affairs of the enterprises under their direction. Furthermore, the managers themselves were compelled to rely in turn upon the representations of their subordinates for information regarding the many phases of the operations for which they were responsible. Consequently these managers required in an increasing degree an examination of independent character.

So as business units became larger and more intricate, the independent certified public accountant acquired an increasingly important status in the world of business. Throughout all this development a considerable body of public accountants, as a matter of policy, excluded from the scope of their examinations any procedures having to do with stocktaking.

As a result of these changes and developments, the problem of the auditor's functions in relation to inventories was given intensive study, and a year ago the American Institute of Accountants approved the report of the special com-

mittee on auditing procedure entitled, "Extensions of Auditing Procedure." It is deemed desirable at this time to review the experiences of the profession in the application of the extended procedure with respect to inventories by setting forth a few of the more interesting situations which have been encountered and the methods of their treatment.

It will be helpful at this point to quote from the committee's report a few passages which seem to me to present the fundamentals of the extended requirements in respect of inventories.

" . . . in addition to making auditing tests and checks of the inventory accounts and records, he (the auditor) shall, wherever practicable and reasonable, be present . . . 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."

" . . . the independent auditor is justified in giving consideration to the effectiveness of the internal check and control as applied not only to book records, but also to the procedure of taking physical inventories.

" . . . the training and experience of an independent certified public accountant do not qualify him as a general appraiser, valuer, or expert in materials."

The purpose of these extended procedures, briefly, is to enable the auditor to express an opinion as to the credibility of the representations of the man-

Extensions of Auditing Procedure

agement regarding quantity and condition, based on personal observations, of methods of inventory taking, supplemented if deemed desirable by physical tests, having due regard for the effectiveness of internal check and control, without investing his opinion with a degree of authority or imposing upon him a measure of responsibility which the nature of his work does not justify.

The experiences of the past year indicate that the purposes of the extended procedures can be effectuated in practice. Most of the difficulties which were anticipated have been overcome by careful planning, carefully organizing the work, and by obtaining the cooperation of the clients. The subject of auditing procedures in relation to inventories has been discussed widely during the past year both in accounting literature and wherever accountants gathered. It should not be necessary at this time to repeat these expressions of opinion as to what can and cannot be done. Representative of the information already available to the interested practitioner are the papers presented at the round-table discussions in inventories held at the last annual meeting of this Institute at San Francisco and included in the book, *Papers on Auditing Procedure and Other Accounting Subjects*, published by the Institute. A more recent contribution to this subject, entitled "Experiences with Extensions of Auditing Procedure for Inventories," by C. Oliver Wellington, appeared in *The Journal of Accountancy* for July, 1940.

This discussion therefore will be confined to the presentation of actual case examples taken from practice and to pointing out how the procedures adopted fit into the broad picture of observation of methods, physical tests, reliance upon internal check, and the resultant formulation of an opinion even though the auditor is not an expert in materials. Mr. Wellington, in

preparation for the paper previously referred to, made inquiry of many different accountants regarding their experiences in the application of the extended procedure in relation to inventories, and the replies which he received have been made available to me. Grateful acknowledgment is hereby made for this assistance and the data so obtained to supplement the experiences of my firm. Liberal use has also been made of the material presented at a round-table forum held under the direction of the technical committee on inventory methods of the New York State Society of Certified Public Accountants. The proceedings of this meeting were published in *The New York Certified Public Accountant*, in the April, 1940, issue.

DEPARTMENT STORES

In some quarters the opinion exists that it may not be practicable to check physically inventories of large department stores. A few of the conditions which give rise to that opinion follow.

Stores organize their staffs to complete the work in a single day. Reserve stocks may be listed over one or more days, but an effort is usually made to complete this work before work starts on floor stocks. The auditors' tests of reserve-stock inventories must be promptly concluded to permit the release of the personnel for other inventory duties.

Stores permit no inventory activities on selling floors until after closing on the day of inventory. Personnel must have supper, sheets must be laid out on the merchandise, and work must be completed within the hours set by the labor regulations which govern the hours of work in that industry. Hundreds of people are working at top speed, and speed is highly essential.

The procedure has been tried of permitting no sheets to be "pulled" until physical tests have been completed and departments released by the auditors. Confusion resulted both for the auditors

and stores. Departments have clamored for permission to "pull" sheets while the auditors were necessarily engaged in other departments.

The net result appears to be that the number of men which can be assigned to this work within the staff limitations of even large firms and within reasonable limits of cost cannot hope to test inventories sufficiently to permit of a final conclusion regarding quantities. However, in addition to the necessarily limited physical test of quantities, it is both practicable and reasonable to undertake critical investigation of proposed methods, supplemented by attendance during the taking of inventory for the purpose of confirming that the prescribed procedures are followed.

Certain elements of internal control are inherent in department-store inventories which afford an additional basis for reliance. The merchandise of the several departments is entirely different in character. Therefore, error to be material could not be in one section of the inventory but must be in many relatively small sections. This would be impossible without collusion among many individuals. The counting and checking is done by hundreds of employees. Errors of quantity and description by a few such employees may occur and escape detection, but would hardly have a material effect upon the total. The manner in which department-store accounts are kept provides collateral overall tests of considerable value. The inventories are *finely* divided as to departments and frequently are classified as to age and season in which purchased. Rather complete records of inventory turnover are maintained as well as records of departmental gross profits.

A matter of importance in this type of inventory is the control of inventory sheets. There may be thousands of inventory sheets, and it is the custom of the trade to list in single copy only. Counting and listing is usually done by separate individuals and the work is

either completely or partially checked by others. Upon completion of listing and checking, the department heads are responsible for the assembly of the sheets and their delivery to the controller.

Some stores use independent computing agencies and forward the sheets to such agencies either immediately after they are assembled or after a lapse of one or two days during which they are reviewed for errors. Some accountants obtain independent confirmation of computed totals direct from computing agencies. The value of such confirmations is greatest when inventory sheets are promptly forwarded to the computers.

Particular attention should be paid to the methods which have been provided to guard against listing as floor stock any of the merchandise which had been listed as reserve stock. Appropriate attention should be given to the establishment of "cut-off" in the receiving, checking, marking, and returned-goods rooms as well as with respect to invoices for merchandise received and the recording of sales.

SULPHUR MINE

The problems of physical verification in sulphur mines are somewhat typical of those found when the inventory consists of bulk material stored in large piles,—for example, coal, sand and gravel, pig iron, etc.,—although the detail devices used for verification will differ in each case with variations in the particular circumstances.

Sulphur is brought to the surface in liquid form and conveyed to large wooden bins without bottoms where it solidifies. It is broken up for shipment by blasting. The determination of the superficial area covered by the bins presents no problem but the depth of sulphur in the bins cannot be measured directly, first, because the top of the pile may be uneven, and secondly, because the weight of the sulphur com-

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bined with the nature of the ground underneath forms pits of varying depth below the visible ground line.

To determine the average depth of the sulphur in each bin, members of the client's engineering staff in the presence of the auditor take test borings at various points in each bin. The estimated average height of sulphur in the bin is thus determined and the estimated cubical contents of the bin then may be computed.

Here we have both observation of methods and physical tests. A measure of internal check is provided in that the person taking the test borings and making the computations is not responsible for the financial records.

Although the auditor is not a sulphur expert, he knows that the company is engaged in sulphur mining. He has observed in the course of his contact with the engagement that the bins are used for the reception of freshly mined sulphur and has observed also that shipments are made from these bins. The material in sight and that brought up by the borings all appears to be the same. Certainly the auditor may express his opinion (as an auditor) that the quantities represented as on hand were in fact on hand on the date of his examination.

NONFERROUS METALS

The inventories of nonferrous smelters, refineries, and manufactories have some features similar to those just discussed, but they also have some marked differences. Smelters and refiners do not customarily take physical inventories at or near the balance-sheet date. Stated inventories are based on perpetual inventory records of receipts, production, and shipment. Bulk materials are stored in piles the purported contents of which are known. The piles are exhausted progressively and the book records adjusted at the time of exhaustion of each pile. A reasonable verification of such items as wire bars, copper

cathodes, etc., which are carefully stored in regular piles, can be made.

In the case of such materials as ores, concentrates, and scrap it is not practicable to check the quantities of such materials, and book records must be used. The principal safeguard lies in adjustment of book records as each pile is exhausted.

The observer should see that there is a pile for each item in the book records and he should be sufficiently experienced to be able to recognize ores as distinguished from earth or rock, or concentrates as distinguished from mud, and be reasonably certain as to the identity of most of the other materials. He will also be able to observe whether separate piles of like materials, substantially equal in quantity, appear to be of the same bulk.

When the auditor approaches the question of assay or chemical purity of the several products he is limited by his lack of qualifications as an expert in materials. He has available for collateral tests the company's assay reports during the year and invoices to customers, which may be based on assays subject, in some instances, to tests by the customer's purchasing organization and similar information. However, these are merely indicative and not conclusive. Ordinarily, the cost of independent assays would be excessive in relation to the additional protection afforded thereby, but if the amount of very high grade materials is substantial, such independent assays may be necessary.

COAL

To the extent that coal inventories are stored in piles they present most of the problems already discussed in connection with other bulk materials. Considerable reliance must be placed upon estimates of company employees not connected with the record keeping. Such estimates are compared with the related records and from actually seeing the piles an opinion may be formu-

lated as to their general reasonableness. In addition to inventories in piles, a considerable portion of the inventory may be in cars or in hoppers of known or determinable capacity. The contents of full cars may be verified by reference to railroad documents and it is usually possible to make a fair estimate of partially filled hoppers.

An added complication has been encountered in coal inventories in that at the inventory date the piles of coal were partially covered by snow. In one instance the client was persuaded to change his fiscal year to April 30th. This change to a natural business year resulted in a presentation of a more liquid financial position in addition to elimination of considerable difficulty in relation to the inventory verification.

CHEMICAL COMPANY

On occasion it has been assumed that it is not possible to form an opinion as to the accuracy of description of an inventory of chemicals except through the means of analysis by independent chemists. One accountant solved the problem of forming an opinion as to the credibility of the representations of management in the following manner: Samples of various chemicals were collected by the accountant and identified by key designations. These samples were then submitted to the client's own laboratory for analysis and report as to their identity. The laboratory reports were then compared with the inventory descriptions.

GROCERY CHAIN

The case next to be considered is that of a grocery chain which has four warehouses, some of which have a number of sub-branches and many retail stores. Perpetual quantitative inventories are not maintained.

Annual inventories are taken at the warehouses, and observation of inventory methods and physical tests present no unusual problems. The retail stores

are controlled by money-control accounts at the head office. The stores are charged, at the retail price, with the merchandise delivered to them and are credited with reported sales again at retail price. There are about two thousand retail stores, no one of which has a stock of over \$1,000. The company has its own traveling audit staff which checks the store inventories during the year. The independent accountant accompanies the company auditors on some of their visits to stores to observe methods. It is not deemed practicable, reasonable, or necessary to make physical tests at the retail stores in view of the internal control exercised by the main office. Further, it is felt that *if* the individual store is to remain in business it must have a stock on hand, and that the aggregate shortage which might exist is not likely to be material. The existence of a local bank account in which the proceeds of reported sales are deposited regularly is considered presumptive evidence that a store exists.

DIAMOND MERCHANT

Two cases involving dealers in diamonds and other precious stones have been reviewed and in both cases the accountant's report contains a complete disclaimer with respect to quality and value. In one of the above instances, physical checks of stones on hand against perpetual records were made, and stones out on consignment were confirmed, but no opinion was rendered as to the quality and value.

MANUFACTURING COMPANIES

The corroboration of physical inventories in the metal trades, woodworking industries, textile mills, etc., presents a variety of problems which frequently challenge the ingenuity of the accountant, but cannot be said to burden him with responsibilities which the nature of his work does not justify. Physical contact with the inventories may re-

Extensions of Auditing Procedure

quire an elementary knowledge of the productive processes involved, the materials used, and in general the auditor should know his way around. However, these qualifications may well be prerequisites to making an intelligent examination of the affairs of such a company entirely aside from the inventory question.

Let us consider the inventory of a concern operating a foundry, machine shop, assembly floor, and related departments. Raw materials usually may be readily identified and the method of taking inventory observed with the accompaniment of test checks. Some bulk materials may be tested by methods already discussed. The auditor will not find it difficult to distinguish between nickel, copper, aluminum, and pig iron. Although he may not be able without reliance on collateral records to distinguish between high-priced alloy steel bars and carbon steel, there are many collateral tests which may be used to satisfy one as to the general accuracy of description. An important measure of assurance is in the fact that the actual inventory taking is being done by the same employees who are handling the materials in their daily work and whose position is seldom one of confidence in financial matters. Tables of weights in relation to cubic contents will frequently assist in identifying apparently similar materials. Other tests are available. Reference to production and usage records is useful. One would expect the quantities of the various materials on hand to bear some reasonable relation to their utilization throughout the year. Stock records used solely for production and purchasing control may be available for comparison with the physical inventories. Frequently materials are marked with heat numbers or similar identification at the time of receipt. Different grades of steel may be painted with distinctive colors. A wholesale falsification of such collateral information would result in confusion to the

client even greater than that occasioned the auditor.

The identification of finished product and parts seldom presents serious problems. The descriptive names will to a large extent be clear to the auditor who is reasonably familiar with the industry. Part numbers are frequently stamped or cast on the parts themselves. Specifications and bills of material may be available.

The verification of work in process frequently presents interesting problems, especially when work in process constitutes a substantial portion of the inventory and the period of processing is long. Detailed verification of a multitude of parts on a given production order and recognition by the layman of the state of completion may not be practicable. However, the major parts may usually be identified, thus evidencing the existence of the order and possibly substantiating a considerable portion of the material component of the accumulated costs of the work in process. The verification of accrued labor and overhead to the point of completion is more in the nature of a problem of pricing than of physical test and usually necessitates an understanding of the cost system in use. In cases where work in process is priced on the basis of specification, standard or estimated costs, some knowledge of labor operations, their sequence and the ability to recognize their incidence on the product being verified is desirable. Here again the fact that the descriptive data are almost invariably supplied by the factory workers themselves provides considerable protection against deliberate misinformation.

SUMMARY

Review of the experiences of numerous accountants with extensions of auditing procedure with respect to inventories indicates:

1. Generally in only relatively few cases involving very valuable ma-

terials and under circumstances where substitution is not difficult need the accountant, due to his lack of qualifications as a general appraiser, valuer, or expert in materials, refrain from expressing an opinion as to the credibility of the representations of the management regarding quantity and condition.

2. In those industries in which it is customary to take physical inventories no instances have been observed where it is not practicable and reasonable to be present at the inventory taking and by suitable observation and inquiry formulate an opinion as to the effectiveness of the methods of inventory taking, although it may not always be feasible to supplement such observation and inquiry by tests of quantities. The extent of the accountant's contact with the inventory will be governed by the effectiveness of the internal check as applied to the taking of physical inventory.
3. In those industries in which the inventory amounts are customarily determined from book records adjusted to facts upon their determination, it is usually feasible for the accountant to examine into the effectiveness of the methods which provide for current adjustment, to make some corroborative tests and in conjunction with related operating factors and pertinent inquiry to formulate an opinion as to the general integrity of the inventory records.

In closing, it may be interesting to refer to some of the comments which were received from several accountants as to the effect upon client relationships and other matters.

The beneficial effect on client's employees when they knew their work was to be checked by outsiders was considered important and was felt to have resulted in more accurate physical inventories.

Some accountants overcame the problem of distribution of staff by shifting the inventory-taking date away from the end of the fiscal year and by establishing from the records the effect of interim transactions upon the inventory. The results were reported as satisfactory and the comment by the client was favorable.

In some instances visiting the clients about a month prior to time of inventory taking and reviewing the inventory instructions resulted in uniformity of inventory methods in warehouses and factories throughout the country, and an appreciation by the clients of the benefits derived.

As a result of quantity tests some instances were uncovered of deliberate falsification of records by branch managers.

In another case errors in physical inventory brought about a rearrangement of stock rooms to simplify taking of future inventories and to provide the management with more reliable interim information.

The impression which I receive from the reported experiences of accountants during the past year is that whereas the extensions to auditing procedure were instituted primarily in response to public demand for confirmation by some independent agency of management's representations as to inventory quantities, the greatest benefit from the new procedures will accrue to management itself. Management realizes that extension of the certified accountant's services to physical contact with the inventories results in more efficient inventory methods and a greater dependability in the reports of departments and branches.

In conclusion, from experience thus far it is evident that the necessary additional fees for such work will be more than justified by the value to clients of the services rendered.

Internal Check and Control

BY CHARLES H. TOWNS, NEW YORK

Member of committee on state legislation, American Institute of Accountants

FIRST let's try to get a common understanding as to the meaning of "internal check and control." An old story, which may or may not be based on fact, will perhaps help to bring our minds toward the general idea.

A man stood waiting for a call beside a public telephone operator's desk. A colored boy stepped into a nearby telephone booth and called a number in a residential district. He left the telephone booth door open and the man heard his end of the conversation. It ran like this: "Is this Mr. Johnson? . . . Well, Mr. Johnson, I read in yesterday's paper that you want to hire a boy. . . . Oh, you have already hired a boy. Do you think he will be satisfactory? . . . You are sure, then, that the boy you have will be satisfactory?" . . . Then the boy hung up the receiver and started out. The man who had overheard the conversation wanted to hire a boy himself so he said: "It's too bad that you weren't able to get the job you wanted." Much to his surprise, the boy said: "But I already have that job; I am working for Mr. Johnson now; I was just calling to check up on myself."

Turning to a more conventional discussion of the meaning of internal check and control, we find an excellent expression of what is perhaps the most commonly accepted view of the meaning of the phrase, in a sentence on page 8 of the bulletin, *Examination of Financial Statements by Independent Public Accountants*, published by the American Institute of Accountants in January, 1936. That sentence reads as follows:

"The term 'check and control' is used to describe those measures and

methods adopted within the organization itself to safeguard the cash and other assets of the company as well as to check the clerical accuracy of the bookkeeping."

We may consider that this sentence expresses the preventive or the protective viewpoint. A somewhat different but nevertheless a very practical and constructive viewpoint as to the purpose of internal check and control was expressed in a paper presented by Mr. S. Einstein, controller of G. Fox & Co., Hartford, Connecticut, before the Metropolitan Controller's Association on January 25, 1939. This purpose may be summarized as that of assisting in coordinating the performance of an organization with the objectives which exist in the minds of the owners and those responsible for general management; or narrowing the gap between performance and policies. In that paper the emphasis was upon the work of an internal-auditing department, but the purpose indicated need not, of course, be limited to that phase of internal check and control.

It is clearly important that the certified public accountant recognize and understand both the protective and the constructive viewpoints.

Distinction has been made recently between "internal check and control" as an expression indicating the check and control which results from so arranging the work of individuals, departments, etc., that they will serve to check and control each other but without a separate auditing organization, and "internal auditing" as the work done by a separate auditing personnel within a business organization. In what is said here the expression "internal check and control" will be used for the

most part to mean check and control without a separate auditing department. However, the work of internal auditors is not intended to be excluded entirely from consideration; where reference is made particularly to the work of internal auditors this fact will be mentioned.

STANDARDS ARE NECESSARY FOR INTERNAL CHECK AND CONTROL

The practical operation of a system of internal check and control is largely a matter of determining whether or not certain functions or results are in accord with standards set for them and, if the two are not in agreement, either taking action directly or making reports for appropriate action. It is obvious and perhaps so generally understood by accountants that it sometimes escapes attention, that, for example, if a person is responsible for determining whether the balance of the accounts-receivable controlling account bears the relation which it should to the total of detailed accounts-receivable balances, he must have in his mind as a standard the knowledge that the two amounts should be in agreement. He must have similar standards in mind with regard to other matters. These standards may run from standards of organization and clearly established responsibilities of individual members of an organization, to standards of procedure and of accuracy in making entries for stamps used or recording telephone calls. It is possible to have substantial value from internal check and control even though the necessary standards have not been reduced to writing, provided they are understood and accepted by all of the individuals who work under them. There is real and practical added value, however, in having the standards made matters of record, for the sake of clearer understanding, to supplement the memories of individuals, to facilitate learning the standards by those who are newcomers in positions in which knowledge

of them is necessary, and for other reasons and variations of reasons too numerous to mention here. Generally the larger the organization and the more people whose work relates to the standards, the more important it is to have them recorded.

As a practical matter the individual in charge of any phase of internal check and control must, in order to make it effective, know what action to take or report to make in case he finds a variation from the established standards, in addition to knowing how to find whether there has been a variation.

DEVELOPMENTS IN INTERNAL CHECK AND CONTROL BY BUSINESS ORGANIZATIONS

There has been interest on the part of directors and officers of companies, over a long period in the past, in the subject of internal check and control. A sharp upward surge in this interest has come during the past few years. The writer's experiences indicate that the increased interest in the practical aspects of internal check and control has been more marked among officials of larger companies than among those who manage smaller companies. However, there are officials of some of the smaller companies who are seriously interested in discussing the subject and in some cases they have taken steps to strengthen their systems.

Perhaps one of the best general indications of interest is the frequency of discussion of internal check and control in meetings of organizations other than of professional accountants.

As a specific example of increased interest in the matter of internal check and control, the directors of one company of substantial size, after study and consideration, recently passed a resolution fixing the duties and responsibilities of the controller. This particular company had not previously had any definite statement of the controller's duties and responsibilities.

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Another example is to be found in the case of a survey by a public accountant of the functioning of the accounting and financial personnel of a company for the board of directors. This survey and the report on it resulted in some shifting of personnel and definite progress has now been made toward the establishment, on a working basis, of uniform accounting standards throughout the various divisions of the company.

In another relatively large company progress is now being made toward having a really effective internal-auditing department, instead of one which had been inadequate. It had been inadequate in number of men in the department, to some extent inadequate from the viewpoint of training and abilities of the men, and its effective functioning had been hampered by the previous attitude of the management toward the department. There has been a progressive change in this attitude and real progress is now being made toward having more men and abler men assigned to this work.

One small company has developed a plan of preparing reports to be forwarded to owners and managers which it is expected will substantially strengthen the internal check and control. In this company policies have been clearly established by the general management but the information furnished to the general management as to the extent to which the policies have been put into effect, and the results of putting them into effect, has been lacking in some important characteristics.

Another indication of increased interest in internal check and control, on the part of others than accountants, is to be found on page 132 of *The Journal of Accountancy* for February, 1940. On that page there is a quotation from a letter signed by John Haskell, vice president of the New York Stock Exchange, under date of January 9, 1940, to the presidents of corporations having securities listed on the Exchange; the

following is one of the recommendations in Mr. Haskell's letter, which is summarized from a report sent with a prior letter dated August 24, 1939. The recommendation, as follows, is for:

"Increasing the responsibility, authority and facilities of the controller or internal auditor through the board of directors defining his responsibilities and taking an active interest in his selection. He should sign published financial statements and report periodically to the board of directors."

It may be of interest to mention here that one of the reasons for increase in interest on the part of those responsible for business management, in internal check and control, is that in some cases it has been found possible to develop methods of internal check and control with a resultant net saving because of reduction of the cost of auditing work done by certified public accountants. This is of course a development which is welcomed by all constructive-minded certified public accountants. It enables them to devote a larger proportion of their time to the more important features of auditing work and, conversely, frees them of the necessity of spending a great deal of time on work which is relatively unimportant and for which the fee should be at a low rate. Any decrease in cost of a particular item of a certified public accountant's services, so long as there is no corresponding reduction in the effectiveness of his work, obviously increases his efficiency, tends to improve the relations between the individual accountant and his client and to improve the standing of the profession in the eyes of the business community. Thus, while the direct result may be a lower total fee for a particular engagement, the over-all result is increased goodwill and broader opportunities for service. In this way the professional accountants as well as business concerns may benefit from any increase of efficiency in auditing work due to improved internal check and control.

Internal Check and Control

PROFESSIONAL ACCOUNTANTS' WORK AS RELATED TO INTERNAL CHECK AND CONTROL

The bulletin, *Examination of Financial Statements by Independent Public Accountants*, published by the American Institute of Accountants in January, 1936, contains numerous references to internal check and control. It is clearly implied in this publication that the auditor is to examine or review the methods of internal check which are in use. The thought is not definitely expressed, however, except in a few cases with respect to particular items, in the detailed audit program, that he is to make such examination or review.

In contrast with this we find the following on page 4 of the booklet, "Extensions of Auditing Procedure," published under date of October 18, 1939, by the American Institute of Accountants:

"In a well organized concern the principal reliance for the detection of such irregularities is placed upon the maintenance of an adequate system of accounting records with appropriate internal check and control. It is the duty of the independent auditor to review the system of internal check and accounting control so as to determine the extent to which he considers that he is entitled to rely upon it."

Under "Inventories" beginning on page 5 of the pamphlet mentioned, we find the following:

"In cases where the concern maintains well kept and controlled perpetual inventory records supported by (1) a complete physical inventory at a date not coincident with the balance-sheet date, or (2) physical inventories of individual items taken from time to time so that the quantity of each item on hand is compared with the inventory record for that item at least once in each year, it will be satisfactory to undertake the procedure outlined at any interim date or dates selected by

the auditor, his purpose being to satisfy himself as to the credibility of the perpetual inventory records and whether they may be relied upon to support the inventory totals as shown on the balance-sheet."

Also on page 9 in the discussion relating to the suggested form of independent certified public accountant's report or opinion, we find this statement with regard to the independent auditor's investigation of the effectiveness of internal control:

"It is worthy of repetition that the extent of sampling and testing should be based upon the independent auditor's judgment as to the effectiveness of internal control, arrived at as the result of investigations, tests and inquiries."

Furthermore, the first paragraph of the "Short Form of Independent Certified Public Accountant's Report or Opinion," as you will no doubt remember, reads as follows:

"We have examined the balance-sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate."

The point to be particularly noted in the foregoing is, of course, that the auditors, under this standard, must "have reviewed the system of internal control and the accounting procedures of the company."

Little published information is available as to the specific methods used by certified public accountants in reviewing internal check and control procedures. In some cases they are able to obtain a copy of the working manual used by the client's office and to make checks or tests of the effectiveness of

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the procedures which it sets forth. In some cases the certified public accountant makes inquiries and prepares an outline of procedure so far as it relates to internal check and control; then he makes such tests and checks of the actual operations as he considers appropriate. Some professional accountants have standard questionnaires prepared with regard to methods of internal check and control and have these filled out with answers which are considered correct at the time the audit is being conducted. Inquiry among certified public accountants and discussion with them gives the impression that there is some tendency to abandon this procedure and to have information obtained as to internal check and control without the guidance of a detailed questionnaire or outline. Only a well trained and experienced accountant is qualified to investigate and pass upon the methods and adequacy of internal check and control and there seems to be a thought that such an experienced accountant does not need the guidance of a questionnaire or detailed outline. Further, it is probably impossible for anyone preparing such an outline or questionnaire to foresee all of the features of internal check and control which it may be advisable to investigate under all conditions; yet, if the auditor has the outline there may be a tendency for him to limit his investigation to those factors which are specifically set forth.

With regard to the extent of review to be made of methods of internal check and control, we have not reached a point of standardization where we can say just how extensive the professional auditor's investigation should be in any given case. There does not appear at present to be any indication that we shall ever pass beyond the point where the extent of review to be made must be tested on the basis of the judgment of an experienced auditor. There are, of course, items of information which can be obtained by preliminary questioning

or investigation which should be used as a basis for judgment, such, for example, as the degree of standardization of procedures in the organization being examined, the purpose or purposes for which an audit is being made, and the results of preliminary tests made to obtain indications of whether the work done by the client's organization is generally of high or low quality. Information must be obtained and considered upon these matters and many others to provide a basis for judgment as to the extent of investigation to be made. It seems reasonably clear, however, that this question is one whose solution depends upon so many, varied, and to some extent conflicting points that it will never be possible to state a formula or rule which can be relied upon for the answer. In practice, the auditor decides the question a little at a time, as his review of the methods of internal check and control progresses. An unexpected bit of information obtained on the second day of his work may cause him to go back for a more extended examination of a matter which he had considered finished on the first day. Actually he does not fully decide upon the extent of his review until he has completed it.

One point which is obviously important in this connection is that of making and having readily available a record of the work done by the certified public accountant in reviewing internal check and control and of the results of that work. No attempt will be made here to go into detail as to methods of making such a record.

Another matter which is also important is that of reporting to the client upon the findings which result from the review of the system of internal check and control. Discussion of this with other accountants indicates that the usual procedure is to prepare a memorandum, separate from the auditor's report upon financial statements, stating any matters of importance which

have been noted in the review and presenting any suggestions which the auditor believes should be adopted or questions which he thinks the client should investigate. Clients have found such reports of substantial value in numerous instances.

SOME QUESTIONS AS TO THE FUTURE

No attempt will be made to prophesy as to what may be expected to develop in the work of professional accountants with reference to internal check and control. There may be some value, however, in presenting a few questions for thought and consideration. This may result in developments in connection with this subject which are more satisfactory to certified public accountants than if we allow the matter to drift or to be handled by others without bringing our thoughts to bear upon it. The following are therefore presented from that point of view and not with any expectation of obtaining immediate answers to the questions:

Is there any substantial reason for thinking that interest in the subject of internal check and control and in review of related methods by certified public accountants will not continue to increase?

Can we expect that study of the subject will result in progress toward definition and clearer statement so that professional accountants can discuss it

more readily and understandably with each other and with their clients?

Will our concept of internal check and control develop broadly to include such items as review of financial reports by men in operating departments and review of reports by general management to find differences between purposes and practices, or are we going to develop a narrower concept to include only the work of accountants and auditors in checking the accounts themselves?

Will our concept of internal check and control place principal emphasis upon the word "check" or shall we, in our thinking, give at least equal rank to the word "control" and to the more constructive features of the work as distinguished from those which exist principally for preventive purposes?

Shall we take the initiative in making suggestions to clients for increasing the efficiency of their methods of internal check and control or shall we wait until we are asked for suggestions?

Shall we endeavor to improve our work in connection with systems of internal check and control by more emphasis upon this subject in our publications and our professional meetings for exchange of ideas?

As previously indicated, there are probably no reliable answers which can now be given to these questions. If they act to some extent in stimulating thought upon the subject they will have served the purpose for which they are intended.

Experiences with Extended Procedures as Related to Accounts Receivable

BY JOHN A. LINDQUIST, NEW YORK

Member of committee on auditing procedure, American Institute of Accountants

THIS discussion is particularly concerned with experiences with the extended procedures as related to receivables. As a background for discussion it may be useful to quote what the profession through its national organization has said as to the verification of receivables in making examinations of financial statements that are to be accompanied by the report of an independent certified public accountant:

" . . . 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 . . . 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."

As applied to receivables, the extended procedure was an enlargement of the use of the process of confirmation by communication, and did not have the same degree of newness in the *generality* of application, as did general physical contact with inventories. That may have been because for many years confirmation of receivables by communication, to some extent, had been growing as a practice, although it had been the *exceptional*, rather than the *general* practice. This is illustrated by the language of the bulletin, *Examination of Financial Statements by Independent Public*

Accountants, which, in the latest edition, January, 1936, refers to confirmation by communication, in the following words:

"The best verification of [receivables] 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."

Such past agreement as the profession had succeeded in securing from business to confirmation of receivables by communication as a part of audit procedure, was probably most often induced by the effectiveness of the procedure, as a deterrent to, or method for discovery of, employee dishonesty. Only rarely, and then under circumstances making the practice *imperative*, had the procedure been particularly applied as a means for satisfying the auditor that managerial fraud did not exist in the form of fictitious receivables.

There has appeared generally to be readier acceptance by business of confirmation of receivables by communication, as normal practice, than there has been of the physical contact by auditors with inventories. This, as I have already mentioned, is probably due to the growing tendency over the years to confirm receivables by communication, and to the fact that the average executive could probably picture certain possible tangible results from the procedure that might mean dollars and cents to his

business. I mean the deterring, or detection and stoppage, of certain types of employee frauds, such as "lapping" of collections; hold-outs by salesmen making collections. Another by-product of confirmation by communication, in many cases, has been the stimulation of collections; or the uncovering of defects in customer relations, such as slow settlement of claims, the correction of which has helped to repair or rebuild goodwill and sales. Whatever the reasons, confirmation of receivables by communication, as a general procedure, did not appear generally to meet with widespread opposition from business especially if the application of the procedure was carefully correlated to conditions of doing business in line with the provision that "the method, extent and time of confirming receivables . . . be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of . . . judgment." For instance, in some cases, it was found that the terms of sale, or periods of collection, were such that effective confirmation could be secured by communication with debtors at a date some time before or after the date of the balance-sheet. Also where business executives understood the sampling principle, confirmation by communication was more readily agreed to, in cases where large masses of receivables had to be dealt with, as, among other things, it permitted the cost of communication to be kept within reasonable bounds. Sampling was something business executives could understand, because in the business world, large transactions are carried out and conclusions reached on the basis of tests made upon often relatively small samples. There were certain lines of business, however, in which considerable opposition did arise, and to these I shall return later. With the ordinary run of commercial and industrial companies, confirmation of receivables by communication, generally received assent

where discussion of the time, method, and extent of the confirmation promised an application of the procedure that appealed to managements as reasonable under the circumstances.

Both the so-called "positive" and "negative" forms of confirmation have been used. In some cases the one method is desirable to the exclusion of the other. In other instances both methods may be used in the same examination—one as to certain of the accounts and the other as to others of the accounts. Generally the "positive" form of confirmation is indicated when the accounts are not numerous and individually of substantial amount in relation to the total of receivables. The "negative" form of confirmation can generally be employed when there is a large mass of accounts, individually of relatively small amount. Both forms of confirmation may be used in the same examination, when the accounts include some of individually important amounts as to which a "positive" confirmation is desirable, together with a large mass of accounts with individual amounts relatively small, as to which the "negative" form of confirmation is satisfactory. Incidentally, the appropriateness of the term "negative confirmation" has been questioned on the ground that confirmation cannot be a negative fact. Another, and perhaps better, term that I have heard used, might be "nonreply" type of confirmation. Longer—but possibly more exact.

The negative type of confirmation appears to be well adapted for large masses of receivables, especially if the communication to the debtors is so worded to make it clear that the absence of a response will be assumed to imply assent to, or concurrence with, the account balance or other state of facts involved.

Naïve responses from debtors may sometimes be received. One interesting response made by a debtor, to a request for confirmation of the balance shown

by the books of a company that was being examined for the first time, read in part as follows (the response having been made to the company rather than to the auditor, for reasons that will become apparent as I read, although a copy went to the auditor):

"While we are confirming this item . . . as owing to your company, we are doing so at your request and as a convenience to you, with the understanding that the (items of merchandise) are actually on consignment . . ."

This response was one incident that disclosed a managerial fraud that had been going on for some time.

Previously, I mentioned that in certain lines of business very definite opposition was encountered to confirmation of receivables by communication. These opponents of the extended procedures were principally in those fields where the accounts are found in large masses that may run into tens of thousands of items of relatively small average amounts individually. Among businesses in which such a condition is met are department stores, instalment houses, chain stores, and other retailers. The enumeration is not intended to be exclusive but merely illustrative. So serious appeared the situation encountered in these fields of business that your committee on auditing procedure was requested to examine the problem and say whether the circumstances in these businesses were such as to make the procedure of confirmation by communication impracticable and unreasonable. After due consideration, that committee issued a statement which was published in the February, 1940, number of *The Journal of Accountancy*. The conclusion of the committee was:

"In the case of the receivables of department stores, instalment houses, chain stores, and other retailers, there might be justifiable question as to the reasonableness of applying the positive form of confirmation, but it is believed

that there is no question as to the practicability and reasonableness of applying the negative form of confirmation which requires no reply unless the recipient challenges the balance shown.

"It is believed, therefore, that department stores, instalment houses, and others dealing with ultimate consumers are among the cases in which the application of the negative form of direct communication with debtors, when carried out in the manner suggested in the bulletin, *Examination of Financial Statements*, is to be considered as compliance with 'generally accepted auditing procedure.'"

What appeared to be the most generally voiced objection by retail-store executives was fear that the process of confirmation by communication would not be generally understood by store customers, and would result in widespread closing of accounts by customers and transfer of their trade to stores which did not so "bother" their customers. Another often voiced objection was the factor of expected added expense. I might add it also has been reported that some business executives have taken the position that the profession had no right to adopt the procedure of confirmation of receivables by communication as normal without first obtaining the approval therefor of industry.

Apropos of the objection based on supposed retail customer displeasure and disaffection, it has been interesting and enlightening to read some reports on retail customer reactions, by controllers of stores in which the procedure of confirmation by communication was followed this year. Some typical controller comments follow:

"Very little unfavorable customer reaction was experienced and this could have been, we believe, entirely eliminated had self-addressed postage-guaranteed envelopes been included with the statements."

"... we have been very surprised at the almost complete lack of comment or

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disturbance among our charge customers."

"We had very little comment—only two or three customers wanted to know what the stickers meant on the bills."

"I do not think the store has been injured in any manner by the verification of these accounts."

"The store had no experience with customers as a result of such confirmation. We have not experienced a dozen customer calls."

"... we received no specific complaints from customers regarding the verification of their accounts."

"The confirmation apparently has had no serious effect upon our customers."

"... we experienced no serious trouble from a customer's angle."

"Our store had very little customer reaction to the accounts receivable confirmation."

And more of like tenor. From this group of more than a score of stores, only three reports of unfavorable customer reaction were received. One said:

"We have had considerable unfavorable customer reaction from this new procedure. A number of our customers received the impression that this was a dun for their account and had been sent by some outside collection agency."

Another reported:

"... we have had a number of complaints from our customers in regard to this confirmation. One of the impressions is that they ... think that we have turned the account over to lawyers."

The third reported:

"We had about twenty to twenty-five customers who resented either the sticker on the open-account statements or the letter on the budget accounts sufficiently to get in touch with us. In all these cases the customers felt that they were being dunned when their accounts were not in arrears."

Where customer reaction was unfavorable, it appeared to be principally

because the communication sent to the customer was interpreted as a "dun." It is difficult to understand how persons, who, on the whole are presumably intelligent, can place such a construction on wording such as the following:

"Please examine this statement carefully. If it does not agree with your records please report any difference to our auditors (name and address of auditors) who are making an examination of our financial statements. If no differences are reported to our auditors, this statement will be considered correct."

Such misunderstanding can probably never be completely eliminated, although it should become less as the procedure of confirmation by communication becomes more general.

Some instances have been reported of a form of communication being under consideration that will have a more personal tone, and call for replies to be made to a post office lock-box address, access to which will be confined to the auditors. As an example of such a communication to retail customers I should like to read from a form prepared by one retail store:

"Dear Patron:

"From time to time we like to find out whether the bills rendered our customers are entirely correct and whether all returned merchandise and payments have been properly shown.

"We are therefore asking that you be good enough to indicate on the form below whether or not the balance shown on your account is correct, signing your name in the space provided. Please return this form to us in the enclosed stamped envelope. We would appreciate receiving at the same time any comments that would help us to improve our merchandise or service.

"Thank you very much for your coöperation.

Cordially yours,

.....

"THIS IS IN NO SENSE A REQUEST FOR PAYMENT."

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At the bottom of the form provision is made for the customer to indicate whether the balance is correct or incorrect and space for remarks if the customer has any exceptions. The return envelopes are addressed to the store under a post office lock-box number, to which only the auditors have access. The customer statements and the confirmation forms are to be controlled by the auditors with safeguards to insure proper mailing.

Careful study of the language of the communication to debtors may reduce customer misunderstanding. Retail customers and many others may be more apt to understand an expression such as:

"As a regular procedure in their annual examination of our books, our auditors request that you report to them, etc."

This is an instance in which "examination of books" may be preferable to "examination of financial statements."

I have dealt at some length with the confirmation of retail receivables by communication, because the objections to confirmation of such receivables by communication appear to have encountered more opposition than in other lines of business.

A number of department-store organizations that did not permit confirmation of their receivables by communication, have securities registered with the Securities and Exchange Commission and listed on national securities exchanges. Auditors' reports on financial statements of such stores contained exceptions because of the omitted procedure, and I understand that the Securities and Exchange Commission has issued deficiency notices because of such exceptions. I have not heard of any final disposition of the deficiency notices, but I believe the Commission's position generally is that a report based on an audit which omitted generally accepted audit procedures as to significant items is not acceptable.

The terms "practicable" and "reasonable" have had some discussion and question as to their applicability. In its opinion in the matter of retail receivables, the committee on auditing procedure discussed the terms "practicable" and "reasonable." It may be worth while here to quote what the committee said:

"The primary meaning of 'practicable' is: 'capable of being put into practice, done, or effected, especially with the available means or with reason or prudence.'

"The primary meaning of 'reasonable' is: 'evidenced with reason, or rational, having or exercising sound judgment or sensible.'

"Rarely is a procedure impossible or incapable of being put into practice, but it seems that the auditor may view 'practicable' in the light of 'with the available means,' or 'with reason or prudence.' The operations may be practicable, but they may not be reasonable, i.e., not 'sensible' in the light of the surrounding circumstances. Notwithstanding these refinements in meaning, it is believed that there will be very few cases in commerce and industry as a whole in which the procedures cannot be applied, to the extent that will afford such tests as the auditor, in the exercise of his judgment, determines to be reasonable."

Earlier I referred to a point of view on the part of some business executives, i.e., objection to the extended procedures because the profession had not, so to speak, first secured industry and business permission for the adoption of the extended procedures. As to this point of view I should like to leave a few thoughts with you.

As auditors we are called on to express our opinion on financial statements. In so doing we assume a responsibility and a liability that we cannot avoid. It is quite apparent that increasingly higher and stricter standards are being applied in judging the adequacy of the measures which auditors

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employ in their examinations. As we are the ones who must bear the burden of defending and supporting our opinions, and proving that the opinions we express are justified, and as that is a burden that cannot be shifted to others, it is only just that we should decide what procedures we should adopt in order that we may have that basis for an informed opinion which the courts have said we must have. When the profession is to be judged by the exacting standards of today, it should be its right to determine the procedures that should be followed in order that its work may be found not wanting.

As confirmation of receivables by communication has proved generally to be practicable and reasonable, a procedure is available to us as auditors which can be used to give us added satisfaction as to the dependability of the accounts and the representations of management. No matter how effective the internal control may be represented to an auditor to be, and whatever may be the extent of his auditing tests and checks as applied to receivables, the validity of the receivables is best determined by communication with the debtors. We have discarded the theory that confirmation of receivables by communication was generally to be carried out only when we were not otherwise satisfied,

and have adopted the principle of communication whether otherwise satisfied or not as to the receivables. In this respect, we treat receivables as we do bank balances and securities. Does anyone suggest that we should do away with confirmation of bank balances by communication? We have adopted the procedure of confirmation by communication as we had come to the conclusion that it was necessary if we were to guard against spectacular frauds, because generally the spectacular frauds had occurred and gone undetected where the auditors were satisfied without the extended procedures. Should we, who must bear the burden of responsibility for our opinions, be denied the right of adopting and applying these procedures which we deem necessary?

In closing, and as a continuation of the thoughts expressed in the immediately foregoing, I would like to quote the following from an address by a member of the Securities and Exchange Commission:

"It is a more shocking case to me when, by the terms of a general audit engagement, the auditor has agreed to forego one of these normal procedures . . . An auditor who agrees not to use some of his tools is like a doctor who has agreed not to use his thermometer or his stethoscope."

Auditors' Reports

BY RODNEY F. STARKEY, NEW YORK

Member of council and executive committee, American Institute of Accountants

THE UNFORTUNATE use of the word "certificate" generally applied to accountants' opinions, or reports (if you prefer), has undoubtedly given the public an impression of accuracy and certainty with respect to financial statements which was never intended by the profession.

Our reports are essentially a combination of two opinions. The first is that after reviewing the internal check and control, and the accounting procedures followed by the company, we have carried out what we believe to be adequate auditing procedures. In general these procedures have been summarized in the American Institute bulletin, *Examination of Financial Statements*, revised in 1936 and supplemented by the pamphlet of last year on extensions of auditing procedure.

These suggested auditing procedures allow considerable latitude as to the extent, methods, and the times that the various steps outlined are to be carried out. They also leave to the individual's judgment the question of whether or not under certain circumstances some of the proposed procedures may be omitted. However, in the latter event, if fraud were to be discovered after the audit was made, the burden of proof naturally would fall on the auditor to show why any such general procedure had been omitted.

The second opinion, of course, is that based on such examination the accounts fairly present, in accordance with generally accepted accounting principles, the position at a given time, and the results of operations for a given period, on a basis consistent with that of a similar preceding period.

The first accounting reports accom-

panying financial statements usually were rather lengthy opinions stating that the cash had been counted or confirmed by the depository; that the accounts receivable, after reserves, appeared to be fully collectable; that the inventories were carried at cost or market, whichever lower; that the charges to fixed assets during a period were proper additions to the property accounts; and that the liabilities were fully provided for. These reports, however, did not contain any statements which might indicate to the public that the examination was limited to certain tests of the various accounts during the period. On the face of it, it might have been assumed that a complete examination had been made.

Accountants then, a few years later, drifted into a very short form of the so-called certificate, to the effect that: We have made an examination of the accounts of X Y Z Company and, in our opinion, the balance-sheet at a given date, and the income for a given period, fairly present the position at a given time and the results of operations for a given period.

Sometimes accountants substituted the words "correctly presents" instead of "fairly presents." In general, however, these reports also did not contain any disclaimers as to the limitations of the type of examination which had been conducted.

Perhaps we were too complacent in allowing the public at large to invest us with a reputation for a greater degree of skill and accuracy than we could possibly attain. Certainly during the development of accounting and accountancy in the first thirty years of this century very little was said publicly

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to warn investors of the inevitable limitations of our work. In short, to dispel the idea that the so-called certificate was an insurance policy.

In 1932, as you recall, the American Institute committee and the New York Stock Exchange had extensive correspondence on this general subject, and as a result a new report, or certificate, was evolved which contained the first definite statements describing certain limitations in the auditor's work on the accounts of companies so large in size that a detailed audit of all transactions was neither practicable nor possible. These disclaimers were contained in the first paragraph of this new form of accountants' report. That is: We examined accounting records and obtained information and explanations from officers and employees of the company, but we did not make a detailed audit of the transactions.

Shortly after that, following what had formerly been a fairly peaceful period, congress dropped into our laps the securities act, with its mandatory annual audits and its extremely drastic liability provisions.

After years of quiet professional endeavor, some of us realized that, quite unintentionally, we had been super-salesmen; that auditing had been oversold to the public. The first regulation regarding certificates for accountants was as follows:

"Any certificate by an independent certified or public accountant with respect to any part of the registration statement, any papers or documents used in connection therewith, shall be dated and shall state that such accountant or other expert has, after reasonable investigation, reasonable grounds to believe, and does believe, at the time of the date of such certificate, that the statements therein are true and that there is no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, except as specifically noted."

This later was modified with the cooperation of the securities committee, and a new ruling on certificates was promulgated which made it practicable to use the stock-exchange certificate of 1932.

So much stress had been laid on accounting principles and practices up to this time that the average layman still considered auditing as such to be somewhat of a mystery, and apparently believed that if the audit was successfully and honestly conducted, the results should be infallible.

True, there had been publications, bulletins and pamphlets. The first was printed in 1917 in cooperation with the Federal Reserve Bank, subsequently revised in 1929, and further revised in 1936, setting forth in general suggestions for the scope of the so-called balance-sheet examination for medium-sized companies; but the public, and the press, as was later proved, apparently never heard of it.

Only fairly recently has the question of auditing procedures begun to attract the public interest to the extent that financial writers are beginning to discuss the subject in their syndicated columns. Our professional bodies—the Institute taking the lead—and various state societies, after a great many months of hard work, adopted resolutions to the effect that in the future if we are to be held responsible we must have the right to insist upon extending certain auditing procedures beyond what had been considered generally accepted practice in the past.

At our last meeting in San Francisco, certain extensions of auditing procedure with respect to accounts receivable and inventories were adopted, after receiving approval of the New York Stock Exchange and the Securities and Exchange Commission. With this a new form of certificate was also adopted, for companies which appeared to have a satisfactory internal check and control.

It seems to me that we are now faced

Extensions of Auditing Procedure

with the difficult job of educating the public. For the first time, with the backing of the Securities and Exchange Commission and the Stock Exchange, we are in a position to insist upon the circularization of accounts receivable, with the alternative of including an exception in our opinions if prevented from doing so by the management.

For the first time, we are in a position to insist upon some physical inspection of inventory, if the opinion or certificate is to be unqualified. Heretofore, of course, unless something appeared to be wrong, we have felt it was satisfactory from the standpoint of auditing to accept both of these accounts from book records, unless, on the instructions of the management, we were asked to take additional steps.

Looking ahead, these new procedures raise a serious question. As our present report contains only two disclaimers, should it be lengthened to the point where it would become practically an audit program, or should it be reduced to a very brief statement of opinion?

Undoubtedly, circularization of accounts receivable is a great improvement. The public, however, and even some well informed financial men, may not fully realize that with an unscrupulous management the accounts could be carried in fictitious names with fictitious addresses, with the result that circularization, which would appear to be an additional safeguard, would not accomplish its purpose.

The physical inspection of inventories undoubtedly is also a forward step and will be an improvement in auditing procedure. We must not forget, however, that the public may not realize that, although an accountant has seen packages, barrels, boxes, or what-not, he is still unable to satisfy himself fully that the merchandise which he has seen actually belongs to the company. It may have been received and held on consignment, but any indication of this may have been left off the records. Further-

more, he does not know whether or not the particular merchandise which he has examined is what it purports to be.

He may also during his examination actually see some of the physical properties which, on the accounts, appear to belong to the company. He does not know, however, if this is actually the case. They may belong to someone else, although there may be no indication of this in the accounting records.

As to accounts payable of any sort, including mortgages, these may or may not be liabilities with fictitious names and fictitious addresses without any indication in the books and records that such is the case.

The larger question arises then: Should we be content to have our reports contain the rather vague disclaimers which now appear in them without acquainting the public with the other possibilities, where, as outlined briefly above, our auditing may have entirely failed of its purpose?

There is now in process a revision of the present bulletin, *Examination of Financial Statements*, including an extension of auditing procedures promulgated a year ago.

As much publicity as possible should be given to this new guide to present generally accepted accounting procedures, so that as far as possible the public may become acquainted with the extent of our examinations and also their very definite limitations.

Recently there has been some agitation to have accountants lengthen their reports. Personally, I believe this would be a step backward. A great many of us deplored the increasing number of footnotes on financial statements, because they were more apt to be confusing than helpful to the investing public. The same results, I believe, would occur if our reports were lengthened to the point where the casual reader would ignore them.

When we have accomplished our program, our ultimate goal in this respect

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as I see it, should be to attach to financial statements a dignified statement of our opinion, without needless explanations or disclaimers, somewhat as follows:

"We have made an examination of the financial statements annexed, and

in our opinion, based on tests of supporting evidence, they have been properly drawn from the accounting records of the company and fairly present the position of X Y Z Company at September 30, 1940, and the results of operations for the year then ended on a basis consistent with the previous year."

II
ROUND-TABLE DISCUSSION
Audit Working Papers

Leader: MAURICE E. PELOUBET

October 17, 1940

Introduction

BY MAURICE E. PELOUBET, NEW JERSEY

Member of council and chairman of the special committee on students' societies, American Institute of Accountants

LIKE every beginner in a public accountant's office who started about the same time I did, my early recollections are divided about equally between working papers and some variation of what Colonel Montgomery has so aptly described as the "tick and holler" method of auditing. The "tick and holler" method was certainly more monotonous than the work on audit papers but considerably less unpleasant. There was a little more certainty to it. The form, size, or placing of the tick was not open to much serious criticism or doubt and once the modulation of the holler was tuned to the senior's taste, things went along fairly well. But with working papers it was another story. The form, content and, to a large extent, purpose of their preparation was uncertain, and this fact, together with a certain testiness on the part of the seniors, without doubt well-justified, on the subject of penmanship did not help the juniors to achieve either peace of mind or efficiency.

I can remember very well my astonishment when a senior looked over my shoulder and said in a kindly tone, "That's a very pretty schedule you are preparing." I could hardly believe my ears but looked up appreciatively. He then finished his remark by saying, "Which end of the pen did you say you were doing it with?"

We have gone a long way since then and there has been a great deal of good work done in the way of improving and standardizing working papers. What we have now in the way of good standard practice is the result of the efforts of hundreds of men over a period of thirty or forty years. There is only one standard to be applied to working papers and

that is a strictly pragmatic one. If they do their work effectively, efficiently, and with the least possible effort, they are good. To whatever extent they deviate from this they are bad. The only way in which a body of practice such as is represented in what are now thought to be good working papers can be built up, is by the thought and effort of a large number of workers, each adding a little to what was known before or each making some apparently small correction or improvement.

I think the history of improvement in working papers may be said to be roughly parallel with the growth of corporations and with the growth of the demands upon them. Obviously, the larger accounting firms were the ones who would be first confronted with the necessity of preparing clear and comprehensive papers because it was those firms which had to deal with the accounts of the larger enterprises. The problems of a small audit are generally not very different in principle from those of a large one. Many things which are passed over or poorly scheduled in a small audit without making any particular trouble or difficulty would cause serious disturbance and inconvenience if treated the same way in a large enterprise. The auditor of a small enterprise when presented with incomplete or imperfect accounts by his assistant can often supply the gaps from his own knowledge or from a little personal work or contact with the proprietor of the business. Anything of this sort is, however, quite impracticable in a corporation of national scope or even in many good-sized local enterprises. The larger firms, therefore, built up in their own organizations, in the shape of office

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manuals or instructions, a body of practice which, while not uniform, tended in the same general directions.

Before there were any texts on the subject of audit working papers, this knowledge was being effectively if rather slowly diffused through the profession by men who had formerly been on the staffs of the larger firms. These men would either go into practice for themselves or join the staffs of some of the smaller firms. They would naturally bring their knowledge of the methods used in the larger firms with them and would put the results of their training into effect.

This spreading of the knowledge of what good working papers should be was accelerated by the publication of two texts on working papers in 1923, that of J. Hugh Jackson and of Leslie E. Palmer and William H. Bell. While each of these texts may be taken to represent the general practice of a single large firm, they were also representative of the best practice at the time of their publication. Since that time these texts have been revised and others have appeared, and there is now no reason why anyone required to prepare working papers supporting an audit should not be able to do so in an effective way without loss of time or effort. This, of course, applies to the supporting papers for internal audit work and for the preparation of statements by controllers as well as to the work of the independent public accountant. From the point of view of coöperation between the internal auditor and the independent public accountant the question of clear and adequate papers covering the internal audit is of considerable importance in enabling the independent public accountant to decide the nature and extent of the reliance which he may place on the work of the internal audit staff.

It seems to me that there are two basic principles or purposes which we must keep constantly in mind in design-

ing and preparing working papers which will produce the best results with the least effort. The first of these is the relation of the particular schedule or account to the completed statement or report, and the second is the inter-relation or articulation of the papers with themselves. This leads us to another point which I think it is difficult to overemphasize, that is, the necessity of basing all of our statements and reports on one set of working papers. Obviously, this is required for the greatest mechanical convenience, speed, and efficiency but it is also of value in supporting the statements rendered.

Two of the most frequent misapprehensions of the layman concerning corporate accounts are: first, that any group of subsidiary analytical or statistical statements or records is "a set of books" when, as every accountant knows, this expression means a group of books or records which are complete and self-balancing in themselves on recognized double-entry principles and, second, that the corporation keeps a number of complete sets of books for different purposes or to produce different statements. He is led into this error by observation of the undoubted fact that a corporation must prepare several different statements for different purposes. It is always valuable and convincing to be able to show that if the statements prepared for a corporation apparently vary, they are all produced by a rearrangement of the same factors or components. It is not difficult to defend different statements emphasizing different points, but it is impossible to prove that the basic facts can or should be recorded differently for different purposes.

For instance, if a plant cost \$100,000, nothing can change this fact. However, the plant might be stated with reserve for depreciation of \$50,000 deducted; it might be stated net; it might be stated gross; the \$100,000 might be used as a basis for appraisal; or an index

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number might be applied to it to arrive at some reproductive value; it might be lumped with other fixed assets where these were unimportant to the purposes of the statement; or it might be analyzed and shown under a number of different classifications. In each case, however, the statement would be based on and go back to the original incontrovertible fact that \$100,000 was spent, and no one could say, despite the diversity of presentation, that the corporation kept more than one set of books, regardless of the number or complexity of analytical or statistical records (incomplete in themselves from a double-entry point of view) which may be based thereon or related thereto.

If the corporation keeps only one set of complete double-entry books to which all other records are subsidiary or related, then we should be able to prepare any and all statements required from properly devised and coordinated working papers which summarize or analyze the corporation's books or, more specifically, which are based primarily on the corporation's general ledger and the subsidiary and analytical records which

are dependent on or related to it. However, we cannot do this unless we know when the papers are being prepared to what use they will ultimately be put. For instance, a schedule might be made for repair expense. This might be shown in the company's published accounts as included in general operating costs. In the report to management it might be divided between mills and branches and might also be divided between products or operations, and in the tax return it might be necessary, to comply with regulations or decisions, to classify some items as operating expense or labor which the corporation finds more convenient to classify as repairs. If we are not aware of the purposes for which this schedule is to be used when we are preparing it, we will either come back to the office without the information or we will duplicate in whole or in part some of our analytical work.

All of the speakers will probably touch on this phase of working papers to some extent but it seems to me so important that I am taking this opportunity to emphasize it as a basic principle.

Working Papers for Consolidated Accounts

BY A. BRYAN BOLIN, MEMPHIS

Member, American Institute of Accountants

GENERALLY speaking, when the balance-sheets of a parent company and its subsidiaries are combined and intercompany items are eliminated the result is a consolidated balance-sheet. A consolidated statement of income is produced in a similar manner. It sounds very simple, but there are complications between the working papers for the individual companies and the final consolidated statements, and difficulties may be encountered if the procedure is not carefully planned.

Before discussing the working papers required, it may be well to review briefly the steps to be taken in the consolidation of accounts, and for that purpose they are stated as follows:

1. Procure a chart showing the capital structure of all companies and their relation to the parent company.
2. Anticipate the various statements required and arrange for the necessary information to be included in the working papers for each company.
3. Adopt a tentative classification of accounts for the consolidated statements to be issued.
4. Classify the accounts of each company to conform to the classification adopted and apply the usual adjusting entries.
5. Combine the adjusted accounts of the individual companies and apply the consolidating adjustments.

When the consolidated accounts are completed, intercompany items, such as intercompany investments, intercompany current accounts, and intercompany profit in the inventory, will have been eliminated from the balance-sheet. Likewise, intercompany divi-

dends and intercompany transactions affecting the income accounts of the companies will have been excluded from the consolidated statements of surplus and income.

The purpose of consolidated statements is to show the financial position and operating results of a group of affiliated companies, as if they were a single entity with the capital structure of the parent company. When subsidiaries included in a consolidation are not wholly owned, a new balance-sheet classification is created to show the equity of minority stockholders in the net assets of subsidiaries, represented by their proportion of the capital stock and surplus of those companies.

Working papers for consolidated accounts may be properly termed the master working papers, and their preparation constitutes an audit of the original working papers for the individual companies. The accounting records examined form the basis of the original working papers on which the information contained in the books of account is recorded in condensed form. A similar relationship exists between the master working papers and the original papers for the individual companies.

The master working papers should not be merely a mechanical device for combining and adjusting the accounts, but should be sufficiently informative to support adequately the consolidated statements, taking into consideration the advanced stage to which the work has progressed. They should include summaries supporting each account classification on the consolidated balance-sheet. The extent to which detailed information in the original working papers should be brought into the master set would depend upon the indi-

vidual case and the statements required, but the master papers should be complete to the point of affording a medium for a final review and approval of the accounts by a principal, with little if any reference to the original papers for the individual companies.

The progress of the consolidation should be orderly, so as to leave a clear record from the point of beginning to the published report. While accounting difficulties may be encountered in the application of consolidating adjustments in particular cases, the main problem is usually one of mechanical procedure.

The consolidation of two or three companies does not present any particular problem and the horizontal method of using consolidating work sheets, with account classifications at the left side and the names of the companies at the top of the columns, will answer the purpose. The reverse order or vertical method, with account classifications at the top of the columns and the names of the companies listed downward at the left side, is the better form for most consolidations, as its flexibility precludes mechanical difficulties regardless of the number of companies involved.

CONSOLIDATION OF DOMESTIC SUBSIDIARIES

The mechanics of consolidation and the vertical method referred to will be illustrated by introducing a hypothetical case, and for that purpose certain pages from the book, *Audit Working Papers*, by Maurice Peloubet, have been reproduced through the courtesy of the author. These exhibits (pages 309, 310, 166, 279, and 280) present a consolidation of a group of domestic companies and show the relation between the accounts of an individual company and the consolidated statements, the mechanics of consolidation and the final result, together with an example of how more than one state-

ment can be prepared from the same papers.

Consolidation of the balance-sheets is shown on exhibit page 309 and that of the income accounts on exhibit page 310. The advantage of the vertical grouping of amounts in each classification, as a medium for a quick review of the accounts as a whole, is apparent at a glance. The expansion possibilities downward are unlimited for the inclusion of any number of companies, the introduction of subtotals by groups of companies, and the summarization of adjustments. Very little space is required for each additional company or other added feature as the measurement is by lines instead of columns.

The amounts combined in the balance-sheet consolidation represent the adjusted accounts of the individual companies transferred from similar work sheets classifying the accounts of each company. The accounts of the parent company and its wholly owned subsidiaries have been entered first and subtotals brought down before adding the company not wholly owned. Black and red figures are used for debit and credit accounts respectively. The source of the amounts for one of the hypothetical companies is shown on exhibit page 166, which sets out the classification of the accounts from the trial balance of that company and the application of the usual adjusting entries.

Consolidating adjustments have been classified as to intercompany eliminations, equity of minority stockholders, and intercompany profit in the inventory. A separate entry has been made for the total of each type of adjustments which are detailed and summarized on supporting schedules.

The same general procedure is followed in the consolidation of the income accounts on exhibit page 310 and the details will not be repeated. Consolidating adjustments to the combined income accounts include the elimination of intercompany sales and purchases,

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intercompany interest and dividends, and intercompany profit in the inventory, together with the segregation of the minority equity in the earnings for the year. Each general classification of income and expenses would be supported by detailed schedules.

The consolidated statements to be issued would, of course, be drawn up from the columnar totals on the work sheets illustrated. When a comprehensive report is required, the working papers should be arranged in such a manner that various statements may be prepared from the same papers. This feature is illustrated by exhibits pages 279 and 280, which present the composition of the consolidated balance-sheet and income account showing the consolidation in two stages, (1) the parent company and wholly owned subsidiaries and (2) the final result after adding the other affiliated company. Reference to the consolidating work sheets will disclose that the accounts of the companies were grouped to facilitate the preparation of statements of this character.

CONSOLIDATION OF FOREIGN SUBSIDIARIES

Accountants are sometimes faced with the question—"To consolidate or not to consolidate." The decision cannot always be reached until the accounts have been consolidated and carefully reviewed, and that factor must be taken into consideration in the mechanical process of consolidation. Some of the special problems of the present day are outlined in the bulletin, "Foreign Operations and Foreign Exchange," issued by the committee on accounting procedure, from which the following statement is quoted:

"The disturbed conditions abroad, and the uncertain future, make it necessary to reconsider the accounting treatment of assets, liabilities, losses, and gains involved in the conduct of foreign business, and included in the financial

statements. . . . It is clear that in many cases in which statements of foreign subsidiaries have been consolidated with statements of United States companies this practice can no longer be followed."

Procedures outlined in the bulletin cite four possible ways of providing adequate disclosure of information relating to foreign subsidiaries, but it may not be possible to determine at the outset what form of report will be appropriate. The working papers should, therefore, be designed to provide readily various statements as follows:

1. Statements of the parent company showing investment in and income from foreign subsidiaries separate from those of domestic subsidiaries.
2. Consolidated statements of domestic companies only.
3. Combined statements of foreign subsidiaries.
4. Consolidated statements of all companies, including foreign subsidiaries.

The mechanical problem of consolidating accounts of foreign subsidiaries under present conditions affords an excellent example of the flexibility of the method under discussion. The situation is met by merely grouping the companies in the downward listing, applying the necessary adjustments to each group and blocking in the group totals, and applying the final consolidating adjustments to the combined accounts. The result is a complete consolidation in the usual manner, except that the different stages of the consolidation will be clearly shown. The first stage is the consolidation of domestic companies which precedes the listing of foreign subsidiaries; the second stage combines the accounts of foreign subsidiaries and eliminates intercompany accounts within the group; and the last stage is the inclusion of foreign subsidiaries and final consolidating adjustments to produce the consolidated accounts of all companies.

CONSOLIDATION OF A LARGE NUMBER OF COMPANIES

Regardless of the number of companies being audited and the division of responsibility for the work, the consolidated accounts must in the final analysis clear through a single mind. When a large number of companies is involved the need for proper control of the material leading up to the consolidated accounts becomes very definite. The time element is an important factor as are also the mechanical balancing of the figures and the difficulty in obtaining uniformity in classification of the accounts of individual companies.

The information contained in the master working papers should be comprehensive but concise. Comparative figures and brief descriptive notes can often replace a mass of details and yet present all the information necessary for a final review.

A large enterprise may include domestic companies which can be classified into several distinct industrial groups, although they may be in kindred lines of business. It may also have widespread foreign interests, both in the war zones and in other countries not directly affected. It is desirable in such cases to combine the accounts by classified groups and provide master consolidating work sheets of the same form as illustrated, on which would be entered the industrial and geographical classifications and group totals from supporting schedules showing the composition of each group.

Some practitioners construct their working papers on the basis of a working balance-sheet prepared from the company's trial balance per books. Each item on the balance-sheet is supported by a leading schedule, the purpose of which is to group the accounts according to balance-sheet classifications. The leading schedules are followed by such detailed schedules as may be required to support the items classified.

The working balance-sheet and leading schedules are arranged in comparative form to show also the balance-sheet and its composition at the beginning of the year.

Due to the comparative features throughout the compilation, the working-balance-sheet method appears to have merit in its application to the master working papers for a large engagement. It is to a great extent only a variation of the vertical method illustrated, although work sheets of both the vertical and horizontal types are used. This method will now be briefly outlined:

The working balance-sheet for a consolidation is constructed according to the regular balance-sheet arrangement, with a column on the left side of the account classifications for the balance-sheet at the beginning of the year. To the right of the account classifications follows a column for the combined accounts of the current date, one or two columns for adjustments, and a column for the consolidated accounts.

Each classification on the consolidating balance-sheet is supported by a leading schedule on which the accounts are combined from the balance-sheets and leading schedules for the individual companies. These schedules show the listing of the companies downward and they serve the same general purpose as the form illustrated, except that more than one schedule is used. A separate leading schedule may be used for each classification, such as current assets, current liabilities, etc., or one for each item on the balance-sheet. Duplicate listing of the names of the companies at the time the work is in progress is avoided by the use of a duplicating machine in providing paper for a particular job.

Control of the accounts as a whole while the work is in progress is provided by a columnar work sheet in balance-sheet arrangement for recording the balance-sheets of the individual com-

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panies. This control sheet is not essential, but it may be used as a double check on the accuracy of the compilation and it makes available the balance-sheets of all of the companies in a convenient form.

Usually a large group of companies will have efficient accounting departments with close supervision being exercised by the parent company. In such cases the usual adjustments may be few and only of minor importance, and the master working papers may well include those adjustments in addition to the consolidating adjustments, applying both classes to the combined accounts per books.

Under both of the methods reviewed, the work of consolidation can be divided among several men, even to the extreme of using one man for each item on the balance-sheet. As stated before,

the preparation of the master working papers constitutes an audit of the original papers for the individual companies, and while a cursory review of the original papers by companies is required, the detailed review should be combined with the preparation of the master working papers.

The need of adequate working papers, both for current use and for future reference, has been well established. When consolidated accounts are under consideration it is important to be assured that the accounts have been combined in their proper classification, that they have been properly verified, and that some important point has not been overlooked in the mass of material accumulated since the job was commenced. The assurance of all of these things is the function of the working papers for consolidated accounts.

Standardization of Working Papers and Effect of Recent Extensions of Audit Procedure on Working Papers

BY M. C. CONICK, PITTSBURGH

Member, American Institute of Accountants

WHEN the chairman of this discussion on audit working papers, Maurice E. Peloubet, asked me to present my views upon the subject, "To What Extent Is Standardization of Working Papers in a Practice Possible or Desirable—and—The Effect of Recent Extensions of Audit Procedure on Working Papers Covering (a) Inventories, (b) Receivables," I was delighted to accept the invitation.

Without further ado, therefore, I will proceed with the subject, which embraces two parts—the first dealing with the practicability of standardized working papers and the second, the effect of the recent extensions of audit procedure on working papers. As to both propositions, my conclusions are that standardization of working papers in practice is not only possible but desirable if an orderly audit program is to be had, providing that such procedure is not substituted for the judgment of the auditors assigned to the job, and that the recent audit procedures with respect to inventories and receivables have brought about far-reaching effects upon the independent auditor's working papers.

I shall preface the reasoning of my first conclusion by two definitions—one of working papers and the other of standardization:

Working papers are the auditor's written record of the accounts analyzed and the procedure followed by him in verification of such accounts, which papers then become the basis of the comments, statements, and opinion presented in his report.

Standardization implies a rule established by authority, custom, or general consent; a model or example; criterion; test; in general, a definite level, degree, material, character, quality, or the like, viewed as that which is proper and adequate for a given purpose. In business, a carefully thought out method of performing a task, or carefully drawn specifications covering material or equipment.

Let us now proceed to the practical application of these definitions in the practice of accounting. While working papers may generally be described as the auditor's record of the accounts analyzed and the basis of verification, they also have certain definite limitations. For example, they are not intended to be in the nature of a codification of the auditor's responsibilities or a statement of accounting principles, nor are they an advance standardized prescription of all conceivable steps which might be covered in the audit.

On the other hand, the working papers command the thoughts of the seniors in charge in prescribing a carefully thought out method of conducting the audit sufficiently adequate to call to the attention of the men on the job in advance of the audit the essentials of the data to be listed and the inquiries to be made. If previous working papers are available, they should be used only as guides in modeling succeeding working papers. It is not at all surprising how well an experienced practitioner, if he will but give it the proper study and time, can lay out in advance of the audit a practical, com-

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prehensive, and standardized set of working papers and queries. The time and care with which this is done determine to a large measure the successful outcome of the audit. I do not wish to convey the impression that the working papers so designed and the bases of verification laid down are permanently established. This would be possible if it were not for the fact that accounting and auditing are social sciences and as such are not static. For this reason every succeeding engagement calls for additional original thinking on the part of the seniors in charge. It is evident, therefore, that standardization of working papers and audit queries, coupled with judgment, can be made both practical and desirable. Such procedure will save the time of the assistants on the job, may become a supplement to the audit procedure, and will enable the senior to review the work of his assistants more intelligently than otherwise. But, this discussion would be incomplete if, in noting the advantages, we would fail to call attention to certain of the dangers inherent in the standardization of working papers and audit queries.

To discuss this phase of the question, let me first ask if you know of any important embezzlement, manipulation of accounts, or other irregularity which was discovered through the continuous application of standard procedures. I don't. Somewhere, somebody made a change. It may be that the audit was commenced on a date not generally expected; perhaps the manipulator was away from the office on account of illness or vacation; or perchance the method of verification analysis was so changed as to enable the senior to more readily detect the hidden signal which led to the discovery. I must admit that I have never found any irregularity worthy of the name without the application of either a surprise procedure or an unexpected change of procedure.

What, therefore, must a practitioner

observe and possibly avoid if standardization in working papers and audit queries is adhered to rigidly?

1. Avoid too great familiarity with your working papers and procedure on the part of the client's employees.
2. Avoid too much reliance upon handsomely prepared papers, as the effort of your assistants in this regard may blind them to the more important phases of the audit,—although neatness and completeness are most desirable.
3. Minimize the extent to which the client's employees may be allowed to prepare certain working papers, usually permitted in the interest of economy, although economy in the cost of every audit engagement should never be disregarded.
4. Avoid too great reliance upon the completeness of your working papers as a basis of fulfilling your responsibility as an independent auditor. Your everlasting vigilance is also required, for the filling in of blank spaces on standardized working papers is apt to become mechanical and not the exercise of professional skill.

We now come to the second part of this discussion,—namely, "The Effect of Recent Extensions of Audit Procedure on Working Papers Covering (a) Inventories, (b) Receivables."

The effects I would summarize as follows:

1. A substantial increase in the volume of working papers, a major portion of which may remain with the client.
2. The character of the papers is such that little, if anything, can be done in advance of the application of the added procedures—i.e., months in advance.
3. The queries are somewhat different from former procedures; the auditor is now coming in direct contact with the physical materials in the inventory and with the client's customers through the verification notices, by follow-up letters, or otherwise.
4. The working papers are more complete with respect to comments upon

Standardization of Working Papers

the obsolete and slow-moving inventories, price variations between inventory periods, conversations with the client's workmen in the factories and warehouses on matters of inventories, markings on the materials regarding hypothecations, if any, and the warehouse receipts if so stored.

5. The extension respecting receivables

is causing more complete working papers in the matters of customers' complaints regarding the products sold to them, the sufficiency of the reserves for bad accounts, unrecorded discounts and allowances made to customers, and, in general, the actual existence of the recorded debtor.

Relation of Questionnaires and Working Papers to the Audit Program

BY FRED J. DUNCOMBE, CHICAGO

Member, American Institute of Accountants

IN ATTEMPTING to produce consistently good working papers, many accounting firms have adopted the use of various questionnaires as a part of their standard auditing procedure. These questionnaires vary as to form and arrangement but, collectively, aim to accomplish three primary objectives: (1) tentative determination of the extent and effectiveness of the client's system of internal control; (2) development of an adequate audit program, appropriate in the light of the system of internal control; and (3), a summary of the extent of the auditing tests and checks made and of observations as to the actual effectiveness of the system of internal control.

The first objective is often accomplished by the use of a questionnaire designed to facilitate inquiry as to the client's bookkeeping methods in recording various types of transactions, the practices followed in the handling of cash, and the duties performed by various office employees. It must be borne in mind that any opinions formed by the accountant based upon this questionnaire are purely tentative. They can only serve as a basis for outlining a tentative audit program which will be subject to change whenever the auditing tests performed disclose weaknesses in the system of internal control or deviations from the practices stated to be followed. Nevertheless, the preliminary survey is essential for intelligent planning of an appropriate audit program.

A written audit program which the accountant deems to be appropriate, without making a detailed audit of the transactions for the period under review, should be prepared by the supervising

accountant or principal responsible for the conduct of the audit. Frequently, such a program is embodied in, or is supplemented by, a further questionnaire. This questionnaire has for its purpose, in addition to the budgeting of time to be expended on various phases of the engagement, the creation of a permanent record for the accountant's files showing, specifically and in detail, the exact nature and extent of the auditing checks and tests performed by the accountants assigned to the engagement. The answers to the questions included therein record the operating effectiveness of the system of internal control and pertinent facts disclosed in the course of the audit relative to accounts and transactions examined.

Regardless of the number or arrangement thereof, if such questionnaires are designed and used with a view toward the objectives herein stated, they will serve to improve the completeness of the accountant's working papers, to correlate the audit program with the client's accounting policies and bookkeeping methods, and will facilitate the review of the working papers for the purpose of determining whether or not an adequate examination has been made. Moreover, the accountant will have for his files permanent and positive proof of the adequacy of his examination assuming, of course, that prudent judgment had been exercised.

Hence, the relationship of the questionnaires to the audit program may be summarized as follows:

1. The questionnaire as to the theoretical system of internal control precedes and forms the basis for a tentative audit program.

Relation of Working Papers to Audit Program

2. The questionnaire as to the actual system of internal control forms the basis for amendments of the audit program to meet the situations encountered.
3. The questionnaire as to the nature and extent of the auditing tests and checks performed amplifies the audit program by demonstrating that the audit has been made as outlined.
4. The questionnaire as to factual data supplements the audit analyses and schedules and aids in the summarization of matters to be made the subject of comment in the accountant's report or other communications to his client.
5. Collectively, the questionnaires, the audit program, and the analyses and schedules become the basis for the accountant's opinions and his evidence of an adequate examination and a fair report.

In addition to supplementary memoranda relating to matters such as corporate minutes, contracts, leases, and other agreements, etc., the accountant's working papers comprise the following:

1. Trial balances of general and subsidiary ledgers showing the status of accounts at the commencement of the audit.
2. Adjustments recommended by the accountant and incorporated into the client's records.
3. Analyses and schedules of book accounts, together with related adjustments and summaries of the contents thereof, as presented in the financial statements and notations as to matters worthy of comment in the accountant's report.
4. Completed audit programs and questionnaires as outlined hereinbefore.

With the working papers completed and adjustments applied to the trial balances, schedules showing grouping of various book-account balances represented by single items in the financial statements should be prepared.

Without such grouping schedules, showing precisely the composition of items presented in the financial statements and the treatment accorded to

every item appearing on the trial balances, the relation between the working papers and the audit report may be obscure. In fact, the working papers may become almost unintelligible and the report may not be susceptible of demonstrable accuracy.

On the other hand, carefully prepared grouping schedules become the missing link between the working papers and the audit report. By means thereof, the accountant can readily establish a definite relationship between the working papers and the audit report. The former exhibits the adequacy of the examination, the composition of the book accounts, and the client's accounting policies. The latter reflects the financial position and accounting policies of the client and the accountant's informed opinion with respect thereto.

In the case of consolidated statements, the schedules showing the groupings of items appearing on the trial balances of the individual companies are supplemented by consolidating statements showing the details of intercompany eliminations and the consolidated totals. The same principles and objectives are involved as in the preparation of reports for individual companies.

Obviously, if differently classified reports or tax returns are required for different purposes, supplemental grouping schedules must be prepared to support each separate report or tax return to the extent that different classifications occur.

In order to bring about the closest possible relationship between the working papers and the audit report, it is vitally important that the accountants engaged on the audit constantly keep in mind the purposes for which the various analyses and schedules are being made and the manner of presentation of the related material in the audit report. By so doing, much unnecessary work will be eliminated, more valuable and pertinent information will be accumulated, and better audit reports will result.

III
ROUND-TABLE DISCUSSION
Accounting Procedure and Research
Leader: GEORGE O. MAY
October 15, 1940

Introduction

BY GEORGE O. MAY, NEW YORK

Vice chairman of committee on accounting procedure, American Institute of Accountants

I DARE say some of you may feel that we haven't made as much progress as you think we should have, but we know that accountants are mostly conservative by nature—they have all fairly well established practices, and are reluctant to change them. We don't want to move without being fairly sure of our ground.

As I see our work, we have two broad objectives we must always keep in mind. One is to deal with the everyday problems and give as much help as we can to members in deciding what are the best practices current in respect to those, and the other is to take a rather broader view and see what changes in the general outlook may be called for by changed conditions—to be a bit imaginative and, perhaps, a little bold at times in striking out on new lines.

We have to try to coördinate those objectives, and I think as we study our problems, we see that the whole problem of accounting is very much the same as the problem of law—that you constantly find you have two objectives you are trying to attain, and they are in a certain amount of conflict. The problem is to reconcile conflicting objectives. We must reconcile the two broad objectives of stability and adaptability.

I have no doubt some of you read some articles in the *Atlantic Monthly*, one by an assistant Attorney General and one by a famous New York lawyer, Arthur Ballantine, on that question, in which they point to a revolution—as it is called—in the Supreme Court. They emphasize that the Supreme Court now is shifting its emphasis from stability to adaptability, and is willing to re-examine every old precedent and abandon any old principle if such change seems to it to be justified “on a purely pragmatic basis by present needs.” I think we have to proceed along those lines. At the same time we don't want to disturb anything unless we are sure we are disturbing it in the right way—that we bring about an improvement and not merely a change.

I just say these introductory words to indicate that the kind of task we face is not a simple one, and that the bulletins you see represent a lot more work than you would think had ever gone into them, because in framing them we are trying to think of other applications of the same principles that will arise in the future, and we are trying to reflect the views—or at least elicit the views—of people all over the country before we promulgate them.

Accounting Procedure and Research

BY HENRY A. HORNE, NEW YORK

Member of committee on accounting procedure, American
Institute of Accountants

ONE OF my earliest memories related to accountancy as a profession has to do with a frequently repeated comment (probably a complaint) that there were no reported cases of accounting practice and procedure. How easy it is to remember the comparison with the legal profession. With many law courts handing down many decisions; with well managed reporting services making those decisions available to all practitioners; and with large and well equipped law libraries preserving all that material in well organized classifications; it seemed that the lawyer had a great advantage over the accountant when it became necessary to back his opinion with "wise saws and modern instances."

Other professions had comparable public records. The achievements of engineers stood open to the world's inspection, and the detailed plans and specifications were matters of public information. The methods adopted to overcome construction difficulties were described in specific detail in the engineering journals. The medical profession had thousands of case histories that had been prepared in hospitals all over the land and all around the world. The results of the treatments adopted for the cure of disease were discussed in the journals of the medical societies. Much the same thing could be said about most of the work done by the practitioners of all other learned professions.

At that time it was the custom to wrap a veil of utter secrecy about the financial accounts of an enterprise. Stockholders of a corporation got only the barest outlines of the operations of its affairs and, generally speaking, out-

siders got no information. The auditors and accountants of the corporation had an obligation then, as now, to preserve absolute silence as to all confidential information that they had.

Few corporations published the reports of their auditors. The auditors had little recognition in the annual reports of corporations. Often the form of the financial statements was decided by the corporation's bookkeeping department without reference to the auditors.

The only published discussions of accounting principles, practices, or methods, were those contained in the few textbooks then available. Those were mostly of British origin and considerable mental reconciliation was needed before those books could be used as guides for American practice. When Robert Montgomery needed a textbook on auditing for his classes he found it necessary to rewrite for American students the book published in London that had been written by Lawrence Dicksee.

Perhaps those memories have dominated our thinking on this subject in all the intervening years. Certain it is that there has been a great deal said, for a long time, about a code of accounting principles, but until very recent years nothing much has been done about it.

The reorganization, in 1916, of our national professional society as The American Institute of Accountants was the outcome of a courageous movement to uplift all the standards of the profession. The new organization was only one year old when a committee on procedure was organized. For several years it was continued. Some of our very best men served as members of the committee during successive years. They took time

out of their busy lives to consider and decide on the questions of accounting procedure that were referred to them through the office of the Institute. They did not, on their own motion, initiate inquiries and no attempt was made to assemble a code of principles or procedures. In 1920 a committee on accounting terminology was appointed.

During the latter part of the decade of the 1920's, the committee on procedure became inactive and was dropped from the list of Institute committees. It is probable that the reason was that new methods had been adopted for doing the work formerly done by the committee. Inquiries about accounting procedures that came to the office of the Institute were referred by the staff to a small group (half a dozen or so) of eminent accountants. They were selected from a rather large list of members of the Institute who were willing to give of their time in considering and deciding questions in the accounting fields in which they had special aptitude and experience. Some of the more important inquiries and the answers (often somewhat divergent) were published in a series of special bulletins for the information of the entire membership of the Institute.

As need appeared, special committees were appointed to consider some particular questions that arose from time to time. An example is the special committee on definition of earned surplus appointed in 1929. Those special committees and the successive committees that worked on the very difficult terminology assignment were the channels through which the Institute gave opportunity for expression of opinion concerning changes in emphasis about accounting matters.

At the 1930 annual meeting, the council reported that a new committee had been appointed. The report stated:

"A special committee on accounting procedure which will undertake to study and render reports on matters of vital

importance to the whole profession was appointed during the year. This committee is composed of eminent practitioners and its conclusions should be of great assistance to accountants everywhere in furnishing a basis for standard practice in circumstances where there is no uniformity. The first question to which the committee turned its attention was that of stock dividends."

The 1933 *Year Book* reported the appointment of a special committee on development of accounting principles. This committee was composed of the chairmen of all the committees that might find it necessary to express judgment on matters of accounting principle. They were the committees on coöperation with stock exchanges, with commercial bankers, with investment bankers, and with the Securities and Exchange Commission, and the committees on professional ethics, education, and accounting procedure.

The two special committees were discontinued in 1936, and thereafter the standing committee on accounting procedure assumed the duties of both of the former special committees.

Enough has been said to make it clear that the Institute knew that there was a need. Also, that the method of supplying the need had not been found.

At the first meeting of the 1937 committee on accounting procedure the chairman, George O. May, proposed that the committee depart from the previous practice of awaiting questions, and that it proceed to give consideration to matters within the scope of its authority on its own initiative. This was the first step toward the work in which the committee is now engaged. The committee adopted the suggestion. A new vitality appeared in committee work and in decisions. At the end of that year the report made in September, 1938, by the committee to the council contained the following suggestion:

"Another more ambitious suggestion is that the Institute should create, un-

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der the control of a somewhat enlarged committee on accounting procedure, a research department for the purpose of preparing studies on particular questions. . . ."

The council approved the "ambitious suggestion." It was apparent that it would require financing outside of the regular Institute budget. Farsighted members of the Institute who recognized the long-term gain that could come from the work of the research department provided the funds that were needed immediately. Contributions came from individual practitioners, from small firms, from large firms. The committee acknowledges gratefully this financial assistance. In addition to giving money the committeemen gave their time.

The committee was enlarged to twenty-two members, selected to give a broad range of viewpoints.

At the initial meeting of the enlarged committee the chairman outlined a program of such intelligent inquiry that the entire committee became enthusiastic. Some of the men on the committee are primarily engaged in accountancy education. To them the outline of the work proposed for the research department seemed like the dawn of a new day. Listening to their approval and expressing my own, I felt moved to quote from John Keats' poem—

Then felt I like some watcher of the skies
When a new planet swims into his
ken;
Or like stout Cortez when with eagle
eyes
He stared at the Pacific and all his
men
Look'd at each other with a wild sur-
mise
Silent, upon a peak in Darien.

It was natural that the accountancy educators should welcome the advent of the research department. They had been advocating it for years. In 1932, Eric Kohler had an article in the *Accounting Review* entitled "Needed: A

Research Plan for Accountancy." Later in the same year, Howard Greer had an article on the same general subject in *The Certified Public Accountant* (magazine).

RESEARCH DEPARTMENT

Early in 1939, the research department was organized. Wisely, the committee decided that it should be headed by an educator, not by a practising accountant. Parenthetically, it seems appropriate to quote from an address made by Professor Sidney Winter at the May, 1939, institute on accounting held at Ohio State University. Professor Winter was speaking of methods of developing a statement of accounting principles, among which methods he mentioned the possibility of the issuing of a set of pronouncements by our Institute. He went on to say:

"The objections to the issuing of pronouncements by an organization such as the American Institute of Accountants may not be so wholly obvious. Nevertheless, they seem to exist. Of necessity, the Institute must represent primarily the accounting practitioner. To this extent its pronouncements are biased. I do not overlook the fact that individual members of the Institute, as individuals, may be most willing and most able to render most helpful service to the government, to bankers, to investors, or to any other group, in a limited and reasonably objective way, but I cannot imagine these same individuals representing the Institute without regarding most subjectively the welfare of the accounting profession which the Institute is incorporated to represent. Those who from time to time direct the affairs and express the attitudes of this organization may in many instances view matters with considerable objectivity and from long range, but they are handicapped in that they must respond in greater or lesser degree to the opinions of the rank and file, opinions of those inclined to view with some alarm any proposals which apparently threaten to disturb established procedures. Prob-

ably the greatest misfortune in this connection is the tendency to glorify practice—to contend that what *is* must be good because it *is*. It is not unlike the contention that the king can do no wrong. And just as sensible! It would seem that neither the public nor the regulatory authorities are going to have any patience with this type of approach."

I have quoted at this length to show the type of reasoning that led to the selection of Dr. Thomas H. Sanders, of the Harvard Graduate School, as the director of research. During the first few months of the operation of the department, while Dr. Sanders was in England on another engagement, the directorship was filled by Professor W. Arnold Hosmer, also of the Harvard Graduate School.

The Institute has tried to select the members of the committee on accounting procedure from that group of accountants described by Professor Winter as those who can "view accountancy matters with considerable objectivity and from long range." The coördinator of all research activities submits all programs and all proposed bulletins to the full committee. There is no disposition to adhere to an accounting procedure merely because it has been done that way in the past. In fact, the basic inquiries are, first—How has this situation been met in past practice? and secondly, Why? The answer to the second part of the question determines the content of the bulletin that results from the inquiry.

Though in my early days in accountancy there was very little published material available for case studies, that is not the situation at the present time. For abstract discussions we have a great variety of accounting textbooks and a number of periodical publications of which *The Journal of Accountancy* and the *Accounting Review* are representative. The reports of Institute committees printed in the yearbooks and

reports by committees of the state societies of certified public accountants are useful. For concrete problems and their solutions there are numerous decisions in tax cases by the United States Board of Tax Appeals, the circuit courts, and the Supreme Court. Tax decisions often need to be considered carefully because they apply primarily to taxable income (a statutory concept) but taxable income must in any event be "income" or it cannot be taxed by the federal government. Other court decisions are available for study on a variety of detailed subjects that fall within the scope of accounting procedure.

Also, there have been reports, pronouncements, classifications of accounts, and rulings, by a great number of governmental agencies, including among others, the state public service commissions, the Interstate Commerce Commission, the Federal Communications Commission, and the Securities and Exchange Commission.

And finally there has become available a long series of reports by corporations to their stockholders, progressively becoming more informative, and constituting a body of recorded accounting practice (often with reasons given) that is very useful as research material.

There is a temptation at this point to attempt to tell how the research department goes to work on its problems. But there is not time for that, and it might not be interesting.

Also, there is a temptation to talk about the way in which the vice chairman of the committee and the research director manage to squeeze out of the time of the busy committeemen a careful and reasoned consideration of the projects presented. Dr. Sanders has an article in the March, 1940, *Accounting Review* that tells the story much more adequately than would be possible for me. It may be helpful to state that a rather flexible plan of appointing subcommittees to work on separate proj-

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ects has been adopted. I say "flexible" because if it appears that results are not forthcoming from a delegation of a particular project, the same task is taken up otherwise.

QUESTIONS DISCUSSED

At the outset it was realized that the committee could not possibly produce a complete body of doctrine as to accounting procedure at one stroke.

It was determined that a beginning should be made. It was decided to study matters on which there seemed to be differences of opinion, with substantial logic in support of each of the various shades of opinion. The discussions of those subjects would, it was hoped, bring into the foreground the basic concepts or principles that were believed to justify each of the variations in practice. To a very great extent this has occurred.

You know about the research bulletins that have been issued. Briefly, I remind you that they were on subjects as follows:

1. General introduction
2. Unamortized discount and redemption premium on bonds refunded
3. Quasi-reorganization or corporate readjustment
4. Foreign operations and foreign exchange
5. Depreciation on appreciation
6. Comparative statements

The committee has not finished with the depreciation on appreciation subject. If appreciation has been entered in accounts and as the result thereof there is in existence a credit account purporting to be an "appraisal surplus" or something similar, the question as to its ultimate disposition is still before us. There are those who hold that it should be carried in that form indefinitely (the usual phrase is that it should be "frozen") unless it be transferred to capital stock by the declaration of a stock dividend. Others believe that it should be transferred gradually to

earned surplus in the amounts annually computable as the *realization* of appreciation through depreciation allowances.

There are three subjects now actively under discussion. They are:

1. Merchandise inventories
2. Accounting for stock dividends
3. Accounting for stock options issued to officers and employees

Research bulletins should be issued on each before long. The most progress has been made on the subject of merchandise inventories and a preliminary statement appears in the October, 1940, issue of *The Journal of Accountancy*.

The two other subjects are not as well advanced, but both have been debated in a meeting of the entire committee.

STOCK DIVIDENDS

The subject of the accounting treatment of stock dividends has been considered as related to (a) the books of the issuing corporation and (b) the books of the recipient.

As to the accounts of the issuer, it was agreed that fundamentally stock dividends have two characteristics—either a split-up which has *no* effect on corporate surplus or an impounding of surplus, resulting in an increase in the statutory capital stock. In the latter case it is within the discretion of the directors, subject to the controlling statutes, to determine how much shall be impounded.

The committee is not altogether agreed as to the accounting for the stock dividend in the books of the recipient.

My own opinion was tersely expressed in an answer to a memorandum prepared for the committee by the director of research, in which appeared this question:

"Are there cases in which the receipt of stock dividends gives rise to a credit to income? If so, what cases?"

The answer that I penciled in the

margin was "Not until there is a new definition of income."

One of the most satisfying evidences of the objective approach adopted by the committee that I can think of occurred in the course of the debate on this subject when, after groping around for all the ideas that could be thought of as possibly justifying the crediting of some amount to income on account of the receipt of a stock dividend, one of the committeemen arose and said, "Gentlemen, let us have done with sophistry. We all know that a stock dividend is not, never was, and never will be, income."

That certainly is my opinion, though it was not I who stood up boldly to say it. Some persons seem to believe that a dividend distributed in another class of stock may be thought of as income. I do not. I think that preferred stock is *not a debt* but is a participation in *proprietorship*. When preferred stock is issued as "a dividend" no assets have been separated from the corporate property and distributed to the stockholders. Those stockholders have only some more pieces of paper.

Those who argue that the stockholder must have received income because he received something that he can sell seem to overlook the fact that if a corporation has earnings it is probable that the market price of the stock has increased ratably with the accumulated income, and hence is salable at a greater price. But the stockholder does not think he has received income if he does not choose to sell his stock. Why should he suddenly think he has received income merely because he has received an additional piece of paper to represent his unchanged investment in the company.

BASIC CONCEPTS

I stated earlier that it was hoped that the discussion of the accounting principles that should be controlling in specific fields of application would cause a clearer understanding of the basic con-

cepts of accountancy. To as great an extent as was expected this has occurred. Perhaps it will be useful to speak of some of the thoughts that have been before the committee with respect to two of our basic principles, namely, (1) the distinction between capital and income and (2) the principle of conservatism.

CAPITAL AND INCOME

The opening words of the book, *A Statement of Accounting Principles*, by Professors Sanders, Hatfield, and Moore, are "Since the distinction between capital and income is fundamental in accounting and in business, it is desirable to set forth working definitions of these terms."

There the difficulty begins. Economists, lawyers, and accountants are supposed to be informed on matters of capital and income. But each of those professions has its own definitions of both. Accountants have become accustomed to using the word "capital" in at least two senses. The phrase "capital assets" is indicative of one direction of thinking. In another sense it is said that "capital . . . refers to the owner's equity in . . . property."

The book, *An Introduction to Corporate Accounting Standards*, by Professors Paton and Littleton, adopts a different method of presenting the fundamentals of accounting. Those authors think primarily of a corporation as an entity in its own right entirely separate from its creditors or its proprietors. With that in mind they suggest that the process of accounting that is useful to that separate business entity is "a periodic matching of costs and revenues."

This method of thinking is in line with that expressed by Professor Winter, then president of the American Accounting Association, in the discussion at the 1939 institute on accounting of Ohio State University. He said in part:

" . . . by definition you could say that accounting is a discipline of some sort

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which has for its purpose this: The recording of costs; the allocating of those costs over a useful life. As that allocating of cost over a useful life goes on, you attempt to match against those costs revenues which have come into the business. If you have more revenues than costs in this matching, you have income; if you have more costs than revenues, you have lost something. That is accounting."

It seems to me, that if I had the obligation of instilling basic concepts in the minds of young men who were taking up the study of accountancy—and of doing it in the shortest possible time—I should prefer to adopt the method suggested by Professor Winter.

Those of us who studied under Professor Joseph Hardcastle and who absorbed the philosophy of accounts from Charles Ezra Sprague felt that we had "come up the hard way." Probably, however, we were thoroughly grounded and are not led astray too quickly by fallacious reasoning. But I recall that later when I read in an outline of a college accountancy course a description of its having been founded on the simple formula "Assets minus Liabilities equal Proprietorship," it seemed like an attractive way of thinking about the matter. The phrase, "the equation of the balance-sheet," was useful as a starting point for many discussions.

However, this seems to have placed too great an emphasis on "proprietorship." That emphasis has infected our thinking. Along with that ever-present thought of proprietorship has gone the phrase often heard in pseudo-legal discussions, "the corporate fiction." Perhaps these ideas explain why some people believe that a stockholder has received income when he has received a stock dividend. Let us stop thinking about "the corporate fiction" and give some attention to "the corporate fact." So long as a corporation is a separate legal entity (and that will be a long time) no stockholder will receive in-

come from the corporation until the corporation distributes to the stockholder some of the corporation's separately owned assets.

The thought of proprietorship by the stockholders seems somehow to have been behind the weird idea that treasury stock can be an asset of a corporation. It seems too clear to require any words of explanation that a corporation cannot have, as *its* asset, a piece of itself. Acquisition of treasury stock cannot be anything other than a reduction of "economic capital."

CONSERVATISM

During the time when most published statements of account were prepared for grantors of credit it was natural, and perfectly proper, to submit balance-sheets in which there was evidence that overstatement was scrupulously avoided. The emphasis in such cases is very strongly on the amount of net current assets.

Recently, it has been declared that the most important purpose of corporate financial statements is the indication of prospective earning power.

The conservatism that, applied to a balance-sheet, shows the net assets at a low amount may be the reverse of conservatism in relation to the next fiscal period when realization of those assets is effected.

As an example, there are those who, in the name of conservatism, claim that merchandise inventories should be carried at the lower of three amounts describable as follows: (1) cost; (2) realizable amount; and (3) replacement cost. This means simply that the past period of time shall be charged with a loss not realized in order that a future fiscal period shall be able to realize a profit equal to the difference between the realizable amount and the replacement cost.

Conservatism does demand, when it is probable that part of the cost cannot be realized on sale, that such unrecov-

erable cost shall be charged off as a loss, but in my opinion there is no justification for using conservatism as an excuse for the writing down of assets to so low an amount that profits on realization in future periods are assured.

These comments often apply with particular emphasis when there has been a change in management of a corporation's business. The new manager wants to give himself a running start, and he proceeds to advocate a drastic writing down of the corporation's stock-in-trade (merchandise, marketable securities, etc.). The excuse is "conservatism" but the reason is personal self-interest.

Comparable with this is the suggestion occasionally heard in the early 1930's, that if the entire cost of a manufacturing plant were charged off to accumulated surplus a very conservative balance-sheet would result, in which the plant would be shown at the nominal amount of \$1, in the same manner as the patents, trade-marks, goodwill, and other intangible assets. Privately, one of the alleged merits of the suggestion was stated to be that thereafter there would be no need for the charging of depreciation to the cost of manufacturing.

Accountants are agreed that dis-

count on bonds should be amortized against income concurrently with the periodic charges for interest on the bonds. Some harsh words have been said about the dishonesty of income statements in which the interest deduction is shown at only the amount payable on the bond coupons, because previously the bond discount had been charged off to surplus. It is much more important that all the costs of manufacturing and merchandising (cost of goods, depreciation of plant, etc.) shall be included in the profit-and-loss statement than that the cost of borrowed capital shall be shown in its full amount.

I have deliberately selected some provocative subjects. There are arguments pro and con.

For example there are investment companies which have very real problems in respect of their receipt of stock dividends. They want to be guided in a practical way.

We have members of the Institute who think of conservatism in relation to the balance-sheet only, and who give never a thought to conservatism as related to future profit-and-loss statements.

I believe that the discussion at this round-table session will help us all.

Recent Accounting Research

BY HENRY T. CHAMBERLAIN, CHICAGO

Member, American Institute of Accountants; Secretary,
American Accounting Association

THE TERM "research" is a high-sounding word which connotes seriousness of purpose, objectiveness, and freedom of thought. It may be defined roughly as a quest for new knowledge, or as the analysis of known facts and the organization of those facts so that they may be viewed in their proper perspectives. The interest of accountants is in analysis and organization; the profession is not seeking new discoveries but is attempting to dissect and synthesize theories and practices long known, so that they may be more solidly related.

Only a small percentage of the annual output of "research" studies can be classified as serious research. Tabulations and surveys are turned out in wholesale lots, but rare and precious are those studies which have the penetrating characteristics of analysis, organization, and perspective. I have difficulty in developing an interest in studies which report that 50 out of 300 companies carry treasury stock as an asset while the others show it otherwise, or that a certain number of companies deduct reserves for depreciation from the assets to which they apply while others show them as liabilities or not at all. Nor am I impressed by surveys of practice which present all sorts of alternative treatments without bothering to analyze underlying principles. When one encounters studies of these types, one is reminded of the nursery rhyme that "some like it hot, some like it cold, and some like it in the pot nine days old."

Early in 1938, the American Institute of Accountants distributed to its members a booklet entitled, *A Statement of Accounting Principles*, by Professors

Sanders, Hatfield, and Moore. A better title might have been, "A Survey of Accounting Practices." It was not put forth as an official pronouncement of the Institute, but it could not help having a far-reaching effect on accountants. The authorship of the book has called for, and I am sure it has had, a "wide and respectful hearing"; but because of distinguished authorship there is a call for vigilance, lest we adopt or tolerate unjustifiable practices on the strength of the authors' names. I can agree with many of the statements made in the document, but there are a large number that disturb me. In the time allotted here, I should like to refer to some of those disturbing elements.

CAPITAL GAINS AND LOSSES—CHARGES AND CREDITS TO SURPLUS

On page 25 of the Sanders, Hatfield, and Moore document, the following statement appears: "... the income statement exhibits the extent to which the proprietorship has increased or decreased during the fiscal period, with the exception of: (a) additional contributions by stockholders or others, (b) returns of capital contributions, and (c) other exceptional increases and decreases discussed under 'Capital Gains and Losses.'" From this statement it appears that what we have come to call capital gains and losses are to be excluded from the income statement, while dividends which are a distribution of income and not a return of capital contributions are to be included. Then on page 27, the authors, speaking of the division of the income statement into an operating and nonoperating section, have this to say: "This section (the nonoperating section) . . . should

include such items as profit on sale of capital assets." Here capital gains should be included in the income statement, but no mention is made of losses from the sale of capital assets. Reading on to page 38 we encounter the following: "So-called 'capital gains' and 'capital losses' are conspicuous examples of occurrences affecting the asset values of a business enterprise for which accounting practice discloses no generally followed or standard method of accounting. The principles which should determine how such losses or gains should be accounted for are discussed in that section of this report which deals with conservatism in accounting. Whether such gains or losses should be wholly included in the current income statement, wholly excluded from all income statements, or apportioned among the current and succeeding income statements, is a matter to be determined by sound business judgment, made upon all the facts of the particular case guided by the principle of conservatism." The authors go on to tell us that when sound business judgment dictates the exclusion of a capital gain or loss it is *proper* to carry it as a deferred charge in the balance-sheet. How can a capital gain be reported as a deferred charge? What asset characteristics are present in a loss sustained to warrant its being shown among the assets? Are the dictates of sound business judgment those of an independent accountant or of an interested management? I would be glad to get answers to these questions.

I see no excuse for all this pussyfooting. A capital gain or loss is an item to be dealt with in the income statement, not, to be sure, as an addition or deduction in arriving at the net results from operations, but rather as a nonoperating addition to or deduction from such results. The objection that net income will be distorted if the gains or losses are material in amount strikes me as being disingenuous. All accountants agree

that the income statement is important and all agree that there has been a shift in emphasis from the balance-sheet to the income statement, but I see nothing of the sacred-cow characteristics in that final figure in the income statement. B. S. Yamey in *The Accountant* for August 17, 1940, had this to say:

"This practice of stating current income at a reasonable figure and burying what are optimistically called 'non-recurring' losses in balance-sheet adjustments is not unknown in Great Britain, and is a practice that should be discontinued. The reader of accounting reports should not have to hunt for his information, even if it is unpleasant."

In connection with the question of distorting net income, there appeared a statement in Accounting Research Bulletin No. 2 issued by the committee on accounting procedure, which deserves mention here. In its discussion of the immediate write-off of unamortized bond discount on a refunded issue, the bulletin had this to say: "If the charge is made against the current-income account, the results for that year are distorted, while if the charge is made against surplus, the fact that it is a proper charge against income for some period or periods is apt to be overlooked." Here, indeed, is a strange statement. It is admitted that a charge against the income of a single period may be proper—a position previously denied—yet the treatment is disallowed on the ground that the net income is thereby distorted. The bulletin goes on to say: "There is today a definite and growing disposition to avoid such results wherever possible by distributing charges over a period of years and of reflecting them under the appropriate head in the income account." Could it have been this "growing disposition" that prompted Messrs. Sanders, Hatfield, and Moore to suggest that capital losses may be treated as deferred charges? It seems strange to speak of a

certain accounting treatment as avoiding certain results. The results are present if a capital loss has been sustained and no accounting treatment can avoid the result—all that can be avoided is showing the result.

Definitely related to this question of distorting income by the inclusion in the income statement of unusual gains or losses, are the two conflicting concepts of the income statement. To those who advocate the exclusion of unusual charges and credits to income, the concept of the income statement is a report of recurring revenues and costs and the emphasis is on current earning power. The opposing view, expressed well by Professors Paton and Littleton in their recent book, *An Introduction to Corporate Accounting Standards*, recognizes the inherent weaknesses that will always be present in periodic income reporting and regards the income statement as reporting asset changes resulting from transactions entered upon in the expectation that they will result in income. This second view, while all-embracing, does not deny the importance of reporting current earning power, but it does deny that a report of current earning power must exclude a showing of current earnings.

TREASURY STOCK

On page 90, Messrs. Sanders, Hatfield, and Moore make the following statement: "Reacquired stock is, strictly speaking, not an asset, but may indicate an instrument which may be used for obtaining assets. Reacquired stock should preferably be shown as a deduction from capital stock issued. It is unwise to make a fixed rule, however, since some circumstances seem to require, or at least to justify, its treatment as an asset." Not a single reason nor a single example is offered in support of the conclusion that under some circumstances reacquired shares may be carried as an asset. It is true that reacquired shares may be instruments

used for obtaining assets, but this is also true of unissued shares; yet I am sure that no accountant would say that under some circumstances unissued stock may be shown as an asset. I cannot think of any circumstance which would justify the treatment of reacquired shares as an asset, though F. P. Byerly, in the August, 1937, issue of *The Journal of Accountancy* gave an example of a case which he apparently thought justified such treatment. Here is Mr. Byerly's example: "Suppose a company purchases its own stock in connection with a bona fide profit-sharing plan for the officers and employees. Suppose, too, that such bonuses are annually accrued in the accounts and that payments of the bonuses are deferred until the following year. The year-end balance-sheet will, of course, show a liability for the accrued bonuses unpaid, which have been charged to income and thus indirectly to surplus. If under these conditions the treasury stock acquired for application in partial liquidation of the bonus liability is deducted from surplus in the balance-sheet instead of being shown as an asset, it seems obvious that surplus has been twice charged in the same transaction." I would answer Mr. Byerly in this way: (1) We have, in the example given, not one transaction but two transactions; (2) I would not charge surplus with the cost of the treasury shares but rather I would show that cost as an unallocated reduction in the proprietorship equity. No one can deny that *at the date of the balance-sheet* the total proprietorship equity has been reduced by the purchase of the treasury shares. The fact that these treasury shares are later to be sold or issued as a bonus does not warrant their classification as an asset any more than we would want to set up unissued shares as an asset if they were to be used in payment of the bonus. (3) The accrual of the bonus resulted in a temporary shift from proprietorship equity to creditor

equity which could be clearly explained by cross reference between the item of treasury stock and the accrued bonus liability. (4) It is true that under the treatment I suggest there will be reported a double reduction in the proprietorship equity, but if we adhere to the thought that a balance-sheet is prepared as of a given point of time, the plain fact is that at the date of the balance-sheet there is actually a double reduction in the proprietorship equity and to conceal this by showing the treasury shares as an asset is, in my opinion, to misstate the facts.

Returning now to the Sanders, Hatfield, and Moore document, the authors state that when shares are reacquired through donation or purchase at a nominal amount, "the resulting capital surplus is a somewhat nominal item." Under such circumstances they are of the opinion that it may be preferable to show the reacquired stock as an asset at cost. This is, without doubt, the weakest argument that could be put forth for the showing of reacquired shares as an asset. Even those accountants who still insist that reacquired shares are an asset will, I am certain, admit grave doubts as to the asset characteristics of shares reacquired through donation or at a nominal amount. While Messrs. Sanders, Hatfield, and Moore think it unwise to make a fixed rule regarding the treatment of reacquired shares I am of the opinion that a fixed rule is needed. I readily admit that judgment does and will always play a large part in accounting statements, but I can see no good reason for leaving the treatment of reacquired shares within the judgment area.

Paton and Littleton have taken a firm stand on the question of reacquired shares, holding that "the acquisition of outstanding shares by the issuing company is in effect a withdrawal of invested assets by the security holders" and that "the treatment . . . should

be consistent with their nature as capital." Their position is definitely opposed, without exception, to the showing of reacquired shares as an asset.

UNAMORTIZED BOND DISCOUNT ON REFUNDED ISSUES

On the question of unamortized bond discounts on refunded issues, we have the statements of Messrs. Sanders, Hatfield, and Moore and the report of the committee on accounting procedure contained in Accounting Research Bulletin No. 2. Both of these documents mention three possible ways of disposing of the unamortized discount on the refunded issue: (1) By a direct charge to earned surplus; (2) by amortization over the life of the original issue; and (3) by amortization over the life of the new issue. Messrs. Sanders, Hatfield, and Moore would permit any one of these methods to be used, for they say "it is a proper function of management to choose which of the three methods shall be followed."

The committee on the other hand has indicated a preference for the second method—amortization over the life of the original issue; tolerates the first—a direct charge to earned surplus; and rejects the third—amortization over the life of the new issue. I dislike all three methods. Apparently, neither the authors of *A Statement of Accounting Principles* nor the committee thought that disposal of the amount by a direct charge to income was worthy of much consideration. To me the whole idea of direct charges to surplus is dangerous doctrine. I dislike the other two methods because they seem to me to be an extension of the idea expressed by Messrs. Sanders, Hatfield, and Moore that it may be proper to carry capital losses as a deferred charge. As I view a refunding transaction, the unamortized bond discount and the redemption premium taken together is the amount that the issuing company is willing to

pay to bring to a conclusion a contract that is now shown to be disadvantageous. To say that a benefit will flow to the company beyond the date of termination of the first contract and on the basis of that argument to attempt to justify a continuation of the amortization process is, to me, the amortization of a dead horse. Any benefit that flows to the company will be the result of the second contract rather than the first, and I see no reason for offsetting a definite loss on one transaction against a benefit to be derived from another. I can see little if any difference between this situation and the case of a company discarding an old but still operable machine for a more efficient machine. Certainly the implications of this bulletin are such as to justify carrying the discarded machinery, or a loss resulting from its disposal, as an asset to be depreciated or amortized over the original estimated useful life.

In rejecting the third method—amortization over the life of the new issue—the committee made one exception. It permits the use of the method, without exception in the certification, when the company is subject to a regulatory body which has prescribed or authorized the method. In all other cases in which this method is used, the accountant should, in the opinion of the committee, “make an exception in respect of such treatment from any certification that the accounts conform to accepted accounting principles.” I think it is unfortunate that the committee felt called upon to take this step. When the argument is presented that the method is inadequately supported in accounting theory, has no marked practical advantages, tends to exaggerate the annual saving from refinancing, and does not conform to accepted accounting principles, why should those companies subject to regulatory bodies be permitted to use or adopt such a method without the accountant making an exception in his certificate? I believe the profes-

sion has a duty to educate regulatory bodies in such matters, but permitting practices which we regard as the application of unacceptable principles without so much as an exception in our certificates, seems to me to raise a serious question. If the committee feels that this method is so unacceptable as to call for an exception in the certification for companies not subject to regulation, I hope it will reconsider its statement regarding regulated companies and recommend that certificates prepared for those companies include the same exception as that recommended for those not subject to regulation. Appropriate explanation of the reason for the use of the unacceptable method would, of course, have to be given in the certificate. Surely, this procedure is to be preferred to the double standard suggested by the committee.

DEPRECIATION ON APPRECIATION

In Research Bulletin No. 5 the committee considered the question of depreciation on appreciation. In this bulletin the committee has limited itself to a consideration of the charge to be made against income when appreciation has been entered in the accounts, but the committee has not expressed its views on other and perhaps more vital aspects of the problem. The bulletin tells us that “accounting for fixed assets should normally be based on cost” and that “appreciation should normally not be reflected on the books of account”; then we are told that income should be charged with depreciation on the higher value when appreciation has been booked.

If fixed assets should normally be accounted for on a cost basis, it seems to follow that depreciation accounting should normally be on a cost basis, and recording appreciation in the accounts is a departure from normal or standard procedure which must be justified by those who depart from the standard. The conclusion reached by the commit-

tee is a logical one if we are willing to abandon the cost standard and if we are willing to admit appreciation and its kin to the family of accepted accounting principles. This, apparently, the committee is not willing to do. In my opinion appreciation has no place in the accounts except in the cases of reorganization or refinancing where the appraisal takes on the characteristics of an "implied cost."

I realize that in preparing this bulletin the members of the committee had in mind the large number of practical situations that public accountants are called upon to deal with. With the men in the field it is not a question of what the client corporation should do or should not do. The question is, what shall the accountant do after the client has done what he ought not to have done? I think Mr. Couchman gave the answer to that in his dissent from the majority opinion on this bulletin. As summarized in the bulletin, Mr. Couchman "would prefer to return more strictly to the cost basis rather than allow further departures therefrom. In cases where appreciation has been entered in the books, he would prefer that the appraisal credit be deducted from the appraised value in the balance-sheet thus restoring it to a cost basis." I hope accountants will go one step further than Mr. Couchman and in their certificates take exception to an appraisal as not being in conformity with accepted accounting principles.

The committee, in arriving at its conclusion on this point, rests its argument on the fact that a representation has been made in the balance-sheet and that the company is thereby estopped from using a lower base for computing the depreciation charge. I should like to ask a question: Suppose a company has not reflected appreciation on its fixed assets *in its accounts* but shows the appraised values (higher than cost) in the balance-sheet parenthetically. Has a representation been made requiring the use of a depreciation base other than cost or is booking the appreciation the controlling factor? Perhaps the committee will extend its discussion of depreciation on appreciation to cover this situation.

While these are some of the ideas that have disturbed me, it is, nevertheless, encouraging to know that the profession has at last interested itself in "research" and "principles." However, it should be remembered that strict observance of the standards of research and an awareness of the responsibilities that research entails are the essentials of an effective research program. The research worker should enter upon his task with no personal point of view to justify. He should know that compromised conclusions and compilations of conflicting practices are not to be dignified by the name "research." Lastly, he should know that principles are something more than merely what accountants do.

Some Thoughts on the Theory of Inventory Pricing

BY GEORGE D. BAILEY, DETROIT

Member of committee on accounting procedure, American Institute of Accountants

IN THE search for sound accounting principles or proper accounting practices, inventories present a problem of major importance (if indeed not the most important problem), and the question of proper accounting for inventories is sufficiently broad to require some decision in almost all the various conflicts that have been going on. Some of these conflicts result from the shift in emphasis from the balance-sheet to the income account and the increasing importance of statements for the short-term and long-term investor; others are the conflicts between accuracy and conservatism; between tax regulations and accounting; between accounting as a science and as a practical tool; and especially that between historical cost and value.

It will be worth while to see where these conflicts affect the inventory problem. Before this question can be settled with any finality, not only will these conflicts have to be resolved, but there must be a reconciliation of each point with the others. Progress can come but slowly and after full discussion. A practice, long accepted and widely used, does not become bad all at once, although a new preference may be so strongly indicated as to cause the rapid abandonment of the old.

It must be conceded that accounting thought has definitely accepted the premise that the income statement is of greater importance to modern accounting than is the balance-sheet. If that is true, the amount at which an inventory is stated in a balance-sheet is of less importance than the effect of inventory policies on income determination, al-

though this point cannot be completely dismissed without considering the problem of the short-term creditor as distinguished from the long-term creditor or investor. To the latter, the income statement is paramount. The short-term creditor, except in quite simple businesses, also may be more interested in earnings or losses than in the inventory amount in the balance-sheet, since financial statements are not prepared on a liquidation basis. Where repayments of short-term credits are expected to come, as is usual, from operations rather than liquidation of the business, short-term unsecured credit needs as good income reporting as possible.

That point leads immediately to a consideration of the place of conservatism in present-day accounting thought. Difficult as this subject is, it must be considered if progress is to be made on the inventory problem. Short-term credits; taxes, both property and income; the many examples of the bad results from undue optimism; the ingrained desire of wise businessmen to cushion the effects of the upswings of a cycle against the inevitable downswings; and just general caution in dealing with other people's property have so contributed to an approval of accounting conservatism that it has become deeply rooted in prudent business practice. Yet it must be admitted that, under certain circumstances, conservatism in inventories can be the destroyer of accuracy in income reporting. Is it, therefore, to be completely discarded?

In a business enterprise, profits can

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rarely be determined definitely until the enterprise is concluded. Accuracy for any particular portion of the period of existence is difficult, if not impossible. Estimates and assumptions are usually required. Since something less than absolute accuracy must be accepted in any event, may it not be possible and proper to continue to give accounting approval to the conservatism in inventories, in reserves, in provisions for losses, which has been thoroughly accepted as wise for financial reporting for business? If the emphasis on conservatism should be given up, optimism, a natural tendency of human nature, rather than accuracy, might well take its place. Without entirely giving up the emphasis on conservatism, it should be possible to avoid excessive conservatism, which has distorting effects on income in that understatement of one year results in overstatement in another, and instead, make use of a conservatism so reasonably applied that it does not materially distort the earnings of any year. We need not give up this philosophy of the prudent businessman.

In any study of inventory-pricing policies, federal income-tax regulations and practices cannot be disregarded. A theoretically unsound procedure cannot be condemned out of hand when it is a required procedure for income-tax purposes and where the differences are not likely to be seriously distorting, particularly if the use of the more correct accounting procedure might require two separate extensive inventory calculations. The income-tax law sets two tests for inventories,—best accounting practice and clearest reflection of income, and the regulations add only one principle—that of consistency. None of those three need interfere with the development of better inventory principles. The mere existence of tax regulations must not prevent discussion of better methods, and better accounting practices so developed may be expected

to be accepted in tax regulations, especially if the change tends to more accurate income determination.

Some of the differences of accounting thought arise through differing concepts of accounting. Some men think of it as a science, capable of resolution into fundamental principles which have a definite similarity to natural laws, and are completely logical. *This* concept is progressive and challenging, and has been responsible for much of the development of accounting theory and practice. Others think of accounting as a practical tool of business, subject, in some measure at least, to practical judgment as to fair presentation. There is, in addition, an intermediate position which has increasing acceptance—that accounting may be looked on as an art, rather than a science, and as an art be subject to the necessity of proper observance of many fundamental practices, but leave room for other practices involving judgment, emphasis, and experience. The committee on terminology of the American Institute of Accountants is proposing a definition of accounting on just such a basis.

Finally, any inventory discussion must deal with the conflict going on between cost and value. That conflict has been well settled as to fixed assets, which are not ordinarily to be written up or down for price fluctuations. The trend in accounting is definitely toward cost as distinguished from value. But the theory of provision for expected loss is so deeply rooted in accounting as a practical business tool that it is difficult to conceive of accounting without such a basic requirement. This is particularly true of inventories, and accordingly inquiry must be directed to whether “cost or market, whichever is lower” is a practice which provides for losses reasonably expected or goes further and results in unwarranted and unnecessary shifts of income; and secondly, to whether the various inventory-pricing methods now reasonably

accepted result in a close approach to an economic income or merely minimize the effect on income reporting of cyclical variations or equalize income which varies between periods for more human reasons.

With all of the foregoing as a background, the specific pricing policies and problems may be considered. The first of the problems must be,—does the theory of the lower of cost or market need to be discarded in favor of a cost theory for income determination? The answer seems quite clear—not if it results in provision for anticipated loss, rather than being a rather artificial rule applied regardless of the probability of loss.

At this point it is necessary to consider what is meant by market, when used in the term “cost or market.” Information from actual practice of individual business enterprises is not available in sufficient extent to give a completely reliable factual foundation for discussion. The requirement of the new Regulation S-X of the Securities and Exchange Commission for a disclosure of what is meant by cost and what is meant by market will not produce for some months reliable data as to definitions of the term as actually applied. The requirement of the New York Stock Exchange for a similar disclosure applies only to new listings, which have not been numerous. However, sufficient information does exist to give basis for a premise that the term “market” has many meanings. The replies to questionnaires sent out by the Institute's committee on inventories, articles on inventories, the replies to the questionnaire of the Institute of Chartered Accountants of England and Wales, data disclosed by published company reports, all support such a premise.

There is little dispute that obsolescence, deterioration, shrinkage, and similar factors, require adjustment of cost. This practice recognizes the neces-

sity of providing for anticipated losses.

There is no such agreement that shrinkages in replacement costs must be reflected in the entire inventory, or that such lower costs must be applied regardless of indicated losses. There is no such agreement that the theory of the application of replacement costs is sound for income determination. This difference of practice and theory exists in spite of income-tax regulations of long standing, which categorically require the complete application of replacement costs and have done much to freeze that theory in accounting thought. That this is true is indicated by the testimony of the accounting witnesses in the McKesson matter who used the replacement-cost theory as the basis for the definition of “cost or market.” On the other hand, objections are held, in responsible and intelligent quarters, to the “cost or market” theory for inventories on the ground that it has important theoretical and technical weaknesses for income determination. It is highly desirable to come to some conclusion on the theory and, on the practical side, to decide whether cost or market if lower should require the complete application of replacement cost, or whether some other understanding is preferable.

The theoretical objections to the basis of the lower of cost or market are that it does not defer costs on an assumed regular flow of goods, that it shifts income from one year to another, and that it violates the principle of determining loss at the point or date of realization. The charge of arbitrary shifting of income must be particularly considered, for, if true, it is a serious practical as well as theoretical objection.

There are those who point out that the complete application of the replacement cost developed from its applicability to the simple business where a decline in replacement costs was regularly followed by changes in selling prices, but that, as a rule to be applied

in every case of reduced replacement costs, it frequently resulted in adjustments when no losses were reasonably anticipated; that its chief virtues were in a resulting conservatism of balance-sheet statement and in being a rule that could be applied with a minimum of judgment. In so far as the rule of complete application of replacement costs does provide for write-downs when no loss is reasonably expected, it causes a shifting of income from one year to another that is little more than arbitrary, and thus has sufficient theoretical and practical objections as to make it unsound to accept it as the *basic* or fundamental requirement of the term "cost, or market, if lower."

On the other hand, if cost or market, whichever is lower, can be considered to require adjustments of cost prices only when losses are reasonably anticipated, then many of the objections disappear. There would be no arbitrary shifting of income,—only the recognition of the principle of providing for losses. The technical objections to anticipating the point of realization or interfering with the flow of postponing costs might be more readily subordinated to the prudent business rule of anticipation of losses than to an arbitrary rule of complete application of replacement cost. Such a definition of cost or market, if lower, might give such a sound theoretical basis for inventory pricing, as to resolve many of the conflicts now existing. The term "cost or market, if lower" would then mean "cost—but market if lower where necessary" as suggested by E. A. Kracke, and that term might well be substituted. Such a meaning would not do away with the theory of replacement cost. The presumption of loss from changes in material prices would be as strong as ever, and in the absence of evidence to the contrary, such changes would require adjustment of inventory prices below cost. Whether this presumption of loss would extend to other

classifications than raw materials would depend on the extent and seriousness of the decline,—the nature of the business,—the method of selling,—fixed or changing selling prices,—trade-marked or similar products,—and other factors. In some businesses (such as distributing) selling prices are extremely sensitive to changes in raw-material prices, while in others, changes in replacement costs have little, if any, effect on selling prices. Thus "market if lower where necessary" might mean complete application of replacement costs in some cases,—application only to raw materials in another,—adjustment of prices of finished goods in one industry and not in another,—and in other cases no adjustment at all of either raw materials or finished products. The test would be a reasonable anticipation of loss, and any determination of propriety would have to be consistently applied, and free from whim.

Admittedly, the acceptance of the anticipation-of-loss theory as an explanation of the cost-or-market theory, would require the exercise of judgment by management and by accountants, both public and private,—but if accounting is an art, a profession, the responsibility for the exercise of an informed and intelligent judgment must be assumed,—in inventories as in other provisions for loss. Since the area for the application of judgment under this theory is larger than under the theory of complete application of replacement cost, disclosure of basis is of great importance,—for disclosure can be expected to assure a proper regard for the realities, and perhaps lead toward the determination of a preferred basis for various industries.

It may be insisted that the anticipation of loss theory is less conservative than the arbitrary rule of complete application of replacement cost. This may be true as to the balance-sheet, but if so, the difference is in the elimination of a conservative factor not based

on anticipated loss, and as such, in the elimination of the factor of arbitrary shifting of income, which results in a conservatism of income reporting in one year with a consequent overstatement in a succeeding year. Whether the loss of some balance-sheet conservatism would be important to a short-term creditor might be open to question. Neither basis discloses the liquidating value, or measures solvency. Both must be supplemented by additional data if short-term-credit problems are to be analyzed from that standpoint. But, analyzed as going concerns, reliable income statements are of greatest importance. The less arbitrary shifting of income between years, the less confusion in credit analysis. The rule of anticipation of loss would not substitute optimism for conservatism. It still would be necessary to write down costs if losses are anticipated, and the short-term creditor gains greatly from a reasonable unanimity of understanding among accountants and businessmen as to the meaning of "cost or market, if lower" or "cost,—but market where lower if necessary."

As to income-tax regulations, this change would seem to be one which might be expected to be accepted in tax regulations, because it would be in the interest of more accurate income determination, and because, as every income-tax practitioner knows, the Bureau of Internal Revenue in actual day-to-day practice has not insisted on the complete application of replacement costs to all of the inventory, regardless of anticipated loss.

Passing from the general to the specific, there are, in the light of the foregoing, a number of points of importance to consider in applying market prices or calculating loss.

There is some difference of opinion as to whether replacement prices should be applied by articles or in the aggregate, and whether, once applied, a new cost is thus established which continues during the possession of the article.

Again considered from the standpoint of anticipated loss, some applicable aggregate might give a better measurement of loss than adjustment of individual articles. If current replacement prices are expected to so influence sales prices as to require an adjustment, the fact that some materials entering into a product have a cost less than market might properly offset a need for adjustment for excess costs of other material for the same product. It is difficult to set the point at which the aggregate method would become unsound. That would appear to be a question of fact for each case, the point being to include in the aggregate no dissimilar products nor products not affected by the same economic forces. The aggregate method might well be accepted as permissible, if not even preferable.

If the aggregate method is used, its application appears to be easier through the use of reserves, than by repricing individual items, although this makes it impracticable to carry forward the written down prices as new costs. Since the latter is sanctioned, perhaps required, by income-tax regulations, the preference for the aggregate rule for income reporting might require pricing the inventory on two different bases. Such a burden should not be forced on business even in the interest of improved theory unless the results would be important. Here again it would seem that income-tax regulations on specific practices might be expected to be changed if the new practices result in less arbitrary shifting of income.

The use of the aggregate does raise the question of whether the written down cost must be continued as long as the item is on hand, or whether adjustments upward to not more than cost can be made without violating the accounting principle prohibiting taking up unrealized income. This question may be more academic than real, because few industries carry over specific items from one annual inventory to

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another, and in even fewer cases would those be on a "specific item" basis of pricing instead of on the basis of some assumed flow. On any assumed basis of flow (average, first-in, first-out, etc.), identity of items is unimportant (except for excess stock and unusual items, when there may well be other reasons for anticipation of loss), and there would seem to be no sanctity in a requirement that the new cost be continued, since identity is lost accounting-wise. Thus the use of a reserve for determining losses in the aggregate would appear to violate no fundamental rule. The reserve would be one for estimated loss based on a market condition and that would seem to be adjustable for changes in market, just as is common, for instance, with respect to reserves for changes in market prices of marketable securities.

The anticipated-loss theory requires consideration of selling prices, as indeed does the complete replacement-cost theory. Changes in raw-material prices, important and definite, are presumptive indications of possible changes in sales prices. If existing sales prices are expected to be reduced, at what point would an adjustment for loss be required? There is reasonable agreement that an adjustment would be required if necessary to bring the carrying value to an amount not more than selling price less distribution costs. This, however, might not be enough. If the items are to be liquidated outside of the regular flow of business or will be a minor factor in that flow, perhaps the no-profit rule is proper,—but when the changes in prices affect products handled in the regular flow (such as all finished products on hand and available for regular sale), there seems little reason to so limit the provision for loss that all sales for some succeeding period would have to be done without any profit. Under such circumstances, is it not consonant with the anticipated-loss rule to write down selling prices by dis-

tribution costs and some reasonable or perhaps normal profit margin? The element of profit is recognized under the retail inventory method in writing down articles where sales prices have been changed, and it is quite customarily considered in pricing repossessed or trade-in articles. The elimination of an amount as a margin of profit may not be wrong or right in itself, but wrong or right depending on individual cases.

Following the theory of anticipation of loss, the existence of firm sales contracts at proper prices might well obviate the necessity for any provision for loss. But here again there must be the exercise of careful judgment. Many firm sales contracts are merely options to buy, enforceable as contracts perhaps, but in many businesses and industries not so enforced as a matter of policy. In many other businesses, sales contracts are sufficiently special to presume enforcement, as is usually true where there are specific authorizations for certain forward purchases. Again, the test is one of a reasonable anticipation of loss.

Purchase commitments enter into the inventory problem, although it is not customary or desirable to include them in the inventory amount. The anticipation-of-loss theory should be applied to commitments in much the same manner as to inventory, except that presumption of loss because of changes in market value may well be even greater than for raw materials. The questions of loss on commitments for firm sales contracts, specific instruction orders, and of minor fluctuations in prices which will have no effect on sales prices, must be decided for each case.

So far, attention has been directed to the meaning and application of "market," as part of the term "cost or market, whichever is lower." There remains the even larger problem of the meaning and application of cost. If one assumes an even flow of goods passing

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through a business, the applicable method of determining cost would be on a first-in, first-out basis. This basis has the virtue of being simple, natural, and unstrained; it is easy to visualize, and fits into a purely theoretical philosophy. The trouble with it is that it appears to emphasize cyclical trends in business, increasing the earnings reported in the upswing years and increasing the losses of the down. Based on the theoretical concept of an even and regular flow, there are those who say the reported trend is not artificial—it is real, as are the profits reported. On the other hand, practical businessmen realize that they must be very careful in dealing with the so-called profits of the years of increasing prices if reinvested in a similar amount of inventory, because they have found that such profits are likely to disappear in the downswings of prices. It is well enough to suggest that necessary conservatism be obtained by a reservation of surplus, or an arbitrary charge against income, but business keeps searching for a way in its regular bookkeeping of taking out of income what it believes to be unreal. The problem may be more practical than theoretical, but it is a very definite problem in businesses where inventories do not turn over rapidly and cannot be hedged either by market transactions or firm sales contracts. Especially is this true in years of heavy taxation, where high rates are applied to income, whether that income is available for distribution in cash or not. Economic income in those cases must be reconciled to accounting income.

Can accounting be theoretically sound and still approve other bases of determining cost than first-in, first-out? First-in, first-out is an artificial rule which does not always accord with the facts of a business enterprise. For some businesses, many think it produces a statement of income that is not real. Many think it is a device that (far from showing the actual effects of a cycle on

business profits), for those businesses sensitive to cyclical change, shows an unsound and unhealthy income if compared to business enterprises not particularly sensitive to cyclical changes. If that is true, there are some business enterprises where a basis should be used which removes the *errors* of the first-in, first-out method. This may be equivalent to a statement that the base-stock method, for example, does not artificially spread income—it is the first-in, first-out method which does so. Like most generalizations that would be untrue if applied specifically to many situations, but there are many sincere men on both sides of that argument. If accounting is considered as an art and as a practical tool for an economy of private enterprise for profit, it probably must recognize other bases of arbitrarily determining cost than the first-in, first-out method.

In a few businesses, simple ones, the specific identification cost may be preferable, as it may truly and properly reflect income. In others such as those purchasing identical goods at different times, specific identification may turn out to be merely a device permitting profits to be determined by selection of articles used.

A step beyond the first-in, first-out basis is that of average cost. In many cases where purchases are merged, the average cost basis may be a more realistic cost than the first-in, first-out basis. In other cases it is a convenience, and in still others a selected short step toward cushioning price changes both for determination of income and selling prices. If the average used has some relation to the period of turnover there would seem to be little criticism of the method.

Next come those methods which were mentioned above as good or evil, depending on the point of view—those methods which rightly or wrongly when compared with the first-in, first-out basis, do reduce income in periods of

rising prices, and increase it in periods of declining prices. Under this head come the better known methods such as base stock, last-in, first-out, and the use of general reserves for price declines which are adjusted with price fluctuations. To say that these may not conform to income-tax regulations and if followed might require an immense amount of duplicate work is to beg the question, for many a business enterprise has believed so firmly in the soundness of such a method that it has been doing the extra work for years. This is not the place for a discussion of the relative merits of the various plans just stated, or for an explanation as to how the bookkeeping should be conducted for each one, but it does seem proper to suggest that such methods should be permitted for those business enterprises to which they are applicable, provided the method or base is worked out for each company with complete honesty and realism. *The important problem is to determine for each company the method of matching costs against sales which most nearly reflects the actual facts of the particular business.*

Mention is constantly made of consistency. With respect to inventories a change of principle may make important and material changes of profit. Consistency, however, does not necessarily mean accuracy. Consistently to price inventory at half of its cost may be a gross inaccuracy. Instead of being

bad accounting to be inconsistent between years, it may be better to make a change, provided of course the change and effect thereof are shown.

The necessity for disclosure is basic. If, instead of putting accounting for inventories in a strait jacket, judgment is to be allowed in the selection of a proper inventory basis, then disclosure must be sufficient to show how the factors were judged and why the particular basis was selected.

The time may have come when we as a profession can no longer say that it does not much matter which inventory basis is adopted as long as we constantly adhere to it. We must help determine what method of inventory costing and pricing best fits a particular business or industry, and what method for that industry best meets the test of real income and proper anticipation of loss.

This is a task for all classes of accountants—public, private, academic, and governmental. It is not a new suggestion. Some trade groups have already attacked the problem with considerable success. But I submit that progress has been held back because we have been trying to fit inventory policies into a few fixed regulations or rules instead of recognizing that major principles can properly be applied with varying degrees to different kinds of businesses. Publicity and disclosure are all that need be added.

IV
ROUND-TABLE DISCUSSION
Professional Ethics

Leader: EDWARD B. WILCOX

October 15, 1940

Introduction

BY EDWARD B. WILCOX, CHICAGO

Member of council and committee on professional ethics,
American Institute of Accountants

SOMEWHERE it is written that fools rush in where angels fear to tread. These words have recurred to me with considerable force as I have contemplated conducting this round-table discussion of ethics. I have even worried a little for fear that their aptness may explain why I was selected. Even so, this subject is one about which I feel very strongly, and I could scarcely have asked for a more interesting topic.

My dictionary tells me that ethics constitute the science of moral duty or, more broadly, the science of the ideal human character. Undoubtedly, if we all had ideal characters, including adequate wisdom and information, we could dismiss any detailed discussion of the application of ethics. It would take care of itself. But ethical practice becomes an exceedingly knotty problem in a complex society made up of different people with differing viewpoints and backgrounds. Ethics have a direct relationship to the social environment in which they are practiced. They are not absolute. They are different at different times and places. Once, in America, the doctrine of "caveat emptor" prevailed, and we glorified the shrewd Yankee who would cheat you in a trade if he could. Today that is not good ethics. The seller is held to implied guarantees. Business ethics have evolved, and they are continually changing and evolving as conditions and requirements change, and as the moral consciousness of the people develops.

The difference between business and professional ethics is fundamentally one of degree. A profession is distinguished by the fact that its practice requires special knowledge, not shared by lay-

men. The possession of this special knowledge gives the professional man an opportunity to betray those who rely on him. The sometimes moot question of whether or not accounting is a profession would never be raised if this simple distinction were understood. The services of the accountant cannot be measured or standardized, and the large number of people who depend on the accountant cannot judge his competence or his integrity. They must, therefore, rely on his ethics. And he must maintain his ethics at a high level in the public interest if he is to justify his existence. It is not even enough that he conform to ethical standards comparable to those of other professions. The accountant has a contractual relationship with his client who, he knows, may cease to employ him, but he must nevertheless deny the wishes of his client if they conflict with his moral duty to the public, even though that public has little opportunity either to thank or blame him. I know of no higher ethical requirement than this, and yet it is one which accountants have voluntarily imposed on themselves.

In the absence of a measuring stick, it is hard to say how adequate and appropriate are the current ethics of the accounting profession, but I am inclined to believe that they are keeping pace with the times. Certainly they are growing and evolving. The by-laws of the American Institute of Accountants provide penalties for conduct discreditable to the profession. This provision has been amplified by rules of professional conduct, and these rules have been subject to periodic revision. Another revision is under contemplation

now. One of the most recently recognized improprieties is that of competitive bidding for accounting engagements.

All of these developments are extensions of the basic concept of professional morals, as they apply to the practice of public accounting. The fundamental purpose of these rules is to insure that this practice will be carried on at the highest possible level of performance. Paragraph 2 of our rules may be regarded as basic. It refers to willful or negligent misstatements, and involves the technical aspects of accounting. To go into a discussion of this phase of ethics would be to cover the whole field of auditing procedure, internal check, and accounting theory and practice. In any event, it would be improper to discuss specific cases which have come before the committee. It is probably of greatest interest in this respect that arrangements have been made with the Securities and Exchange Commission whereby cases are called to the attention of our committee on professional ethics whenever the Commission feels that the accountant has been guilty of any serious failure. These communications from the Commission are treated by our committee as though they were complaints. They are investigated in the same way, and the Securities and Exchange Commission is advised as to the disposition of the cases. There was published in the July, 1940, issue of *The Journal of Accountancy* a statement which your committee made to the Commission regarding its disciplinary machinery. This entire process of coöperation with the Commission has for its primary object the maintenance of high standards of performance of the accounting profession. As long as we evidence our willingness to do our own disciplinary work in this manner, I believe there will be little tendency on the part of the Commission or anybody else to attempt to do it for us.

Other paragraphs in the rules of professional conduct represent the accumulated wisdom of the profession, and the extent of its moral growth toward the creation of conditions under which accountants can be of greatest service to the public. Solicitation and advertising are forbidden, and competitive bidding is frowned on because these activities undermine the dignity and the independence of accountants, and because cut-throat competition tends to lower standards and to reward misrepresentation. Fee splitting or engaging in other activities at the same time that one is practising as an accountant are apt to be mere subterfuges for more open methods of competition. Contingent fees and ownership of securities in client corporations both tend to undermine the independence and the impartiality of the accountant. Incorporation implies a lack of confidence in his own work. Whatever purports to be the work of an accountant should actually be his own, or that of his own assistants, in the interest of maintaining professional standards. All of these things are covered in the rules of professional conduct, and the purpose of them all is greater usefulness of the profession to the public. Neither standards of ethics nor professional privileges nor immunities which may come with them are justifiable if their purpose is the personal aggrandizement of members of the profession; they are only justifiable if their purpose and effect is to maintain standards of performance. All of our rules of conduct must be viewed in this light if they are to be understood.

There is an inherent defect in all rules. When they are written down in black and white they become rigid. I have already emphasized that ethics are never fixed, but are always growing and evolving. That is part of the difficulty in writing them down. Cold type refuses to evolve. But there is another difficulty. I doubt that any definite line can be drawn between the ethical

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and the unethical. Borderline cases exist, and if a man desires to come as close as he can to an impropriety, without actually committing it, he will find himself in a twilight zone where his bearings are quite vague. Then he may ask the committee on professional ethics for an opinion or, if he is more defiant, he may go his own way until a complaint has been made and then protest that he has not broken the law. I have small patience for such a man. Any accountant who desires to carry on his practice in an ethical manner may do so without entering this twilight zone. Nobody need be honestly puzzled if he grasps the spirit of the rules of professional conduct of the Institute and if he has within himself a genuine sense of professional ethics. I regard it as fundamental in matters of morals that definitions are invitations to evasion rather than guides to conduct.

Nevertheless it is helpful to know what the committee on professional ethics thinks the rules mean. When complaints are received, they are judged as best the committee is able, and when inquiries are received, the committee furnishes its opinion as to the application of the rules. It must be understood that disciplinary action is not confined to matters coming within the scope of the published rules. These rules are provided as clarifying and illustrative of those things which are discreditable to a public accountant, but any act of a member in violation of the by-laws of the Institute, or which is discreditable to the profession, will subject him to disciplinary measures. I am going to give you a brief summary of the opinions which the committee has rendered during the past year:

Rule 4 forbids fee-splitting with the laity, but the committee decided that the purchase of the practice of a deceased accountant from his widow was not a violation of this rule, even though the basis of the purchase was a percentage of the fees.

Rule 5 forbids an accountant to engage in a business or occupation conjointly with that of public accounting which would be incompatible or inconsistent therewith. The committee has held that any occupation would be incompatible with that of public accounting if it is carried on in a manner to violate any rules of professional conduct, or any by-laws of the Institute. Therefore, any member carrying on any other activity in addition to that of public accounting must be governed by our rules and by-laws in all his activities.

In considering rule 10 forbidding contingent fees, the committee has stated that tax cases are exempt because the accountant is acting in the rôle of an advocate. Contingent fees are not permitted in cases where the accountant is acting as an impartial and independent expert.

Rule 8 and rule 11 refer to soliciting and advertising, respectively, and in many cases it is difficult, if not impossible, to distinguish between these two activities.

With respect to matters that are recognized as solicitation, the committee held that it was improper for accountants to call on businessmen to ascertain the status of their personal-property taxes, and to offer to file claims for refund. It was also held that it is improper to offer professional services in connection with the selling of books, although the sale of books in itself was not improper. It was held to be a violation for a former employee to solicit the clients of the employer whom he has left, even though these were the clients whom he had personally served. It is not a violation to write to governmental bodies asking for consideration as auditor, when it is commonly known that the policy of such bodies is to rotate or to change auditors from time to time. Neither is it a violation of rule 8 for an accountant to solicit the clients of a firm of which he was a member, after that firm has been dissolved.

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Under advertising, it is considered that a memorial or any other special edition of a newspaper is no exception to the rule. Cards are permitted if they do not exceed the size prescribed in rule 11, but it is contrary to the spirit of the rule for such a card to be headed, "Income-Tax Returns." The name of the accountant should come first, followed by reference to his type of service. Reference to membership in such organizations as the Municipal Finance Officers Association may properly be included in such cards. A member may permit his photograph to appear as one of a group in advertising matter distributed by a friend or client, if the accountant's firm name is not mentioned, but it is improper for an accountant to be named as such with his professional designation in an advertisement of an organization offering services such as those which he might render professionally. An electrically operated sign-board in the lobby of a hotel, bearing an accountant's name and address, was held to be improper. Publication of firm bulletins is permitted, if distribution is limited to clients and personal friends, but wider distribution constitutes a violation of rule 11. It is not proper to circulate booklets or pamphlets, no matter how useful or valuable they may be, if they bear such inscriptions as "Compliments of John Jones, C. P. A." and if they are distributed to others than clients or personal friends of the member.

Among those activities coming before the committee which appear to be both solicitation and advertising is the use of letters sent to mailing lists. Such letters describing tax laws and offering services, or implying the offer of services, are improper if sent to a large list including others than clients or personal friends of the accountant. It is improper for an accountant's name to appear on the letterheads of trade associations, especially so when these letterheads are used in writing to members offering the

accountant's services. It is also improper for an accountant to write to members of trade associations urging them to take part in surveys of the industry, even though the letters do not directly solicit accounting engagements from the members. All correspondence addressed to members of a trade association should properly come from the office of the association, and if any professional services are offered, it should be as a service of the association to its members, and not as a suggestion from a practising accountant. Neither should an accountant solicit opportunities to speak before meetings of trade associations. Such invitations should come from the association rather than from the accountant. The use of mailing lists other than trade association membership rosters is held to be equally objectionable, even though an accountant's client suggests or urges that the accountant write to guarantors, stockholders, deferred creditors, or others. The objection is not cured, but is rather intensified, if the accountant offers free advice to the persons addressed.

A resolution was adopted by the council of the Institute on October 15, 1934, forbidding the certification of financial statements by an accountant who owns a substantial financial interest in the enterprise. Under this resolution, it was considered improper for an accountant to accept stock of a corporation as compensation for professional services, and it was also considered improper for him to serve as a voting trustee and auditor unless the terms of his appointment as trustee clearly remove the possibility of conflict with his duties as auditor. Some leniency in the interpretation of this resolution was considered desirable in the case of a small, closely held corporation if its financial statements are not used for credit purposes. It was considered entirely proper for an accountant who was a member of a fraternal or social organization to act as its independent auditor.

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One inquiry arose in connection with the confidential nature of an auditor's relationship with his client. Although there is no rule of professional conduct referring to this matter, violation of confidence was considered to be an act discreditable to an accountant. In particular, it was the view of the committee that an auditor of a municipality would be guilty of violating this confidential relationship if he was engaged as an independent auditor and then made public his findings, even though he did

so in the interests of good citizenship. If, however, he were an employee of the state rather than an independent auditor, he might be fulfilling a public duty by doing so.

These opinions are not intended as an exposition of the meaning of the rules. They are the run-of-the-mill questions which the committee has answered during the last year. It is partly on the basis of experience with such questions that the committee has proposed revision of the rules.

Proposed Revision of Rules of Professional Conduct

BY FREDERICK H. HURDMAN, NEW YORK

Member of committee on professional ethics, American
Institute of Accountants

IT IS of interest to note that the first rules of professional conduct were adopted by the old American Association of Public Accountants and appeared in the annual report of the meeting at St. Paul, Minnesota, in October, 1907, as article VII of the by-laws. These rules were recommended by a special committee in a complete revision of the Association's by-laws. The committee suggested six rules, but only five were approved. Incidentally, the rule not approved was one relating to contingent fees. The rules adopted related to the following matters:

1. Practice by someone else under a member's name.
2. Commissions to the laity.
3. Engagement in business conjointly with that of the public accountant.
4. Certification of statements not prepared by the member, his staff, or some other member of the Association.
5. Use of initials not authorized by statute.

This set of rules adopted in 1907 evidently prevailed until 1915, with the addition of one other rule relating to a member taking part in legislation without first notifying the Association.

After the formation of the Institute in 1916, no formal set of rules appeared in the annual yearbooks until 1919, although the reports of the committee on professional ethics during those years would indicate that that committee was being guided by a set of rules. In the yearbook for 1919 there appears for the first time, not as part of the by-laws, but separate therefrom, a set of eleven rules. With the exception of rule 9, re-

lating to the distribution of circulars or other instruments of publicity, which was later dropped, all of these rules are still in effect and correspond to rules 1 to 10.

The first resolution, which relates to audit companies, was adopted at the 1919 meeting, but rules 11, 12, and 13 and the three additional resolutions were adopted subsequent to that date.

I believe that many of these rules were promulgated as a result of specific cases or situations arising in the work of the various committees on professional ethics. For instance, rule 11, relating to advertising, was adopted because of an increasing tendency on the part of members of the Institute to resort to paid advertising and a feeling on the part of the membership that this tendency if allowed to persist would have a bad effect on the profession. Rule 12, having to do with practices in certain schools, was adopted to meet a case which could not be reached under any of the Institute's existing rules. Rule 13, relating to practice under corporate name, was adopted last year as in the best interests of the profession. The 1932 resolution barring estimates of future earnings was intended to curb this practice which appeared to be growing, and which it was believed if allowed to develop would affect the profession adversely.

The 1934 resolution, having to do with ownership of securities in corporations audited by a member, grew out of a case presented to the trial board. The 1938 resolution, relative to competitive bidding, was passed in order to meet a situation in a state where a state

Proposed Revision of Rules

society of certified public accountants had adopted a rule banning competitive bidding.

The present ethics committee, believing that there should be some clarification of the rules, undertook the revision which is the subject of our consideration. This revision has been con-

cerned mainly with a positive rather than a negative statement of the rules, the removal of ambiguities, an improvement in phraseology, and the elimination of unnecessary repetition such as "of the American Institute of Accountants" following the words "a member or an associate" throughout the rules.

Competitive Bidding

BY J. WILLIAM HOPE, BRIDGEPORT, CONN.

Member, American Institute of Accountants; past president,
Connecticut Society of Certified Public Accountants

IT is generally agreed that the practice of competitive bidding for audit services is detrimental to the interests of both the business public and the accounting profession.

Yet many reputable practitioners are of the opinion that any attempt to outlaw competitive bidding by restricting the actions of society members will fail, due to the fact that good business judgment sometimes requires forehand acquaintance with the cost of proposed auditing services, and accountants cannot very well be expected to refuse to coöperate in such instances.

The reasonableness of these claims is not disputed, but the mistake in permitting them to control lies in the fact that most cases of competitive bidding result in price cutting to the point where the results are so inferior that the attaching of a certified public accountant's signature thereto is a disgrace to the profession.

Good ethical practice does not prohibit discussion of price or fixing a fee for assignments of a known nature.

But where price is the dominating consideration and one accountant's cost estimate is to be weighed against those of others, we cease to be providers of specialized professional services and are nothing more than competitors in the labor market.

We should realize that a prospective client comes to us expecting a service which will produce required information and definite results and, if we encourage a limitation of those requirements by price cutting, we are not only doing ourselves and our profession irreparable harm but we are inflicting an injustice on those who have confidence in us.

We are supposed to be acquainted with all of the intricacies of an accounting engagement and, when we subject ourselves to competitive price fixing, we cannot very well expect a client to take the needed precautions against the evils which abound in this sort of performance.

Though there may be situations where prices must be fixed in advance and at as low a figure as possible, they are few in comparison to the many engagements where price should not be permitted to be the dominating factor.

If all reputable accountants refused to enter into price competition of any kind and took advantage of every opportunity to explain the dangers that are inherent in such a practice, the business public would soon recognize the soundness of our position and would follow our reasoning to the point of agreement.

I maintain that our difficulties with the question of competitive bidding are caused by business-hungry accountants, and I am convinced that the profession will be healthier and more deserving of public respect and confidence when this type of practitioner is erased from the rolls of every reputable accounting organization.

It is now three years since the Connecticut Society of Certified Public Accountants incorporated in its "Rules of Professional Conduct" the following:

"Competitive bidding is deemed to be detrimental to the interest of the public and the accounting profession. No member shall at any time knowingly, directly or indirectly, enter into competitive bidding for any type of professional service whatsoever, in competi-

Competitive Bidding

tion with other accountants. Competitive bidding is hereby defined as bidding for work in competition with other accountants on any basis."

I would be something less than honest if I were to say to you that no member of our society has made a competitive bid since that time.

Some very innocent responses to requests for estimates of costs have, in the light of later information, turned out to have been competitive with similar responses from other accountants.

Our grievance committee has had some busy and trying times in these past three years, for we are just as human in Connecticut as are the folks in the rest of the world.

New business is still attractive and it hurts to have to let it pass by.

Imagine what we were up against when our 1939 state legislature passed the municipal auditing act, requiring what turned out to be practically a detailed audit of every municipality in the state.

Most towns and cities wanted to know what such an audit was going to cost, and naturally nearly every accountant hoped he was going to get some of the business.

It looked for a time as though our competitive bidding by-law was going right out the window.

We have weathered that storm but not without some serious questions, some hard work on the part of our grievance committee and our board of governors and, I am sorry to say, some strained relations among members who learned that the price proposals they made in certain cases were not as low as those submitted by others, who also did not bid.

At our annual meeting last June we succeeded in securing an overwhelming vote against modification of our by-law to permit responses "when approached in a businesslike manner for estimates of costs."

Our board of governors has very recently recorded its interpretation of our by-law by issuing the following statements for the guidance of the membership:

1. Section 9, article VII, of the by-laws does not prohibit a member from making a proposal to a prospective client if such proposal is not knowingly submitted in competition with any other accountant.
2. Submission of a proposal in response to any request for bids in competition shall be considered a violation, whether such proposal includes a flat-price fee, an estimate of cost, a maximum fee, per diem rates, or any other basis for computation of fee.
3. Submission of a proposal to a prospective client, formerly served by another accountant, shall be a violation unless such prospective client has stated that he is dispensing with the services of his former accountants.
(See also section 6, article VII.)
4. Submission of a proposal in instances where a member, without definite knowledge, has reason to believe that proposals either are being or may be requested from other accountants, shall not be held to be in violation, provided, that the member includes in his proposal a clear statement that such proposal is automatically voided and withdrawn if it is to be considered in competition with other accountants.
5. Submission of a proposal by a member for additional or continuing accounting services to a client last served by him shall not be in violation.

It should be understood, of course, that the foregoing is based only upon phases of the by-law which have come to the attention of the board for interpretation and does not attempt to cover all of the possible conditions which may or may not be considered "competitive bidding."

These interpretations are intended to make it more clear to our members what is meant and we expect they will be

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helpful in certain situations. They should serve to strengthen the by-law as originally written.

We are more confident than ever that our purpose is good, even though we have suffered some very embarrassing moments with municipal boards whose members insist on getting estimates for budget purposes from more than one accountant. We will continue to feel their scorn of our professional ethics and to be abused for our lack of coöperation, until they finally concede the fairness of our position, which still remains that we cannot give them any kind of a price if it is to be considered in competition with similar proposals from other accountants.

We are firmly convinced that a municipality is better served if it selects a reputable accountant and arranges audit scope and cost with him on a businesslike basis.

We know that, in many instances, our members will have to stand aside and permit some very desirable business to go to nonmembers of our society. We are aware that this does not create a pleasing situation for men who must earn a living in their chosen profession.

However, we also know that the best portion of our business has always come to us on a noncompetitive basis, and we do not want to take any chances on sacrificing all of the progress we have made as a profession by entering into situations where our demonstrated capacities to render a fully adequate service are limited by prices set in competition.

We must never forget that our real position as an integral part of the

business world is to render a specialized professional service for which we are expected to be particularly qualified.

It is better that we do less work and do it well, thereby insuring continued confidence and renewed engagements, than to get the immediate increase in dollar value assignments at an ultimate cost of loss of prestige and business.

We will utterly fail in our missions as professional practitioners if we permit anything to so alter the effect of the services which we are retained to render that the poor results we produce will constitute a fraud on those who have placed their confidence in us.

We cannot excuse our failures by claiming that we were limited by price.

We would refuse to coöperate with a client who requested that we prepare a false statement.

Likewise, we should refuse to coöperate with a client who requests competitive bids when we know that it will encourage unscrupulous practitioners to cut prices to the point where an honest service cannot be obtained.

Participation in a bidding situation puts the high bidder in the same classification as the low bidder. By bidding he has approved the practice as a desirable one.

The solution of this problem rests with accountants alone and we should let no other considerations influence us in our purpose to meet our full responsibility in this matter.

If we are sincere in our intentions to eliminate this evil as an accepted practice, there is but one answer—*reputable accountants must refuse to make competitive bids.*

V

ROUND-TABLE DISCUSSION

Progress in Accounting Education

Leader: SIDNEY G. WINTER

October 15, 1940

Introduction

BY SIDNEY G. WINTER, IOWA CITY

Member, American Institute of Accountants; past president,
American Accounting Association

FOR OUR consideration this afternoon there is the subject of progress in accounting education. I take it that no one of us will have difficulty with the three words "progress," "accounting," and "education." To be doubly sure on this point I have consulted some of the authorities and I wish to report certain definitions.

"Progress" is "a moving forward, more particularly an advancement toward maturity or toward a better state." This is unquestionably the import of the word in our present meeting.

"Accounting" is, oddly enough, a word much less satisfactorily defined. It is "the action, process, or system of accounting" and appears to be closely allied with accountancy, which is the "art or practice of an accountant." Having mastered so much in so short a time, we now find it necessary to define ourselves. An accountant is "one who professionally makes up or takes charge of accounts." For this enlightenment on accounting, accountancy, and accountants we are indebted to the *New English Dictionary* published at Oxford in 1888. This work gives a number of citations to various uses of these words in literature, the earliest which I chanced to note being 1494. There may or may not have been progress in the field of accounting education but there is some evidence to support the contention that there has been little progress in the matter of defining these terms. In the shorter *Oxford Dictionary* published in 1933 there is exact duplication of the material quoted above. Other source books are woefully short of information about accounting. You will find in the *Encyclopedia of Social Sciences* (1930) a very satisfactory twelve-page exposition of

accounting but even in this excellent work little or nothing on organizations of accountants. In several other encyclopedias, even the most recent editions, there is little about accounting and nothing about accountants. What little I found did not impress me too favorably. It is a bit discouraging, for example, to have an article begin: "It is difficult to distinguish between book-keeping and accounting." It is to be hoped that we shall make sufficient progress in the near future to insure our being accorded some recognition in these standard publications.

"Education" may be defined as "the systematic development and cultivation of the natural powers by inculcation, example, etc." or as "instruction and training in an institution of learning," or "instruction as a system, science, or art." Any or all of these meanings may come in for a share of our consideration during the afternoon.

So much for definitions. I hope you will have noted that this meeting is scheduled as a round table. It is my judgment, and I am sure it is yours, that each of the speakers on this program is thoroughly qualified to speak on the subject assigned him. Without in any way minimizing the importance of the papers which will be presented for our consideration, may I emphasize the point that a round table should provide an opportunity for all in attendance to exchange ideas. It should be borne in mind that these papers serve as a point of departure, a springboard from which all of us may enter into a discussion of accounting education. At the forum or round table one should be both learner and teacher. I bespeak your full coöperation.

The Goal of Accounting Education

BY ERIC L. KOHLER, KNOXVILLE

Member, American Institute of Accountants; editor of *The Accounting Review*

I HAVE been told by Professor Winter that my answer to the topic he has put in the program for me, "The Goal of Accounting Education," is not to be that we need better training for the profession. Beyond that he has refused to commit himself; and I have been left to my own devices. If I have been unable to find the one answer that would satisfy me or anyone else, I have at least been convinced that the selecting of one answer out of the many that suggest themselves has been a pleasurable thing on which to speculate. I am sure that no one who has combined teaching with practice has not often devised schemes intended to bridge the differences between the two. Many of these differences have narrowed to a point where the step across seems easy and natural. Others are ready to be removed. Not a few are where they always have been; and from this last group emerges an item which offers a convenient point of departure.

The item, seemingly unimportant, may be stated in the form of a question, as follows: May accounting be taught without the employment of practice sets and written problems? Particularly may this question be examined in its relation to beginning students, and social-science students limited to a one-year course. Because of the limited time available I will endeavor to present to you the reasons commonly cited for this practice, move on into a few of the larger implications, and present an argument for your consideration and discussion.

Most accounting teachers advocate a practice set in a beginning course or a one-year course, although I know of a few exceptions. If you ask "Why?"

you will get a variety of responses. In general, they will agree that accounting is a practical subject dealing largely with figures; hence a knowledge of figures and a facility in their use must be acquired at the outset. Some will say that the aptitude of students for accounting can be determined only by ascertaining their ability to handle the simple situations that a practice set involves, or that the time of teaching can be materially shortened by the grasp of detail that comes with the successful completion of practice sets. Others will point to the lack of knowledge of business practice found in every student, and explain that this can be overcome quickly by ploughing through a mass of individual business transactions and relating them to final results; and the final results, the subject-matter with which the accountant is constantly dealing, is no more significant than the detail of which it is composed.

These are convincing arguments and are not often disputed. There would be little point in questioning the practice before a group of practitioners were it not for the fact that a little inquiry into basic causes raises practical questions as to the whole meaning that conventionally attaches to the accounting field.

I should like to devote a few moments to some of these basic considerations.

DEVELOPMENT OF SUBJECT MATTER

Accounting, which has been designated as one of the more "imperfectly unfolded" social sciences, employs techniques the common characteristics of which have only recently been seriously examined. True, accounting teachers and practitioners have formed large

techniques from simple ones, switched their support from those the effects of which they did not like to those that led to more agreeable conclusions, and rejected profferings that, as one well known practitioner has put it, have substituted "rigid formulae" for "broad concepts"; but these acts and statements, closely examined, are all too often found to be expedients of the moment rather than parts of a carefully conceived scheme of subject-matter development. Ernest endeavors to reveal the continuum of accounting thought have been both few and futile; and there is an undoubted need for scholars who can not only discover that continuum but also criticize and remold it at a level we do not now possess. The recognition that many of our techniques are not as closely related as they ought to be has of late become more general; this in itself is an important indication of a growing professional skepticism that augurs well for the future.

As for the point under consideration here: uncorrelated techniques indicate that the philosophy on which accountants have rested their case may need an overhauling; because if that philosophy shows up badly when accounting practices are dissected, and no orderly body of theory can be presented, it may be true that only the procedures exemplified in practice sets, and not abstract principles, can be taught. Generalizations derived from various accounting practices have of course often been made; as a rule their significance is rather heavily discounted when it is discovered they are in conflict with other practices. Rationalizations are common indeed; but they should be encouraged to go beyond the obstacle of "sound accounting" at which so many of them stop. Under present circumstances, accounting instructors cannot be expected to develop theories not immediately associated with specific practices.

ACCOUNTING RESEARCH

Another condition which accounting faces is the tendency of practitioners to dominate the thinking and research within the field. Perhaps the distribution by the Institute of a recent publication of the American Accounting Association on standards is an indication that the professional mind in welcoming a most interesting inquiry by nonpractitioners, has broadened. But as long as the Institute maintains a "research" group which delves, apparently at random, into various fundamental problems having momentary importance, without any serious attempt to correlate the findings, this broadening process may be doubted.

Domination by practitioners of accounting research seems at first blush to be an entirely proper procedure. They have funds available for research and have a wealth of research materials at hand. But three main difficulties arise immediately. First is the direction, easily predictable, taken by research. Subjects of research are chosen for the researchers, and the findings must not be harsh. Under such conditions, no basic research is possible. Second, the orderly development of lay controls over professional activities is postponed. In this second point lies a rich field of inquiry which I can only mention here. I refer to the dangers of the intraprofessional growth of ideas, unchecked by outsiders. The Securities and Exchange Commission has on the whole displayed courage and competence in dealing with the profession, but it is not a research agency and it has had to accept a good many preconceptions of the accountant and his habits without critical analysis; its attitude, moreover, is necessarily restricted by its limited field of interest. Other agencies have had even less effect on the profession. No independent appraisal of the aims and objects of professional accounting has ever been made by any disinterested group. Third, is the

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type of thinking in which influential practitioners so often indulge. I have already referred to the concept of "sound accounting," that temple of refuge to which many a promising argument has unblushingly fled. Not many accounting practitioners who have chosen to write or talk on the subject of accounting fundamentals have been exempt. I am afraid, too, that a number of accounting instructors, in books on accounting principles, have likewise sought asylum there. "Conservatism" and "consistency" have also been treated as concepts or as bodies of concepts that justify the superiority of one procedure over some alternative. These acquired inhibitions effectively prevent anything like a scientific growth of accounting thought by practitioners.

EXTENT OF SERVICE

A further check on the independent development of fundamental accounting concepts has been the inability of accountants to free themselves completely of the notion that their services extend only to the management of business. Certificates are still addressed to boards of directors, occasionally to stockholders, although their importance extends far beyond these groups. Again, the fiction is still indulged in that financial statements are the managements', even where, as in most cases, the accountant has a free hand in their preparation and content.

It is true that the accountant certifies to figures the basic data for which he has for the most part only test-checked. But in the typical case this limitation has little importance, for in the system of internal controls he has a much stronger proof of accuracy—in fact his dependence on these controls is admitted in his certificate.

For present purposes, the content of the certificate has importance only as reflecting in various ways the dependence of the accountant on business

management. There can be little doubt that in the written word on fundamentals he will be similarly affected.

LIMITS OF DEVELOPMENT

Within the field of business, the accountant and his ideas have had their principal development. This development has on the whole been carefully reviewed by interested groups, and on many aspects of corporate accounting there has been general agreement. Particularly in this country the agreement has extended to the public at large, to legislative bodies, and to regulatory commissions. However, outside of the business field, accounting has not reached very far. Its techniques are applicable with equal validity to government and to the domain of the social scientist. I wonder if this fact is generally appreciated.

The National Committee on Municipal Accounting has made great progress during the few years of its existence and many of its findings can be applied to government generally. It has not reached the same stage of development as has corporate accounting, for two reasons: it needs a wider acceptance which only many more years can give, no matter how excellent its premises may be, and it needs external criticism, which as yet has not appeared. Accounting practices of the federal government are still comparatively untouched, although at present a number of stimuli are being applied in order to determine the extent of the problems that are involved.

Also untouched are certain other fields in which performance and accomplishments need to be measured for the information and criticism of the general public. The medium of measurement need not be the dollar, for the accountant long ago discovered that often the value of his services was to be found in his narrative rather than in his schedules. The techniques needed in these instances are a capacity to in-

investigate performance and an ability to impart information on accomplishments, coupled with a highly developed sense of recognizing the relevant. Suppose an example be chosen within the field of government. Several hundred thousand dollars are spent each year on the forest service, a division of the Federal Department of Agriculture which manages the 350,000 square miles of the country's national forests. An accountant, if called upon to say something about the forest service, would probably find out first what appropriation had been devoted to it last year by Congress. He would then ascertain its expenditures and compare the total with the appropriation. He would have some trouble making up his mind as to expenditure classification, for he could break down the total by the organizational pattern, by the functions served, or by objects of expenditure. He would hesitate a good while before doing any more, for he finds no parallel elsewhere and cannot easily devise any measurement of the results secured. Yet the methodology required does not call for more than what has been accomplished in the field of private business.

What I have said thus far means that accounting has not reached the point where it can realistically be called a developed subject. As with other social sciences, its practitioners have been immersed so completely in procedures that thinking planned for the future in terms other than those employed in the present has been unknown. There has been no projection of aims or problems that the future must solve. The accounting instructor must teach procedures because the groundwork for principles hasn't been laid.

From these and similar premises, it seems to me that accounting educators should assume a more positive rôle in the development of the accounting background and that practitioners should aid them in doing so. Until more progress in that direction has been

shown, instructors will have to continue to teach procedures to beginning students, and to indicate vaguely that these procedures somehow illustrate principles that cannot now be made objective; for they cannot expect to find more than proposals for procedural changes coming from the profession. I prefer, therefore, to see the Institute's research activities transferred to a non-practitioner group under whose sponsorship many projects in the academic and professional fields could be conducted simultaneously and the research projects now in process could where practicable be more closely correlated.

In conclusion, I present for your consideration a series of propositions.

1. Accounting is a language that ought to be talked by the greatest possible number of persons.
2. Principles of accounting can be acquired by patient, scholarly studies under an objective, independent plan of research.
3. Research now conducted under the auspices of the Institute's committee on accounting procedure may have value in indicating the problems now of concern to the profession, but with no central scheme of correlating the subject matter the findings of the committee will tend to be inconsistent with each other and with any coherent concept of accounting, and hence short lived.
4. A knowledge of business practice is of course essential to beginners in accounting, but ways and means need to be devised for teaching business practice before accounting instruction is commenced. Concentration on accounting matters can thus be facilitated and much less time devoted to the first course.
5. An orderly statement of accounting principle, once developed and following a well planned course in business practice, should be possible without the necessity of providing practice-set work.
6. Such a course, covering the highlights of the entire field, would then be suitable alike as an orientation for

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beginning accounting students and as a survey course for those whose contact with accounting will be limited to one or two courses. Considerable value would attach to a course that could be universally applied.

7. Particular attention should be paid to the possibility of extending accounting and auditing methodology to any field where reporting on a program of activity, and the results se-

cured by that activity, are required. The usefulness generally of the so-called procedural audit made by accountants, in which no figures may appear, deserves careful study.

8. In general, the goal of accounting education should be to make of accounting something more solid than a well ordered collection of procedures, and to extend its usefulness far beyond its present confines.

What the Practitioner Looks for in the College Trained Accountant

BY T. EDWARD ROSS, PHILADELPHIA

Member of committee on education, American Institute of Accountants

THERE are certain primary qualifications which should be looked for in all who enter the field of public accountancy. Whether one has had the advantages of college training or not, it is important that he be trustworthy and dependable. Even a junior member of a staff, to a greater or less degree, represents his employer and, therefore, his character, personality, industry, discretion, and tact should be such as to warrant the good opinion of the client and the members of the client's organization. He should be willing to accept responsibility, and also should be quick to realize that, in view of the confidential nature of his work, he should refrain from gossip about his employer's affairs and those of his employer's clients. On the other hand, he should exercise good judgment in communicating to his chief any pertinent information which he acquires.

It is expected that the college man entering the field of accountancy has been trained in habits of logical thought, and has learned to go below the surface of things in order to see if conclusions are established on solid foundations. In his work he will meet with many records which appear on their face to be true and accurate, but which an adequate investigation will prove to be otherwise. He will also learn that statements made to him in good faith are not always based upon adequate knowledge and cannot be relied upon.

Some men with good memories may succeed in acquiring a reputation for scholarship because they can answer questions according to the book but without giving much thought to the underlying principles involved. In their

accounting work, men of this type are prone to follow instructions and programs in a slavish and routine manner. They set the net in accordance with rule and then fail to draw it because they have not accustomed themselves to carrying their work to a logical conclusion. As it is impossible for the practitioner to prescribe minutely in advance methods of procedure to cover all matters which may be discovered during the course of an investigation, it is essential that those entrusted with the responsibility for any part of the examination should be able to recognize the need for proper action in the event of unexpected developments.

Before entering the field of accountancy, one should realize that public accounting, like other professions, is an exacting occupation. The accountant's responsibility does not end with his client, and this larger accountability demands careful and painstaking service. The accountant has his full share of drudgery, and frequently he is called upon to forego his social and recreational activities, so that anyone who is not willing to make sacrifices in these respects had better enter some other field where regular hours and routine duties prevail.

There would be some hesitation in even mentioning a few primary educational matters in this connection if it were not that many employers have referred to them repeatedly and members of examining boards have stressed the deficiencies of so many candidates for certification.

Good, legible handwriting, although it has become less important as educational equipment because of the wide-

spread use of machines, is very desirable. It has become a rather common practice to have signatures on letters and other communications followed by the name in type, so that the recipient may be sure of the identity of the writer, but balance-sheets, schedules, and working papers are still being prepared in manuscript, and those, at least, who have to type the reports appreciate a manuscript that can be read without undue strain on the imagination.

Turning to another subject which is presumed to be taught in the grade and secondary schools—a workable knowledge of arithmetic is of value. An astonishing number of college graduates when tested fail in solving simple problems in commercial arithmetic or take an unusually long time to produce correct results. Criticisms of this condition are not confined to practitioners. The Carnegie Foundation for the Advancement of Teaching reported that in twenty out of a total of thirty-three colleges included in a survey, the average student had gone backward in mathematics during his course and, further, that the students in the business group showed the heaviest loss.

The college graduate is expected to be able to present the results of his investigations with facility and precision, but such expectations frequently meet with disappointment. The faculties of a number of our colleges have recognized the need of placing more emphasis on the study of English, and some have included in their accountancy courses studies in report writing and public speaking.

The college-trained man, generally speaking, has an advantage over one who has not had such training, but many of the latter, by determination and industry, have overcome the handicap of limited schooling and are able to

hold their own in all departments with those who have enjoyed more extended scholastic privileges. The report of the Carnegie Foundation for the Advancement of Teaching, to which reference has been made, points out that there is a large percentage of high-school graduates who are unable to enter college, but whose school records indicate that they would profit more from a college course than many of those who enjoy that privilege. Many of them secure training in business courses which prepare them to take up the junior work in accountancy at an earlier period. From this group have come many of the successful men in the profession.

Preference should be given to the man of the broader training afforded by the college, provided the superstructure is based on a sound foundation. The profession needs men whose educational equipment is comparable with that of any of the professions. The accountant should be able to meet upon equal terms the lawyer, the banker, and others in so far as his educational and cultural equipment is concerned.

There is a belief among some that the employer has an obligation to his clients, as well as to his junior employees, to see that before the junior is assigned to work upon clients' accounts the gap between the academic course and professional work is bridged by an intensive course in practical problems, the proper use of various forms, methods of procedure, relations with clients and, generally, the standards and methods of the organization. Such a course has been found to give the beginner a facility in his work and a knowledge of many important matters which he would not acquire in a much longer period if left to learn them incidentally in the daily routine of his duties.

Combining Practical Experience with Education

BY JACOB B. TAYLOR, COLUMBUS, OHIO

Member of committee on education, American Institute of Accountants; past president, American Accounting Association

ONE OF THE acute problems facing accounting departments in collegiate schools of business is that of bridging the gap between the work in the classroom and the accountant's activities in business. A sound program of work in the university will most certainly provide a direct way to ultimate success in the practice of accounting. It is the painful transition period that furnishes problems for both the practitioner and the student embarking on what he hopes will be a successful career in a growing profession.

As the student approaches the time when he will graduate from the university, he faces also the decision of whether he will enter the practice of public accounting or whether he will find his best success in an industrial accounting position. Without the benefit of previous experience, he must determine which of the two fields of accounting he will enter. In most cases it is a "shot in the dark." He may be conscious of the fact that the requirements as to fine personality, good appearance, consummate tact, honesty, and respect for confidences, must all be met if he is to succeed in public accounting. He may not know whether he possesses these attributes to the required degree.

Equally important is the necessity of weighing the advantages of a constantly changing type of work in public accounting against the disadvantages of frequent travel from one city to another and alternate periods of great activity and relative idleness. In industrial accounting, the advantages of a perma-

nent location may be offset by the eternal sameness of the everyday tasks. There are advantages and disadvantages to both fields of accounting endeavor.

The opportunity to "sample," so to speak, one of these fields would be welcomed by alert, ambitious, and qualified students. The experiences gained thereby would help them to a choice of occupations at the end of their university career.

The field-work plan for those students who wish to enter public accounting has been developed to establish a means whereby the students may gain such valuable experience before graduation. The plan which is here described is the one which has been in successful operation at Ohio State University for about thirteen years. Being located adjacent to several cities of considerable size, it has been possible for the university to secure the coöperation of a large number of public accounting firms.

In fact, the geographical spread of the coöperating firms is somewhat amazing, extending from New York and Newark, New Jersey, in the East to Pittsburgh and then through Cleveland to Detroit and Chicago in the West. Many Ohio cities and firms are, of course, included. The firms and the cities range from the largest to the relatively small. The types of engagement undertaken by the firms are of almost every type and variety. Thus the opportunity for gaining wide experience is presented to the students in the best possible way.

Briefly the operation of the plan is about as follows. During the winter quarter of the senior year, those students who participate in the field-work

NOTE. — In Mr. Taylor's absence, his paper was presented by Professor Hermann C. Miller, of Ohio State University.

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plan withdraw from the university and accept employment as junior accountants on the staffs of the coöperating firms of certified public accountants. At the end of the winter quarter, the students return to the university and again take up their studies. Graduation follows then at the end of the spring quarter or the summer quarter after the return from field work, depending upon whether the student has anticipated his absence in the winter quarter of his senior year by attending some previous summer session.

Participation in the field-work plan on the part of the students is not compulsory. The success of the venture would be jeopardized if it were to be made so. Only the better students are privileged to take part in the field work, and even in these cases it is optional. No university credit is given, but the student is paid by the firm which employs him the regular salary paid by that firm to its junior accountants.

The distribution of the students among the various coöperating firms has been left generally to the department of accounting of the university. The demand for the students is usually greater than the supply. The department makes the allocation of students so that each coöperating firm secures the services of at least one student. Some firms, of course, are sent several students, the largest number ever going to one firm in one year being eight. In the last few years, the demand for our students far exceeded the supply of those qualified and none is sent on this venture who is not deemed qualified. The largest number of students sent on field work in any one year would approximate forty. A few public accounting concerns have been able to maintain an unbroken record of coöperation with the university in this venture.

In selecting the students for the various firms, care has been exercised to take into account peculiarities in the type of practice of a firm, the emphasis

by the resident partner or principal on particular personal traits, or other requirements. Students with antagonistic personalities, with physical defects, with negative personalities, with poor personal appearance have never been sent on this work. In addition, only those students who rank in the upper half of the senior accounting class have been eligible.

The variety of accounting engagements in which these students have been used by the accountants by whom they were employed has been one of the satisfactory features of the field-work plan. The students, even though performing only the tasks of the junior accountant, are enabled to study at close range, the methods of accounting, the economic problems and the methods of doing business of many different kinds of enterprises. The broadening effects of this alone would be sufficient justification for the whole plan, were there no other benefits.

Close contact is maintained with the coöperating firms through the medium of a member of the faculty of the department of accounting. This faculty member calls on or communicates with the office managers of the accounting firms at least once a year and in some cases twice a year. All matters pertaining to placing the students are discussed at these conferences. At these times, too, criticisms of the work done by the students are solicited by the faculty member.

It is always the hope in soliciting criticisms that the department of accounting might be assisted in improving the quality of its teaching. Weak spots in the training of the students are sought and each office manager is requested to point out those which he has discovered. From this angle, the criticisms have not been so helpful. There is very little tendency, perhaps too little, on the part of the firms which use these students to find fault with their training in accounting or even to suggest ways

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in which it could be improved. This, of course, has been disappointing. However, there have been some criticisms of personal characteristics of the students themselves which have been carried back to younger students with beneficial results. One firm regularly complained of the poor handwriting of the students until it secured a student who was not only a good accountant but a splendid penman. Many of the objections and criticisms are overcome by sending these firms men without the faults which seem glaring to them. One firm insists on neatness to the extreme. Others are not so particular. If the matters upon which certain emphasis is placed by the various firms were not taken into account, the criticisms which would result would be along these very lines. It has been the happy experience in the time in which the field-work plan has been in operation at Ohio State University that most of the criticisms have been favorable ones and those which could be construed to be unfavorable at all were given in an extremely helpful manner.

The advantages of the field-work plan from the standpoint of the cooperating firms of certified public accountants as taken from their own comments are somewhat as follows:

1. That university students sent to them under the field-work plan after careful selection are much more satisfactory than the junior accountants who may be picked up at random.
2. That these students are available at the time of greatest activity in public accounting and return to the university when the work begins to slacken in the early spring. Thus a satisfactory supply of junior accountants is available at the time when it is needed, yet there is a definite understanding that the employment is not permanent.
3. That this trial period of about three months gives the public accounting firm an opportunity to determine

whether or not the student would prove satisfactory if given a permanent position after graduation.

The advantages to the student are that:

1. He gains useful experience which permits him to make the last two quarters' study much richer and much more satisfactory.
2. He is enabled to determine by actual trial whether or not the public accounting field will prove attractive to him and whether he will be able to succeed in it.
3. He may secure for himself a permanent position if he acquits himself well as a junior accountant. A great proportion of the students who have been placed under the field-work program have been given permanent positions by the firms after graduation.

There is an equally good possibility of developing the field work in industrial accounting. The opportunity to utilize university students by industrial concerns would arise generally in the summer vacation period. The students could then be used to assist in disposing of the accumulation of work during the time that clerks in the accounting departments were on vacation. In this way, the employing company would have available a sufficient number of temporary employees to assist in caring for routine tasks during the busy season. The student could perform a variety of tasks and would benefit by being subjected to a reasonable amount of mechanical routine. The advantages of inspecting the accounting set-up of a single company with the possibility of returning to that company in a permanent position are also present.

Regardless of whether or not a student has a definite idea of which branch of accounting—public or industrial—he wishes to enter after graduation, a summer quarter in an industrial accounting position and a position as junior accountant with a public ac-

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counting concern during the winter quarter will assist him materially in choosing wisely and correctly. Also the benefits to him as a student because of this participation in practical accounting work should not be minimized.

As one of the developments of the field-work plan, several of the coöperating firms have urged certain of their regular employees to take time off during slack periods to return to the university for graduate work. This is entirely possible at Ohio State University where the quarter system is in operation. Thus practical experience and education may be combined after the bac-

calaureate degree has been gained and after the graduate has entered fully on his chosen work in public accounting. Carried to the greatest possible fruition, with the utmost coöperation on both sides, special graduate courses could be made available to the younger college trained staff members of public accounting concerns at times which would best suit their needs and opportunities.

Based on the experiences at Ohio State University, the benefits of combining practical experience with education are so vast as to outweigh completely the mechanical difficulties involved in executing the plan.

VI
Addresses

The Sin of Perfectionism

BY JEROME N. FRANK, WASHINGTON, D. C.

Chairman, Securities and Exchange Commission

THESE tragic days, when so large a part of the world is being destroyed, to talk of governmental regulation of corporate accounting may, to some of you, recall the poet's line about "lecturing on navigation while the ship is going down," or Anatole France's comment, "We should conceive a positive pity for our economists arguing with one another about the cost of the furniture in a burning house."

But those of you who are in that mood should also recall President Roosevelt's recent remarks when he signed the investment-company act and the investment-advisers act. "These acts," he said, "give the Securities and Exchange Commission power to regulate investment trusts and investment counselors. They mark another milestone in this administration's vigorous program . . . to protect the investor. As the pressure of international affairs increases, we are ready for the emergency because of our fight to put our domestic affairs on a true democratic basis. We are cleaning house, putting our financial machinery in good order. This program is essential, not only because it results in necessary reforms, but for the much more important reason that it will enable us to absorb the shock of any crisis."

I

There could be no single blow more deadly to the protection afforded to investors by the S.E.C. than a successful attack on its accomplishments in the field of corporate accounting. Without the S.E.C. supervision of accounts,

regulation of the issuance of utility securities under the public-utility holding-company act of 1935 would be meaningless, and the securities act of 1933 would be a joke.

It is for that reason that I want to discuss the assault on the accountancy work of the S.E.C., launched by John M. Hancock, of Lehman Brothers, on April 26, 1940, in a speech entitled "Responsibility on the Part of the Public Accountant and His Client."¹ There he referred to "the securities acts and their administration," and, noting that annual corporate reports to stockholders are not within the scrutiny of the S.E.C. under those acts, said that "a better job is being done in the unregulated field, than in the field covered by regulation." Admitting the need and value of auditors' reports, he spoke of "the trend of development in this field over the last six years" which seemed to him "to have placed a false emphasis upon the need and value" of such reports. Mentioning the days when monkish "mental gymnasts" theorized as to how many angels could stand on the point of a cambric needle, he said, "In these days the same kind of mind—possessing plenty of intelligence but lacking in judgment—seems to be busy in developing theories about all sorts of precise practices for improving accounting methods and results." "I think," he remarked, "the current drift is towards an undue emphasis upon the accuracy of accounting for corporate reports." And he doubted whether "there is any warrant for devoting working time to a consideration of many of the finely spun arguments

NOTE.—In Chairman Frank's absence, his address was read by William W. Werntz, chief accountant of the Securities and Exchange Commission.

¹ Delivered at the Accounting Clinic held at Northwestern University School of Commerce.

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striving for absolute accuracy of annual reports." The "attempt to get so precise . . . is not worth while," he commented, and asserted that "there is no sound usefulness in the extreme precision and extended presentation now being demanded." He emphasized "the impossibility of absolute factual certainty" in accountants' reports.

Observe what Mr. Hancock has done: He has pictured the S.E.C. as consisting of intelligent but academic theorists and impossibilists—monkish "mental gymnasts"—striving, foolishly, in a necessarily imperfect world, for absolute perfection.

I want to discuss that ridiculous picture and to demonstrate its falsity for these reasons: First, it is being paraded about the country by a small group of ultraconservative investment bankers who are engaged in an effort to have the securities act gutted by amending it in such a way that the S.E.C. would be powerless to prevent the sale of certain large security issues—even if the registration statements were clearly false

and misleading.² Second, such a picture, if it were believed to be accurate, would discredit the important work which the S.E.C., in coöperation with such organizations as yours, has done in gradually raising the standards of corporate accounting and in establishing some relatively uniform procedures in order that investors, and the public generally, will be better informed as to what corporate managements are doing with the assets of investors entrusted to their care.

In sharply disagreeing on the subject of corporate accounting with Mr. Hancock and with those investment bankers who accept his views, I am distinctly not to be understood as expressing any personal animus towards him or them on the part of the S.E.C. or myself. In a democracy, all men, of course, are entitled freely to criticize any aspect of government. And such criticism should not provoke anger in those government officials who are criticized. Freedom to reply to the criticism, however, is the privilege of those officials. And a reply,

² They favor an amendment which would provide that, if certain facts existed, a registration statement, as to a security issue, would become immediately effective upon its mere filing with, and after no prior scrutiny by, the S.E.C. That is, the Commission would be given no opportunity to inquire, before the securities were issued, as to whether the facts required as a basis for such "automatic registration" did or did not exist, or whether the facts set forth in the registration statement were or were not clearly false and misleading in material respects.

Among those cases in which, under the proposed amendment, there would be such "automatic registration"—and where the Commission would be powerless to act, *in advance*, to prevent the issuance and sale of the securities—was to be the following: Where a company, which has no previously registered or listed securities, has been in existence and carrying on the same general type of business for a given period of years; has made generally available to its stockholders and to the public, for a given number of years, annual reports containing financial statements of a certain character certified by independent public accountants; had a net income, as set forth in those reports, for a certain number of years; and had had, during those years, a given number of stockholders. The obvious effect of the amendment would be to prevent the institution, by the S.E.C., of

stop-order proceedings before the registration statement of such a company would become effective.

There are many large corporations, whose securities have heretofore not been registered or listed, which could put out issues that would *immediately be sold, simultaneously with the filing of their registration statements—a filing that, under the proposed amendment, would at once make the registrations effective under the proposed amendment.*

In such circumstances, as to such an issue, *even if the S.E.C. discovered, after the filing, that the registration statement was clearly false and misleading (or that the facts entitling the registrant to an "automatic registration" were absent), it would be futile for the S.E.C. to begin stop-order proceedings, since, by the time such proceedings were begun, the issue would have been sold to the public.*

To the S.E.C. it seems that an amendment, having such consequences, would strike at the very heart of the securities act. Since Mr. Hancock and some other investment bankers sponsored such an amendment to the securities act, it is entirely correct to say that they were for "gutting the act by amending it in such a way that the S.E.C. would be powerless to prevent the sale of certain large security issues—even if the registration statements were clearly false and misleading."

The Sin of Perfectionism

by one on the S.E.C., to adverse comments by an investment banker must not be interpreted as an expression of hostility towards the critic in particular or investment bankers as a group. The S.E.C. has always recognized that the investment bankers perform a vital function in our economy: They supply one of the means by which the savings of our citizens are converted into labor-producing plant expansion; without the investment bankers, America could not have grown as it did, and could not continue to grow. But a recognition of those facts, and respect for Mr. Hancock in particular as an able investment banker, do not require that I refrain from saying—without any rancor—that I have little respect for the kind of attitude he has expressed with respect to corporate accounting and its regulation by the S.E.C. That attitude can be illuminated by observing a similar attitude in another field.

Time was, not so long ago, when a physician, engaged in making an educated guess as to what was wrong with a patient and as to his future health, relied chiefly on the appearance of the patient, his pulse, his temperature, a glance at his tongue and throat, and on the physician's trained judgment, based on his background of previous experience. Today, most physicians also employ a multitude of laboratory tests. Suppose now that a critic of modern medical practice came before you and said: "What's the use of all this expensive laboratory hocus-pocus? It's sheer nonsense to expect absolute exactitude in medicine, and these newfangled gadgets can't produce it. Nor will their use make everybody well. A doctor must exercise judgment; and judgment based solely on laboratory tests is no substitute for the good old ways. Many patients were cured before there were any medical laboratories. Let's scrap them and go back to the old, simple, observational methods."

Such remarks are an instance of dan-

gerous, uncompromising thinking. They present a false antithesis. They divide the subject of medical practice into two distinct hemispheres: first, one in which doctors make their educated guesses as to a patient's present and future health without modern laboratory aids, and second, one in which those aids and *nothing else* are employed. It erroneously depicts two and only two alternatives. Of course, today no physician in his senses relies solely on laboratory techniques. He uses judgment based upon both the old and the new methods.

But the critic stupidly insists on either the old or the new. And he rejects the new because (1) it alone is insufficient (as every doctor knows) and (2) it does not bring perfection in doctors' educated guessing (which no doctor or intelligent patient expects).

Such a critic dogmatically employs what may be called "either-or" thinking, an approach which is wholly fallacious with respect to most subjects—including accountancy—since it unwisely confines attention to one of two possible methods. Usually, there is not such a limited choice—as if between black or white. There is a spectrum of choices or, rather, there are choices between several possible blendings of methods, old and new. Frequently, the new does not displace the old but supplements and improves it.

What we need is "*both-and*" thinking which says, "We want *some* of this *and* also *some* of that," which does not pit the "purely" good against the "purely" evil, but makes nicer discriminations and differentiations. You will note that science employs graduated scales of value. It does not portray heat *versus* cold, but speaks rather of 20 degrees or 60 degrees or 100 degrees of temperature.

We should beware of the dogmatic "either-or" man. He is, in most instances, a kind of perfectionist; and perfectionists are dangerous people who

often stultify progress and prevent desirable change. *The sin of perfectionism is that it mutilates life by demanding the impossible.*

Perhaps I should be a little more explicit. There are, I suggest, two kinds of perfectionists. The *positive* perfectionist is a man who insists that men must live up to his ideals, even if they are impossible of attainment. He demands the impossible in conduct. He is impatient with anything short of absolute perfection. But, in his favor it should be noted that, at least, he is usually aggressive—forward moving—in his search for perfection.

There is also the *negative* perfectionist. He is against all change because it will not bring perfection. Unless a proposed forward step will produce the "absolutely" perfect, he opposes it. He prefers whatever exists, no matter how bad, unless it can be supplanted by a flawless substitute. He is a passive resister. He usually tries to defeat a particular change by mistakenly charging that its proponents make extravagant claims. He erroneously reports them as saying, "This new device will have no defects." He ignores their qualifying adverbs, puts in their mouths words which they never uttered, and ascribes to them attitudes which they never entertained. He somehow induces himself to believe that they are one-hundred-percenters, all-or-nothing fanatics, wild-eyed advocates of the impossible.

II

Mr. Hancock's speech is an excellent specimen of that kind of absolutist or negative perfectionist approach in its most pronounced form. You will recall how, in favorably contrasting (1) unregulated accounting with (2) accounting when regulated by the S.E.C., he characterized the latter as involving an impossible striving for "extreme precision" and for "absolute accuracy" or "absolute factual certainty."

You see, at once, the tactics of the negative perfectionist: Mr. Hancock has loaded the dice in favor of unregulated corporate accounting. He describes, as the one and only alternative, a kind of regulation which seeks to require the "extreme" and the "absolute." If that description were correct, there could be but one verdict: regulated accounting under the securities act would be ridiculous. If the choices were, in truth, restricted to the two presented by Mr. Hancock, no sane man would fail to elect in favor of unregulated accounting—in favor either of the repeal of most of the securities act or the condemnation of those who have administered it.

But that picture is absurd. The securities act does not contemplate anything so impossible as "absolute accuracy" or "extreme precision" in accounting. Nor does the S.E.C. seek to obtain it. As you are well aware, its aims are far more restrained. It strives for improvements in accounting standards, admitting freely that perfection is unattainable. That the S.E.C. does not deal in "absolutes" or "extremes" is well known to most of the accounting profession which, I am glad to say, has cheerfully coöperated with us in striving to improve corporate accounting—and without aiming to reach the moon of perfectionism. Neither the S.E.C. nor the accountants discard all the old techniques (necessarily involving judgment), nor assume that all the new and improved accounting standards—which are gradually being evolved—will ever exclude all error and produce absolute precision and infallibility. But you and the S.E.C. believe that accounting must be constantly re-examined, and that revisions of procedures must be made again and again, in order that the profession may serve the current needs of the investing public with all practicable efficiency. To my mind, our coöperative program has not overemphasized the need and value of your reports as

auditors; and I believe the improvements which have been made have been salutary.

Mr. Hancock deplores "the kind of attacks which have been made upon management and upon auditors during recent years." If he means *unfair* attacks, I concur. If he means severe criticism of *some* managements and auditors based upon such cases as McKesson & Robbins or some of the cases recently reported in our investment-trust studies, then he is surely wrong. I hope that, in that respect, I have misunderstood him. But I do go along with him in objecting to those who have tried to put business, as a whole, "in the dog house." It is just because I think that indiscriminate efforts to overpopulate the kennels with businessmen should be avoided that I trust that, by the coöperation of honest practical businessmen, accountants, and government, we can make life so hard for the crooks that honest businessmen may not unfairly be accused because of the misdeeds of their dishonest fellows.

As the heart of Mr. Hancock's attack on S.E.C. regulation of accounting is to be found in his commendation of the unregulated annual corporate reports to stockholders, it is of interest to note that the *New York Herald Tribune*—a most conservative newspaper—said, on August 22, 1940, of those unregulated reports: "While a number of corporations have realized the wisdom of publishing informative, detailed reports of their operations, complete with comparisons and share earnings, there are still too many companies which believe that the function of the report is to obfuscate rather than to elucidate."

That statement is amply confirmed by the exhaustive studies conducted by the S.E.C. of malpractices by certain investment trusts. In our report to Congress on the accounting methods of those companies we said, in part:

"With this large industry almost

completely unregulated and unsupervised, information concerning these abuses and some protection against them might have been afforded the investing public had there been in general use a sound and recognized body of uniform accounting principles and practices. The Commission's study of the accounting practices of investment companies has disclosed, however, that during the period studied there was almost completely lacking in the investment-company industry any such recognized body of uniform accounting principles and practices. Instead, there reigned such diversity and confusion, that accountancy sometimes was transformed into an instrumentality by which abuses were both perpetrated and concealed rather than exposed. It is clear that the managements of many investment companies, free from almost any restraint, favored those accounting practices in connection with their companies which were not in accordance with sound accounting principles, but rather according to whatever designs seemed to the managements best fitted to promote their immediate objectives, and the adaptability of one method or another to the accomplishment of these ends. So great was the variety of accounting practices in use among the various companies that the terse terminology of the stockholders' report became either unintelligible or definitely misleading. The few short words which traditionally comprise the vocabulary of income statement and balance-sheet—'income,' 'profit,' 'capital,' 'surplus'—were invested with such varied and conflicting significance that they afforded no true measure of the performance of the individual company, and rendered almost impossible accurate comparisons between companies.

"For example, at least four different methods were available to investment companies in computing the cost of securities disposed of from a block which had been acquired at different times and prices. Frequently, the use of one or another of these methods would result in the recording of a 'profit' on the sale, while use of the others would

have produced a loss. In consequence, it frequently occurred that a company which reported substantial earnings fundamentally had a position no better than another company which reported a loss, due to the use of varying criteria of cost measurement. Moreover, from one year to the next, behind apparently identical earnings reported by a company might lie very different results caused by a shift from one method of determining cost to another. In the same manner, and with like effect, securities carried in the portfolios of investment companies were valued in accordance with four distinct standards, each of which affected investment and profit accounts differently.

"Reports to stockholders were found to be deficient in numerous respects. Some were deficient in their failure to reveal the basis of computation of profits or losses upon sales of securities. . . . In others there was a deception arising from the failure to qualify the amounts of profits and losses when portfolio securities had been disposed of after a write-down. . . . Likewise, trading losses were considerably understated. . . . By a failure in some instances to publish adequate analysis, reserve accounts became instrumentalities for covering up realized losses and for the distortion of trading results. Similarly inadequate analyses of surplus accounts in published reports led to the concealment of substantial realized losses. . . .

"Accountants' certificates which accompanied statements sent to stockholders were often characterized by equivocal phrases and material omissions. The statements themselves appear to have been more often inscrutable than informative. . . . The conclusion seems unavoidable that large numbers of stockholders were led to repose confidence in reports which would otherwise have aroused their suspicion, by the very presence in these reports of the names and certificates of certified public accountants. Although this may have resulted in some measure from the failure of the public to apprehend the limited nature of the accountants' engagement or from the fact

that those limits were not made known, the study discloses that, even within the scope of their contractual duties, the work of many accountants was replete with faults, both of omission and commission, which contributed materially to the end result. It is a commonplace, to which the present study gives point and substance, that protection which does not protect is more dangerous than none at all."

It is gratifying to note that Mr. Hancock's eloquence did not persuade his own business associates. For Mr. Arthur Bunker, of Lehman Corporation (affiliated with Mr. Hancock's banking house), in the summer of this year—a few months after Mr. Hancock's attack on the accounting provisions of the securities act and their administration by the S.E.C.—joined with other leaders of the investment-trust industry and with the S.E.C. in recommending the bill which, in August—without a single dissenting vote in either house of Congress—became the investment-company act of 1940. That act contains provisions which go beyond the securities act of 1933 in conferring upon the S.E.C. powers to regulate the shockingly substandard accounting practices which had occurred in parts of that industry. The business spokesmen for that industry recognized that the establishment, by S.E.C. regulation under legislation, of decent accounting standards was essential to protect honest managements from unfair competition by dishonest managements. They did not accept Mr. Hancock's views that legislation of that kind "hampers or prevents . . . sound, healthy business life."

And they did not agree with him that annual corporate reports to stockholders, not subject to S.E.C. scrutiny, show that in corporate accountancy "a better job is being done in the unregulated field than in the field covered by regulation" or that "the uniform tendency for law or regulation is to

set up either unworkable standards or low standards . . ." For the investment-company act specifically gives the S.E.C. jurisdiction over the annual reports of investment companies to their stockholders.

To E. F. Connely, President of the Investment Bankers Association, such governmental scrutiny is "espionage."³ That, of course, is mere name calling. It could be employed to damn any necessary governmental scrutiny: Shall we say, for instance, that government bank examiners, inspecting a bank, are engaged in "espionage," and shall we, accordingly, abolish government bank examinations? At any rate, many investment bankers who sponsored the investment-company act of 1940, and who are also leading members of Mr. Connely's I.B.A., plainly did not accept his philosophy.

Investment companies, however, comprise only a small fragment of our corporations. The reports of most corporations to shareholders have for the most part been subject neither to scrutiny by a governmental agency, nor to specific statutory requirements. Many, in the 1920's and early 1930's, used the "dance-card" report—a ten-item balance-sheet, and possibly a few kind words by the president. A reasonably detailed income statement was a rarity. The critics of the time, many of whom were accountants, were by no means oblivious to these shortcomings. The condemnation by W. Z. Ripley⁴ has become classic. You may say that such examples are of a long-past era. By no means. True, there has been some improvement—and particularly so because, after the passage of the securities

acts, many accountants have refused to certify annual statements unless in substantial conformity to the annual report forms filed with the S.E.C. But many areas of information are still omitted from the reports sent to stockholders. The far-flung industrial empire of parent, subsidiaries, and intervening holding companies is still reflected, for the most part, only in the form of consolidated statements. The balance-sheet of the parent, the only entity in which its stockholders have a direct interest, is seldom made available, even when there are large minorities or heavy debts in the subsidiaries—all ranking ahead of the parent's creditors. When consolidation is not complete, separate statements, even for important unconsolidated subsidiaries, are the exception. Often nothing is said as to the relation between the earnings and dividends of subsidiaries or as to the increase or decrease in the parent's equity. Sometimes not even the extent of the minority interest is separately shown. In one case at least, the balance-sheet was for one group of companies—the income statement for another. Can these be examples of information unnecessary for an investor? I think not.

A study we have made of reports sent to stockholders shows many cases of deficiencies in vital information. What profit is it to the investor to know that the lump sum of cost of goods sold (including, without a breakdown, selling, general, and administrative expenses) is so much, or, indeed, merely that the difference between these expenses and net sales, both undisclosed, is such-and-such an amount? Much better than nothing, perhaps, but is it comparable in adequacy and informativeness with the reasonably itemized statement of income and expenses, required in reports to the S.E.C., and found more and more frequently in the annual reports of progressive companies?

In the course of our consideration of

³ "Excessive Regulation of the Issuance and Sale of Securities," a speech delivered on October 11, 1940.

There he said, "Business is made extremely difficult when conducted under a cloud of continuing show-cause orders—the practical effects of constant espionage as to business behavior."

⁴ *Main Street and Wall Street* (1926).

particular cases, accountants on our staff have again and again told us that there was no single well settled practice in a given field. Indeed, in some cases there has been a wide divergence in the views of various members of the staff as to the proper practice to be followed. Adoption of one or the other would have resulted in wide differences in the amount of reported income and assets. The organization and operation on your part of a research department is also evidence of diversity in practice. Many of our footnotes are designed to require a disclosure, in reports to the S.E.C., of the accounting policies followed in a particular field. Yet a comparison of the unregulated annual reports sent to stockholders with the filings with the S.E.C. (10-K reports) clearly shows that most of these footnotes are omitted from the former. So long as wide divergence in practice exists, can such omissions be justified? Or is it to be concluded that it is unimportant to an investor how income is computed—so long perhaps as the result of the computation is shown?

Under the securities-exchange act of 1934, the Commission has power with respect to proxies of corporations, the securities of which are listed on a national exchange. Pursuant to that provision, we require the furnishing of certain information as a basis for the solicitation of proxies; and, if financial statements are called for, there is a tendency to assimilate the annual stockholders' report and the proxy statement. In that indirect way, we do have some effect on the annual reports of listed corporations. Under the securities act of 1933, however, we have virtually no direct or indirect power over such annual reports. The obligation to file statements with us has had, to be sure, the collateral effect of placing the unregulated report to stockholders on the defensive, if it differs substantially. But that is not a very effective method. The investment-company act

goes further, as I have pointed out, with respect to investment companies.

There is a provision in the trust-indenture act which opens up an almost new field for conveying information to security holders: A corporate borrower, subject to that act, is required to file reports with our Commission comparable to those required of listed companies under the exchange act. But the trust-indenture act goes beyond that point. It requires the borrower to transmit to each security holder such summaries of those reports as may be required by rules and regulations issued by the Commission. The recipients of these reports are not stockholders—but bondholders (including debenture holders). This is a partial recognition of the principle to which the Supreme Court last year adverted, in *Pepper v. Litton*, 308 U. S. 295, that the officers of a corporation owe fiduciary obligations to "the corporation, its stockholders and creditors." We are confronted under that act with these problems: Of what should these summaries, sent to bondholders, consist? Should they approach a prospectus in scope? Or the brevity of the average stockholders' report? Being designed for bondholders, as distinguished from stockholders, what special features and what differences, if any, from annual stockholders' reports should be introduced? These questions are not yet decided. Before they are, we shall again, as we have in the past, seek your counsel and explore your suggestions. But I have no doubt that the result at which we will arrive will give the bondholders much greater accounting detail than Mr. Hancock thinks they should have.

In Mr. Hancock's paper he referred frequently to an alleged suggestion that corporate accounting could and should eliminate the exercises of judgment on the part of accountants, and enable investors to make unerring judgments as to future corporate earnings and as to the future market value of corporate

securities. He characterized such a proposal as "sheer nonsense." Now no one connected with the S.E.C. has ever made such a ridiculous suggestion. I agree that such a notion, to use Mr. Hancock's phrase, is "sheer nonsense." If science cannot predict next week's weather with any degree of accuracy, how can any intelligent person believe it possible to predict, with exactitude, future corporate earnings—which are a function of innumerable unknowable variables?

Since, however, in October, 1939, I made a speech, "Accounting for Investors," in which I discussed the possibility of improved accounting as an aid to somewhat better educated guessing about future corporate earnings, and since, so far as I know, no one else in the S.E.C. has as extensively discussed the subject of the relation of accounting to earning forecasts, it is fairly obvious that Mr. Hancock was referring to that speech of mine. It is true that I there suggested that accounting for investors—which I differentiated from accounting for other purposes—should give considerably more emphasis to those aspects of the corporation's history bearing on its past earnings and their causes so as to furnish somewhat more assistance to the investor than he can now obtain in forming a judgment as to a company's future earnings. But I went on, at considerable length, in that speech to point out that, by no possibility could any corporate accounts reflect the numerous factors—many of them unknowable by anyone—which an investor would need to know if it were ever to be possible for him to form anything like a precise judgment as to a company's future earning power or the future market value of his securities. Time and again I stressed the impossibility of an absolutely accurate prediction as to such matters.

That speech of mine was published in *The Journal of Accountancy* for October, 1939, and I shall therefore not

repeat it here in detail. Those of you who have read it will recall that my main theme was that more consideration of the kind of information which is valuable to investors might be given in the preparation of those accounting reports designed for the use of investors. I said that the investor must be made aware that not only are the principles of accounting not fixed and certain, but that the facts to which they are applied are often matters about which reasonable men can differ since, frequently, those facts rest upon human—and therefore fallible—judgment; that the arithmetical form employed by accountants is a convenience which often expresses something that is but, at best, a conjecture about conjectures; that the investor should not be deceived as to the inherent uncertainties which lie back of the prim and neat arithmetical façade of the accountant's report. I pointed out that, while the primary value to investors of the accountant's report was to aid them in conjecturing the future net earnings of the corporation, they must recognize that no one can "determine" future earnings. "All that we can do," I remarked, "is to conjecture, to surmise—to guess. And that is true not only because 'net earnings' is a relatively vague term—involving, as it does, fallible judgments as to depreciation, bad debts, and other items—but, far more important, because the past is no infallible guide to the future—except to an Omniscient Being, who knows all the events of the past and correctly interprets their meaning for the future. No man either knows all past events or is able thus to interpret them; no man can, therefore, with surety, predict the future. . . . Factors which are inherently impossible to weigh and measure and therefore to estimate in advance may . . . upset a well thought out business forecast. . . . In an era where change, not permanence, is the norm, where the one certainty is that there is

no certainty, we capitalize earnings which have been stable in the past as if they were sure to be stable forevermore. We thus project the impermanent present into an imaginary permanent future. . . . The truth is that profits are subject to hundreds of incalculables which neither accountants, nor anyone else, can foresee. *Future earning power, and therefore 'value,' are, I repeat, a prediction, a guess. But that guess should be an educated guess.* When I say that, I do not mean, of course, that, because complete certainty in accounting is lacking, there is or must be complete uncertainty. The accountant's performance lies between those polar extremes. . . . We are but mortal, and contingency is the essence of mortality. Only in the grave do we escape it. Almost all thinking is based on mere probabilities, not on guarantees. . . . To ask for complete and absolute exactitude, at all points in accounting, is absurd."

And I concluded that part of my remarks thus: "The accountant . . . supplies *some* of the materials for, some of the ingredients of, the investor's judgment. The ingredients he supplies should, therefore, be as pure as possible; *but the investor's judgment (or that of his advisers) cannot be compounded solely of those ingredients, nor can the accountant be asked to do the work of the investment analyst.* It is, accordingly, essential to emphasize the importance of good accounting, but a mistake to overemphasize it to the exclusion of many other factors. *I distinctly do not mean that the accountant is to forecast future earnings.* I do not mean that he should give greater recognition to the fact that the principal interest of the investor and his advisers is future prospects—earnings. In sum, I do not mean that the present financial statements should be replaced by earnings forecasts. But I do mean that financial statements intended for investors should be designed with a view to their ultimate use in

appraising earnings prospects. That should be the focus of the accountant's attention in preparing reports for investors."

Now those remarks on the importance of the income account to investors were not entirely unorthodox, excepting, perhaps, in their cautiousness. For your own American Institute of Accountants had said five years earlier that "the real value of the assets of any large business is dependent mainly on the earning capacity of the enterprise," and also said, "It is probably fairly well recognized by intelligent investors today that earning capacity is the fact of crucial importance in the valuation of an industrial enterprise, and that therefore the income account is usually far more important than the balance-sheet."⁵

And on April 26, 1940—the very same day and at the same meeting at which Mr. Hancock delivered his paper—Mr. Bowlby, a partner of the well known accounting firm of Barrow, Wade, Guthrie & Co., after referring to and generally approving my October, 1939, speech, said: "It may be accepted as the present philosophy of investment that earning power is the major factor. However, investment judgments are not formed on past results, except as those results throw light upon what may happen in the future. Hence, it is essential that financial statements disclose such information, regarding past events under known economic conditions, as will enable a prospective investor to form intelligent conclusions with respect to future trends. Probably no great portion of the investing public can make an intelligent forecast, but those who can are entitled to the information. Hence, a principal objective of financial statements is to disclose the reasonably prospective net earning power of the enterprise." I suggest that you contrast those remarks with Mr. Hancock's as-

⁵ *Audits of Corporate Accounts* (1934), pp. 6, 10.

sertion that "it seems futile to think of an annual report as giving *any* adequate basis for appraising future value of securities . . ."

The uninformed reader of Mr. Hancock's paper would conclude that we on the S.E.C. believe that the investor should rely, to quote him again, "upon details of accounting almost to the utter neglect of other factors." Of course, that is not true. No one believes more emphatically than I—and I have said so, in public and private, many times—that *when one invests in a corporation he is inescapably investing in management*; that management involves the exercise of judgment and discretion; and that the qualities of good or bad management include many intangibles which cannot possibly be recorded in figures.⁶

Mr. Hancock, subsequently, made much the same point. But because of the impossibility of catching, in the net of efficient accountancy, *all* the facts bearing on the future of a corporate enterprise, he concludes that it is silly to use accountancy as *one* of the aids in surmising a corporation's future. He is guilty of a well known fallacy—the confusion (to use high-brow terminology) of a "necessary" with a "sufficient" condition: Thus, while it is true that men cannot live without salt, that is not the equivalent of saying that men can live by salt alone. Similarly, while good accounting is indispensable, it is not, alone, sufficient. And so, that accounting can never be precise, that it unavoidably involves judgment factors, that it alone cannot be a guide to predicting future earning power and that, indeed, there is no unfailing method of predicting future earnings or future

market values—all that does not, at all, compel the conclusion that accounting for investors cannot be so revised as to give to the investor *some* more help than accounting has heretofore given in affording him *part* of the data upon which he can base a *guess* as to future earnings and market values.

Of course, there are no infallible means for arriving at precise judgments as to such matters. But we must do the best we can with the best knowledge we can obtain. "Every year, if not every day, we have to wager our salvation upon some prophecy based upon imperfect knowledge," said Mr. Justice Holmes. Surely, if the past history of a company's earnings is told with approximate accuracy and the telling shows that the earnings have heretofore been very bad, that narrative is *some* help in forecasting the future earnings. And the same is true as to a narrative showing a very handsome earning history.

The point is that it is unsound to reason in any field that, because perfection is not possible, and because increased information will not furnish a foundation for completely guaranteed judgments, therefore attempts to procure as much more adequate and useful information as is available—within the limits permitted by the nature of the subject matter—is useless or nonsensical. It is well to bear in mind these wise words of Aristotle: "We must not look for the same degree of accuracy in all subjects; we must be content in each class of subjects with accuracy of such a kind as the subject matter allows, and to such extent as is proper to the inquiry. . . . An educated person will expect accuracy in each subject only so far as the nature of the subject allows."

The history of thought in every field contains instance after instance of just such objections to procuring more accurate information as have been voiced by Mr. Hancock. He referred to the days when men argued about how many

⁶ In my speech of October 10, 1939, I said, "It is one of the many valued contributions of my distinguished predecessor, now, Mr. Justice Douglas, that he focused attention on the fact that men are at least as important as assets in the efficient functioning of a business; that stupid or crooked management on the one hand, and wise and alert management on the other, can break or make the business."

angels could dance on the point of a needle. In those days, the Middle Ages, men were burned at the stake for wanting to learn more about arithmetic, astronomy, and dozens of other subjects.

Galen's writings on human anatomy were derived from studies of the insides of monkeys. When Vesalius subsequently began dissection of the human body in order to discover what it was like and how it differed from a monkey's interior, he was charged with impiously trying to upset the established rules of anatomy. As Andrew D. White tells the story, the cry that went up against Vesalius "has been the same in all ages—the cry for what is called 'sound learning.' . . . The idea has always been that the older studies are 'safe.'" Certain men, one might say—thinking of Galen and Vesalius's critics—have a fondness for "monkey business."

As to vast areas of experience, the human race is ignorant and will always remain largely so. There are factors in the universe as to which, because of our limited equipment, we shall always, almost surely remain in darkness. Chance will always play an important part in human affairs. Comparatively little of the future will, I think, ever be precisely predictable. But because our ignorance is and must be large, that is no reason why we should wallow in it, no reason why we should diminish our efforts to reduce the unknowable, the unforeseeable, so far as possible.

It has been said that the better is the enemy of the best. Sometimes that is true. But it is no less true that the all-or-nothing men, those who will have nothing but the unattainably perfect, are the foes of improvement. If all men had insisted that either they must fly with the skill of birds or not fly at all, aviation would not be here today.

Negative perfectionism has often retarded the use of inventions. Robert Fulton's steamboat was called "Ful-

ton's Folly." DeForest's efforts to launch the wireless telephone were laughed at by the Western Electric Co. Not so very long ago, the chief engineers of a leading telephone company scoffed, before the American Institute of Engineers, at the automatic telephone.

Paradoxically, the calm acceptance of unavoidable imperfection improves effectiveness. For such an admission rids us of an impossible task and enables us to face the environment unburdened by a feeling of the necessity to stretch our aims beyond their practically possible scope. By conceding the immense amount of our inescapable ignorance, we become more alert in detecting facts. To the extent that one goes to sleep in a dream of attainable perfection, he becomes the victim of uncertainties and imperfections which he ignores and which he therefore fails to allow for. The courageous attitude of accepting as inescapable the existence of uncertainties and imperfections, makes one's world picture more complex; life is disclosed as far more precarious and difficult to conciliate. But such an attitude usually drives men to learn more about what was previously undetected, thereby reducing the area of the unknown and uncontrollable. It is indeed true that, in so far as we become mindful that life is bound to be less perfect than we might like it to be, we tend to improve it. We should never have had steam engines if men had been content with dream engines. Airplanes were not invented by believers in wishing rugs.

III

Please do not misunderstand me. I am not for a moment charging Mr. Hancock with deliberately and intentionally distorting the views of the S.E.C. He is an honest man. But I surmise that what happened to him was something like this: As I've indicated, he joined a campaign to have the securities act disemboweled. Now if the S.E.C. in its administration were de-

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manding perfection, if it were made up of academic extremists, then Mr. Hancock would have had an excellent argument in favor of such an amendment. He, therefore, doubtless wanted to show that such was the case. Presumably, when he came to write his April, 1940, paper, he vaguely remembered what I had said in October, 1939. If I had said what, in his paper, he ascribed to me, it would prove his point. And so this is what I surmise:

Wishful memory came to his assistance. No doubt he honestly believed that I (or someone in the S.E.C.) had made the absurd statements which he erroneously imputed to us. He was, I suspect, so carried away by the music of his own rhetoric that he neglected to check up on the accuracy of his reporting.

Every lawyer knows that honest witnesses sometimes remember past events in accordance with their desires. The courts have observed that "men are prone to see what they want to see"; that "our sympathies and our prejudices bias our memories"; that "very honest persons often deceive themselves without being aware of it"; that, when a person has a deep interest, "his interest will, even if he wants to be truthful, impress upon his memory with much greater distinctness those things which make in his favor than it will those which make against him"; that "our memories are easy and oftentimes unconscious slaves to our will"; and that "the interest of a perfectly creditable and innocent witness may, and often does, color his recollection and mold his impressions, sometimes even insensibly to himself." It is also a fact that Mr. Hancock was inciting to war on the S.E.C. and was perhaps influenced by the precept that men do not follow an uncertain call to battle.

Let us look now at the central thesis of Mr. Hancock's criticism of the securities act: He points to the fact that most corporate managements are honest. With that the S.E.C. heartily agrees.

He goes on to say that there have been some "notorious exceptions" but that the "good human qualities" of "integrity, probity, ability and judgment" of corporate management cannot be "injected into a situation where they do not exist through the operation of any act of Congress or regulation based thereon." He says that he "has little belief in the power of law or regulation to make men honest . . ."

Again you will perceive a false picture made up of sharp blacks and whites: Of course, laws cannot make all men honest. But that does not mean that one must go to the other extreme and say, "Therefore, let us abolish all laws prescribing standards of honesty." Of course, regulation is no substitute for good faith. There are thieves and murderers in the world despite the fact that for many years there have been laws against theft and murder. Should we, therefore, repeal the laws against theft and murder? Surely not. Laws have their effects, partly because fear of punishment for a violation of the laws acts as a deterrent and—far more important—because, after a while, the existence of the standards of minimum morality enacted into law creates habits and customs so strong that most men will not break with those habits and customs, will not even contemplate doing so, because they accept their operation as they do the air they breathe.

As I said, Mr. Hancock is a "*negative perfectionist*": If a law is not sure to be 100 per cent effective, then, he feels, the law is not good enough and should not be enacted, or, if it is already enacted, should be repealed.

Mr. Hancock goes on to say that it is unthinkable to him that any body of sensible men "will say as their deliberate judgment that the present securities acts and their administration are *in all respects* reasonable." Again I am in accord with him—as far as he goes. For you will note the perfectionist phrase, "*in all respects*." I defy anybody to find

any statute or any administration of any statute or any human institution which is "in all respects" reasonable. I do not believe that, at any foreseeable time, there will be a world in which that will be possible. Human institutions are, as their name indicates, human, and therefore necessarily fallible.

The members of the S.E.C. recognize that because they are human, and are called upon to act, they are bound to make some mistakes. They would not want you to believe otherwise. For they are devoted to democracy. *And only under a dictatorship is it a dogma that those who hold office can never err.*⁷

The S.E.C. Commissioners take only this to their credit: They do their conscientious best to avoid mistakes. When they find that they have erred, they admit it and change their ways. In April, 1940, Mr. Brownell, counsel for Morgan Stanley & Co., in arguing before us, in the Dayton Power case, that one of our own rules was invalid and that we should reverse ourselves, said that he knew, from experience, that we would consider his argument "with the same disinterestedness as the Supreme Court"⁸

⁷ Without claiming to be "good," we do share something of the attitude expressed by the poet MacNeice:

"And to the good who know how wide the gulf,
how deep
Between Ideal and Real, who being good have
felt
The final temptation to withdraw, sit down and
weep,

We pray the power to take upon themselves the
guilt

*Of human action, though still as ready to confess
The imperfection of what can and must be built,
The wish and power to act, forgive, and bless."*

⁸ I refer here to the following:

"Mr. Brownell: *I am in the position*, where we often find ourselves in this connection with administrative procedure, *of urging you gentlemen to reverse yourselves* on a rule which you yourselves have adopted and also of asking you to find that a case which was brought as a result of your own order to show cause and was tried by your own staff is not a well founded case.

"Chairman Frank: That will not have been the first time.

"Mr. Brownell: It will not, as I was going to say, Mr. Chairman, have been the first time and I was going to add that *I know that when this*

Mr. Hancock reports that he is "impatient over the attempt to improve everything at once." If he means instantaneous improvement, I share his views. But I deplore his intimation that a fanatical passion for impractical instantaneous improvement of everything is characteristic of the S.E.C. If the S.E.C. were so daft, why is it that the investment-company act of 1940, at the express request of the businessmen in that industry, conferred upon the S.E.C. far more discretionary power than the S.E.C. requested? *That added discretion, in other words, was thrust upon us by those businessmen.* Did not that fact—plus the fact that those businessmen vigorously urged the enactment of that statute this year and did all they could to avoid postponement of its enactment until next year—go to show that they were willing to trust to the good horse sense of the present personnel of the S.E.C.?

And did not those facts, too, serve to answer the recent remarks of E. F. Connely, that the federal government is endeavoring to overregulate transactions in securities?⁹ For it is a notable

Commission sits in its judicial capacity it considers questions that come up from its legislative branch, as it were, and its executive branch, with the same disinterestedness as the Supreme Court would consider a question that came from Congress or that came from the Attorney General's office. I would also add that although in the last seven years I have appeared before the Commission a good many times, and I have worked with the administrative departments a good many times, I have never appeared before the Commission en banc, when it was sitting in its judicial capacity, without getting a full, fair, and considerate hearing, and a determination of facts and the law which was unprejudiced and fair."

⁹ See his speech of October 11, 1940, in which he said:

"Even though it were possible to enact regulatory laws without delegating some discretion to the enforcing agency, I don't think it would be practical. The exercise of discretion as to the same or like subject matter by different individuals of varying training, experiences, attitudes and personal predilections is, however, a most uncertain factor. Frequently it is an expensive and embarrassing factor. Yet certainty of law, including rules and regulations, under which issuers and underwriters must operate, is of the utmost importance and economic value. Unlike

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fact, as I have said, that some of the principal members of his own Association were among those who, a few weeks ago, successfully urged Congress to pass the investment-company act. Obviously they did not accept Mr. Connelly's thesis that such regulation paralyzes free private enterprise and promotes totalitarianism. They knew that the preregulation exploitation of thousands of middle-class investors might constitute a prelude to totalitarianism; that, if such exploitation continued, there would be grave danger of so angering the great middle class that it would be likely to turn to some dictator who, falsely promising to save the middle class, would destroy it, and, with it, democracy and capitalism. The truth is that the major function of the S.E.C. laws and the S.E.C. is conservative—to aid the conservation of our American profit system under our democratic form of government.

I repeat, we on the S.E.C. are not perfectionists or panacea-mongers. We are firm believers in sensible and intelligent working compromises. I wrote a whole book on that subject, published two years ago, in which I said this: "All compromises are not evil or foolish. Life

is full of compromises. Walking is a compromise between falling down and standing up. . . . Most dealings between human beings in daily life involve innumerable compromises; civilization is built on mutual yieldings and concessions. There are good and bad compromises. Some deserve applause and others condemnation. And so with objections to 'half way measures' and 'gradualness.' Life could not go on without them. Sleep is a half-way measure. When one uses brakes on a steep hill he is practising gradualness. To avoid gluttony or drunkenness is to be gradual and half-way."

But, although the S.E.C. does not believe in perfection or in trying to improve everything at once, it does believe in constant sensible efforts at improvement. I had always thought that was the American way of life. I had always thought that the great progress which this country has made over the years was largely a result of the fact that we have never been satisfied. We have constantly driven ahead to make things better and to make better things. That applies to manufacturers, doctors, scientists, lawyers, and to government as well. There is no

the courts, these discretionary opinions, rulings and orders do not become precedents for future guidance. They are differed with, overruled, set aside or ignored by others with almost reckless independence. No commissioner need be influenced by the opinions or orders of another. There are times when it appears that some obstinately exercise discretion contrary to opinions of others of parallel authority as a sure way of asserting independence of thought and action with but little or no thought to the expense and other burdens entailed upon the industry seeking capital for its operation or expansion. There are those whose philosophy of government is law by man rather than by statute, who with the least bit of discretionary power set themselves up as prosecuting attorney, judge and jury, and I don't have to tell you that such a situation is unsound and *not* apt to be in the public interest. If discretion were exercised strictly within the spirit and intent of the law, expressed or clearly implied, there could be no fair complaint."

It is interesting to compare that statement with a letter to *The New York Times*, published on October 11, 1940 (the same day on which

Mr. Connelly made that speech), by Arthur Dean, who has been acting as special counsel for Mr. Connelly and the I.B.A. in recent conferences with the S.E.C. concerning amendments to the securities act. In that letter, Mr. Dean said, in part:

"As one who has followed the work of the Securities and Exchange Commission since its inception and who in the Dickinson report recommended the establishment of an independent agency to administer the securities act and the law affecting stock exchanges, I can testify that the President has not turned the Securities and Exchange Commission over to partisan classes or groups without regard to the principles of fair play in public administration. While on occasions I have disagreed with and have criticized the Commission for various of its acts or decisions, it would be difficult, if not impossible, to prove that the Commission has a personnel friendly to any particular classes or groups or that it has acted without regard to the principles of fair play in public administration. On the contrary, I think the country has been exceedingly fortunate in the Commission's members, personnel and decisions."

Extensions of Auditing Procedure

question but that it applies to accountants and auditors. We are not perfectionists, but we are "improvisers."

While we on the S.E.C. are devoted to gradualness and intelligent compromises, we are definitely not appeasers. We go along with those who believe that there are some fundamental principles which must not be compromised. The British people are valiantly demonstrating that attitude today. They have cast off their former false leaders who believed it possible to compromise concerning the minimal decencies of life with an absolutist whose purported compromises are but deceptive means for achieving a victory by which he can work out his own absolutism that abolishes all free choice for the average man.

Such absolutism is abhorrent to Americans. We do not want dictators, nor even an elected government, to manage all the affairs of life. Large areas of industry need no governmental regulation. And, even where regulation is needed, it should not be all of the same pattern. It should vary according to the peculiar characteristics of the particular regulated industry. In some industries, it should take the form of governmental consultation and coöperation. In others, some form of industrial self-regulation, with residual governmental supervision, is sufficient. In still others, experience shows that varying degrees of more drastic regulation are necessary.

Rigid and inflexible uniformity in the field of accounting would be nonsensical. And Mr. Hancock, in attacking it, is knocking down a straw man. Perhaps I can explain the difference between his point of view and that of the average investor: He is an important investment banker. He personally knows many industrial leaders and, without too much difficulty, he can obtain personal access to those he does not already know. He can talk personally to them about their business and form a first-

hand judgment of their abilities. In so far as he can trust the information he gets, he is peculiarly able to know about the future of business or the future of any particular enterprise. In short, he is in a most enviable position—a position not available to most investors who want to find out about various enterprises. He can place an enormous amount of emphasis, in his analysis of a particular situation, on management—because he knows management personally.

But the average investor who is not in that position, must place his reliance on the *record* of management rather than on the *personality* of management. And for the fair presentation of that record, the investor must rely to a considerable extent on you accountants. The investor may miss many factors which Mr. Hancock can discover, but, if you give the investor or his investment analyst enough details, he will find out at least whether or not the record is a good record or a bad record and how it compares with other records in the same industry. That is especially true, if the investor can feel confident that accounting practices and principles are relatively standardized and that the accountant who has reviewed the data is completely independent and reasonably curious.

To Mr. Hancock, the unregulated annual report to stockholders is apparently good enough. But Mr. Hancock's perspective can hardly be said to be that of the average investor. He is much more fortunate. He lives in an environment which, for most investors, is nonexistent. He needs to have much less down on paper than the average stockholder. But it is difficult to believe that important investment advisory services, like Poor's, Moody's, or Standard Statistics would want to go back to relying on the meagre accounting data contained in the average report to stockholders. In fact, I cannot imagine that even the analytical staff of the invest-

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ment trust sponsored by Mr. Hancock's own firm would want to be obliged to rely solely on that information. Of course I would admit that the average stockholder must find detailed balance-sheets and income accounts—especially when there are a lot of footnotes—pretty heavy going. But I fail to find there even a weak argument against the inclusion of such details. After all, the influence of the informed investor and the investment adviser, availing himself of fuller information, is quickly felt in the market place.¹⁰ Artificial market prices based on needlessly inadequate information—so ruinous to the mass of investors in the past—are today made almost impossible, as to registered securities, by the use of detailed and more adequate information. I am sure that you accountants will not at all agree with Mr. Connely that “investors today actually receive in understandable form less pertinent information than before the enactment of the securities act of 1933.”¹¹

And so, to repeat, I feel that we on the S.E.C. and you in the accounting profession can take pride in our constant efforts to improve the standards of corporate reporting. I feel confident that we have already made a contribution so substantial that, even if the securities laws were to become a dead letter, corporate reporting would never again shrink to its former status. The stature of your profession has grown immeasurably in the past few years. Your increasing independence is the envy of other professions. Neither you nor we will ever attain perfection, but I anticipate that we will spend a good many more years on our joint effort to improve the quality and value of information to security holders.

What we want for investors is the best available data practically obtainable. That they procure it may make life duller for some persons. As Abe Martin said, “Nobuddy kin talk half as interestin’ as the feller that ain’t hampered by facts or infermashun.”¹²

¹⁰ As to benefit to investors, through investment analysts, of the work of the S.E.C., see Graham and Dodd, *Security Analysis* (2d ed. 1940), pp. 49, 50, 53, 146, 229, 280, 286, 406, 420, 426, 446, 456, 598, 600, 609, 656.

¹¹ That was the language used by Mr. Connely in his speech of October 11, 1940, as released to and reported in the press. Mr. Connely subsequently changed this language to read, “There is reasonable doubt that investors today actually receive in understandable form as pertinent information as before the enactment of the securities act of 1933.”

¹² Because of a public statement by Mr. Connely to the effect that the foregoing speech was to be taken as a repudiation of the understanding that the S.E.C. would continue to abide by its undertaking conscientiously to confer with the I.B.A. concerning proposed amendments to the securities act and the securities-exchange act, I issued to the press on October 22, 1940, the following statement:

“I am informed that a statement made by me in my recent remarks before the American Institute of Accountants in Memphis has been misinterpreted as indicating that I believe that the Investment Bankers Association is engaged in a concerted effort to ‘gut’ the securities act. I do not believe that and I have never said that I believed it. On the contrary, I am informed that conferences dealing with amendments to the statutes between representatives of the securi-

ties business (including of course those of the I.B.A.) and the representatives of the S.E.C. have been proceeding with the greatest good nature and earnestness. I am further informed both by our staff and by representatives of the industry that distinct progress has been made. I am heartily in favor of this shirt-sleeve approach to the problem. The various groups in the industry have appointed men of high intelligence and serious purpose to work with our staff and they have told me that they have been well pleased with the progress of the negotiations. I understand that the representatives of the industry are now reviewing with their principals the ground which was covered last week and that the meetings are to be resumed within a few days. It seems likely that they will continue to be held at frequent intervals between now and January. At the time we agreed to discuss these matters around the table, Mr. Connely made it clear that he was to remain free to carry on the I.B.A.’s program of public information. He has now made it clear that he feels that our agreement to discuss these matters does not restrain him from a public discussion of various related issues. He obviously does not regard his frequent recent utterances or those of individual investment bankers criticizing the S.E.C. and the S.E.C. laws as violations of that agreement. I am sure he would not impose upon anyone restraints he does not impose upon himself and his individual members.”

Comments on Address of Jerome N. Frank

BY GEORGE COCHRANE, NEW YORK

Chairman of committee on professional ethics, American Institute of Accountants

IT IS only within the last few minutes that I have been asked to make comments on this paper, and you will realize that with its references to the classics, of which I know nothing, and to a long distant past, in which I have had absolutely no experience, it is extremely difficult to do any justice to its excellence.

I am sure we all regret extremely the inability of the chairman of the Securities and Exchange Commission to be with us in person. We, who have had our practice take us before the Commission, have known him always as an understanding gentleman in dealing with the matters in which we have taken part. I think the presence of Mr. Werntz in reading the paper takes away a little from our disappointment at not having the chairman with us.

Arising out of the matters which are brought before us, we do recognize, and I think the Securities and Exchange Commission recognizes, that out of a body of men so broadly spread over our country and whose work is always practical—we are dealing with these practical matters each day and each hour of our business day—serious mistakes have been few, and that our efforts to correct those mistakes are earnest and thorough. Our various committees, working by themselves and in coöperation with the chief accountant of the Securities and Exchange Commission, are all striving to improve the standards of the profession and, I believe, justifiably can look at the accomplishment with pride.

It is extremely interesting to have the Commission, through its chairman, express what has been understood clearly by us for years—perhaps we have

been too modest or too busy to mention it—that is, that inherent in all accounting statements lie certain fundamental shortages. We are unable, by means of a statement, to give all the information that is necessary for investment counsel and others to have. We have known this, and I believe our practice has been on this basis. The difficulty is and has been that many of those outside the profession have not recognized these shortages. One of the features of the address this morning is, I believe, the very definite recognition in the minds of the Securities and Exchange Commission that there is inherent in our statements a weakness—if you call it a weakness. The statements are estimates; they are not absolute. Those facts are now recognized, and I believe the recognition will remove certain of the criticisms which were directed at us even by the Securities and Exchange Commission in its first days of being, when perhaps it did not understand, and we had not explained, our work to the extent that we have today.

Apparently this address represents a clash of views, with Mr. Hancock on the one side, and Mr. Frank on the other. We know that both men are of steel. As a result of this clash, sparks fly, and in the light of those brilliant sparks we accountants may gain more knowledge.

It would be futile to attempt to analyze, reply to, or acquiesce in the comments which were made in this paper this morning. It has been far too deeply and carefully thought out to be answered in the few seconds that I have. I am sure, however, that it will be the basis for a great deal of thought and much study during the coming months, and I have no doubt that others very

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much more capable than I will put before you, and that you will be putting before one another, the views which we have in respect to the remarks which have been made.

I am glad there is a recognition in the paper of the lack of perfection. I am sure that in that regard we lead in the realization that we have not yet reached perfection. I believe we are traveling and have traveled a long way along the road toward perfection, but those of

us who have to deal with these things are cognizant of that lack of perfection and how far away we are from the standard which we have set for ourselves.

May I, therefore, in conclusion, express our deep appreciation of the time, thought, and care which must have been spent in the preparation of this paper, and ask Mr. Werntz on our behalf to convey to the chairman our sincere thanks.

Responsibility of Accountants in a Changing Order

BY LELAND OLDS, WASHINGTON, D. C.

Chairman, Federal Power Commission

I COME to you as a representative of the Federal Power Commission with the hope that I can give you some impression of what the Commission is doing, particularly in the field of accounting. But I want, even more, to give you my idea of the significance of that work in terms of the crisis through which the world is passing. And this will lead me to suggest the extraordinary significance which attaches to the accountant's profession in terms of events which are world shaking.

We are all conscious of the crisis. We are all conscious of dictators and marching men and destruction falling from the skies, like the fire and brimstone which engulfed the ancient cities of Sodom and Gomorrah. We are all conscious of the tremendous national defense effort which this country is making.

But I think that if one of the great Hebrew prophets of the Bible were among us, he would be interpreting the dictators, threatening us from across the sea, as instruments of God, designed to awaken us from our callous violation of His laws. I can imagine him saying:

"Because you as a people have given yourselves up to pursuit of personal riches; because you have run after licentiousness and riotous living; because you have forgotten widows and orphans and destroyed the security of the poor; because you have turned from Me and worshipped the golden calf (Mammon), I will send a dictator, with a multitude of tanks and airplanes, out of the East to overrun your fields and destroy your cities and take your children into bondage. Unless you turn

again and worship Me and obey my laws, I will blot out your boasted civilization, and your mighty buildings, which are a burden to the poor, shall be as dust."

You say that we in America are not guilty of forgetting widows and orphans and oppressing the poor, but I say that as long as we participate in business practices which entice widows and orphans to invest their small savings in securities which have no real value behind them or permit a constantly increasing overhead of unearned increment in wealth to render millions unemployed, we cannot plead "not guilty."

Now I think that America is turning toward a new conception of social responsibility and that the change can be carried out under the framework of our democracy before bankruptcy breeds forces that are hostile to the institutions in which we believe. And you, as representatives of the great accounting profession, should have a deep understanding of the process in order that you may play your great part in re-establishing the books of our business system on a sound basis, assuring people as a whole that stability and security of life which is essential to the perpetuation of human freedom.

A symbol of the great turning of the human cycle through which we are passing is, I think, to be found in the concept of property which determines the rules of the business game as played in any era. For a long-range view of the history of human institutions reveals a slow swinging of the pendulum from emphasis on the private nature of property rights to emphasis on the social

characteristics of property, and back again. Periods of emphasis on property as altogether private are associated with the dominance of materialism, the worship of Mammon. Periods of emphasis on the social responsibility attaching to property are related to the religious outlook on life.

The changes through which we are passing today, especially in the concept of property, correspond with the great changes which came at the end of the Roman Empire.

Roman Law held that private property was a natural right of the individual, although at the close of the Roman period a great proportion of the people had no property or were themselves the property of others. But in Rome a man of property could do what he would with his property and no one could say him nay, even though the use of his property might be militating directly against the public interest in the fundamentals of social stability.

With the collapse of the Roman Empire came the beginning of a new period of law, the Canon Law, the law of the church militant, representing a major swing of the pendulum toward a more social conception of property. Property was no longer a natural right under the law. In fact, the philosophy underlying the Canon Law held that in a natural state all property would be held in common. But, on account of the inherent imperfection of human nature, all property could not be held in common and the institution of private property grew up as a compromise. But the right of private property was considered a limited, not an absolute right.

Perhaps the simplest way to express the concept of Canon Law in regard to property is to speak of all property as belonging ultimately to God, open to be shared by all, but with private property as a trusteeship, necessary to make society workable in terms of men's imperfections. Men who held property assumed a social responsibility for its

administration in terms of God's purposes, which meant in terms of the general welfare. They were entitled to hold it only so long as they did not abuse that responsibility.

The beginning of our modern era in the 17th and 18th centuries represented a swing back to the Roman Law conception of property as a natural right. And, within more recent years, the increasing exaggeration of man's right to be free from interference in his use and abuse of great properties has been a major factor in creating our present economic and social problems because, as in the days of Roman materialism, it has placed crushing burdens of cost upon the operation of what, in the last analysis, is a huge, integrated machine composed of interrelated human beings.

Again we have arrived at a new turn in the wheel. It is turning back toward the conception of the Canon Law, the conception of property as a responsibility, a trusteeship in behalf of the common life. This change is going forward all over the world. Nothing can stop it. Where it is blocked by the inability of a democratic system to adjust conflicting interests to the trend, democracy breaks down. So those of us who would preserve democracy must work together, tirelessly, without rest, to overcome the misunderstandings which are preventing the natural process of change from running smoothly in our land.

Now what is the significance of this to you of the accounting profession and to those of us who are working in the field of regulation? I think we will find the answer in the new fields which government has entered in recent years, representing efforts, far from perfect, to introduce social responsibility into the management of the huge aggregations of property which constitute the wealth of the nation. And, as I have already suggested, it is significant that these developments in government have opened up tremendous fields of public

opportunity for the trained accountant.

The development of the conception of property as a trust is tremendously important in these days when private ownership embraces the great aggregations of property in natural resources and manufacturing establishments through which people secure their livelihood. It means that those who have misused the greatest trusteeship in human history have been called upon for an honest accounting. It attaches a social responsibility to the profession of accounting which cannot be exaggerated.

In order to make what I am saying as concrete as possible, I am going to take the group of great privately owned electric power corporations as an example and, in doing so, to refer to some of the efforts of the Federal Power Commission to assure the conduct of that business as a trusteeship, a social responsibility.

And here it may be remarked in passing that, under the law, the business of supplying electricity is a public business, whether performed by the government itself or delegated to private operators. That is why it is classed as a public utility, even though ownership of the facilities is in private hands. This is not New Deal law—it is ancient law. The social responsibility remains the same, whether the ownership is public or private, namely, to assure the widest possible use of electricity in the home, in the operation of farms, in business, in industry, in transportation, in lighting of streets and highways—in fact, wherever it can serve the general welfare.

The carrying out of this social responsibility in the electric power business, as in every other essential business, means securing the largest possible output at the lowest possible cost, for high costs reflected in high rates or prices are the main barriers standing between the people and the maximum use of their resources.

In the days when business was truly competitive, the force of competition itself was sufficient to assure the production and distribution of goods at the lowest possible cost. For, as pointed out by Leverett Lyon, executive vice president of the Brookings Institution: "If there are five manufacturers of a given commodity competing in a given market, and each has a cost that is different from the others, the one with the lowest cost will get as much of the business as he desires or can supply—unless others sell below so-called costs. It does the high-cost competitors no good to complain that their costs will not permit them to compete profitably. Prices simply are not made that way in competitive markets. In such a situation a high-cost manufacturer has no choice but to forget part of his costs."

Mr. Lyon adds: "No one has ever presented another plan so well calculated to make the resources of a nation at all times give the largest total yield to all the people as this plan of economic organization."

In the power business, as in many other basic economic activities of the nation, monopoly opened the way to price control, making possible the creation of great private fortunes through capitalizing artificially high values masquerading as costs. Not only was the incentive to low costs provided by competition removed but the incentive worked the other way. Progressive inflation of costs through the creation of fictitious private claims raised higher and higher barriers to hamper the steady flow of the products of our resources into consumption.

Commission regulation, which had been set up as a substitute for competition to assure the lowest possible costs for the services rendered by utility monopolies, failed of its purpose because it lacked any basis for the determination of valid cost standards. For the courts, under pressure from utility lawyers, held that the rates of any

particular utility enterprise must be based on the costs of that particular enterprise, not upon comparative cost standards. Actually, these lawyers, with the assistance of engineers and, I am sorry to say, accountants, devised increasingly ingenious and complicated ways of inflating the so-called costs which a particular company could justify in litigation.

Many of you are probably familiar with the procedures of the era in which the great utility combines were created. You know how books were rewritten and rewritten to reflect progressive revaluations of assets, to balance the face value of securities issued in excess of the legitimate original cost of utility properties. Instance after instance could be cited from the famous investigation conducted by the Federal Trade Commission, showing such write-ups reaching staggering totals. It seemed to be an accepted principle of accounting during this era to state assets at the face value of the watered securities issued.

Such inflation of the costs of utility services was not limited to the writing up of assets to support watered capitalization. The Federal Power Commission has just issued an opinion based on an extensive investigation of the service companies of the Associated Gas & Electric System. The investigation revealed that tens of millions of dollars were paid out by the operating companies to more than a score of engineering, accounting, insurance, secretarial, publicity, and other companies, the responsible operating officials being frequently without definite knowledge as to what they were being billed for.

From study of the question extending over many years, it is my impression that, if honest cost accounting, actuated by a keen recognition of the public interest in the lowest possible costs, had prevailed throughout the life of the power industry, the present cost of power service would have been

perhaps a third lower than it is today. The savings would have come from both capital and operating costs.

The importance of the matter is not measured solely in terms of injustice to consumers who, as a result, pay higher electric bills. It is measured by the cumulative effect of high costs in this and other monopolistic lines of business on the consuming power of the people, an effect which inevitably translates itself into widespread unemployment threatening the stability of our entire system. I am convinced that the salvation of the institutions in which we believe depends upon our success, within a reasonably short term of years, in restoring the honest cost standards which would have been enforced by competition. And this means the conduct of essential business undertakings as a social responsibility by men who recognize that private ownership of the great business properties is a trusteeship.

The work of the Federal Power Commission's bureau of accounts, finance and rates, I think, foreshadows the contribution which the accounting profession can make to restoring the conduct of our economic system to the controls of social responsibility. It is directed to making regulation effective through establishing a sound basis of accounting control. Actually, and this is the expression of a hope which is gradually being realized, it affords a basis for self-regulation by corporations directed by men who have come to recognize the nature of their trusteeship. Time permits me only brief reference to some aspects of this work.

The first important step in assuring that the conduct of the industry would be guided by a sense of social responsibility was the adoption in 1936 of the Commission's Uniform System of Accounts for electric power systems. This system of accounts had the effect of turning a searchlight on the conduct of the power business, affording investors

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as well as consumers an accurate insight into all its transactions.

Actually, the utilities opposed this system of accounts and, when it was under consideration in one state, one of their witnesses stated that he was opposed to the new system because it would give interested parties too much information.

The value of this uniform system of accounts is being steadily enhanced as the Commission proceeds with its duty of seeing to it that the accounts of the utilities subject to its jurisdiction are set up on an original-cost basis, with all excess capital placed in special adjustment accounts. A review of the original-cost figures, already reported, reveals two highly interesting trends:

1. A tendency for the original-cost figures to correspond almost precisely with the results which would be obtained by appraising the company on the basis of unit costs derived from similar companies which have always been conservatively capitalized;
2. A tendency for the companies with adjustment accounts well below the average, that is, with book costs closely approximating prudent investment, to be those which have become well known for their low electric rates. Similarly, high rates appear frequently associated with book costs largely in excess of such prudent investment.

In discussing the very important work which the Commission's bureau of accounts is doing, I want to refer specifically to the annual volume entitled "Statistics of Electric Utilities in the United States," which has been issued for the second time during the current year. This volume makes data reported by the companies on a uniform basis available to all interested in the conduct of the industry.

Investment houses, insurance companies, state commissions, municipalities, consumer organizations, and the utility companies themselves are in-

creasingly using this volume. Without coming to Washington to plow through the hundreds of annual reports on which it is based, they can test the operation of a given company by comparative standards of cost and operating efficiency derived from similar data from other companies. Our files contain communications indicating that important utility systems are already using the publication as a tool with which to achieve more economical operating standards. It is thus serving as a stimulus to the self-regulation to which I have already referred.

This work of the bureau of accounts is thus providing a basis for the development of sound cost standards, in a sense competitive cost standards in the power industry. Out of it should grow cost "yardsticks" which will provide an essential complement to the Commission's electric rate "yardsticks" published annually under the general title of "Typical Electric Bills."

These typical bill reports, also a product of the bureau of accounts, finance and rates, have provided, for the first time, an opportunity to compare charges for residential, commercial, and industrial service throughout the country. They cover all communities of 250 population and over. And, here again, we find that important results are flowing from the "yardsticks" in the direction of self-regulation, for their influence has led many utilities to take steps to bring their rates for electric service more nearly into line with the lower rates prevailing in other areas.

It is true that the courts have held that comparative rates cannot be advanced as valid evidence in rate cases, on the assumption that the rates of any single company can be adjudged just and reasonable or otherwise only on the basis of data reflecting its own characteristic costs. But it is my belief that, with the new possibilities in the way of comparative-cost standards, which our accountants are developing, the stone

which is now rejected by the builders will become the headstone of regulation.

In general, I think I can state it as the conviction of the Commission that coöperation of regulatory bodies and the utility companies themselves in the development and utilization of valid cost standards, properly related to the varying conditions of service in different types of service area, will prove a most important step toward the restoration of public confidence in regulated private operation.

An interesting example of the use of the unit-cost standards which can be derived from the Federal Power Commission data is to be found in a market letter issued on January 17, 1938, by Goodbody and Company, investment bankers. Their application of a "prudent investment yardstick" to the asset equities behind the shares of twenty-two leading holding companies, revealed the extent to which the various power systems had departed from the cost standards which would have been enforced if regulation had been a real substitute for competition.

Based on unit costs derived from the reports of the operating subsidiaries to the Federal Power Commission, this analysis revealed a \$1,685,000,000 excess in book assets of these systems over what the properties would have cost if constructed on the basis of unit costs derived from the twenty most economical companies. This checks closely in percentage with that just shown to represent the excess costs on the books of companies which have already reported original costs to the Federal Power Commission. And the range, reaching a high of \$218,000,000 for the Commonwealth and Southern, is very similar.

One further conclusion to be drawn from the Goodbody analysis is significant. It shows broadly that the systems, with book costs closely approximating the requirements of the prudent investment yardstick, are those whose

operating companies have been most frequently exposed to actual or potential public competition.

In closing this brief discussion of what I believe to be significant of the period in which we are all destined to play a part, I want to return to my original theme and restate it in terms of what I consider the great opportunity of the accounting profession. I want to make the attempt to answer the question, what has all this to do with the accounting job as affected by the changing conception of property?

A partial answer will be that in the old regime accounting served the purposes of an order of business which considered itself strictly private, without responsibility for assuring the lowest possible costs. In that period, a steady and sometimes extraordinary inflation of costs served the purposes of those concerned only with the building of private fortunes, constituting gigantic claims which must be included in the costs of every industry. Accounting must now change its allegiance in order to assist in the great social purpose of bringing about a steady deflation of these artificial costs in the interest of social stability.

Stated in another way, questions of unit costs are today questions of public policy, because they determine the extent to which the people as a whole can make the greatest possible use of their resources. It is along this line that low costs contribute to social security. Low costs make possible the balancing of society's books; high costs result in their unbalancing.

One of the most important things in the management of society is honest balancing of books, and the accountant can establish the pattern of all social accounting. But the conception of honesty in the balancing of books must be broadened and deepened.

For society as a whole, as well as for the individual businesses with which you as accountants deal, the honest

balancing must, today, be concerned with something more than the assets and liabilities, the debits and credits measured in money terms. It must be concerned with such a statement of the books as will contribute to the social balance.

The liability side will show honestly the advances in the way of social resources with which the enterprise has been entrusted and the extent to which they are protected by a sound depreciation policy. The asset side will show whether the advances have been economically embodied in useful property which is actually being used to capacity.

The debit side will show the current use of social resources in the form of labor and raw materials. The credit side will show the extent to which the use of these social resources has made possible the maximum consumption of goods or services, representing the product.

In the days of truly competitive small business, bookkeeping and accounting were more individualistic matters because competition quickly eliminated those whose contribution to the standard of living of the people did not warrant their receiving continued advances in the way of social resources. Monopoly and other forms of price control have long since abolished that automatic balance.

In a sense the whole purpose behind the new functions undertaken by the federal government in the past seven years has centered around accounting. Those responsible for our business life had misused the greatest trusteeship in human history. They had set up books which indicated that they had been made responsible for more social advances in labor and materials than they had actually received—and embezzled the difference. These trustees who had set up false books are being called upon for an honest accounting, an accounting which reveals rather

than conceals what a people should know about the business system which pumps the lifeblood through its veins and arteries.

In a real sense the great transition that the world is going through in our time is one in which irresponsible private accounting, anarchistic accounting, is being forced to give place to responsible public accounting actuated by a sense of social responsibility. Fundamentally, it involves a change in the conception of property from that of property as an absolute, natural right, to that of property as a trusteeship.

Once again men who control great enterprises are going to be called regularly to give an account of their stewardship. They can no longer attempt to conceal the antisocial conduct of those enterprises behind false accounting.

The accounting profession is like the doctor's profession. It must develop an ethic worthy of the tremendous responsibility which this new conception of property places upon it. No accountant should be tolerated in the profession who misuses his knowledge of accounting technique, his professional ability, in order to serve some selfish, private end.

Finally, the integration of our whole economic life—the achievement of a balance between production and consumption with its elimination of unemployment, the banking function—is essentially a great accounting job. In a real sense, the accountants, rather than the engineers or the entrepreneurs, are equipped to solve our greatest national problems.

Any great economic system operates on some kind of a credit basis—private, coöperative, or public. And in the long run the books must balance, not in terms of money claims so much as in terms of human effort and human enjoyment. On that basis we have been going through a long period reflecting very badly balanced books.

Responsibility of Accountants

Credit means social backing for an enterprise—it means an allocation of social resources to the enterpriser in the belief that his use of social resources will produce more resources for human happiness, will contribute to the general welfare.

In the end, if the books are properly kept, the nation can judge whether the

credit, the social backing, was well placed—whether it was accepted as a trusteeship.

So, in the last analysis, accounting should be an important factor in economic government—and the solution of our problems may be found in the establishment of dynamic accounting control of our economic system.

Comments on Address of Leland Olds

BY PAUL GRADY, CHICAGO

Chairman of special committee on public-utility accounting,
American Institute of Accountants

AT THE outset, let me state that I agree with the premise that the control of property should be regarded as a trusteeship to be administered with a proper social consciousness. Translating this into terms of American business, the management has a responsibility to deal honestly and fairly with its customers, employees, and investors. To my way of thinking, the use of property or business, representing economic power, is only one angle to a much larger problem, which is the ethical and social use of all kinds of power, the principal forms being: (1) governmental power; (2) religious power; (3) economic power; (4) power of opinion. It is highly important, not only that economic power, but that governmental and other forms of power be exercised as a trusteeship and with honesty and fair dealing.

Unfortunately there have been abuses of economic power, and all reasonable citizens would agree that it is a proper function of government to establish such forms of regulation, particularly in the so-called noncompetitive fields, as may be necessary to prevent wide abuse. Caution must be exercised, however, in the application of these measures in order to assure that the zeal to reform will not be allowed to carry beyond the proper limits of regulation, and extend to the actual taking over of economic power by the government. The centralization of all forms of power is, of course, the greatest danger to society. If that happens the entire purposes of reform will be defeated and it will require generations for the people to reacquire their personal liberties.

Mr. Olds' address carries the strong implication that most of our current

problems arise out of the failure of business managements to recognize their full social responsibilities. If this had been said eleven years ago I think I would have agreed with it. But is it the real crux of our problem today? I believe that the many regulatory measures, most of which were needed, adopted by the government during the past decade have established a very effective "system of internal control" to prevent abuses of economic power. I wonder, however, if the spirit in which these measures have been applied, together with fiscal and other policies followed by the government, haven't shifted the primary problem from the business or economic field to the governmental side of the picture. I shall not attempt to develop this point in any detailed manner, but I sincerely hope that the leaders in our government may somehow be brought to a realization of the fundamental importance of a dispassionate consideration of the question as to whether the governments—federal, state, and local—are faithfully discharging the vast responsibilities in human and material resources entrusted to them by the people. A correct diagnosis of this question might well provide a sound basis for a coöperative program between government and business, each acting in its own proper sphere, which is so vitally needed by our nation today.

Mr. Olds states that the electric power industry, in order to meet its social responsibilities, must secure the largest possible output at the lowest possible cost and sales price, thereby assuring the widest possible use of electricity by the people. I am enthusiastically in accord with this principle and

would like to see it applied to all industry. Greater production at lower costs is the key to an increased standard of living, and it is a real tragedy that our national program for the past several years has not been in accord with this sound economic principle.

The following quotation from the address sets forth some principles of rate-making for utilities which are news to me, or which I fail to understand: "For the courts, under pressure from utility lawyers, held that the rates of any particular utility enterprise must be based on costs of that particular enterprise, not upon comparative cost standards. Actually, these lawyers, with the assistance of engineers and, I am sorry to say, accountants, devised increasingly ingenious and complicated ways of inflating the so-called costs which a particular company could justify in litigation."

I haven't had access to a library this morning, but from my memory of the numerous Supreme Court cases I have read in the past, I thought the Court's rule was that a company is entitled to a reasonable return on the fair value of its property. There has been no formula for determining fair value, it is a judgment matter for the determination of the regulatory commissions and courts, and proper weight is given to all elements of value, such as original cost, corporate cost, book value, and cost of reproduction new, less accrued depreciation. Of these elements it has been my experience that up to the present time book value is accorded the least weight and cost of reproduction new, less depreciation, has usually been given the greatest weight.

It is possible that the preceding quotation refers primarily to costs of operating expenses rather than the cost of properties. In that event I am also unable to agree that the commissions and courts have automatically allowed all of a particular company's operating costs, because it has been the custom

for many years in rate inquiries to make exhaustive studies of operating expenses from the standpoint of determining whether they are reasonable from a rate-making viewpoint. On this point I can refer you to an example of a case decided within the past year by the Illinois Supreme Court, and in effect also passed upon by the Supreme Court of the United States through its refusal to hear the case. In this case, as I recall, depreciation expense was reduced over \$1,000,000 below the amount actually provided in the accounts, and promotion of new business expense was reduced approximately \$500,000 below the amount actually expended by the company for this purpose.

Regulatory commissions and courts also consider the matter of the value of service in the determination of rates, and the application of this yardstick or principle has often resulted in the establishment of rates which do not and cannot give anything near a reasonable return on the company's book value or fair value of properties devoted to the public service after deduction of actual operating costs. This will be evident to you from a study of a dozen published annual reports of utility companies selected at random.

I do not intend to imply by the foregoing comments that I disagree in any manner with the desirability of establishing comparative cost standards. I think that Mr. Olds is right in feeling that too little use has been made of this type of yardstick by managements and by regulatory bodies. I have no doubt that the work of the bureau of accounts of the Federal Power Commission in its statistical studies of comparative rate schedules and comparative costs will result in a major benefit to the electric industry and to the public.

From the standpoint of personal pride in our profession, it would be very pleasing to me if I could agree with the challenging picture portrayed in the address to the effect that the solution of

national problems may be found in dynamic accounting control of the economic system. From the standpoint of realism and honest self-analysis, however, I feel that to do so would be to mistake cause for effect.

This is a problem which is worthy of our most profound consideration. I haven't the slightest qualification as a prophet; on the other hand, I hope I am not completely without vision as to the opportunities and responsibilities of accounting. Corporate or operating accounting should supply and interpret all of the financial and operating information needed for sound management, whether the enterprise be business or government. The independent public accountant should be in a position to aid very materially in the establishment of proper procedures and methods of internal accounting for his client. In doing so he must necessarily look at the problem from the viewpoint of the needs of managements and the sphere of his work may well include: (1) the establishment of an effective system of internal accounting control over all of the assets, revenues, and expenditures of the company; (2) the establishment of logical and economical accounting methods and procedures; (3) the review or preparation of regular financial and operating reports. The independent accountant, through his wide accounting experience, should also be in a position to render valuable advisory or consulting service to his client, particularly on financial matters. In addition to these broad constructive and creative services the independent accountant must discharge his full responsibilities as an independent auditor of

financial statements, to all who may be entitled to rely on the statements. Our responsibility, in so far as the integrity of our work is concerned, is not a matter of "allegiance to business clients" but extends to society as a whole.

I hope that the foregoing comments make it clear that accounting is an indispensable tool of business and government and that the information supplied by logical accounting procedures can serve as the basis for the determination of policies. It should be equally clear, however, that accounting does not and should not embrace responsibilities on matters of either business or governmental policy which necessarily must rest upon the common sense and judgment exercised by executive management or authority.

All accountants will agree that our profession should continuously strive to develop higher standards of ethics worthy of our responsibilities. As a profession we have undoubtedly had our share of unfortunate cases, and we will continue to have some of them for we are only human beings. But I should like to ask our critics, in all fairness, to also consider the hundreds of engagements handled with complete satisfaction, which can be named for each unfortunate case.

If the relatively short life of our profession is taken into consideration, I do not believe we would make an unfavorable showing when judged by the comparative standards of performance of the older professions of law, engineering, and even medicine; and I am sure that our profession will continue to do its utmost to fully measure up to our proper responsibilities.

Federal Trade Commission Procedure—with Particular Reference to Accounting

BY EWIN L. DAVIS, WASHINGTON, D. C.

Chairman, Federal Trade Commission

IT is a pleasure to respond to the invitation to address the annual meeting of the American Institute of Accountants on the Federal Trade Commission's procedure, with particular reference to accounting.

The Federal Trade Commission is an independent, administrative, and quasi-judicial tribunal, created by act of Congress in 1914. The Commission is composed of five members appointed by the President, by and with the advice and consent of the Senate, for terms of seven years. Not more than three of the Commissioners shall be members of the same political party. To aid the Commission in its labors, it has a staff of trained, efficient lawyers, economists, accountants, statisticians, and clerical personnel.

FUNCTIONS OF THE COMMISSION

While the Commission has certain other powers and duties, its chief functions are:

1. To prevent unfair methods of competition, and unfair or deceptive acts or practices, in commerce.
2. To make investigations upon the direction of the President, the Congress, upon the request of the Attorney General, or upon its own initiative.
3. To enforce certain sections of the Clayton antitrust act, including an amendment to section 2 of that act, enacted in 1936, and generally referred to as the Robinson-Patman act.

Incidentally it may be mentioned that the Commission has jurisdiction over the export-trade act and the re-

cently enacted wool products labeling act.

The processes of the Commission are injunctive or preventive, not punitive. The success of this procedure has been indicated by the fact that during the twenty-six years since the Commission was established, it has with relative infrequency had to appeal to the courts to discipline respondents for disregarding its cease-and-desist orders.

UNFAIR METHODS OF COMPETITION

The Federal Trade Commission act declares "unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce," to be unlawful and directs the Commission to prevent same whenever "it shall appear to the Commission that proceedings by it in respect thereof will be to the interest of the public." The purpose of preventing such unfair methods is twofold, namely, the protection of members of industry from the harmful effects of unfair practices by competitors, and the protection of the public interest.

Congress very wisely did not undertake to enumerate the various unfair methods and unfair or deceptive acts or practices against which the act was directed; such are as infinite as human ingenuity can devise, and constantly appear in new forms and guises.

Unfair methods and practices generally fall within two broad classes: first, those which involve an element of fraud and dishonesty, and secondly, those not inherently dishonest, but which are restrictive of fair competition.

In defining the words "unfair methods of competition" as used in the Fed-

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eral Trade Commission act, the Supreme Court in the Gratz case (253 U. S. 421) referred to them as practices "opposed to good morals because characterized by deception, bad faith, fraud or oppression, or as against public policy because of their dangerous tendency unduly to hinder competition or create monopoly."

The Federal Trade Commission handles thousands of cases annually involving a charge of misrepresentation, deception or fraud in the sale of products and various other unfair practices covering almost every conceivable character of commodities. A substantial number of the Commission's cases are directed against conspiracies and combinations in restraint of trade.

COMMISSION PROCEDURE

The procedure of the Commission in all such cases is simple and effective. A case may originate in several ways, although generally it is through complaint of an unfair practice made by a competitor or consumer. This requires no formality. The complaint may be made by letter setting forth the facts. The identity of the complainant is kept confidential.

Whenever a matter is brought to the attention of the Commission indicating a probable law violation, the Commission directs an investigation by its own staff. If from the facts developed by such investigation it has reason to believe that the law is being violated, the Commission orders the preparation and service of a complaint. Such service is ordinarily made by sending a copy of the complaint by registered mail to the alleged offender, who is called the respondent, and who is granted twenty days within which to make answer, after which hearings are conducted, evidence taken, briefs filed and the case argued, if either side makes request to be heard before the Commission in oral argument. The Commission then takes the case under advisement and renders its

decision. If the Commission finds that the evidence sustains the allegations in the complaint, it issues an order requiring the respondent to cease and desist from the unlawful practices in question.

COMMISSION'S RECORD IN THE COURTS

If the respondent feels that the Commission's order is not justified, he has the absolute right of appeal to the circuit court of appeals of his own jurisdiction. The findings of fact by the Commission, if supported by evidence, are final, but the court passes upon the validity of the legal conclusions applicable thereto. If the court affirms the Commission, it directs the respondent to obey the Commission's order.

Relatively few appeals, however, are taken to the courts from the Commission's orders to cease and desist. The Commission is proud of its record in the courts as conclusive evidence of the impartial administration by the Commission of the laws over which it has jurisdiction. For example, from January 1, 1933, to April 30, 1939, the Commission investigated and reviewed 22,038 cases, accepted 3,379 stipulations to cease and desist, and issued 1,220 orders to cease and desist.

The record shows that from January 1, 1933, to date, 128 Commission cases, exclusive of injunction and civil penalty proceedings, have been reviewed by the courts. Of these 128 cases, the results of 120 were favorable to the Commission. Of the remaining 8 cases, only 5 were reversals of the Commission's orders and of these 5, one is now pending in the Supreme Court on petition for writ of *certiorari*; in another the reversal was not on the merits, but solely on the question of jurisdiction; and a third was decided on the issue of *res judicata*, and is to be appealed to the Supreme Court. In other words, the Commission has handled thousands of cases during the past few years but has been reversed by the courts in only two or

three. During the past nine years the Commission has been reversed by the Supreme Court of the United States only once, and that by a five to four decision in a Clayton act case, reversing a favorable decision by a United States circuit court of appeals. During this nine-year period the Supreme Court has decided five cases in favor of the Commission. The foregoing figures do not embrace a considerable number of cases in which respondents applied to the Supreme Court for *certiorari* from decisions of circuit courts of appeals favorable to the Commission, but which applications were denied by the Supreme Court. Since September 1, 1938, the Commission has filed 31 suits to enjoin unfair practices and the courts granted injunctions in all except one.

STIPULATIONS

I have described the Commission's formal case procedure. We have an informal procedure by which the Commission has been able to expedite its work and save much time and expense both to the Commission and to persons charged with violations of section 5 of the Federal Trade Commission act. This is known as our stipulation procedure. A large percentage of our cases are satisfactorily adjusted in this manner. It frequently happens that the violator expresses a desire to refrain from any violation, advises that he does not wish to resist the proceeding, but wishes to adjust the matter in the simplest manner possible. Ordinarily he is given the opportunity to sign a written stipulation of the facts and an agreement to cease and desist from the practices involved. If the respondent observes his agreement, no further action is taken. Violations of these stipulations are extremely rare.

As indicated, the stipulation procedure is a privilege and not a right. Whether an offender is permitted to sign a stipulation is a matter within the discretion of the Commission. Such

privilege is not accorded where the Commission is convinced that the practices in question are fraudulent or of a serious nature.

TRADE PRACTICE CONFERENCES

After several years' experience under its organic act, the Commission developed still a third method of eliminating unfair trade practices. I refer to the Commission's trade-practice conference procedure. The purpose of the trade-practice conference procedure is to afford industries a means whereby they may more effectively cooperate under government supervision in the elimination of practices which are unfair and harmful.

The Commission has sponsored upward of two hundred trade-practice conference agreements, and now has under consideration a substantial number and inquiries with regard to many more. Many of these conference agreements have been adopted by large industries, with investments running into hundreds of millions of dollars, and employing large numbers of workers. By this conference method, the unfair and dishonest practices, which are frequently the result of economic and competitive forces rather than deliberate design, are often corrected by wholesale, where otherwise it might be necessary to take action against each individual offender, with the effort, time, and expense incident thereto.

ROBINSON-PATMAN ACT PROBLEMS

Reverting to the cases arising under section 5 of its organic act and under the Clayton act, accounting problems are frequently involved. However, it is in the type of cases involved in the administration of the Robinson-Patman act that accounting plays the most vital and important part.

The Congress enacted the Robinson-Patman act in June, 1936, as an amendment to the Clayton act, which was enacted in 1914. Such act is adminis-

tered by the Federal Trade Commission. Under the provisions of section 2 (a) of the act, discriminations in price having an injurious effect upon competition are unlawful if the differential makes other than due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such goods are sold or delivered. Such discriminations, however, may be justified by showing that they make only due allowance for differences in such costs.

Anyone may file a complaint with the Commission alleging that some concern named therein is violating the Robinson-Patman act. After receipt of such complaint the Commission conducts a preliminary investigation to determine whether or not facts are present making it reasonably appear that the charge is well founded. During the course of such preliminary investigations by the Commission, prior to the issuance of a formal complaint, proposed respondents usually seek to present what they consider is a justification for the price differences. If such cost data are submitted, they are reviewed and studied by the accountants of the Commission to determine if they have been compiled and prepared in accordance with sound accounting principles and whether or not the prices under review make other than the due allowances to which I have referred above.

Where justification of different prices is attempted in Robinson-Patman cases, it is usually based upon differences in distribution costs. The problems involved in determining the facts usually concern the allocation of distribution costs to lines of products, classes of customers, sizes of orders, and so forth.

In some cases, the proposed respondents are somewhat in doubt about the scope or nature of suitable cost data, particularly as to whether the data which they contemplate submitting are likely to be regarded by the Commis-

sion as adequate and proper for this purpose. Problems of this nature are sometimes discussed at informal conferences between members of the Commission's staff and representatives of the proposed respondent, in order that the work of both may be minimized and a better understanding reached with respect to the data ultimately submitted.

These discussions concern the necessary segregation of sales covered by the price structure under consideration and the expenses pertaining thereto, and also as to an equitable allocation of these various expenses against the sales subject to each of the discounts involved. In the case of companies with a nationwide system of distribution such an analysis of their unit operations for a year would likely require a prohibitive amount of work. This is often avoided by limiting the studies to selected territories and shorter periods which are truly representative of the average conditions under which the respective discounts are allowed. However, in every instance, it is distinctly understood by all concerned that the presentation of such cost data and the manner in which they may be compiled is optional with the proposed respondent. It is also understood that any suggestions or other expressions by the Commission's accountants are offered only in an effort to be helpful and represent their personal opinions which are not binding upon either the Commission or the proposed respondent.

I will not attempt to detail, however, the various factors which are considered when the respondents submit cost data as a justification for price discriminations.

To give you an outside viewpoint, I quote from an article entitled "The Robinson-Patman Act Acquires Meaning," which appeared in the April, 1940, issue of *The Management Review*, as follows:

"The objective of keeping price discrimination within reasonable bounds

had to be given a half dozen radically different forms to prevent the most commonplace practices from frustrating it at the very outset of its life. Among them were restrictions on direct money concessions in the form of discounts on payments and of brokerage; hedges against indirect concessions in the form of advertising allowances and special services—all with numerous combinations and permutations.

"While no sweeping changes have occurred in the American distribution system as a result of this measure, here and there momentous decisions have been reached that in their slow way might make stray parts of the system over.

"Cost analysis has of necessity been at the heart of more cases than most of the other unknown quantities in the act. In this area the Federal Trade Commission has seldom hesitated to recognize that price differentials can usually be justified by proof of definite cost savings in manufacturing, selling or delivery. It is quite clear that lower advertising costs and general sales expense, fewer salesmen's calls, nonuse of branch warehouses and merchandising service, and decreased credit expense by large buyers can all properly be reflected in lower prices. Familiarity with the reasoning in the Standard Brands case can be of considerable value to the man responsible for keeping his company's business in line with the act.

"Of importance from an accounting standpoint, the respondents have not been required to endow each penny of expense with a personality of its own and trace it down to its last resting-place. The other side of this coin, however, is that for safety's sake cost accounting must be much more detailed than has ordinarily been the case. Furthermore, an awkward shift must be made from the categories ordinarily set up in books and statements for purely operating and financial purposes, to categories based upon an extensive allocation of overhead to different functions and customers."

GENERAL INVESTIGATIONS

While accounting and statistical problems are involved in many of the Com-

mission's cases and in other phases of the Commission's work, yet the Commission's functions which involve accounting to the greatest and most important extent are in connection with the administration of section 6 of the Federal Trade Commission act. This section provides as follows:

"Sec. 6. That the Commission shall also have power—

"(a) To gather and compile information concerning, and to investigate from time to time the organization, business, conduct, practices, and management of any corporation engaged in commerce, excepting banks and common carriers subject to the act to regulate commerce, and its relation to other corporations and to individuals, associations, and partnerships.

"(b) To require, by general or special orders, corporations engaged in commerce, excepting banks, and common carriers subject to the act to regulate commerce, or any class of them, or any of them, respectively, to file with the Commission in such form as the Commission may prescribe annual or special, or both annual and special, reports or answers in writing to specific questions, furnishing to the Commission such information as it may require as to the organization, business, conduct, practices, management, and relation to other corporations, partnerships, and individuals of the respective corporations filing such reports or answers in writing. Such reports and answers shall be made under oath, or otherwise, as the Commission may prescribe, and shall be filed with the Commission within such reasonable period as the Commission may prescribe, unless additional time be granted in any case by the Commission.

"(c) Whenever a final decree has been entered against any defendant corporation in any suit brought by the United States to prevent and restrain any violation of the antitrust acts, to make investigation, upon its own initiative, of the manner in which the decree has been or is being carried out, and upon the application of the Attorney General it shall be its duty to make such

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investigation. It shall transmit to the Attorney General a report embodying its findings and recommendations as a result of any such investigation, and the report shall be made public in the discretion of the Commission.

"(d) Upon the direction of the President or either House of Congress to investigate and report the facts relating to any alleged violations of the antitrust acts by any corporation.

"(e) Upon the application of the Attorney General to investigate and make recommendations for the readjustment of the business of any corporation alleged to be violating the antitrust acts in order that the corporation may thereafter maintain its organization, management, and conduct of business in accordance with law.

"(f) To make public from time to time such portions of the information obtained by it hereunder, except trade secrets and names of customers, as it shall deem expedient in the public interest; and to make annual and special reports to the Congress and to submit therewith recommendations for additional legislation; and to provide for the publication of its reports and decisions in such form and manner as may be best adapted for public information and use.

"(g) From time to time to classify corporations and to make rules and regulations for the purpose of carrying out the provisions of this act.

"(h) To investigate, from time to time, trade conditions in and with foreign countries where associations, combinations, or practices of manufacturers, merchants, or traders, or other conditions, may affect the foreign trade of the United States, and to report to Congress thereon, with such recommendations as it deems advisable."

Over one hundred investigations (in addition to the Commission's extensive World War cost work) have been made under that authority, the greater portion of them pursuant to Congressional resolutions, a substantial number upon request of the President, and several upon request of the Attorney General. The Commission's reports on most of

these investigations were printed as government documents.

Among such investigations conducted and reports made by the Commission under this section of its act are the following, alphabetically arranged: accounting systems, agricultural income, bakeries, bread and flour, calcium arsenate, cement industry, chain stores, coal—anthracite and bituminous, commercial bribery, coöperation in foreign countries, coöperative marketing, copper, cost of living, cotton merchandising, cottonseed industry, cotton trade, electric and gas utilities, electric power, farm implements and machinery, feeds, fertilizer, flour milling, various food investigations covering flour milling and jobbing, grain elevators, grain trade, food canning, meat packing, wholesale marketing and private car lines, foreign trade—antidumping legislation, coöperation in American export trade and cotton growing corporation, gasoline, gasoline importation, gasoline prices, grain exporters, wheat prices, guarantee against price decline, house furnishings, leather and shoes, lumber costs, lumber trade associations, meat-packing profit limitations, canned milk, milk and dairy products, millinery industry, motor-vehicle industry, national wealth and income, open-price associations, packer consent decree, paper—book, paper—newsprint, peanut prices, various petroleum investigations covering petroleum industry, foreign ownership, petroleum industry on the Pacific coast, petroleum industry in the Panhandle, petroleum industry in Wyoming and Montana, petroleum pipe lines, petroleum prices, 1920, and petroleum decree investigation, price bases, price deflation, profiteering, radio, raisin combination, resale price maintenance, salaries inquiry, sisal hemp, southern livestock prices, steel code inquiry, steel industry—costs and profits, stock dividends, sugar, sugar-beet, taxation and tax-exempt income, textiles—combed cotton yarns, textile

industry, tobacco, tobacco marketing—leaf, trade and tariffs in South America, utility corporations, World War—cost finding.

Most of these reports were based upon accounting investigations and analyses.

The mere publicity of the facts developed in these inquiries generally proved beneficial, and often resulted in reforms forced by public sentiment or voluntarily adopted by those who were shown to have been engaged in unlawful or unfair practices. Some of these investigations also resulted in prosecutions by the Department of Justice and a number of them resulted in the issuance of complaints by the Federal Trade Commission. Investigations by the Commission have several times resulted in the enactment of important Congressional measures.

ELECTRIC AND GAS UTILITIES INQUIRY

If time permitted, I would be glad to give a more detailed explanation of many of these investigations and show the vital importance of accounting in the Commission's inquiries. However, by way of illustration, I shall comment upon some features of the electric and gas utilities inquiry, conducted by the Commission pursuant to a Senate resolution. This investigation covered a period of about seven years, and the results thereof were reported to the United States Senate in approximately one hundred volumes, all of which were printed as Senate documents. This was doubtless the most comprehensive and most extraordinary investigation ever conducted upon any subject at any time by any tribunal. The factual features of these reports consisted of analytical reports of our accountants based upon their personal examinations of the books and records of the corporations in question. Advance copies of such reports were furnished to the respective companies for their critical inspection; and they were advised of

the date of the public hearing when such report would be presented for the record, at which time they would be accorded the privilege of cross-examination of our accountants, and of offering any evidence they might desire to present in refutation of the contents of such report.

While the corporations involved generally had representatives at such public hearings, yet they seldom availed themselves of the privilege of cross-examination or of presenting any rebuttal testimony. So far as I am aware, nobody ever challenged the accuracy of any facts stated in the reports of that comprehensive inquiry.

The investigation covered the principal holding companies and certain of their subsidiary holding companies, management and engineering service companies, and operating companies. It was particularly concerned with the holding-company form of organization and its management and financial relations with subsidiary companies.

Among other things, the Senate resolution called for a study of the growth of capital assets and liabilities of holding and operating companies, the method of issuing securities, the price realized or value received, the commissions or bonuses paid or received, and other pertinent facts with respect to the security issues. To answer these requirements naturally necessitated an intensive accounting study and analysis of assets and security issues covering a long period of time, generally from the date of organization of the company under examination.

A matter of importance was also the analysis of income, expense, and surplus accounts of the companies under investigation. This involved a study of the nature and sources of income, methods used in accounting for depreciation and other deductions, and analysis of surplus with respect to its origin and the sources from which dividend payments were made.

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The inquiry also included a study of management and engineering services performed by holding companies, or their affiliated companies, for the operating companies; the services rendered and the fees or commissions charged therefor; the expense of performing these services; and the profit obtained from this business.

The reports prepared by the accountants on their examinations of the respective companies, together with the record of their testimony, were primarily the basis for the Commission's report to Congress containing the results of the investigation and its conclusions and recommendations.

An important feature of the other inquiries mentioned was the determination of capital investments, earnings, rates of profit and costs for selected companies in each industry. Such information provided, among other things, for comparisons of the financial resources of the various companies, their relative profitableness, and their share of the business of the industry.

The lack of consistent and uniform accounting procedures by the various companies in an industry, and even by the same company at different periods, makes it difficult to secure comparable information of this sort. The Commission's accountants are often required to analyze accounts in considerable detail. This is necessary because of the differing methods of accounting and because of the ramifications of the operations of some of the larger companies. The assets of some companies include property and investments that are not directly related to the principal business in which they are engaged, or are not pertinent to the inquiry, or include intangibles that do not reflect actual investment. Also their income and expenses include amounts which are not directly related to their principal business or pertinent to the inquiry, or include items of a surplus nature, such as capital gains or losses and revaluations

of securities and other assets. For these reasons, capital investments and income and expenses are adjusted to exclude all such items in order to have the required information for all companies on a comparable basis.

WORLD WAR COST ACCOUNTING

The determination of unit costs of specific commodities has also been an important requirement of some of the general investigations conducted by the Commission. For instance, during the World War, the Commission was the general cost-finding agency of the government. In this capacity the Commission made upward of three hundred reports to the President, the War Industries Board, the Navy Department, the War Department, the Congress and other agencies of the government. The chairman of the price-fixing committee of the War Industries Board in a report to the President stated in part as follows:

"In conclusion, we would fail in appreciation if we did not make proper acknowledgment of the splendid service rendered us by the Federal Trade Commission in gathering the data or evidence upon which we were necessarily most dependent in forming our conclusions. The Commission informs us that they have maintained a staff of between 500 and 600 accountants and their assistants, and the volume of business upon which they have furnished cost sheets has aggregated more than \$30,000,000,000, representing invested capital of over \$20,000,000,000, and that practically all of this service has been rendered to the price-fixing committee."

The chairman of the War Industries Board in his final report described in a most complimentary manner the important part played by the Federal Trade Commission in the work of the Board.

The Commission recently issued a report on the World War activities of the Federal Trade Commission.

CURRENT COST ACCOUNTING INQUIRY

The current inquiry of the Federal Trade Commission into methods of cost accounting is limited to a study of distribution costs. In this inquiry the bases and methods of allocating the various elements of distribution cost to commodities, classes of customers, size of orders, etc., are being analyzed; and an evaluation of them is being made in an effort to determine those best suited to the requirements of various businesses and of the government.

DEVELOPMENT OF ACCOUNTING

Accounting is an important factor in the administration by the Commission of its organic laws. Accounting in the broad sense of the term includes not only business records but the principles and techniques involved in properly establishing and maintaining such records. The history and development of accounting closely parallels that of trade and commerce. Improvements in the technique of accounting have made possible and feasible the growth and extension of business operations. It is my understanding that the first association of accountants of which there is any record is the Collegio dei Raxonati, which was founded in Venice in 1581. In the nineteenth century a number of societies of accountants were organized in Great Britain, and later the New York State Society of Certified Public Accountants was the forerunner of a number of such organizations in this country.

Many years ago there was a comparatively simple economy and few commodities were bought and sold. Commerce was generally confined to limited trade areas and business records were largely a matter of simple bookkeeping. Some of you will remember with a smile the so-called "books" kept by the ordinary businessman during the nineteenth century. The industrial revolution, the rapid substitution of corpora-

tions for individual enterprises, including the development of holding, affiliated, and subsidiary corporations, mass production, the improvement of our communication and transport services, marked the advent of a new and much more complex economy. As a result there were created new problems of government as well as of business. Unfair and deceptive practices, monopolistic tendencies, and other restraints on our competitive economy demanded an adequate remedy.

A wise government like a wise businessman develops new techniques and concepts to meet changing conditions and circumstances. Hence the Congress enacted the Federal Trade Commission act, clothing the Commission with broad and comprehensive powers to collect and report information about corporations and industries. In practice the Commission seldom exercises these compulsory powers, because it generally meets with full coöperation from businessmen. The Commission itself wishes to deal with them entirely in a spirit of fairness and reasonableness. The Commission does not approach the problems of accounting in any narrow or traditional spirit. The basic requirement, apart from an accurate reflection of the facts, is that all the important facts shall be clearly developed, whether important for the management, the stockholders and investors, the general public, or the government.

CONCLUSION

I have in a general way outlined the importance of accounting in the work of the Commission. In connection with its accounting work the Commission has had the benefit of frequent contacts with many talented men in the accounting profession. It is cognizant of conditions which sometimes hamper public accountants, as members of other professions may be hampered, in giving the best professional service of which they are capable. The attitude of the Com-

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mission has been to try to promote improvements in these conditions, in order that our public accountants may have a more responsible and more independent status. The Commission believes that this will develop better accounting, and it regards good accounting as a very important element in business prosperity and the national welfare.

The Commission has noted with satisfaction that businessmen generally have a steadily increasing realization of the importance of accounting in revealing to them the essential facts regarding the conditions in their respective industries and in furnishing a guide to intelligent management. It has been truthfully stated that the kind of records that are needed depends upon the business, but the kind of business that

is possible and profitable depends upon records that are properly kept. The accounting profession has its finger on the pulse of business and its judgments and abilities are important factors in contributing to the health of our body politic. The accomplishments of your profession have been very considerable but, as I am sure you yourselves are aware, there is still much room for improvement along certain lines and in some fields.

We are doubtless all interested in the same objective, and that is in making our competitive economy work more efficiently, profitably, and usefully for industry and all of our people.

The Federal Trade Commission sincerely invites your coöperation in attaining that end.

Comments on Address of Ewin L. Davis

BY VICTOR H. STEMPE, NEW YORK

Member of committees on accounting procedure, auditing procedure, and federal taxation, American Institute of Accountants

WE HAVE listened with keen appreciation and interest to the address presented by the chairman of the Federal Trade Commission, which described the objectives and operations of the Commission.

Mr. Davis says the Commission is charged with quasi-judicial authority to prevent unfair methods of competition, and that the processes of the Commission are injunctive or preventive, and not punitive. Underlying these motives are the protection of the public interest and the promotion of healthy and competitive operation of commerce and industry.

Mr. Davis rightly has pointed out that accounting has implemented the growth and extension of trade and commerce. Management, in the broadest sense, has come to depend on accounting services, both internal and external, in the formulation of policy. Just as the pilot, who formerly guided his plane by observation and knowledge of topography, now depends upon an imposing panel of recording instruments, so the executive who formerly carried all his business facts in his head and relied largely on personal observation, now uses accounting reports and analyses as guides and indicators to aid him in keeping on his course, while at the same time assuring compliance with the many regulatory measures which increasingly harass business administration.

Although giving accountancy full credit for the contribution which its concurrent development has made to the progress of business, it must be acknowledged that the strongest factor in successful operation is the trading instinct which has been inherited by

those who stand out as distinguished merchants. Without this instinct, all other talents and controls in business are futile.

The original businessman's only burden was the pack on his back, and his only overhead was his living expense. He knew his purchase costs, and every dollar he got beyond them recouped a part of his expenses. Today, at the other extreme, we have the complexities of huge establishments, with imposing fixed costs, and the added expense of maintaining functioning organizations of personnel and services, which combined constitute the "standby expenses" of being set up to do business whether one unit of product or a million be sold.

No one factor in our economy is more potent in the maintenance of life, liberty, and the pursuit of happiness than a healthy, ambitious, and prospering commerce and industry which assures increasing employment of capital and men, the enlargement of our national wealth, and the enhancement of the welfare of the masses of people who coöperate in business conduct. Healthy business must be profitable. To be profitable continuously its public relations must be sound, its industrial relations must be fair, and its financial, operating, and marketing policies must at the same time be intelligent, courageous and sanely conservative. To the extent that regulatory measures promote these objectives, facilitate and encourage sound business venture, we, as citizens and professional accountants, may say "Amen." But we must be diligent and aggressive in opposing unrestrained, unduly complex, or oppressive extensions of these measures which may substitute rules and

regulations for the free play of initiative, freedom of contract, and business judgment, within due bounds of ethical conduct.

The fairness and utility of these measures depend upon the tenor and tempo of their interpretation and application by the respective commissions; all of which should be governed by the rule of reason. It is interesting to observe that, in so far as restraint of trade is concerned under the antitrust laws, the adjective "unreasonable" applies to the noun "restraint" and not to "price." It is the restraint that may be unreasonable, whereas the Robinson-Patman act of 1936, which amends the Clayton act of 1914, provides that "price" may be "unreasonable." Under the Patman act, discriminations in price having an injurious effect upon competition are unlawful, if the differential makes other than due allowance for differences in cost of manufacture, sale, or delivery, arising from different methods or quantities in which goods are sold or delivered.

It is axiomatic that profit begins where cost ends—that means all costs: manufacturing, selling, distributing, administrative, including the last dollar of income tax. It follows that an intelligent understanding of costs is essential, not only to profitable operation, but vital to compliance with regulatory laws.

The study of distribution costs currently in progress under the auspices of the Federal Trade Commission is highly meritorious. The widest possible research should be undertaken. The views of industrial accountants, professional accountants, and professors of accountancy should be sought through the coöperation of the American Institute of Accountants, the National Association of Cost Accountants, and the American Accounting Association. Ideals should be tempered by due consideration of what is practicable and feasible, within a commensurate ex-

pense. The conclusions of these studies should await deliberate hearings, and full consideration of conflicting views.

Accounting for distribution costs has not been developed in industry to the same degree as cost accounting for production, largely because of the greater proportion of fixed costs as distinguished from variable costs, and the fact that many costs are joint, making it difficult to allocate them. Industry is not fully alive to the large dividends inherent in better control and improved performance through analyses of distribution-cost factors. There are nevertheless outstanding examples of industry-wide studies and applications conducted by several trade associations, and the literature of accountancy has been enriched by many articles on the subject, particularly in the bulletins of the National Association of Cost Accountants.

These industry-wide activities of certain trade associations have aroused suspicion and attack by the Federal Trade Commission in some cases. Our primary interest in industry-wide accounting relates to the opportunity it affords for the accumulation, comparison, and analysis of the costs of individual units in industry. The manufacturer who does not know his costs is a danger both to himself and to others in the industry. A faulty knowledge of costs may be even more harmful. The development and promotion of sound cost and accounting methods for an entire industry is bound to promote the general health of the industry and to encourage the type of informed competition which is the reverse of cut-throat competition.

The famous Maple Flooring decision said in effect that such activities are not in themselves unlawful; that "its consequent effect in stabilizing production and price can hardly be deemed a restraint of commerce," and that "restraint of free competition begins when improper use is made of that informa-

tion through any concerted action which operates to restrain the freedom of action of those who buy and sell."

Four factors of prime importance control business policy: price, profits, volume, and cost. As to price, it is pertinent to refer to the common belief that 75 per cent of our population can buy only bare necessities. Here the old law of supply and demand steps in. The only way of reaching these buyers is to offer something within their means. Only volume, with an assured market, enables low-cost production, which may be sold profitably at a low price.

We should beware lest undue restraining influences on price throw the monkey wrench into the machinery; the result inevitably will be increased costs or restricted markets.

Cost is not absolute—there is no one overall method of cost determination which will serve all purposes; no single concept of cost will answer management's problems of economic survival. We do not have time adequately to re-

view this postulate. I can allude only to cost concepts affecting: (1) inventories from the viewpoint of conservative management or the Securities and Exchange Commission; (2) legal viewpoints of amounts available for dividends; (3) the Robinson-Patman act; (4) Vinson act; (5) war contracts; (6) federal taxation; (7) the problems of price and volumes; (8) whether to increase or decrease production or shut down; (9) whether to take such business or turn it down; (10) whether to risk decline in price of total sales or to sacrifice volume for price. All these point to alternative cost determinations, variable costs which depend upon the interrelation of price, volume, and related profits.

In our ardor for cost analyses, however, let us not forget to keep the cost of cost analyses within reasonable cost, lest we fall into the same pit as the man who considered himself the most valuable asset of the community but who failed to realize that he overvalued himself by two letters.

VII

ROUND-TABLE DISCUSSION

Internal Conduct of an Accounting Practice

Leader: PARRY BARNES

October 16, 1940

Introduction

BY PARRY BARNES, KANSAS CITY, MO.

Member of special committee on disciplinary procedure, American Institute of Accountants

THE PUBLIC accounting profession, in common with all others, includes a science, a philosophy, and an art. The science of accounting is concerned with the mass of technical knowledge which must be mastered as a preliminary step toward the practice of our profession; its philosophy deals with the fundamental principles of logic underlying the science and perhaps, in a broader sense, the relationship of accounting to human affairs. But a knowledge of the science and an understanding of the philosophy are useless and impractical without proficiency in the art, which is the practical application of the principles and philosophy of accounting to everyday affairs.

We are here dealing with accounting as an art. We are further restricted in that we are dealing with it only to the extent that it involves what we designate the internal rather than the external phase of practice. This internal aspect of accounting practice is readily divisible into three sections, dealing respectively with practice routines, office routines, and personnel problems.

Since internal conduct of accounting practice has been the subject of a round-table discussion at several prior meetings of the Institute, an effort has been made to avoid as much as possible the direct duplication of topics which have been the subject of previous discussions. Since it is to be assumed that those who are here are interested to an unusual degree in this particular subject, it is suggested that anyone who has specific suggestions as to a particular topic which should be covered here but which may be omitted, due to lack of time, communicate to the executive offices of the Institute his suggestion in order that the desired topic may

be scheduled for a future session.

This particular discussion may be likened to a clinic, one of the definitions of which is "An institution in which concrete cases or problems of a special type are studied." For many years the science of accounting received most of the attention at meetings of professional societies. In recent years accounting philosophy has come to the fore as a subject of interest, but it is only very lately that the practice of the art of the profession is being given the attention which it deserves. This is more readily understandable when we consider that it is much easier to acquire a knowledge of the philosophy and science of accounting in an educational institution than it is to acquire a knowledge of the art. Furthermore, many of us acquired all of our knowledge through the apprenticeship system, and perhaps since securing our certificates or opening offices of our own have considered that we have learned what there was to learn and that we know what to do and how to do it.

Also, perhaps until recently, there was little time for introspection until the pressure of events forced upon us a consideration of the efficiency of our practice methods. Even now it is difficult if not impossible for one practitioner to obtain knowledge of the practice methods used by his fellow workers, a condition which it is to be sincerely hoped time will remedy.

In these clinical sessions the Institute is putting forth a sincere effort to provide for the interchange of knowledge and opinions upon this subject among the members of the accounting profession. Let us hope, therefore, that we will all carry away from this session some new thought or idea.

Audit Program

BY J. GORDON HILL, SAN FRANCISCO

Member, American Institute of Accountants

AT THE outset it should be recognized that the audit program is but a guiding memorandum subservient to the principles and procedures which must be applied to attain the objectives of each accounting undertaking. It is important only to the extent that it serves to assist in accomplishing these purposes.

It is not our present purpose so much to consider the make-up or content of an audit program as it is to study its use as a means of insuring that the audit is planned so as to accomplish the objectives of the engagement with a maximum of efficiency.

The question of the form and extent of any particular program is one which must be left to the judgment of the principal or supervisor having the general responsibility for the examination. It is conceivable that an examination might be made properly without the preparation in writing of any program as, for example, in the case of an examination performed in every detail by the individual responsible for the preparation and issue of the report. But even under such circumstances, it should be clear that our one-man auditor had some plan of procedure outlined in his mind even though he did not reduce it to writing. This is really the all-important concept of an audit program; it could be termed the orderly arrangement of the mental processes by which an examination is accomplished. However, it will be generally agreed that there should be some written memorandum in the files of the auditor as to the details of the work performed. Even the one-man auditor would find such a record desirable to support the opinions and conclusions expressed in his report.

Where the accountant's organization

embraces one or more principals upon whom rest the responsibility to the client and where there is a staff of senior and junior accountants having responsibility for the actual performance of the various examination procedures, the importance of the program increases, not only as a means of conveying instructions from the principal to his staff as to what is to be done but, also, as a means of reporting upon what has been done and of determining its adequacy as a basis for the principal's opinions. In such cases a program becomes a means of insuring that the examination is planned so as adequately to accomplish the purpose of the engagement and to meet the requirements of normal audit procedure and, later, to confirm that it has been carried out with effectiveness and efficiency. The extent to which it is desirable to use and rely upon an audit program as a record or report of work performed, as well as a guiding memorandum of what is to be done, is one subject that warrants some discussion.

In practice there are two general forms of audit programs. One may be called the detailed or predetermined, and the other, the general or progressive. The first constitutes a detailed specification, prepared by the principal or supervisor, of each verification or testing procedure which is required to be performed. The second constitutes a mere outline of the scope, limitations, and objectives of an engagement supplemented by a record, prepared progressively by the senior in charge of the engagement, of each step which has been taken in reaching the objectives. Each method has its advantages and disadvantages. One is more to be preferred than the other in engagements of

Audit Program

certain characteristics or by accountants whose offices have certain characteristics of organization. The relative merits of these two general forms of programs appear to be an appropriate subject for general discussion.

The predetermined program, whether of a standard form or specially prepared, constitutes specific instructions to the senior in charge of an engagement as to each individual step to be taken in performing what may be termed the mechanical processes of examination. Under such arrangement the responsibility for their being appropriate or adequate, to accomplish the objectives in the case of each account embraced by the examination, rests with the principal or supervisor preparing the program. This is advantageous in that, if the program is to be intelligently prepared, it requires a personal contact by the principal or supervisor with the actual accounts and the accounting organization of the enterprise under examination. The desirability of such personal contact recently has been emphasized by comments of officials of the Securities and Exchange Commission.

On the other side of the picture the predetermined or detailed program has the disadvantage of limiting the responsibility of the senior in charge, or of circumscribing what he is to do. It has a tendency to reduce the requirement for his independent thinking. Even though it be presumed that the principal responsible for the preparation of the program has had adequate contact with the accounts under examination and the related situation, his knowledge cannot be as thorough as that obtained by the staff member in charge of the case and it would be rare indeed for a detailed program to be prepared, except in periodical recurring engagements in which the circumstances are relatively fixed, which would not require considerable modification in the actual carrying out of the work. It may be argued that the preliminary specification of proce-

dures does not release the senior from the responsibility of independently determining their requirement or adequacy for the accomplishment of the desired objective. But this is theory. In practice it cannot be denied that there is a tendency to follow the line of least resistance by doing only those things which are required, without giving them that critical consideration necessary to determine the effectiveness of the procedures at the time of their performance.

In the general or progressive form of audit program, the program itself outlines briefly the general character, scope, and limitations of the examination and of the desired objectives, dealing specifically also with particular problems which the principal's or supervisor's knowledge of the particular circumstances indicates will present particular problems or require particular attention. To illustrate, such a program might merely state that the objective of a particular examination was to enable the issue of an unrestricted certification of the balance-sheet and income statement, and then might proceed to specify the percentage of accounts receivable to be confirmed, with the manner and date of the confirmation; might specify the manner and time of inventory testing and the percentage of items or value to be tested by inspection; and might point out the particular requirement of considering critically the provisions of a trust indenture.

With such a program before him, the senior has a clear picture of what is required, leaving to him the responsibility of carrying out those processes which, through his training and experience, he knows to be necessary. His instructions are to reach an objective, the manner of reaching the objective being left to his knowledge of accepted audit procedures and his judgment of their application.

The detailed or predetermined program has the advantage of providing the senior in charge with a check sheet

which constitutes a protection against oversight, an advantage not existing in the general program. The general program has the advantage of accentuating objectives rather than methods thus placing greater responsibility and necessitating greater thought upon the part of the senior accountant, an advantage not possessed by the predetermined program.

No matter which method of approach is employed, it is important that the preparation of an audit program be preceded by a preliminary survey embracing any conditions peculiar to the business, the general character of its personnel, assignment of their duties and responsibilities (particularly as to custody and control of cash) and the routine accounting methods and procedures. A consideration of these factors will enable the auditor to provide in his program for such verifications or tests as would be most likely to uncover any irregularities which might result therefrom.

One of the most difficult and precarious phases of an examination is to determine the character and extent of testing or sampling. This is a subject which is too broad to be covered fully in our present discussion. In brief the audit program should provide for tests sufficient to establish to the extent required by the nature of the engagement, the general accuracy or reliability of the accounting.

Any discussion of an examination or audit program would not be complete without some consideration of the familiar phrase "internal control"; no phase of an examination is more important. It should be so studied by the auditor as to be thoroughly understood before the preparation of any program. The result of such a study may evidence a situation ranging all the way from its total absence to a really comprehensive system. But even where a complete system is found to exist, the effectiveness of its operation must be established by test.

In connection with the personnel of the client, particular provision should be made in the audit program to establish the integrity of individuals having important responsibilities for cash, securities, or other property. Where such individuals are not under bond it may be that the hazards of impropriety are increased. While the auditor is not responsible for the qualifications of the client's employees, he frequently is responsible for uncovering dishonesty. The audit program should recognize conditions or information which might have a bearing upon this element.

Where a predetermined or detailed program is used, it would be dangerous to regard it as an inflexible rule of procedure under any and all circumstances. It should never be accepted as a substitute for discriminating judgment; even the junior accountant should be made to understand that the value of his work depends more upon the keenness of his observation and his ability to grasp the significance of his findings, than the mere following of a program. In the case of recurring examinations especially, it would be well for the auditor to make a deliberate effort to discover some procedure not thought of before which would uncover an irregularity of unusual character such as was not anticipated in preparing the program. It is far better to invest some available time in doing the unusual thing than to spend it all on a predetermined schedule of work.

In the event of unusual development in the progress of an examination, an immediate consultation should be held between the principal and the senior accountant in charge as such development may require extension or modification of the program, or even authorization from the client to amend the engagement. Such revision, where required, should be made by coöperation between the principal and the senior accountant with the same thoroughness and along the same general lines of

Audit Program

procedure indicated for the original program.

When the details of the examination have been completed in accordance with the procedures we have outlined, it is then necessary for the principal to review the findings as evidenced by the working papers, in connection with a further discussion of the audit program. This affords the principal the necessary opportunity to reconcile the findings with the objectives, and to provide for possible extensions appearing to be necessary to the completion of the report.

By way of recapitulation, the following is a brief statement of the most important points:

1. The audit program is a mere guiding memorandum of the examination procedures to be accomplished. It may be prepared in full detail or as a general outline to be supplemented by a detailed record of the procedures taken. In either case it may be used

as a record and report of the actual work performed.

2. It should be based upon a full knowledge of the accounting procedures and methods of the client and of the particular problems likely to be met.
3. The extent of the planned or executed procedures should recognize the human equation as an affecting factor.

As a basis for general discussion, the following subjects appear to be of general interest:

1. The extent to which it is desirable to use and to rely upon a program as a report of work performed, as well as a guiding memorandum of what is to be done.
2. The relative merits of the detailed or predetermined program, on the one hand and, on the other, of the general program supplemented by a record of the work done developed progressively during its performance.

Office Review of Field Procedures

BY HARRY L. STOVER, KANSAS CITY, MO.

Member, American Institute of Accountants

THE AUDITOR'S work is intangible. Its results may not be weighed on a scale nor measured with a caliper, and its quality has no relationship to the inherent merit of one group of raw materials as against another nor, generally speaking, to the dexterity of skilled technicians. It is the auditor's primary function to furnish reliable opinions respecting the financial statements of his client companies; to this end, it is his duty to perform all of the reasonable tests and make all of the reasonable inquiries necessary to lend reliability to the grounds on which his opinion is founded. It is his further duty to ascertain the relationship between the principles underlying his clients' statements and those to which his professional colleagues, over the years, have granted recognition—his opinions must be stated in terms of recognized accounting principles.

The effectiveness with which the auditor performs these fundamental duties must be gauged with reference to intangible standards: the sum total of the accumulated experience of those who preceded him in the profession, the standards of procedure and performance laid down by those whose purposes may be served by audit examinations, his own immediate experience, his policies based upon a continuous study of principles and procedures and, finally, the purposes toward which his examinations are directed.

The audit certificate, the detailed report, or the letter of opinion, as the case may be, constitute the medium through which the auditor presents his opinion, but, with equal importance, they constitute the auditor's written acknowledgment that the related work

measures up to requirements either in entirety or for the most part. In the latter event, they further constitute the medium through which he indicates the manner and extent to which standards for one reason or another have been modified in the performance of the work.

When the auditor who accepts final responsibility for an examination is the same person who performed the examination, his knowledge of the procedures employed, his knowledge of the scope within which his inquiries were made and his knowledge of the transactions which gave rise to the financial statements covered by his certificate, are all direct and immediate, having been obtained at first hand. If the groundwork has been adequate, he knows this to be the case and may forthwith render his opinion.

Audit examinations for the most part, however, are no longer performed by the persons ultimately responsible for their results and it becomes necessary in consequence that a means be devised whereby the acceptance of ultimate responsibility may be based upon a substitute adequate in every respect to replace first-hand contact. This need must be satisfied by the form and content of the field auditor's working papers and by a process of review, second- or even third-hand contact. The standards by which the quality of working papers is measured are constantly being revised, refined, and improved; progress along these lines may be seen and even measured and it may easily be safeguarded through a program of education and strict adherence to formalized rules. The process of review is affected to a much greater extent by the element of judgment, and the degree to which

Office Review of Field Procedures

the process must be varied in particular cases complicates any statement of the standards governing its effectiveness. This discussion relates to the question of review in all of its broad phases.

In the light of the preceding comments it becomes apparent that, to me, the title assigned to this discussion—"Office Review of Field Procedures"—seems to understate the extent of the undertaking to which it applies. Much of review is preview and most of it is supervision. Consideration of the procedures employed by the field auditor would appear to be inseparable from consideration of the data to which the procedures were, or rather are being applied, and the review itself, if it is to be genuinely effective, would appear to be inseparable from continuous supervision of all of the examination's phases from the earliest stages of planning to the final editing of the auditor's report. This being the case, it becomes almost obvious that all of the functions of review except the final editing of the report may best be performed in the field. After all, review proposes to replace firsthand contact, and is necessarily a more adequate substitute the more nearly it resembles the genuine article.

This interpretation of the concept of review, of course, does not intend to imply that the accountant charged with managerial or supervisory responsibilities must sit in constant attendance upon his field staff or undertake to direct actively any detailed phases of the examination. Neither does it intend to imply that he must maintain daily or other regular periodic contact with the field work. The supervisor's frequent visits to the field, however, would offer these distinct advantages:

1. He may consider and promptly approve expansions or contractions in the audit scope originally outlined as it becomes apparent from the progress of the work that the audit program under- or overemphasized certain phases of the examination.

It is virtually impossible for an audit program, however carefully prepared, to appraise accurately all of the circumstances with which the examiner will be confronted before his work is concluded.

2. He may detect omissions, misinterpretations and other deviations from the most desirable and most nearly applicable audit procedures and may promptly initiate corrective steps, whereas, if the review were performed away from the field, the discovery of the omissions or other faults would probably occur at or near the conclusion of the field work, and to remedy them might involve unwarranted delay, embarrassment, and difficulty, in addition to being unnecessarily costly.
3. To his client's great advantage, he may deal promptly with controversial issues and the propriety of proposed adjustments, again in this instance avoiding unwarranted delay and unnecessary cost.
4. He may direct his total attention to the problems of the engagement at hand, excluding from his mind the other matters, which would tend to distract him if he attempted to perform the work within the confines of his own office. This advantage is at once apparent to those of you who have had to answer innumerable telephone calls, interview an applicant for employment or suffer other distractions while you were attempting to concentrate on one particular problem.

The need for the reviewer or supervisor to visit the field is frequently modified, of course, in some instances most considerably, by a number of important factors. The results of extensive preliminary work may indicate that there is little likelihood that material problems will arise. The size of the client company, and, relatedly, the degree to which internal control and effective internal audit procedures are found to have been developed will have an important bearing on the supervisor's responsibilities and program. A previ-

ous familiarity with the client company, its procedures, problems, and personnel frequently tends to simplify the supervisor's work, and finally, the experience and other qualifications of the senior accountant in charge of the examination, when viewed in relationship to the job at hand, may tend to minimize the necessity for field review on the part of the supervisor.

Regardless of whether the review of field procedures is conducted in the field or in the auditor's office, and regardless of whether it is performed periodically during progress of the work or strictly on a review basis, the objectives to be attained are fairly well fixed.

The reviewer must satisfy himself that the work performed constitutes a reasonable verification of the account balances supporting the certified statements and that it conforms in procedure and scope to the auditing standards recognized, accepted, and adopted by the profession. If the engagement is a balance-sheet audit the procedures used must meet the tests outlined in the bulletin, *Examination of Financial Statements*, and in the supplemental work, "Extensions of Auditing Procedure." He must satisfy himself that the certified statements offer a fair presentation of the financial position of the enterprise at the date in question and of the results of its operations for the period then ended. He must further satisfy himself that the underlying accounting procedures conform to accepted principles of accounting and that these principles have been consistently applied. Finally, and the importance of this point is being accorded ever-increasing recognition, he must ascertain that the working papers furnish an adequate permanent record of the nature

and extent of the audit work performed, and completely support his opinion and the statements to which it refers.

The chronology of the reviewer's work to determine the above described objectives is somewhat as follows:

1. Supervision of the preparation of the original audit program.
2. Review of the examination of the system of internal control.
3. Revision of the scope of the audit program as viewed in the light of the internal control of the company.
4. Contact with the work as it progresses in the field.
5. Final review at completion of the engagement.

The digression from the confines of the title of this article has been deliberate in order to express my opinion of the functions of review. The office review would then consist of the following:

After the working papers and report have been reviewed and after the report has been typed, refooted, and proof-read, the report and working papers are given to a senior accountant who has not been assigned to the engagement with instructions to "reference" the report. This procedure consists of checking the figures shown in the financial statements to the various analyses and summaries underlying the trial balances. It further consists of a cross reference of amounts shown in the various exhibits and in the report, and details which appear in text comment only are traced to the working papers. Text comments, item description, and footnotes are reviewed as to accuracy and clarity of expression. The report is then finally reviewed by the principal in the light of the changes suggested by the referencer and, after any changes, is ready for signature and delivery.

Problems of Filing in an Accountant's Office

BY HAROLD R. CAFFYN, NEW YORK

Member, American Institute of Accountants

WHEN I was asked to come to this meeting prepared to lead that part of the discussion relating to filing in certified public accountants' offices, I wondered at first what remained to be said on the subject. I naturally felt that the system used in our own office was effective. Certainly, we never, or maybe I should say hardly ever, lose anything, and we can generally find what we want if we look long enough for it. As a matter of curiosity, however, I thought that it would be well to find out what some of the other firms did. Accordingly I communicated with ten or a dozen of them who are located in New York. They were all extremely courteous and co-operative, and I would like to take this opportunity of expressing my appreciation to them. They certainly laid the groundwork for the education of my naïve self in filing matters.

I find that they all have satisfactory filing systems. Not one of them, however, is the one we use; not one of them, moreover, is exactly the one any of the others uses. The moral of my tale is obvious. There is no one filing system for an accountant's office. Each firm must develop its own system according to its size, the nature of its clientele, and the habits and eccentricities of its partners.

In these circumstances, any attempt to outline the perfect system is both out of place and hazardous. I therefore suggest that you re-read chapter 15 of *Audit Working Papers*, by Maurice Peloubet, entitled "Indexing and Filing Working Papers." For my part I shall describe what I saw in other accountants' offices.

WORKING PAPERS

There is obviously a growing tendency to the use of the permanent folder. This folder is usually filed in front of those containing yearly working papers. It contains historical data regarding the engagement and the client, such as memoranda outlining the terms of the engagement, special points to be observed in connection therewith, extracts from minutes and important contracts and analyses of continuing interest.

I observed a preference for the binding and indexing of audit working papers in accordance with standard classifications. One firm used two such classifications, one for mercantile concerns, and one for public utilities. This practice is extended in most firms to cover not only the trial balance and supporting schedules, but also audit programs (if any), audit questionnaires, extracts from minutes, etc. One of the most ingenious plans I saw provided for the binding of working papers by the left-hand margin. There was a standard classification and order for filing of the papers. The accountant was provided with loose-leaf punched sheets to serve as dividers between the papers filed under each classification symbol. These dividers had an extension tab to the right-hand side indicating classification symbol and caption, e.g., "G"—Accounts Receivable. On each divider sheet so provided were printed the principal steps normally taken in connection with the audit of the item it referred to. For example, on the sheet for investments twenty-two steps were listed as follows:

1. List by classes.
2. Examine securities on hand.

3. Obtain certificates for those elsewhere.

Etc.

Against each of these steps was space for a check mark or initials indicating whether or not this work was to be done. To the right of this column were others in which were recorded by whom the work was done, the period covered, and the man-hours consumed. This, of course, gave an excellent rough audit program, a good history of the work performed, and a splendid index to the working papers.

Working papers are usually bound together in folders, on the outside of which are stated the name of the client, client number (if any), brief description of work and period covered. Where more than one bundle is needed for a single piece of work, it is a good custom to indicate on the outside of a package that it is, say, three-stroke-four; that is, the third package of four for that piece of work. Some firms go considerably further in the details included upon their covers, indicating senior in charge of the job, assistants employed, etc.

Many firms go a step further and place the bundles of working papers in stout manila envelopes, which in turn bear on their face concise information similar to that on the working papers cover. This practice, while perhaps a little extravagant, certainly makes for order in the files. This was particularly true in one case I saw where the manila envelopes were stacked side by side on shelves, the canvas gussets to the side of the envelopes being stenciled with a brief description of the client, job, and year. In this case, incidentally, it was the practice to keep in the current file papers for the last four to five years. The papers for the current year for any particular job were always on the bottom shelf, those for the preceding year were on the shelf above, etc. Each year, all files were moved up one shelf, the

contents of the top shelf being transferred to the vault.

Once the papers are in bundles and/or envelopes, filing again becomes a matter of taste. Some firms file numerically by client number, some alphabetically by clients. In either event, it is customary to file subsidiary companies alphabetically behind the parent company within the parent company's section of the files. I saw one plan in which each job, regardless of client, was filed on shelves chronologically, i.e., in order of receipt in the file room. This, of course, is a good space-saving device and one which simplifies the systematic transfer of old papers to vault storage.

Regardless of the filing method employed, numerical, alphabetical, or chronological, it is desirable that an adequate record of bundle descriptions be maintained. In the case of numerical files, this control will consist of an index card, filed alphabetically, bearing the client number and listing the various bundles inserted in the drawer or shelf bearing that number. In the case of the alphabetical files, the same controlling cards would be prepared, but would bear no client number. In the case of chronological files, it is desirable to have a register listing bundles received by the filing department. The register will show date of receipt, client, and description of papers in the bundle. Each line on the register has a serial number which will be stamped on a corresponding bundle.

The entries on the register will naturally be posted to cards or ledger sheets prepared for each client and filed alphabetically. These sheets will describe each bundle and indicate the serial number, and thus, the location of that bundle in the files. One other form of index should be mentioned before I leave the subject of working papers. This is one I saw in a large firm in which storage space was available in the building in which the head office was located. The files are in four locations.

Problems of Filing in an Accountant's Office

Each location is covered by a file index drawer, and working paper descriptions are posted to cards in these drawers as papers are removed or inserted. Incidentally, this concern filed all its working papers in boxes approximately 10" x 10" x 15".

REPORTS

In discussing the filing of reports, I intend to include registration statements except where specifically excluded. Here again considerable latitude exists in current practice. Most firms favor the filing of reports separately from working papers and this seems to be logical in view of the fact that it is generally necessary to retain reports for a longer period than working papers in the current files. There is definitely more of a tendency to maintain a register of reports than was apparent in the case of working papers. Most of the larger firms used chronological filing, and here, of course, a register or card index is essential. The best report registers that I saw constitute a good record of the report description, number of copies prepared, date prepared, date delivered, and to whom the individual copies are delivered. An interesting practice was one in which the report description was typed vertically as well as horizontally on the cover of the file copy of the report. This greatly facilitates reference where the reports are filed in drawers.

A desirable practice is that of setting aside in a permanent report file a copy of every report made in the office. In some cases, not even partners are allowed access to this file except in emergency. It follows that in such cases a copy is prepared for office use and filed with the working papers. A number of firms prepare an additional office copy of audit reports. This is filed with the working papers and is used as a draft in the preparation of the report for the following year.

The second and third office copies

above referred to are usually typed on thin copy paper and in some cases the third copy, which is likely to be cut up and mutilated is not put into a regular folder but is bound in a temporary folder with a corner clip. While I would condemn any attempt to make the text of any one year confirm with that of the preceding year, I can see that for certain jobs use of these extra copies can be a time-saver and a valuable guide.

CORRESPONDENCE

Four principal divisions of correspondence suggest themselves:

- (a) Correspondence with clients.
- (b) Correspondence re office matters.
- (c) Partners' correspondence with respect to committee work, etc.
- (d) Partners' personal correspondence.

In no case, I believe, did I see partners' personal correspondence filed in the general files, and I shall not attempt to cover the subject in this paper, inasmuch as these files are relatively simple and are usually under the care of a specific partner's secretary. In the case of the other three divisions, however, every possible variation presented itself.

I will merely describe one plan which appeared to be effective. In this case all correspondence is filed alphabetically under three-position guides. The position guides indicate:

Left —Subjects
Center—Clients
Right —Organizations

This file is well cross-referenced. Let us take for example a four-page letter on inventory practice written to the president of corporation B, a subsidiary of corporation A. The original of this letter would be found in the "A" drawer in a folder bearing a center position (that is, client's tab). The folder is in front of those for corporations C and D, also subsidiaries of corporation A, but it is behind the main folder for corporation

A, itself. In addition to this, as the letter dealt with inventory practice, a sheet of paper is inserted in a folder carried under letter "I" for inventories in the left-hand (that is, subject matter) tab position. This sheet refers to a letter written on blank date to so and so, and I can well see that in times like the present it is an extremely valuable thing to be able to refer readily to all the significant correspondence that has gone through the office on a subject of this importance. If one of the partners has, let us say, been working on a committee of the American Institute of Accountants studying inventory procedure, the correspondence relating thereto is filed in a folder bearing the name of that committee in the organization (that is, right-hand) tab position, and a reference is made to the committee file in the inventory folder.

Correspondence is usually bound into folders. In most cases a rule is in effect that correspondence is not allowed out of the vault except on loan to, or by permission of, a partner.

One firm had an extra thin copy of all outgoing correspondence prepared. These copies were kept separately until they were five hundred to a thousand strong, at which time they were put in permanent folders.

In another firm, a large one, I was interested to see that an extra copy of each day's outgoing mail was put into a folder early the following morning. This correspondence was sorted so that routine matters were at the bottom and relatively important ones at the top. The outside of the folder was stamped with the initials of each partner, and the folder was passed from partner to partner and initialed by them.

The largest firms with large staffs in their filing departments have little difficulty in keeping correspondence filed currently, but in some firms only slightly smaller, this appeared to present some difficulty. One of them had solved the problem by maintaining an unfiled

letter bin into which all unfiled letters are immediately sorted between dividers set up on a straight alphabetical basis.

The "awaiting-reply" file of another organization interested me. Into this file were placed outgoing letters calling for a reply. The partner writing the letter would indicate to the stenographer that a reply was expected by a certain date. The partner's initials and anticipated reply date were placed by the stenographer on a copy of the letter and this copy, together with relative correspondence, was placed in the "awaiting-reply" file under an alphabetical arrangement.

I have since wondered why this excellent idea had not been carried a step further, the file being arranged on a day number rather than on an alphabetical basis.

INCOMING MAIL

Some firms register incoming mail. The registers refer to the serial numbers placed on all incoming mail, and proceeding from that number, contain information as follows:

1. Number of enclosures
2. Date of letter
3. From
4. Subject
5. Refer to
6. Answered
7. File reference

In some of the larger firms, all incoming mail is rubber stamped with the initials of all partners and departments and checked by whomever opens the mail against those partners or departments to whom the mail should be passed. In such cases, it is usual for the head of the file department to see that all partners checked have initialed the correspondence.

PUBLISHED REPORTS

Many firms maintain a printed report file. The firm which had gone farthest in

Problems of Filing in an Accountant's Office

this connection has a rule that at least one printed report be stapled to the permanent file copy of each of its clients' reports. In addition, it maintains files for all other printed reports it can obtain. These reports are filed alphabetically by corporations and are covered by a comprehensive three-way index under which the reports are listed:

- (a) By types of business
- (b) By the accountants certifying
- (c) By corporations

TAX REPORTS, CORRESPONDENCE, AND WORKING PAPERS

It is difficult to generalize on this subject, but inasmuch as I was studying the files of the larger firms, it is natural, perhaps, that I should have detected a distinct preference for separate filing of all tax data. Most of what I have already said with respect to working papers, reports, and correspondence will apply to tax matters, but as you well know, follow-up is such an essential part of tax work and this is so closely related to indexing that I hesitate to get into a subject which I know I cannot possibly cover in the time available.

GENERAL OBSERVATIONS

I found that in most firms only those in the filing department are allowed access to the files. I found, too, that in most cases receipt or out-cards are placed in the files for reports, correspondence, or working papers extracted therefrom. These cards usually bear an out-tab and indicate in columns client number or name, date, and by whom taken. In some cases the signature of the borrower is obtained, in others his name is filled in by the filing department. An interesting variation was observed in one firm in the form of a duplicate file receipt. This receipt, approximately 8" x 4", has space for date, client's name or number, description, signature of

borrower, and probable date of return. The original is placed in the files in place of the item extracted. The duplicate is placed in a tickler file, kept by the file department, by probable return dates.

One of the larger firms has a separate vault for the overnight storage of work in process. This vault has adequate rack space into which bags containing working papers or loose working papers are readily placed.

It might be of interest to point out that the filing personnel in the firms I visited runs all the way from one girl doing all the filing, in addition to a certain amount of secretarial work, to a case at the other end of the line in which the staff consists of a woman file department head with one assistant and eight or ten junior accountants. In the latter case, I was impressed with the excellent training afforded the junior assistants who take the papers turned in by the "in charge" accountants, study them, bind them, and file them.

I am compelled to race through some of the other angles on filing in an accountant's office. The firm's own accounts, its bills receivable and payable, canceled checks, etc., are all matters on which I think specific comment is not called for. I do think it wise, however, to mention that in all cases where letters are written regarding arrangements with clients, either as to work or as to fee, extra copies should be prepared and filed with the firm's own papers.

Applications for employment are in many cases kept indefinitely, although sometimes, after a number of years, summaries are put onto cards and the original applications are destroyed.

The question of an adequate index to the office library and services is one which I know has given many accountants some trouble. To those who are fortunate enough to be located close to the Institute library much trouble can be saved by the use of its facilities and

Extensions of Auditing Procedure

of the *Accountants' Index* which it prepares from time to time.

In any event I do not think that any better subject-matter index can be built up than the *Accountants' Index*, and it seems to me that the use of this volume, coupled with a simple card index, showing only volume titles of books contained in an office library will serve to let a practitioner know where to locate data on any specific accounting topic.

STORAGE

The problem of storage space is probably one which does not concern the practitioner in the smaller cities. In the larger cities, however, it is sometimes found economical to take additional storage space in an adjacent suburb in which realty values are at a low level. Matter is transferred to this space when it is four or five years old and is not likely to be called for frequently. For this reason I rather like the plan adopted by one firm. Regardless of the job number or other identification which filed matter might have had in the regular files, it is given a new serial number when it is delivered to the transfer vault. Five or ten bundles on one job for one year would be wrapped together and given one of the serial numbers. The bundles so registered are then placed on shelves, subdivided into sections so that no space is lost. Control is effected by two sets of cards: small cards are filed alphabetically by clients, a card for each client showing brief description, year, and section number; the other set of cards is somewhat larger and is filed numerically by section numbers. There is a card for each section, listing the contents of that section, showing client, working papers, file number, and description of each bundle filed.

Another firm, having out-of-town storage space, has worked out a withdrawal-receipt form in conjunction with

the warehouse company involved. These receipts are bound and serially numbered. Each receipt consists of three parts: the bound section is the permanent record retained in the office. It shows date, client, by whom required, description of papers, and has spaces for the signature of the office boy and partner's approval. The next section tears off from the bound section and has similar information. It is also signed by the office boy and a partner. This second section is retained on file in the storage space. The third section is addressed to the warehouse company by whom it is retained. It requests permission for a firm's representative, Mr. Blank, to enter the storage room, and includes Mr. Blank's specimen signature. It is signed by a partner of the accounting firm. In addition to this, the firm runs record-withdrawal registers showing the date and number of the withdrawal request, client or description, identifying numbers, required by, withdrawn by, date, by whom returned, transferred to, and any desired remarks.

DESTRUCTION OF PAPERS AND RECORDS

I would now like to devote a few minutes to the problem of destruction of accountants' papers and records. To many of us this has already become a problem and there is little doubt that the great increase now called for in confirmations alone will tend to make it even more so.

I will deal with the easy part first and submit for your consideration and as a guide the policy adopted with respect to everything but working papers by one of the larger firms.

This firm's instructions are permissive and not mandatory. They stress the importance of considering each case individually. They call for destruction by cremation and insist that a careful record be left of all matter destroyed. They suggest the following practice.

Problems of Filing in an Accountant's Office

To Be Retained

Reports, main office copies	Indefinitely.
Reports, second office copies	Indefinitely, but those of clients for whom no service has been rendered for twenty-five years may be destroyed.
Reports, spare copies	Current plus five years.
Reports, spare printed copies	1 for at least ten years in addition to copy bound with office typed copy.
Correspondence	Indefinitely, but those of client with whom there has been no contact in twenty-five years may be destroyed.
Applicants' files	Indefinitely, but those of applicants with whom there has been no correspondence in ten years may be destroyed.
Staff files, past and present	Indefinitely.
Time records	Indefinitely.
Engagement memoranda	Current plus fifteen years.
Staff cash reports	Current plus one year.
Canceled checks	Current plus fifteen years, but important checks to be extracted prior to destruction.
Check stubs	Current plus one year.
Bills rendered	Indefinitely.
Accounts payable vouchers	Current plus six years.
Clients' books, ledgers, etc.	Indefinitely, but those of clients for whom no work has been done in twenty-five years may be destroyed.

Now for working papers. The Ipswich Mills case seems to settle the point that they belong to us and not to our clients. We are faced with the problem of destroying those which are obsolete in accordance with a sound and conservative policy. Looking at the legal side for the moment, the picture is rather disheartening. The one important reason for preserving our working papers would naturally lie in their value in defense of action based on alleged negligence or fraud. The statutory limitations are, therefore, significant. Most of us probably think that six years covers us here, but there is wide variation as between the different states, particularly as to the point from which the statutory limitations would run. In this connection, I cannot do better than quote from an informal opinion given me by a responsible attorney:

"Probably an action against an accountant for negligence would be based

on breach of contract and the period of limitation probably would begin to run from the time his report was made, not when the negligence was discovered or when the damage resulted. In the absence of specific provision the limitation on an action based on fraud would begin to run when the injury occurred and not from the time that the report was made or the time the fraud was discovered. In some states, however, the statute of limitations provides that it shall run from the time of discovery of fraud.

"The accountants should consider the fact that frequently an audit is made in a state where the accountant does not live. An accountant might go into a state and make an audit and then return to his own home. The fact that he had left the state where the audit was made and where the negligence or fraud was committed would under most statutes suspend the running of the statute of limitations against him so far as a suit in that state was concerned, until such time as he might return.

Extensions of Auditing Procedure

"If he were sued in his home state, its statute would apply. In such case, there are the following possibilities:

1. In about half of the states, the statute provides that the period of the other state applies.
2. His home state might provide its own period, running from the time he re-entered the state.
3. His home state might provide its own period, running however from the time the action accrued in the other state.

"If the accountant, at any time after making an audit in his home state, should move into a state having the second type of statute (where its own period applies but does not begin to run until he enters the state), he would be subjected to the startling possibility of suit there, even though the action might be long barred in his original home state."

If, therefore, most of us approach this problem solely with the legal viewpoint in mind, it is doubtful if we would ever destroy a single working paper. On the other hand, such a policy would be burdensome and costly, and I think even the most cautious of us would like to find a middle-of-the-road policy based on prudent business judgment. In this connection, I think that it would afford a valuable protection to the profession if the Institute would appoint a committee to study this subject and to issue for our guidance a schedule of minimum lengths of time that papers should be retained. Such a policy must naturally represent the combined judgment of a representative group. Despite this, however, I am willing to stick my neck out a little way and to submit for what it is worth to you, or to such a committee if it is to be formed, a suggestion as to standard policy.

I will suggest for the basis of discussion the following rules, that

1. All reports or letters having the force of reports or opinions be retained indefinitely.

2. Working papers of clients for whom no work has been performed for ten years be destroyed.
3. Working papers of current clients be divided into two groups. The first group to be retained indefinitely, the second group to be destroyed at the end of ten years. The first group will consist of:
 - (a) Audit programs, audit questionnaires, internal-control questionnaires, etc.
 - (b) Extracts from minutes and other corporate historical data.
 - (c) General-ledger trial balances, and trial balances of other ledgers, the accounts in which are of an impersonal nature or which are not covered by general-ledger controls.
 - (d) Analyses of fixed-asset accounts.
 - (e) Analyses of surplus accounts.
 - (f) Analyses of corporate financial structure.
 - (g) Other working papers of lasting interest such as those normally included in the so-called permanent file used by many accountants.

The second group will consist of those papers not included in the first group and will comprise mostly current asset and liability trial balances, analyses, and confirmations. This group will also include papers in connection with systems installed, etc.

4. Destruction to be by cremation.
5. Destruction to be authorized specifically by a senior partner or a partner responsible for any particular job, his authorization to be made a matter of record.

It will be apparent that what I have suggested above is merely the framework. Countless exceptions will occur to you. I will list a few that come to my mind. They are the points which a partner will have to consider in deciding whether or not standard destruction policy is to be adopted in any case.

1. The accountant's knowledge of the nature of a client's business, manage-

ment or personnel may indicate the wisdom of exceptional treatment.

2. Adjustment of standard practice may be called for where clients operate under regulatory bodies, governmental or otherwise, such as the Interstate Commerce Commission, public service commissions of the various states, federal and state bank and insurance departments, Federal Power Commission, National Electric Association, American Gas Association, National Conference of Bank Auditors and Comptrollers, etc.
3. The provisions of the recently enacted investment-company act are significant. Section 32-C of this act reads as follows:

"The Commission is authorized, by rules and regulations or order in the public interest or for the protection of investors, to require accountants and auditors to keep reports, work sheets and other documents and papers relating to registered investment companies for such period or periods as the Commission may prescribe, and to make the same available for inspection by the Commission or any member or representative thereof."

I understand that no regulations have been issued under this section.

4. Possible service to the client must be

kept in mind. The accountant's working papers have been known to constitute a better record of certain accounts than the client's ledger. Moreover, we probably all have clients who have developed the habit of calling us for every manner of information regarding their financial affairs.

5. Should there be a possibility of your client registering under the securities acts, care should be taken to see that no papers are destroyed that would be of value in building up the necessary information. In this connection, form "A 2" calls for information as far back as January 1, 1922, in the event that there have been significant changes in capital structure or asset valuation since that time. The statutory limitations as set forth by the act of 1933 are also of interest and should be studied. It is likely, however, that those following a standard practice such as I have outlined above, will decide that it provides a longer period of retention than is required by the act.
6. Accountants having a great amount of practice in the banking and stock brokerage fields might well feel disposed to adopt a more drastic destruction policy with respect to the enormous mass of confirmations they accumulate. I would not be inclined myself to keep these for more than three years.

Organization and Operation of the Typing Department

BY H. ASHLIN DYKES, ST. LOUIS

Member, American Institute of Accountants

THE PROBLEMS of organization which arise in the operation of the report department in the office of a certified public accountant naturally vary with the size of such a group. The same general principles of organization and operation, however, are applicable to large, medium, and small departments, although the practical means of their application may differ. In presenting these remarks, I shall keep in mind the medium-sized department, rather than the very large office where definite division of duties among the various employees is possible.

In discussing the report-typing department, it seems proper to keep in mind the important part which it has in the presentation of one of the tangible results of the professional accountant's work, namely, his report. An attractive appearance cannot make up for lack of quality in a report's contents, but one which is neat and pleasing in appearance and presented in an easily readable manner is of material value in creating a favorable impression in the mind of the reader. The organization of the typing department should be such as to accomplish this result.

The duties of this department will necessarily vary somewhat with its size. Generally, it is concerned with the typing, binding, and preparation for delivery of reports and tax returns, comparing typed copy with the draft, proving the mathematical accuracy of figures appearing in the typed matter, and possibly cross-checking figures and other references in the report. This group also may be called upon to maintain the report files, keep the inventory of report stationery, and render secre-

tarial service. The latter is particularly true in smaller offices. The reference checking which may be performed by the report-typing department should be limited only to the cross-checking of figures and other data within the typed report. It should not contemplate any reference to the accountant's working papers, as the reviewer and accounting staff should be responsible for the correctness of the draft.

The class of work handled by the report-typing department requires that considerable care be given to the selection of its personnel. The staff should be intelligent, possess a good degree of speed and accuracy in their work, and have at least high-school educations. It is desirable, though not necessary, that at least the department head have some knowledge of accounting principles. Some of the members of the department should be able to write shorthand, so that they may be used for secretarial work when desirable. In some offices it has been found practical to combine the duties of an office boy and relief typist; in others, some of the younger members of the accounting staff are temporarily used as typists. Where the volume of work warrants, it is considered advantageous to assign young men recently employed for the accounting staff to this department to assist in the comparing and proving of reports so that they may acquire firsthand knowledge of report procedure. In instances where it is necessary to employ additional persons to meet the demands of the winter season, probably the most satisfactory results are obtained by the full-time employment of capable typists a short time in advance of the need for their

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services so that they may receive a brief training in the technique of the typing department. The head of the report-typing department should be directly responsible to the office manager.

In order that all reports issued by a firm may be generally uniform in appearance, it is necessary that the type of stationery used be defined as to size and quality. It is also desirable that standard typing instructions be used in order to accomplish uniformity in spacing, indentions, capitalizations, under-scoring, etc. A material improvement in the appearance of reports can be accomplished by a little thoughtful attention to these simple matters.

The various operations performed in the report-typing department should be evidenced by signatures and other information recorded on the typed proving copy of the report. Space for indicating this data is usually provided by a rubber-stamp impression which may show the number of copies made, by whom typed, the persons who compared the typed copy with the draft, the employee who proved the figures, checked the references, made corrections, etc.

In order that there may be a thorough understanding as to the operations which should be covered by persons engaged in comparing and proving reports, and cross-checking of references therein, standard instructions in this connection are desirable. These might, among other things, specify the type of check marks and colors thereof used to indicate the different operations.

Material delivered to the typing department should be legible and so set up that members of that department, however well qualified, will not be required to make decisions as to the manner of presentation. This requires that staff accountants and reviewers be familiar with the standard methods of presentation which may have been adopted by the practitioner. All drafts of reports presented for typing should be signed by the writer and reviewer

and bear a stamp impression, or be accompanied by a form, showing the number of copies to be typed, the required date of completion, and information as to the persons to whom the reports are to be delivered.

All members of the typing and report department should be required to submit periodical time reports showing the type of work performed and, if chargeable to a client, the name of the engagement. Time reported may be divided between typing of reports and tax returns, comparing and proving, general office work, and unemployed time. In reporting time chargeable to clients, either the actual time required for the operation may be shown, or a charge computed based upon a standard time for a page of comments or a statement. Time spent in making rewrites, corrections, and proving rewrites should be considered as general office time. In order to provide information to the office management as to the status of work in the department, a report may be prepared at least weekly, showing reports and tax returns awaiting typing, those in typing, and those on which typing has been completed, but which have not been released for reasons indicated.

It has been found advantageous to file all office copies of typed reports in individual folders on which provision is made to show the number of copies prepared, their disposition, the person signing the report, and other data which should be of value in subsequently referring to the files. If the reports are printed by the client, this also might be indicated and provision made to insure proper follow-up as to the checking of printer's proofs and obtaining of file copies of the printed matter. In order to maintain control over copies of reports temporarily in use, receipts should be taken for all items removed from the files.

Proper functioning of the typing department requires that it complete work

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assigned to it in time to permit delivery of reports at specified dates. In so far as is possible, a relatively even flow of work into the department is desirable. Even though this frequently may not be practicable, the planning of work will be greatly facilitated if the head of this group is kept advised as to reports which are to be delivered to it in the near future, particularly those of considerable size and those requiring prompt delivery.

If stationery supplies are in custody of this department, valuable information as to usage of the various kinds of supplies may be easily obtained by use of a simple inventory record show-

ing the quantity of each item on hand, purchases, and usage determined on the basis of physical inventories taken at least quarterly. Information shown by this record should be of material assistance in placing orders for stationery and supplies and in avoiding the accumulation of unnecessarily large stocks.

A properly organized typing and report department should be a definite asset to the practitioner. In addition to producing reports of which he may be justly proud, it should be the means of saving valuable time of partners and principals, which otherwise might have to be spent on more or less routine and detail matters.

Some Personnel Problems

BY HAROLD L. KLAGSTAD, CHICAGO

Member, American Institute of Accountants

ANY ATTEMPT at complete coverage of personnel problems in the conduct of a public accounting practice would be a rather formidable undertaking and it would involve considerable repetition of certain phases of the question such as staff organization, staff training, and the recruiting of the temporary staff, which have been ably dealt with at recent meetings of the American Institute of Accountants and on which considerable literature is available. For that reason I have felt that by confining the discussion to a few suggested points on which there seem to be differences of opinion, it may be possible to bring about a general discussion in which the opposing views can be aired.

Any discussion of the general subject of personnel should take into consideration the change which has come about during the last ten or fifteen years in the type of applicants for positions as junior accountants. I refer particularly to the advent of college-trained men in the public accounting field. There were, of course, before that period a fair percentage of men with college degrees who found themselves in public accounting without having shaped their educational program in that direction. There were also a large percentage who, although without college degrees, had obtained some education in accounting and related subjects in the form of home-study and night-school courses.

Today, however, there are being graduated annually from our leading universities hundreds of young men who have chosen accounting as a career and to that end have spent four years or more in obtaining a general university education with specialized training in the accounting and allied phases of

business administration. I know of no complete statistics on the number of university graduates who have majored in accounting, but on the basis of figures furnished me by a few of the larger universities who have pioneered in accounting courses, I would estimate that for the year ended June, 1940, the number of such graduates of eight or ten better known or larger universities having commerce or business schools would approach one thousand. It is impossible to estimate the total annual number of such graduates, but it seems reasonable to assume that there would be several thousand. Further information furnished me indicates that the annual number graduated had approximately trebled in the last fifteen years and had more than doubled in the past ten years.

I was somewhat surprised to learn, however, from the experience of several of the major universities that over the last ten years the number of these graduates absorbed by the public accounting profession is estimated at less than thirty per cent. This seems a relatively small proportion since public accounting is presumed to be the natural field for these graduates to find their places permanently or at least to spend a few years in obtaining practical experience before entering some other field of business. It is true, of course, that a substantial number of these university graduates have found positions in the industrial and commercial accounting fields and during the last six or seven years an expansion in state and national governmental bureaus has developed an important outlet for these career men.

One factor which tends to reduce the number who seek public accounting

employment is that the college man is prone to feel that his preparation should entitle him to employment with some probability of permanence, a thing which the average public accounting firm is loath to promise definitely. Another factor is the matter of travel involved in obtaining personal interviews. This latter objection does not seem important to many firms who make it a point to have representatives interview a substantial number of men at several of the universities some months before graduation. Still another is the tendency of the accounting firm to confine its attention largely to the cream of the crop from a scholastic viewpoint. This practice might be questioned since it may eliminate the man who has the important quality of personality and the ambitious fellow, whose marks may have suffered by reason of the necessity of financing his education by a heavy program of outside duties. However, I have the distinct impression that the heads of the commerce and business administration schools feel that the public accounting profession as a whole is not taking advantage as it should of the availability of this source of personnel for its permanent staff and that the college men who are hired are not given an adequate trial period.

It seems significant that in testimony given before the Securities and Exchange Commission by representatives of eleven accounting firms, it was, with one or two exceptions, stated that the policy of each firm represented there was to recruit its *permanent staff* from college graduates who had specialized in accounting and allied subjects. This was qualified in most instances by an explanation that an applicant or a temporary staff member of unusual qualifications in other respects would not be passed up simply because he did not have a college degree. There appears, however, to be a wide variation in the degree to which this policy is

followed, both as between individual firms and as between different branches of the same firm. In his testimony Professor Scovill, of the School of Commerce of the University of Illinois, stated that he felt that public accounting firms could, by and large, be divided into two general classes. The one class holds to the apprenticeship system, which is a carry-over from the times prior to the entrance of our universities and colleges in the field of business administration. The other school, he stated, has come to believe more in the procuring of staff members, at least its permanent organization, through retaining college graduates who have had proper academic training.

It is interesting to study the arguments advanced by the proponents of each method. Those who favor the college man advance these arguments: (1) Public accounting is a profession and its status as such should be protected and fostered by requirements as to training and education generally comparable to those required of the other professions; (2) one state has indicated a possible trend by making a college degree obligatory for future candidates for C.P.A. certificates; (3) the college graduate is assumed, by having completed an academic career in an institution maintaining high standards, to have demonstrated that he has a high degree of intelligence; (4) there are roughly four times as many high-school graduates entering college today as there were fifteen years ago. This is due partially to increased opportunities given the ambitious boy to work his way through. This means that a large portion of a very desirable element are no longer available among the non-college group; (5) it may also be assumed that, in addition to having received a technical and theoretical knowledge of accounting and allied subjects, he will during his college career have acquired a certain amount of poise, the ability to meet people, the

ability to use fairly good English, both written and spoken, and sufficient general educational background to make him an interesting and intelligent conversationalist. This latter assumption may be to some extent theoretical, although it cannot be discounted altogether.

Parenthetically, I would like to suggest that the universities could render a valuable service to the profession by bearing down more than they have on the matter of a wholesome respect for clear, concise use of the English language, for it is no exaggeration to say that financial statements today have become literary as well as statistical documents.

On the other side are those who admit that a college degree is not a detriment, but that it should by no means be a requirement. They point out that the typical noncollege man with at least a high-school education and some specialized study in accounting theory and auditing, and several years of actual accounting and business experience is of considerably more value during the first year or two due to his familiarity with office procedure and his advantage in the mechanics of accounting.

Both schools admit that the basic requirements for a successful public accountant,—namely, character, integrity, resourcefulness, and intelligence,—are as likely to be found in the noncollege applicant as among those holding college degrees. It seems to narrow itself down, therefore, to the question of whether in the long run the assumed cultural advantages of the university background, plus a rather intensive technical and theoretical training, can be presumed to offset a temporary lack of practical accounting and business experience.

Many who have had opportunities of studying the college men in the accounting field are of the opinion that in the average case over a period of years he

has certain advantages which seem to carry him farther and faster. The experience of others may not have been as favorable, and there may be opposing views.

Another matter on which there seems to be a variety of opinion within the profession is the question, to phrase it bluntly, of how long a staff member may be justifiably retained in the organization after it has become apparent that he does not have all of the qualifications required of a supervisor, executive, or partner. It would obviously be an ideal situation if the accounting practitioner could, by a process of developing and pruning, so maintain his organization that he could honestly feel that every member was a potential partner. There are many accountants, however, who feel that while such a policy might be ideal, it would be somewhat impracticable and that it cannot be and is not adhered to. They take the position that there is a definite place in the accounting organization for the capable senior accountant who may be entirely satisfactory in all other respects but may lack a particular quality or trait, which lack serves as a bar to his further progress. This lack might be a matter of personality or any one of a number of qualities which would detract in no way from his ability to do consistently good work of a high order. Admitting that this class of man can be of service for an indefinite period of years, it is argued by some that it is unfair to the man himself, to the accounting firm, and above all, to the younger men in the organization, to permit any stagnation at the top. It is contended that it would be a better policy for all concerned to work toward the ideal of a live, moving organization in which general progress is not impeded by a policy which permits an accumulation of staff members who, after a reasonable testing period, seem to have reached a rather definite limit. While

such a policy may sound ruthless, there are many who believe it is eminently fairer to the man involved than a policy of permitting him to remain on the staff indefinitely, with the result that when the question of placing him becomes imperative, the added years may become a handicap in seeking private employment. One of the additional advantages which is claimed is that the younger element in the organization would be benefited, both from a psychological and from a practical standpoint. Such a policy would, of course, encounter several hurdles, a very practical one being the necessity for maintaining a reasonably balanced staff.

This leads directly to another question of policy in that same general category. The client has come to regard the staff of the public accountant as a logical and convenient source of well trained accounting help just as the public accountant often finds it convenient to place members of his staff in the employ of his clients. This is a mutually helpful outgrowth of the relationship between client and accountant in spite of the fact that it often means a loss to an accounting organization of staff members or executives whom it would otherwise have been pleased to retain. The advantages, however, outweigh such occasional hardships. In this phase of client relationship, however, the accountant must be as scrupulously honest as in any other. The placement of any staff member in a client's organization can only be beneficial when it is done as a result of an honest desire to help both the client and the staff member involved. The question might fairly be asked as to the justification for attempting to place with a client a senior accountant, for instance, who has not measured up to the requirements for retention in a public accounting organization. The obvious explanation is that the requirements for private accounting positions are not necessarily

the same, and the staff member who might have certain limitations in public practice might well prove to be outstanding in a private position. A large group of capable alumni in the ranks of business organizations is, without question, of considerable value. If placements are made under mutually happy circumstances, the benefits are numerous. If, however, either the client should subsequently feel that he has been taken advantage of, or the staff member feels that he has been pushed into an undesirable position, the accountant may well anticipate trouble. There is, without question, an obligation on the part of the accountant to a former employee, particularly one whose length of service merits a mutual evidence of loyalty. After lending all reasonable assistance in obtaining a position commensurate with his ability, he should not be abandoned to sink or swim, but should, within reason, expect advice and counsel, together with a generally helpful attitude toward his well-being and success. Such a relationship could not, of course, be permitted to reach a point which might be considered as affecting the independence of the accountant.

It was suggested that I say just a word or two regarding a question which is frequently asked of public accountants — by prospective employees, young men entering college, and many laymen—and possibly one which members of the profession occasionally ask themselves, namely, just what are the chances of the average staff member's ultimately becoming an executive or a partner in the public accounting field? This question is, of course, difficult and, without analysis, might produce a discouraging answer from the standpoint of the average man, inasmuch as the mathematical probability of such an occurrence is obviously not high. Some people seem to feel that the probability of ultimate success in the individual case is less in the accounting field than in certain of

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the other professions. I am inclined to feel, however, that it is unfair to consider the matter from the standpoint of the junior accountant since, after all, during his first three or four years in public practice he is still in the process of being educated, and during that period, even though he may ultimately find that accounting is not his field, he will have received full compensation in the form of a liberal education in general business practice that could probably not be obtained in the same time in any other way.

If we were to consider the probability of success within the field of public accounting itself from the standpoint of the developed senior accountant, they are, of course, greater. If we are talking about monetary success, and I suppose we should be, it is interesting to note that statistics show that the average income of the certified public accountant compares very favorably with that of the average doctor, lawyer, or engineer.

But there is another factor to be considered. It has been said that there are at least as many successful businessmen trained in public accounting

now outside of the profession as there are within, and it is a fact that a roster of the presidents, treasurers, controllers, and other important officials of industrial and commercial enterprises who received a substantial part of their business training in public accounting offices, would be rather imposing.

One might well ask why the so-called average man should seek to enter the accounting profession. Professor Scovill, whom I have quoted before, in his testimony before the Securities and Exchange Commission stated that from his observations the basic qualities sought by the profession in staff members were character, intelligence, technical training, resourcefulness, tact, judgment, and personality. If he had added "a strong constitution and an appetite for responsibility," the profession as a whole would, I believe, subscribe to this as a modest appraisal of what it takes. But that is not the average man. That's the ideal man and, incidentally, the man for whom the field is wide open and who need have no concern as to how far he can go in public accounting.

VIII
ROUND-TABLE DISCUSSION
Audits of Building and Loan Associations
Leader: THOMAS A. WILLIAMS
October 16, 1940

Introduction

BY THOMAS A. WILLIAMS, NEW ORLEANS

Chairman of special committee on savings-and-loan accounts,
American Institute of Accountants

IN JULY, 1940, the American Institute of Accountants published a pamphlet entitled *Audit of Savings and Loan Associations by Independent Certified Public Accountants*, being a program of audit. On January 30 and 31, 1940, at a conference held in Chicago, Ill., this program had been considered and reviewed by duly authorized representatives of the accounting division of the United States Savings and Loan League, of the supervisors' division of the United States Savings and Loan League, and of the examining division of the Federal Home Loan Bank Board. It is, therefore, an authoritative document.

The building-and-loan industry is an integral part of our national economy. It renders needful service by affording a convenient form of financing for persons of moderate means to acquire homes, and by affording the average individual a safe medium of investment for his savings. Dependable information on the financial operation and condition of this industry is essential, if the investments of depositors are to be safeguarded, and efficient management and investors' confidence are to be assured. The independent audit report is the working tool of management, and certified financial statements, if published, will furnish information about management which will make its accomplishments better understood by the investing public.

The publication I have referred to, then, is also an important document. It is my considered opinion that if accepted and used by all the parties at interest it will in time be found to be one of the most important publications of the Institute since there was first

issued in 1917, and since revised in 1929 and 1936, the one entitled *Examination of Financial Statements*.

The first tentative draft of the program of audit contained in the pamphlet was discussed and approved at a meeting held in Philadelphia, Pa., on April 28, 1939. Among those in attendance at the Philadelphia meeting who are also scheduled to speak at this round-table session were Verne C. Bonesteel, C. J. Burns, and the speaker. George P. Ellis was chairman of the Institute's advisory committee appointed to coöperate with the special committee on savings-and-loan accounts in making changes in the program. Abraham H. Puder is a member of the special committee. Therefore, we who have been invited to participate in this round-table discussion, and give our views on this subject today, have each had a part in the preparation of the pamphlet. Consequently we are familiar with the problem which made it necessary to formulate the audit program for savings-and-loan associations. We hope the work which has been accomplished will go a long way toward solving that problem.

May I also remind you that during the fifty-first annual meeting of the Institute at Cincinnati, Ohio, in 1938, there was a round-table session on this subject. Frank S. Glendening, then chairman of the Institute's special committee on savings-and-loan accounts was the leader. John W. Ballard, then chief examiner of the Federal Home Loan Bank Board, George L. Bliss, chairman, accounting division, United States Savings and Loan League, and your speaker presented papers and entered into the discussion that followed.

Besides the meetings, conferences, and round-table sessions I have referred to, the several tentative and final drafts of the audit program, and the problem in relation thereto, were discussed and acted upon by committees of the Institute, the United States Savings and Loan League, and officials of the Federal Home Loan Bank Board over a period of time beginning in January, 1938. The Institute's pamphlet on audit of savings-and-loan associations is not, then, a hastily drawn document, but its contents have a background based upon intelligent discussion and the considered judgment of competent men well informed upon the specific problem with which we are concerned.

At the Chicago conference in January, 1940, the program of audit (I quote from a resolution adopted at that conference) "was unanimously approved as providing a proper and adequate procedure for the independent audit of savings-and-loan associations and, as such, acceptable as meeting the requirements and needs of the investing public, the management of such institutions, and supervisory authorities." Because of the weight of authority behind the adoption of this resolution, it appears that the statements it contains should be taken at face value.

It is right and proper that the federal agency concerned should have access to the books and records of the building-and-loan associations whose deposits it guarantees up to \$5,000. Also that it should make an "examination" or survey for the purpose of verifying the status of collateral behind the loans made, etc. No one will question the fact, however, that it is in the public interest that impartial audits of the affairs of such associations be made by reputable certified public accountants.

It is obvious that the cost of federal and state supervisory examinations, as well as of independent audits, has to

be controlled and kept in proper relation to gross operating income. Experience indicates that if adequate independent audits are to be made, the scope of federal "supervisory examinations" will have to be curtailed. We have seen that representatives of the building-and-loan industry, of the federal agency, and of the accounting profession have stated that the audit program is a proper and adequate procedure, and acceptable as meeting their requirements and needs as well as those of the investing public. It seems to follow as a logical consequence, then, that independent audits made in accordance with the program by reputable certified public accountants should obviate the necessity for other than routine and inexpensive examinations by supervisory authorities.

The representatives of the interested groups have harmoniously worked together over a period of months, and have accomplished something, I believe, that is in the public interest and their own. Besides, there has developed a mutual understanding of the problems of each related to the problem as a whole. I anticipate that the continued coöperation and understanding between all groups will make it possible to use the program as a guide for making independent audits which will adequately inform management, supervisory authorities, and the investing public as to the financial and operating status of individual institutions. The independent and impartial audit therefore should, from now on, assume increasing prestige and importance in the financial affairs of building-and-loan institutions.

I believe it is incumbent upon the representatives of all groups responsible for what has been accomplished to educate the individual members of their groups to the need for using, and in the proper use of, the medium provided.

Audit of Savings and Loan Associations

BY VERNE C. BONESTEEL, WASHINGTON, D. C.

Chief Examiner of Federal Home Loan Bank Board

SPECIALIZATION or departmentalization in all fields of endeavor has been going on for many years. It is often said that the aim of experts or specialists seems to be to know more and more about less and less. Although the work of a savings-and-loan examiner requires broad knowledge of accounting and auditing, of business and real-estate law, of corporation finance and economics, and of credits and human nature, it is at the same time an extremely specialized field. Having to do with only one type of institution, the work of the federal or state examiner is less diversified than that of virtually all certified public accountants.

There are both advantages and disadvantages to specialization. Possibly the examiner, who examines and audits savings-and-loan associations only, can offer something of value from his training and experience to the public accountant. I am sure the public accountant, with his more diversified experience in accounting and auditing in general, can contribute much to the examiner. Too little attention has been given to coordination of supervisory examinations and independent audits. I am therefore grateful for this opportunity to exchange views.

I shall try to remember that my remarks are being made to professional and experienced auditors. I shall therefore not attempt to discuss principles of good auditing, except to indicate our procedure in examinations as distinguished from audits, and to make some references to your program for audits of savings-and-loan associations and what we consider the minimum requirements of an audit.

Since the independent auditor is employed by owners or managers while the

examiner is employed by federal or state governmental agencies, we do not regard you as competitors. Frankly, we have no preference as to whether we conduct the audit or whether an independent auditor does, provided the independent audit is of such quality and scope as to comply with the minimum requirements laid down by the board of trustees of the Federal Savings and Loan Insurance Corporation.

If the opinion has developed in some quarters that we are competing with the accounting profession, I wonder if such an opinion is not an outgrowth of a forgetfulness in such quarters of the responsibilities of supervisory officials. It is generally understood that state banking departments and the Comptroller of the Currency, as well as the Federal Deposit Insurance Corporation which is insuring the deposits, have a great responsibility to the public—the depositors in banks. It should also be realized that state supervisors and the Federal Home Loan Bank Board, as well as the Federal Savings and Loan Insurance Corporation which is insuring the accounts, have a similar responsibility to the public—the investors in savings-and-loan associations. Because we must make regular supervisory examinations, we have work to do without attempting to compete with you for audits of all associations which we must examine annually.

Applications of associations for insurance of accounts contain an agreement that if the insurance is granted, the applicant will permit and pay the cost of such examinations as in the judgment of the Insurance Corporation may be necessary. The rules and regulations for insurance of accounts provide that if an association is not audited at least

once each year in a manner and by auditors satisfactory to the Corporation, the annual supervisory examination "by the Corporation shall include a complete audit." You and I might raise certain questions regarding the words "a complete audit" and yet it is clear that their use was to distinguish between an examination and an audit.

The public accountant has shown some preference for the word "examined" rather than "audited," for the very reason that he may not like to use the words "a complete audit." An audit usually implies what is generally understood as a detailed audit as distinguished from a balance-sheet audit. The use of either the word "examined" or "audited" calls for some explanation of the work done. I shall emphasize this later in my remarks.

In the periodical investigations of financial institutions by supervisory authorities, however, the distinction between examinations and audits has been more definite. This distinction has long been accepted by supervisory authorities and management, if not by the accounting profession. To clarify this statement, I refer to the examination of banks by the Comptroller of the Currency. In his book, *Romance and Tragedy of Banking*, published eighteen years ago, Thomas P. Kane, who was Deputy Comptroller of the Currency for about twenty-five years, said, "When an examiner satisfies himself that . . . the assets are equal in value to the amount called for by the books, he is bound to assume that the original individual entries which go to make up the grand total are correct, and he cannot know otherwise except by a complete audit of the books unless errors or false entries are discovered by accident or otherwise.

"There is only one way of determining the accuracy of an individual ledger or certificate of deposit register, and that is by calling in and balancing or otherwise verifying all of the depositors'

passbooks and verifying each individual certificate of deposit.

"An audit of a bank calls for the performance of this work and similar detail. An examination does not. In addition to the periodical examination, every bank should be required to have an annual audit."

Normally, an audit of a lending institution is conducted for three purposes: first, to determine by analysis of assets and liabilities, lending policies, and operations, the actual condition of the institution and whether it is being operated in accordance with sound principles; second, to see whether there are violations of charter, by-laws, statutes, or rules and regulations; and third, to see whether all transactions have been properly recorded. These are the purposes of an independent audit whenever the auditor is employed with that understanding. However, in the savings-and-loan business, which is examined and supervised by federal or state authorities, a division of purpose or at least a division of emphasis has naturally developed.

Supervisory examinations of savings-and-loan associations are made principally for the first and second reasons,—that is, to ascertain whether the association is being operated soundly and is following the laws and regulations,—while audits are conducted principally for the third reason,—that is, to see whether accounts are accurate, whether there are technical errors such as inaccurate computations and posting to the wrong accounts, and errors of principle such as confusion between capital accounts and profit-and-loss items or failure to discriminate between apparent and real profits. It would be wholly theoretical, however, to say that there can be this complete separation, for there must be some overlapping in examinations and audits when conducted separately.

If supervisory officials are to point out weaknesses in an institution, the

examination report must contain summaries, comparisons, and certain supporting schedules. Such analyses are considered essential in a supervisory examination, and the examination report form is set up on that basis. In other words, the form of the examination report has been determined by supervisory authorities in collaboration with examining authorities and with certain suggestions from representatives of management, while the form of an audit report is determined by the accounting profession.

An examination must include what is usually referred to as a balance-sheet audit—a proving of the subsidiary accounts with the controlling accounts, and a sufficient review of the income and expense accounts to distinguish operating and nonoperating items and to see that reserve allocations are proper. This, however, does not mean any detailed analysis or verification of receipts and disbursements or income and expenses.

In an independent audit, some of the work done in an examination must be duplicated. However, this overlapping is not so serious when one considers that often the examination and the independent audit do not cover the same period. The Board's examiners cannot reduce procedures or omit information required by supervisory officials. Therefore, if the independent auditor makes merely a balance-sheet audit without verification by direct correspondence, everything he does is duplicated in the minimum examination procedure. The independent auditor, however, may reduce duplication by omitting procedures which are solely for the purpose of testing compliance with statutes, regulations, charter, and by-laws. This approach points the scope of the audit largely to testing the integrity of the accounts.

To summarize, then, I might say that the supervisory examination is for the purpose of observing the financial condi-

tion and testing compliance with laws, regulations, and recognized principles of sound savings-and-loan operation; and, in an examination only, the integrity of the accounts is to some extent accepted, since the examiner depends upon the auditor for adequate test checks and proofs.

Let me give you a few illustrations to emphasize the difference between an examination and an examination-audit as we use the terms.

In connection with first-mortgage loans, the examination, of course, would have to include the running of tapes and comparison with the controlling account. The audit, while it includes this proof, also includes a test check of the cash record against the postings to the general ledger account and the subsidiary loan accounts and verification of at least ten per cent of the accounts by direct correspondence.

In the inspection of mortgage-loan files, when the first examination is made after insurance of accounts, all documents are inspected, except that in the examination of a state chartered association when the state examiners have adequately inspected documents in previous examinations, only ten per cent of the old document files are reviewed. In subsequent examinations, documents on loans made since the previous examination, and, if there has not been an independent audit, at least ten per cent of the documents in connection with old loans, are inspected. However, in an audit, although we do not inspect the document files in their entirety, we make certain that all notes and mortgages or trust deeds are in the files or accounted for.

In connection with share loans, we run a tape in an examination to make certain that the subsidiary accounts are in balance with the general ledger control. We inspect the documents to determine that the notes are properly executed and that the collateral has been assigned. Signatures are compared

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with those on signature cards. We determine whether the loans are within the legal or charter limitations and whether they were properly authorized. In an audit, the procedure and the comments should also embrace the following: a test-check of the cash book records against the subsidiary loan accounts and the general ledger; a test-check of the computation of interest; and a report of requests for direct mail verifications.

With reference to real estate owned, all real estate is scheduled in the first supervisory examination after insurance of accounts, unless the eligibility examination report contains a complete schedule. If the previous report does contain such a schedule, only real estate acquired since that examination is scheduled. On each successive examination we schedule only the real estate acquired since the previous examination and make a summary of the changes. If, however, the real estate owned is a serious problem in the association, we increase the amount of information submitted in order that the supervisory authorities may make a closer analysis of the problem, program, and trends.

In an audit, we also check in detail all real-estate income and disbursements for one month. We check postings from the cash book to the general and subsidiary ledgers. We check income against the original rental records, and vouchers against the disbursement entries in the cash book and also make certain that disbursements are properly supported. We check in detail commissions paid on sales of real estate. We verify by direct correspondence with tenants the rentals received from at least ten per cent of the rentable units owned by the association.

I believe these few examples point out most of the differences as we see them between a supervisory examination and an audit. I should like now to refer to the bulletin recently published

by the American Institute of Accountants entitled *Audit of Savings and Loan Associations by Independent Certified Public Accountants*.

Your committee is entitled to a great deal of credit for this important contribution. We had an opportunity to confer with the committee on two occasions. In our effort to make the program acceptable, we went so far that in general it might be said that in some respects the program exceeds the minimum requirements.

The following minimum requirements for the independent audit of a savings-and-loan association have been approved by the Federal Home Loan Bank Board and the board of trustees of the Federal Savings and Loan Insurance Corporation:

1. The audit should be made by a qualified accountant.
2. The scope of the audit should include:
 - a. Verification of assets
 - b. Determination of the extent of the liabilities
 - c. Verification of income accounts
 - d. Verification that expenses and disbursements are proper
 - e. Satisfactory audit of investors' accounts by direct correspondence (at least ten per cent in number, the total of which shall be not less than ten per cent of the aggregate dollar amount of all investors' accounts), exceptions, if any, being reported
 - f. Satisfactory audit of borrowers' accounts by direct correspondence (at least 10 per cent in number, the total of which shall be not less than ten per cent of the aggregate dollar amount of all borrowers' accounts), exceptions, if any, being reported
 - g. Verification of compliance with reserve requirements under section 301.12 of the rules and regulations for insurance of accounts, and, if a federal savings-and-loan association, with charter requirements

3. The audit should contain a certificate by the accountant that in his opinion the statements contained in the report are correct.

In addition to these requirements, we strongly recommend that the independent auditor try to maintain the element of surprise which we think is extremely important in the starting of an examination or an audit. I know that you have a problem which supervisory examiners do not have. The manager will sometimes ask you to start on a certain date or he will inquire about when you plan to appear. If the management and the association's employees know when an auditor is going to start his work, some of the value of the audit is lost.

Section 3 of your bulletin states that the certified public accountant is not relieved by examinations by federal or state examiners "from carrying out his regular program, although the reports rendered by supervisory authorities may be of value to him." I do not disagree with what I believe is the intent of that statement. However, as you know, there are procedures which cannot be omitted in any supervisory examination. If technical procedures pertaining merely to the rules and regulations are *unnecessarily* repeated in an independent audit, the association will have just cause to complain of the expense. I refer to such matters as percentage of loans to appraisals; whether requirements have been met regarding loans, if any, beyond fifty miles from the principal office; and whether straight loans, those which exceed \$20,000, and those on other improved properties total more than fifteen per cent of assets.

The bulletin under the caption "Mortgage Loans" says, "It is preferable to confirm mortgage loans outstanding and arrearages thereon directly with the mortgagors. If this cannot be done, a qualification to that effect should be included in the accountant's report." The auditor's report certainly should

contain comments regarding direct verifications or any failure to obtain them; but please remember that in an audit of an insured institution a minimum verification of ten per cent is required. The same applies to share loans and other loans and to share accounts.

The auditor's report should be sufficiently definite to show the scope of the work, as is well explained in the last section of the Bulletin. It is simply impossible from some of the certificates or comments for us even to guess what was done. It is probably unnecessary to mention to public accountants the importance of retaining and filing working papers; yet I do so in passing because reference to working papers may some time be necessary should there be any specific questions of whether the minimum requirements of an audit have been met.

The audit of savings-and-loan associations is complicated by the fact that there is great variety in accounting practices. Toward greater uniformity, the accounting division of the United States Savings and Loan League, the American Savings and Loan Institute, state supervisors, representatives of the Federal Home Loan Bank Board, and some of the outstanding men in the American Institute of Accountants, have endeavored to coöperate. The value of uniformity in accounting is not confined to similarity in forms and procedures, but it is also an important factor in obtaining uniformity in operating policies. Although considerable progress has been made in recent years, only about thirty-six per cent of the state chartered insured institutions have adopted the standard accounting system worked out by representatives of these organizations. Since 98 per cent of the 1,430 federal associations use the recommended standard form, this means that 1,690 or about seventy-five per cent of the 2,260 insured institutions have adopted it. But you will find a great variety of systems in the remain-

ing 570 insured institutions and in the uninsured institutions.

A large number of associations are using window posting machines. There are some advantages to the association in using posting machines; by their use records are made clearer and there is less probability of discrepancy between members' passbooks and the association's subsidiary records. On the other hand, the window posting machine violates a fundamental principle of internal check; namely, that an employee in charge of cash receipts and disbursements should not have control over customers' ledgers. To offset this situation, various methods of internal control have been developed, and the scope of the audit must be determined to some degree by the effectiveness of an association's internal check.

We consider the internal control satisfactory when the machine is kept locked and under the control of an internal auditor who is a responsible person other than the one who operates the machine, and when sufficient details are recorded on the audit tape and daily proof sheet to permit of verifying all entries at some subsequent time.

Even when we find satisfactory internal control, we cannot omit certain audit procedures or verification of accounts by direct correspondence, because:

1. Use of the machine does not eliminate the possibility of establishing dummy accounts.
2. There may be improper withdrawals from share accounts, especially from inactive accounts.
3. An investment share certificate may still be issued for the full amount of an investment, but through the use of an incorrect ticket and ledger card the cash may be entered for a smaller amount.
4. Mail payments sent in without passbooks may be manipulated.
5. There are numerous cash transactions wherein the person making the

payment does not have a passbook which is posted simultaneously with the association's ledger card, such as rents, loans in process, real estate sales, and miscellaneous accounts receivable and payable.

6. Adequate control over the machine does not eliminate the necessity of checking the charging and collection of interest or errors in dividend computations.

I hope this partial list of errors which might occur does not imply that we look with disfavor on the use of window posting machines. I merely mention these possible errors because some managers will tell you that most of the audit procedures may be omitted when they use a machine.

We recommend that the auditor carefully analyze the phases of the work handled through the machine and consider the methods of internal control. He can then determine the scope of his audit; but he should in no event omit the direct-mail verifications required in the minimum program.

We have endeavored in the examining division of the Federal Home Loan Bank Board to build high standards. We believe that the examination reports are of real value, not only to the supervising authorities, but to the associations themselves. Through the twelve district examiners we keep in close touch with the entire staff and try to encourage improvement and to recognize ability. Most of our men are started as junior or assistant examiners and, within the limitation of our maintaining a staff balanced as between seniors and assistants, are promoted as they obtain more experience and efficiency. We have constantly stressed quality of work.

The audit of savings-and-loan associations is a field for which an accounting firm, if it is large enough, might develop specialists. Although it has been necessary to define the *minimum* requirements of an independent audit, we have

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no thought of attempting to limit the scope of your work. There is much that an experienced public accountant can do to depict trends and to improve systems. It is up to you to sell associations the idea that your service would have a value in excess of the cost.

We are confident that in whatever ways it can be done, the American Institute of Accountants will promote and maintain among public accountants interested in the field of auditing savings-and-loan associations, those standards which are constantly our goal.

Savings and Loan Management Asks "Why an Audit?"

BY C. J. BURNS, CHICAGO

Manager of the accounting division, American Savings and
Loan Institute

EVERY member of the accounting profession can immediately conjure up a hundred and one answers to the bold question, "Why an audit of a savings-and-loan association?" but the managers of these associations are not putting the question in so blank a form, and thus it is far more difficult to answer.

While in a few instances those who raise this question are unfamiliar with the purpose of an audit, in the main, savings-and-loan association management is audit conscious. To realize this all we have to do is review the history of these institutions. Almost from their inception, even before they were brought under statutory regulation, they have provided in their by-laws for an auditing committee whose function it was to make an audit of the records of the secretary and treasurer of the association.

Judge Seymour Dexter, one of the first authors on the subject of savings and loans, in his treatise published in 1889, in explaining how to organize an association similar to those operating under the New York act of 1851, specifically provides for an auditing committee appointed by the president from the stockholders who are not officers in the association, the committee's duty being to examine the books of account of the treasurer and the secretary.

A review of the by-laws of the Guardian Coöperative Bank of Boston, Massachusetts, one of the pioneer associations in the State of Massachusetts, reveals a by-law provision as follows:

"Auditors—There shall be three auditors elected annually at the annual

meeting, to serve one year. Their duties shall be to examine and audit the books, accounts and vouchers of the secretary and treasurer, and certify as to the correctness of same at or before the annual meeting next following their election. They shall have the power to make partial or special reports at any regular monthly meeting. Vacancies occurring from any cause shall be filled for the unexpired term by the board of directors. No person shall serve as an auditor and director at the same time. The directors shall appoint auditors to serve until the first annual meeting."

An interesting by-law provision for an auditing committee is that of the Peoples Building and Loan Association of the Town of Harrison, Harrison, New Jersey, an association organized in 1873.

"Auditors—The auditors shall be elected by the stockholders at the annual meeting of the association. Immediately after the first election they shall meet and draw lots for their terms of office, viz., for one, two and three years, respectively. The one drawing for one year shall have his place supplied at the next annual election; the one drawing for two years shall have his place supplied at the second annual election; and the one drawing for three years shall have his place supplied at the third annual election. At each succeeding annual election auditors shall be chosen by the stockholders to supply the places of those whose terms expire, or of a vacancy in an unexpired term.

"Their duty shall be to settle and adjust the accounts of the association prior to the annual meeting, and to report to the stockholders with a faithful and ample exhibit of the financial affairs of the association, the state of

the treasury and the value of the shares; which exhibit they shall have printed at the expense of the association.

"In the event of their neglect or refusal to furnish to the stockholders at their annual meeting a detailed exhibit of the finances, as hereinbefore provided, they shall be fined five dollars each.

"They shall have power at any time to inspect the accounts of the treasurer and secretary, and upon five days' due notice call a meeting of the stockholders.

"They shall have power to fill any vacancy that may occur in their number, until the next annual election; but in the event of their inability to agree upon a choice, the vacancy shall be filled by the board of directors.

"They shall superintend all elections but theirs (which shall be conducted by a committee from the board of directors)."

Similar provisions will be found in the by-laws of most of the pioneer associations. There is one interesting feature,—that of stipulating that the auditors shall be other than those acting as officers or directors. This is evidence that the two positions were recognized as being incompatible—that the duty of the auditors was to examine the records and the acts of those who administered the affairs of the business.

This recognition of the necessity for an audit or examination of the association's records on the part of the organizers and operators of these institutions was again given force and effect when these men proposed regulatory statutes to their various state legislators and sought governmental supervision of their operations, for in almost every instance some requirement for audit or examination was written into the statute. The development was somewhat evolutionary, passing through various stages such as: first, audits by committees constituted of qualified members; second, reports to state officials; third, permissive examination by state officials; and, finally, compulsory periodic examinations by state officials.

Typical of this evolution are the changes that took place in the State of New York, the first state to set up any semblance of supervision. New York passed its first statute pertaining to savings and loan in the year 1851. This act permitted the creation of these co-operative institutions as corporate bodies and established general rules for their operation, making no provision for an audit or examination, but requiring that a statement of the financial condition of the association be published.

In 1871 the original act of 1851 was amended, setting up the requirement for submitting a full report of the affairs and condition of the association in writing to the superintendent of banking. In 1878, statutory provision was made whereby the stockholders of the association could request that a personal examination be made by the superintendent.

In 1887, the savings-and-loan statutes of New York State were entirely rewritten including a definite provision for examination of the associations by the superintendent of banking upon application of three or more members of an association. In 1892, annual examination of the associations by the superintendent of banks became compulsory.

Supervision and examination developed rapidly in other states in the years immediately preceding the turn of the century and this development has continued until now some semblance of examination and supervision exists in every state in the Union except one, Maryland. Now definite attempts are being made to secure legislation in that state which will establish supervision and examination.

Some of the states are still in the evolutionary stage as far as the examining procedure is concerned, although most have adopted in whole or in part the examination report forms developed by the supervisors' and accounting divisions of the United States Savings and

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Loan League and the examining division of the Federal Home Loan Bank Board, thus establishing some uniformity in examining procedure.

When we bear in mind the evolution of the examination procedure and consider that it is, in reality, an outgrowth of the audit committee, we can readily realize why the examining procedure that has become an established routine so closely parallels audit procedure. This was a logical development for those who were seeking supervision and examinations of the associations and, in turn, played a major part in the designing of the examination function, very apparently had in mind a transfer of the duties of the audit committee to the examiner who had the police power to enforce his recommendations and prosecute his findings.

A number of the states make no requirement for or reference to an audit while others either require an audit or recognize an audit as part of the supervisory procedure. In the State of Illinois the secretary of every association is required by law to file with the auditor of public accounts, within sixty days after the close of its fiscal year, a detailed financial statement. This statement must be sworn to by the secretary and must be certified to by either a committee of three or more members, not officers of the association, or by a public accountant appointed by the board of directors.

Section 403 of the banking law of the State of New York requires that between March 1 and September 1, 1940, a committee of not less than three directors examine fully the records and affairs of the association for the purpose of determining its true financial condition. No director who is a salaried officer or employee of the association may serve as a member of such committee. The directors are permitted in their discretion to employ such assistance as they deem necessary in making the examination. This provision enables the engage-

ment of outside auditors or accountants to do the actual work.

The Louisiana statutes provide that semiannually the association shall file with the state banking commissioner a detailed report of its business which report shall be sworn to by the secretary and auditor or the members of the auditing committee.

The Federal Home Loan Bank Board by regulation sets up the requirement for an audit of federal associations as follows: "If a federal association is not audited at least once each year in a manner and by auditors satisfactory to the board, the examination of such federal association shall include an audit."

The Federal Savings and Loan Insurance Corporation by regulation sets up the requirement for an audit of insured associations as follows: "If an association is not audited at least once each year in such manner and by auditors satisfactory to the corporation, the examination of such institution by the corporation shall include a complete audit thereof."

In these states¹ and the federal structure you will observe that the audit is mandatory and in addition to the examination by supervisory authority.

In the State of Ohio the superintendent of banking has the option of demanding at any time, not more often than once each year, that the accounts of an association be audited by a qualified accountant or accountants not otherwise employed by the association, the expense of such audit to be borne by the association.

The Iowa statute is rather unique in that it places with the association the option of either having an examination by the state supervisor or instead an audit by a licensed accountant.

¹ This discussion does not attempt to cover the procedures in all states. A review of the statutes of each state will disclose the statutory requirement, if any, for an audit.

In many states there are no statutory requirements for audits, yet we find many associations in those states that have their accounts audited by public accountants.

In those states where an audit of the association's books is required by statute and in the case of all other state-chartered insured and federally chartered associations where an audit is required by regulation, the management is definitely audit conscious. To some it is an enforced burden of expense that they must bear while others take a broader viewpoint, indicating that they sense in the audit made by outside auditors separate from the examination, benefits or protection which isn't obtained through the examination conducted by supervisory authority.

The question, "Why an audit?" is probably raised most often in cases where the audit is compulsory, and there is no doubt some real justification for the question, especially when we consider the increased burden of expense that is involved. Just the other day, as a reaction to the League's mailing of the booklet, "Audit of Savings and Loan Associations," we received a letter from one of our members which is representative of the attitude of a number of association managers. You'll be interested in it.

"The letter by the president of August 13, 1940, together with the pamphlet, 'Audit of Savings and Loan Associations by Independent Certified Public Accountants' is at hand. I think your book is very well written with reference to such audit. However, there is some question in my mind as to the advisability of expending depositors' funds for the purpose where an adequate annual audit is made by the supervisory authority.

"I know that my opinion is distinctly in the negative where the personnel of the bank has been properly chosen and there is no known irregularity which makes it necessary for the bank as such to proceed on the bond by necessity.

"Certified public accountants' work is, in my opinion, of questionable value in institutions of our kind, but there does seem to be a very definite drive on the part of accountant associations to intrude themselves on the scene as an independent accountant or at time of verification of passbooks which appears periodically. I think that we should not lose sight of the fact that they are seeking employment and usually at a much higher rate of pay than the banks would even consider paying to the junior executives and employees and in many instances at a higher rate than their highest paid executive.

"Personally, I feel that if money is to be spent it would be more advisable to increase the payroll of our institutions rather than to hire more expert accountants."

And here is our reply:

"The distribution by the League of the pamphlet 'Audit of Savings and Loan Associations by Independent Certified Public Accountants' was not an attempt to urge the associations to employ certified public accountants but rather an endeavor to serve the many hundreds of associations which do deem it advisable to have audits by public accountants, by making available to them a standardized procedure which will in time, we hope, be accepted by the supervisory authorities, instead of part of the work that is now being done in the examination.

"This is one of several phases of standard procedure that has been developed by the accounting division of the League in coöperation with the state supervisors' division and the Federal Home Loan Bank Board authorities, all of which point to a more unified accounting procedure in our institutions.

"Many of our associations feel that the audit and the examination serve two distinct purposes and are made for two separate bodies. The examination by supervisory authority is for the benefit of the public and is a review of the operations of the association with the purpose in mind of proving com-

pliance with statutory regulations and the solvency or insolvency of the business. The audit is made for the benefit of the management and directors of the association, with the object of proving the existence of the assets and liabilities and the proper recording of all transactions involved in the handling of these items. In most cases the auditors are employed by the directors and are directly responsible to the directors, reporting to them on the conduct of the affairs of the association by those whom the directors have selected to operate the organization."

In quoting our reply there has been revealed to you some of what is to follow regarding the differentiation between an audit and an examination. However, for the moment, let's look at the cost angle as raised in this letter.

The basis of charging for the examinations of the supervisory authorities varies materially, ranging from examinations that are made at the expense of the state with no cost to the association, through the categories of a flat annual license fee which includes examination, graduate scales of percentages to assets, and varying per diem schedules, the highest of which is, I believe, the \$25 per day plus railroad expenses charged by the state of Illinois, with several other states and the federal structure following close on its heels, the federal charge being \$22.50 a day for the senior examiner and \$18 a day for juniors.

From recent figures compiled by the examining division of the Federal Home Loan Bank Board we learn that the average cost of examination of federal associations by the federal examiners, for each one thousand dollars of assets, ranges from 30 cents for associations in the \$500,000 to \$1,000,000 group, to 14 cents for associations in the five to ten million group. What do these average figures represent in cold dollars and cents? Let's take an association having \$750,000 in assets. On the average, it can expect an annual cost of \$225 for the examination alone, to say

nothing of the audit expense, while a \$5,000,000 association can anticipate an annual cost of \$700. Bear in mind that these are averages and the average figure may be higher or lower in the individual association, depending upon conditions.

The management of the industry is viewing with alarm this ever-mounting, enforced burden of audit and examination expense and asks, "Why incur the expense of an audit when the public has its protection through the examination?"

Not only does the cost item loom large in the minds of the association management but the disturbance of the records and disruption of the general office routine are major factors. When the audit is made at a different time than the examination, it means two periods of more or less confusion in the association. Can you blame the association manager for trying to reduce this by having the audit and examination made by the same persons, which is possible under the federal structure? At least one period of confusion is eliminated and, from the figures which have been compiled, I believe some real dollars-and-cents savings have been made.

Probably the association which feels the pressure of these compulsory examinations most is the state-chartered insured. In many instances this type of association is subjected to two separate examinations, one by the federal authorities and one by the state, and then in addition an audit by qualified accountants,—three periods of confusion, three items of expense, and often each duplicates the work of the others. There has been an attempt to alleviate some of this by arranging joint state and federal examinations and in a number of instances these joint efforts have proved beneficial, not so much in reducing the costs but in eliminating the confusion. There is room for marked improvement in this procedure.

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Our hope is that in time the two supervisory authorities can reach agreement by which the examination of one supervisory authority will be accepted by the other.

This doesn't take care of the situation when there is objection to the duplication of expense and effort that exists in the audit and examination procedure. The drafting of the specification for an audit of a savings-and-loan association was the first step toward a probable solution. We hope that the supervisory authorities will eventually agree to acceptance of the audit report which has been made by a qualified accountant instead of much of the work that is now being done at the time of making the examination.

Statutory amendments are now being considered by the Congress which, if enacted, would permit the federal authorities to accept in whole or in part, reports of audits made by qualified accountants. As this is only permissive legislation and not compulsory, there would remain for the accounting profession the task of convincing the authorities that the work they do and the reports they render are acceptable.

Should the change be made in the federal statutes, this would then set a precedent for similar changes in the state statutes, ultimately pointing to the time when association management has the option of having the work done either by the supervisory examiners or by a qualified accountant with full assurance that there would be no duplication of expense.

If the foregoing is not possible there occurs to me one other approach. It involves a change in procedure on the part of both the accountant and the examiner. This may appear to the accountant to be an attempt to set up a new theory of auditing. It is treading on untried ground but I give it to you to study over for I do believe it has possibilities for solving our problem.

In order to eliminate all possibilities

for duplication of effort, we must draw a definite line of cleavage as between an audit and an examination. To do this we must first establish definite purposes for each function, which purposes are in no way duplications. The examination by supervisory authority is for the benefit of the public and is a review of the operations and condition of the association to determine compliance with statutory regulations and the solvency or insolvency of the business. The audit is made for the benefit of the management and directors of the association, with the object of proving the existence of the assets and liabilities and the proper recording of all transactions in the operation of the business.

If the auditor will keep to his field and the examiner to his, and each is willing to give up some of his pet prerogatives that have grown out of custom or procedure, and each recognizes and accepts the work of the other, all duplication of effort and expense can be eliminated and the benefits to the association and the public will multiply.

What is the field of the auditor? From the purpose stated heretofore a definite field of endeavor can be established. The auditor's efforts should be pointed toward verifying the existence of the assets and liabilities and the proper recording of the transactions that occur in the operation of the business. He should accept, within reason, the values placed on these items by the management realizing that he is not in a position to evaluate except in a limited way.

What is the field of the examiner? The examiner's efforts should be pointed toward evaluating the assets and liabilities in order to prove solvency or insolvency, and determining statutory compliance by reviewing the acts of the corporation as reflected in the minutes and as shown by the records.

With men skilled in accounting procedure making the audit, and others skilled in valuation making the exami-

nation, each accepting the findings of the others, once the circle is started it doesn't matter which comes first or last, the audit or examination.

You may say that there is nothing in this procedure that gives consideration to default or fraud, but think it over again and I am sure you will agree that the auditor's function should bring to light defalcations, and the examiner's function uncover fraudulent transactions. It isn't necessary to say that if during the course of either operation the examiner or auditor find evidence of illegal procedure it should not be ignored.

The foregoing division of effort keeps the accountant in the field for which he is best trained,—his natural field,—but I am afraid that it will require a complete change on the part of the examiner.

This is a new approach and there is a lot more to it than the brief outline given here, but I admonish you not to cast it aside as just another hallucination for there are some sound arguments in its favor.

The question has been raised as to whether or not the United States League and its affiliate, the American Savings and Loan Institute, will carry on an educational program among the building-and-loan associations to acquaint them with the approved program of audit and the need for engaging independent accountants upon an adequate fee basis so that they can make their examinations under the scope of the program.

I might be facetious and counter with the question, "Will the American Institute of Accountants carry on an educational program among its members regarding the advisability of investing in savings-and-loan associations?" I am not going to do this but will give you a direct answer in the

negative to your question as I understand it. The League is not organized to promote the sale of services of others to our members and to do so would be a violation of the trust that is placed in us. The purpose of our organization is to foster and promote everything that will prove helpful and economical for our members. Just so far as a measure of benefit can be shown and a true economy established,—that will be the measure of our efforts toward promotion. Our participation in the drafting of the audit procedure and distribution of the booklet by our president with his personal recommendation should be sufficient evidence of our interest in the matter and our willingness to coöperate.

Now I am going to put a serious question to you. Here is an industry, a rapidly growing one, requiring an audit function which the certified public accountant should be equipped to perform. Here is a golden opportunity laid in your laps. Have you prepared yourselves and your staffs to take advantage of it? You say you want the work on an adequate fee basis, and the association naturally wishes to have the job done with as little expense as possible. One way to benefit yourselves is to study our business. You, as principals in your audit organizations, should study our business as well as require your staff members to do so. None of us is so learned in our profession that we do not need to continue our education.

In every major city you will find a chapter of the American Savings and Loan Institute. Attendance at the chapter classes will more than repay you for the time and money spent. Although some of the work may seem elementary to you, a thorough understanding of our business will assist you in rendering the utmost in service when called upon to audit our associations.

Maintaining the Integrity of the C.P.A. Certificate

BY ABRAHAM H. PUDER, NEWARK

Member of special committee on savings-and-loan accounts,
American Institute of Accountants

IT IS of great importance to certified public accountants, from a professional as well as a personal point of view, to have the scope and character of their professional engagements intelligently conceived and thoroughly formulated, and to have as a basis for audit or examination some more or less official outline of generally accepted procedure. Losses incurred by reason of reliance upon statements which are false, misleading, uninformative, vague, or ambiguous, tend to discredit accountancy as a profession and to undermine the confidence of the public in the real value of the work of accountants, their utterances, and their certificates or reports.

Certified public accountants have made great progress in gaining recognition by the public, by clients, and by governmental authorities, of the place of accountancy in the business and social life of the country. But this recognition was not easily achieved. It was accomplished by years of ceaseless effort, training, experience, and education; it was nurtured by a confidence born of experience and inspired by devotion to the ideals of honesty and integrity. Recognition has been won, to be sure, but with it responsibility has been enlarged. There is great need today for authoritative pronouncements defining the duties and responsibilities of accountants, to the end that practitioners will be properly disciplined as members of the profession, and for future usefulness.

It is significant that progress of an individual, or a profession, is best measured in retrospect. It is recognizable only in relation to an era or period in which less was accomplished. It is, in

its essence, purely relative. What is hailed as progress today is but a step onward in the right direction. It is not static; rather, it is continual adjustment to changing times and needs. It is the way of wisdom, therefore, to look back occasionally, to recall the abuses and ills which the fleeting years had controlled and cured, lest we re-establish the old abuses and ills under new names and in different forms. A case in point is the savings-and-loan business. Let us look back.

For many years, independent public accountants had been engaged by savings-and-loan associations to audit their accounts and prepare financial statements and reports. Outside examinations of such associations were required, but under the regulations of the Federal Home Loan Bank Board, each association had the option of either submitting to an examination by the examiners of the Federal Home Loan Bank Board, or engaging independent (public) accountants. That independent professional accountants were engaged for such audits was regarded as a distinct recognition of the desirability of the professional auditor, implying *as of course* that the examination would be adequately performed to satisfy the needs of the investing public, the management of such associations, and governmental authorities. An opportunity for enhancing the reputation of the profession and its members existed. Did accountants profit by it? It is painful to relate that many of the reports fell far short of what was expected. Competition for such engagements was keen among members of the accountancy profession. Under the circumstances, some engagements were undertaken

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by independent auditors at a pecuniary "sacrifice" as it were, and without a general agreement as to an adequate standard of performance, with the result that the work performed was unsatisfactory.

In consequence of the careless manner in which some audits were arranged for, and of the lack of appropriate and adequate audit programs and because examination by federal examiners was compulsory and it seemed easier and cheaper to let them make the audit too, the savings-and-loan audits gravitated toward the examiners of the Federal Home Loan Bank Board at the expense of the independent accountants. This condition was quickly recognized by the profession, but among many practitioners it was believed that the loss of this type of audit was caused by competitive pressure exerted by the examiners of the Federal Home Loan Bank Board. Upon inquiry and investigation it was learned that this was not so. The findings and reports of some independent accountants were plainly unsatisfactory. The problem, thus recognized, was approached by the American Institute of Accountants and since 1937, when the Institute first undertook the preparation of a standard audit program for savings-and-loan association audits, until July, 1940, when the approved program was published, the special committee of the Institute gave unsparingly of its time and effort in study and coöperation with the Federal Home Loan Bank Board. Its achievement in this respect is admirable and reassuring. It is succinctly conveyed in the language of the preface of the bulletin, prepared and published by the American Institute of Accountants, entitled *Audit of Savings and Loan Associations by Independent Certified Public Accountants*. I quote:

"The program for the independent audit of the savings-and-loan associations prepared by the American Institute of Accountants and contained in

this pamphlet was considered and reviewed by duly authorized representatives of the accounting division of the United States Savings and Loan League, of the supervisor's division of the United States Savings and Loan League, of the examining division of the Federal Home Loan Bank Board at a conference held in Chicago, Illinois, on January 30 and 31, 1940.

"At that conference, this program was unanimously approved as providing a proper and adequate procedure for the independent audit of savings-and-loan associations, and, as such, acceptable as meeting the requirements and needs of the investing public, the management of such institutions, and supervisory authorities."

The development of a much needed standard of performance for savings-and-loan association audits does not, in and of itself, solve the problems of the accountants who obtain such engagements, nor relieve the profession of its vigilance in safeguarding the integrity of the C.P.A. certificate. It is but a well coördinated plan of procedure, the observance of which falls to the lot of the individual practitioner, who must assume full responsibility for deviations therefrom.

Of course, accountants must be objectively viewed as distinct individuals. They differ in their capacities and skills, in their education and training, in their experience and background. They are drawn from every level of society, and are the products of their environment and the influences of the times. The accountant of twenty-five years ago would look with awe, and not without trepidation, at the vastness and scope of modern accountancy and the demands being made upon it by an ever-changing pattern of life.

Today, every engagement which is affected with a public interest presents a real challenge to the accountant, and to the profession which he represents. This is especially so where the reports and statements of the accountant be-

come matters of public record or are subject to examination by governmental authorities. Few of us have forgotten the stir occasioned by the securities act of 1933 and the securities-exchange act of 1934, nor will any of us forget the provisions of these acts which impose upon accountants a liability to those who sustain loss by reason of reliance upon statements prepared by them in which there is an untrue statement of a material fact or an omission to state a material fact, necessary to make the statements made not misleading.

In the process of adjustment to the securities acts, and the regulations which issued therefrom, it was quickly perceived that the practices and procedures of the profession which were accepted and approved were in no material way new or untried. They were, however, made more meaningful by association with the *authority* of the Securities and Exchange Commission. The profession thus learned that practices which it had held to be improper or undesirable were now to all intents and purposes condemned by federal agencies, and practices which it urged business to adopt *long before* the securities act came into existence were now required under statutory authority.

Under these conditions the independent certified public accountant could serve a useful purpose only if all concerned were assured that he would observe the highest standards, in other words, that a professional discipline existed.

Discipline in a profession is necessary; both that which is established from without and that which is established by the profession itself. *But by far the greatest good and the most enduring satisfactions are derived from self-discipline.* It is, therefore, incumbent upon the profession of accountancy to exert its energies toward the attainment of self-discipline by its members. An opportunity presents itself in the savings-and-loan audits.

The American Institute of Accountants has taken the initiative; it has formulated an approved program for savings-and-loan-association audits, and has thereby organized the lessons of experience into a practical standard of performance. But this is but one aspect of the problem which the profession now faces in this and in other industries or types of engagements. The other is control over the individual accountant. It is not enough for the profession to put itself on record that a certain mode of behavior is unprofessional, or is inimical to the best interests of the profession. The code must be enforced rigorously. It is submitted, therefore, that the profession should sternly exercise its authority to impose discipline among its members; so as to require adherence by all to its code of professional proprieties.

Many will argue with this premise. They will point out that the profession is without legal power to compel such discipline. They will stress the fact that there are state laws embodied in the statutes and court decisions which render the wrongdoer answerable for negligence and deceit, and that there are federal laws with severe penalty provisions. Not a few will emphasize the presence of non-certified public accountants who would not be amenable to the dictates of organized certified public accountants. A retort readily suggests itself. Do any of these restrictive laws apply to the practices of competitive bidding? Do they not reach but a few, and then only those who are guilty of the most extreme violations of professional conduct?

What is it in a profession which sets it apart from a business, a trade, or a vocation? Is it not engagement in a type of work which calls for special skill, education, training, and experience; and which requires of its members the exercise of judgment, mutual respect, and gentility of manner and behavior? The tests of such a profession are not the ethics of the market place;

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the standard is higher and approaches the domain of moral philosophy—almost the ideal of righteousness in its superlative sense.

The strength and purpose of the profession derives from the strength and purpose of its members; the respect for the profession originates with the accountant's respect for himself; the knowledge of the profession is but the recorded and communicated knowledge of each of its members. In short, the profession and the individual accountant are but one.

A plea has been made for discipline. Is it not clear that in its most effective form it is self-discipline? And is it not equally clear that among the members of the profession there must be mutuality of discipline to support mutuality of interest? Each practitioner owes it to himself and to his profession to stand firmly by the code of proper professional behavior in his manifold relations to clients, to accountants, and others. Is it not, therefore, the will and hope of most of us, that the profession will command compliance from those few

among its members, whose existence must be threatened, before they can fully apprehend the dangers which beset them and their fellow practitioners?

In conclusion, may the suggestion be offered that a joint educational campaign be undertaken by the American Institute of Accountants, the United States Savings and Loan League, and the Federal Home Loan Bank Board, with the objective to have public accountants, whether certified or not, and the associations themselves, realize that the reorganized standards must be adhered to.

"Let me but do my work from day to day,

In field or forest, at the desk or loom,
In the roaring market place or tranquil room;

Let me but find it in my heart to say,
When vagrant wishes beckon me astray:

'This is my work; my blessing, not my doom;

Of all who live, I am the one by whom
This work can best be done in the right way.'"

—van Dyke.

IX
ROUND-TABLE DISCUSSION
Reports of Municipal Bodies

Leader: LLOYD MOREY

October 16, 1940

Accounting for Public Dollars

BY LLOYD MOREY, URBANA, ILL.

Chairman of special committee on governmental accounting,
American Institute of Accountants, and professor of account-
ing, University of Illinois

THE AMERICAN people are paying fourteen billion dollars annually in taxes, direct and indirect, for the support of their various governmental activities. Thirty per cent of this sum is for local agencies—county, city, township, schools, and other branches; the remainder goes to state and federal governments.

As owners and supporters of this vast enterprise, the taxpayers are entitled, as they would be in any business in which they invest money, to a financial accounting. Officials and employees of these public agencies are servants and trustees of the taxpayers. They are accountable to those who provide the necessary resources and are under obligation to make a suitable return of their stewardship. They must have the interest and support of the citizens whom they serve, to secure the revenues essential to carry on the public activities for which they are responsible.

Many public officials do issue comprehensive and informative reports, and the number is steadily increasing. Take for example, the town of Greenwich, Conn. Its annual report begins thus:

"Whether you pay direct taxes as a property owner, or whether you pay taxes indirectly through rents and purchases, this report is addressed to you as a citizen-stockholder of Greenwich.

"The town government is your business. You finance it. You choose and hire the people to run it. The owners of any business must give it time and attention if they wish it to be run to suit them. How much attention do you give to the business of your town?

"Here is some of the information you need to begin with."

But of the 160,000 agencies of local government, a large proportion still makes no such accounting, or at best a most inadequate and unsatisfactory one. Many local bodies receive only a treasurer's report, giving a list of receipts, disbursements, and cash balance, often disregarding separate funds, and without reference to other assets or liabilities. Many reports consist only of a detailed list of money received and warrants paid, instead of an intelligent and meaningful analysis of revenue and expenditures, and the net results and present condition. Some start out, "As required by law I transmit herewith my report," followed by a long list of unrelated financial statements. Some reports, even by accountants of standing and experience, present a consolidated balance-sheet of all funds and assets, and a single figure of surplus, including both the balance or deficit of expendable funds and the investment in city property, thus confusing both officials and taxpayers as to the true financial condition. Numerous appropriating bodies work on the basis of the cash balance, and many taxpayers are fooled into complacency regarding the financial condition of their local bodies by seeing such a headline as "Cash balance of city's funds, \$134,000."

The people are demanding an accurate and informative accounting from their public servants. Among the objectives of the California Taxpayers' Association is: "Improvement in the auditing, budgeting, and reporting procedures of the state and local governments of California." One of the items in the five-point program of the Illinois Chamber of Commerce is: "A uniform

system of auditing accounts of the various governmental units and periodic audits of expenditures." Read in the *American Magazine* for October, "Taxpayers on the Warpath," describing activities in New England; Nebraska; Kentucky; Fort Wayne, Indiana; and many other places. Numerous states have passed laws making audited reports of local taxing bodies mandatory. Much of this unrest is taking place because citizens are not properly informed as to what is being done with their money.

There is no longer any doubt as to what constitutes good municipal accounting, reporting, and auditing. The work of the National Committee on Municipal Accounting, in establishing standards and models in this respect, provides an authority to which officials, accountants, and public may turn with confidence. These standards have been accepted in principle by accountants and teachers generally, and have been applied by numerous cities and other public bodies. They enable the official responsible for finance and accounts to answer the primary questions asked about every public enterprise: What is the present financial condition of the city; what does it have and what does it owe? What are the results of the financial operations of the past year or other period? Have the revenues collected or realizable in a reasonable time equaled or exceeded the expenditures,—both paid and incurred, and including not only operating expenses, but interest on debt, and a proper amortization of long-term indebtedness incurred for improvements or emergencies? Unless these things are accomplished, the budget is not in balance, and a deficit is accumulating to plague future generations of taxpayers.

Many appropriating bodies have incurred deficits because they did not have accurate answers to the foregoing questions. Citizens of many communities have had to face bond issues, tax

increases, and curtailment of services because they have not known the true condition of their affairs. An adequate accounting system, based on modern principles and practices, and regular financial reports of the proper scope and character, are the answer to this condition, and a boon to legislators, administrators, and public alike.

An independent verification of public financial records and reports is also essential in the form of periodical audits by competent outside auditors. Honest officials are entitled to and should insist on such examinations for their own protection. Unfortunately, not all public officials are honest. A certain proportion, fortunately small, are willing to defraud those whom they serve. "Township books are short \$4,197," says a headline. "Shortage of \$5,320 bared by audit," says another, and adds that the audit was the first in seventeen years. So, while the discovery of possible dishonesty is not the only purpose of or reason for outside audits, it continues an essential feature, for the protection of the public.

For these same reasons, and in even greater measure, investors in public debt issues need the protection afforded by an adequate accounting system, regular financial reports, and independent audits. Emphasis on legal exactness and completeness in such obligations is all very well and essential, but it does not assure proper or even honest handling of funds after the money is borrowed, or indicate ability to manage finances or control expenditures. These points are as essential in a public obligation as in one of a private concern if the investor is to be certain of his security.

The taxpayer and investor are little better off, however, when auditing services are purchased on competitive bids at the lowest price, in the manner followed by many public bodies. Auditing is professional service and, as in any other profession, requires adequate

training and experience. No one would think of engaging a doctor, lawyer, or architect primarily on the basis of lowest fees. No more should it be expected that satisfactory auditing can be secured in such a manner. The American Institute of Accountants considers it unprofessional for its members to make bids on auditing engagements in competition with other accountants. Taxpayers and officials should cooperate in eliminating this unethical and unreliable practice.

Audits by state agencies also are not the cure-all that they are at times held out to be. Such agencies can do much in setting standards for local financial management, and in compelling adherence to those standards. Rarely are they able to carry on actual auditing and system installation effectively. They can do so only if they follow proper professional standards in selecting personnel and in their programs. The interests of local initiative and responsibility are better served, as the Connecticut law provides, by leaving these matters to local authorities, but having the state agency see that they are done and done right.

The responsibility for correcting this situation where it needs correcting is a joint one. The first responsibility is on the public official. He must see that his records are of the right character, and that regular reports of an informative and understandable type are made. He should see that these records and re-

ports are independently verified. Accountants share the responsibility for promoting these practices, for informing themselves as to correct procedures, and for applying correct principles when called on to serve public bodies. Citizens must understand that their governments will only be as good as the interest taken by them may demand; that, like their private affairs, if they neglect them, their dividends will be passed and their investment dissipated, but if they watch them, their interests as well as their peace of mind will be preserved and protected.

Our major effort as individuals and as a nation is now bent toward the common defense of our lives and our institutions. A primary factor in an adequate defense is financial control and stability. As the National Consumers Tax Commission aptly says: "City, town, and county governments do not spend money on arms. These costs are borne by the national government. But local bodies can save millions of dollars each year by improved business methods. Since money for national defense and for local governments must come from the same taxpayers' pockets, local savings contribute to our national defense." Governmental efficiency and economy begin at home, in every community where public activities are carried on. Only as local units are kept financially sound can the national economy survive the terrific strain now placed upon it.

Responsibility of Municipal Finance Officers for the Preparation of Financial Reports

BY JOHN R. LINDSAY, LOUISVILLE

Director of Finance, Louisville

THERE was a time, not so long ago, when I thought I could visualize the verbal presentation of a municipal financial report in such a manner that my audience would be held spell-bound to the very last zero. Can't you hear a blare of trumpets and a roll of drums heralding "The Accountant's Hour" on the radio? Imagine the hush that spreads through the vast auditorium as the pages of the past fiscal year's report slowly unfold. Can't you feel the excitement as the fixed assets are intoned one by one, and the growing tenseness as the current assets position is approached? Then on, through the other side of the balance-sheet; liabilities, fixed and current, and other lesser items; all, however, leading up to the climax of the first act—that punch-line, as the curtain drops:

"The total of all assets equals, exactly, to the last cent, the total of all liability."

But that isn't all. The second and third acts are soon to follow. That soul-stirring second act, wherein detailed receipts and expenditures are recounted, slowly and with telling effect; miscellaneous revenues are accounted for; incidental expenses, contingent expenses, extraordinary expenses, each leaving the audience on the edge of their respective seats. Silence reigns supreme. So on, through the third act and to the grand climax; the climax that all drama that *is* drama must possess. What subject is more appropriate for such a climax than the detailed presentation of bonded indebtedness and sinking funds? Nothing slipshod or shabby in this statement! Every bond listed in detail, by purpose, date of issue, date of maturity, date of redemption, interest

rate, par value, market value; and followed by a statement, elaborately presented, beautifully worded, of individual sinking-fund assets. What a dramatic situation! I wonder why Noel Coward doesn't use it?

It sounds attractive; it would even be a lot of fun—but it just can't be done, because it won't work. A financial report—a municipal financial report—in its entirety, is the one outstanding document most certain to cast its recipients into the arms of Morpheus. It is, to my way of thinking, one of the dullest bits of literature in existence. Ninety-nine out of a hundred persons who receive it don't or won't read it, and the other one doesn't understand it. The practice of the publication and general distribution of a detailed financial report by a municipality is continued, I believe, largely for the simple reason that it has always been done and, therefore, always should be done. If there is any phase of municipal finance that badly needs intelligent and constructive thinking, it is the field of the dissemination of financial information.

Standardization of financial reports, the adoption of uniform terminology and the compilation of statistical data are excellent. They are necessary for comparative purposes and highly desirable for use by municipal bodies and others directly concerned with financial practices in government, but are of little or no value when it comes to public consumption. Surely there is some method of giving the general public information about their own city, which they want and which they are entitled to have, and at the same time, of presenting this

information in such a form that it can be easily and pleasantly digested.

Several years ago I prepared, as an experiment, a single sheet, mimeographed, showing the detailed operating costs of all city owned passenger automotive equipment. This statement showed total cost, total repairs, total maintenance, etc., also total mileage and cost per mile. I mailed it out without comment to fifty hand-picked executives in Louisville who I thought might be interested in automotive costs. Within one week I had received some sort of comment from thirty-five of these men, although I had specifically not asked for comment or criticism. These same fifty men had been receiving copies of my annual report for six years and I had never heard one word of comment or criticism from them on that report, though it included exactly the same figures I had sent in mimeographed form.

There can be but one conclusion drawn, and that a very obvious one: the average citizen simply will not read a consolidated financial report although it may contain many things that he is directly interested in. I draw that conclusion from the fact that if not one of fifty hand-picked executives would apparently look at the report, surely the average citizen and taxpayer is not going to give it any serious consideration.

This is not an isolated example. I know from my own experience that the financial administration of a fairly large American city is a very exacting and difficult job and when that job is well done I think it deserves recognition. I have always believed in the theory that the American public does not object to paying taxes, even high taxes, if it is firmly convinced that its tax money is being well and properly spent. That's what financial reports are for; that's the legal and moral obligation of the finance officer, but the failure to convince is not entirely his fault.

Having existed in a goldfish bowl of public office for some seven years, and having been subject to daily and even hourly criticism during that period of time, it is with a feeling of some gratification that I pass a little criticism on to someone else.

Has the accounting profession been negligent? Has it been mentally lazy? Has it been handicapped by outmoded tradition? Or are those questions too direct, perhaps too strong? I don't believe that they are. Accountants and auditors have too long been critical of government; not that that critical attitude has not been thoroughly justified. I think it has, but at the same time, I believe that the profession has almost entirely overlooked one of its main responsibilities. If there has emanated from the accounting profession a new and worth-while idea for presenting governmental financial data to the public, I haven't seen it. If there is a realization that such ideas are necessary and that they constitute an integral part of the auditor's job, I have seen no evidence of it.

Generally speaking, auditors and accountants plying their trade in governmental circles are not handicapped with the same restrictions that beset financial officers. They have a much freer hand in making suggestions and recommendations. In many ways they are in an enviable position, but they have not, as a group, made the most of their opportunities.

Go ahead and make yourselves invaluable. Surely no one will benefit more directly and to greater extent than yourselves. Why not analyze municipal reports and select therefrom those facts best suited for public consumption? I do not give up on my dream of dramatization. I still think there are parts of a standard financial report that can be successfully dramatized. I am not quite sure what sections of the report are subject to this type of treatment, nor am I clear as to how such

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treatment should be executed, but I do believe that an artistically prepared canvas of blended colors is more attractive to the eye than straight lines of charcoal drawn on a flat white surface.

Distinguish, if you will, between corporate finance and municipal finance. Stockholders in a corporation are primarily interested in earning, equity, and dividends. The best management in the world is not overly popular with stockholders unless it is ultimately able to show a profit from operations; a profit, part of which, at least, might be paid out in dividends. The stockholders of a municipality, on the other hand, do not expect or desire profit. A large surplus, in many ways, is just as indicative of poor management as a large deficit. Stockholders, or taxpayers, are interested in the way their corporation functions; not in its results from a profit or surplus standpoint. They want to be convinced that the management they have selected is performing its job efficiently and well, and if the majority are not so convinced, you can be assured that a new and different management will be at the helm, come next November.

Municipal management, more so even than state or national, must keep a finger on the pulse of feeling in the local community; must take the people into its confidence and educate and explain

the reasons for the various acts and decisions, and convince them, not once a year, but all during the year, that their board of directors, their president, their officers, are performing their allotted tasks in a satisfactory manner.

The surest way to perpetuate our democratic principles of government is to hold fast to the conviction and belief that through our two-party system of election of public officials we not only can, but do, secure highly qualified public officers, officers well qualified to fill their respective positions and worthy of the responsibilities entrusted to them.

Perhaps I have wandered a little from the subject in hand. I readily accept the responsibility of a municipal finance officer. I have been trying to convince myself that this responsibility might be shifted to other shoulders. I would like to be able to hand some of the burden on to you. I realize that this cannot be done; however, I do solicit your help, especially those of you who have contact with municipal audits. We, who represent the hard-working and, we think, unappreciated, public officials, earnestly and sincerely seek your assistance. Give this phase of our problem a little serious thought, and I believe you will be amazed how quickly your ideas will be used and how much they will be appreciated.

Auditor's Report of Municipal Bodies

BY JAMES A. RENNIE, RICHMOND

Member of special committee on governmental accounting,
American Institute of Accountants

THE MOST constructive function of an auditor's report of a municipal body is the force it lends to securing improvements in fiscal administration. Where improvements have resulted, it will be found that in the vast majority of cases the document which prompted them was an auditor's report.

Usually, the first demand for services of a public accountant by a municipality originates in a movement to improve fiscal administration. I do not refer to a political movement sponsored by the "outs" in the hope that they will get in. I mean a movement by citizens or officials genuinely interested in improving their government. Invariably, one of the cardinal planks of such a movement is that an audit and survey of the city's fiscal affairs be made by an independent accountant. This is a logical beginning because sound reforms depend on full facts and informed judgments.

The auditor has the responsibility of furnishing the data from which informed judgments can be made. How he discharges the responsibility is measured by his report. Too frequently excellent field work is partially nullified by an inadequate report. An inadequate report is often the result of failure to consider its use.

Every report of a public accountant on the affairs of a municipal body is of public interest and being a public document is available to the press. How the press interprets the report to the public determines to a large degree the success of adopting its recommendations. Unless the subject matter is arranged coherently, and vital information separated from minor detail, the press treatment will be cursory. Reporters

working under pressure of time cannot be expected to digest a bulky volume of technical detail; the same thing is true of public-spirited citizens, whose interest is chiefly in the larger phases of fiscal administration. Governor Price, of Virginia, recently said of state agency reports: "unreadable by reason of their length, their minute detail, and their highly technical character." Accountants should be careful to see that their reports do not fit this description.

Detail that reveals significant facts and trends is essential in a report, but its use should not confuse the main objective, namely, an accurate, impartial and logical presentation of findings and recommendations that can be used as a sound premise for forming judgments and taking action.

What should an auditor's report contain? The answer depends on the type of engagement, but it will be assumed for the purpose of the answer that the engagement covers an audit and survey, the latter being considered as an essential part of an audit. A report of such an engagement would follow the usual arrangement of two main divisions, viz., comments and statements. As statements furnish the subject matter for much of the comments, they will be considered first.

The National Committee on Municipal Accounting in its publication, "Municipal Accounting Statements," describes the essential statements to be included in a report. These are:

1. Balance-sheet for each fund.
2. Analysis of surplus of each revenue fund, department, or institution, operated as a financial entity.
3. Statements of revenue of each revenue fund and comparisons with estimates.

Extensions of Auditing Procedure

4. Statements of expenditures of each revenue fund and comparisons with appropriations.
5. Operating statements for each utility or other public service enterprise.
6. Statements of receipts and disbursements and of changes of balances of special funds.
7. Statements of changes in fixed assets.
8. Debt statement.
9. Summary statement of cash receipts and disbursements.
10. Statistical section dealing with vital statistics relative to fiscal matters.

The statements are illustrated and the principles underlying them are explained.

The National Committee on Municipal Accounting has as its goal the bringing about of improved methods in municipal accounting, budgeting, and reporting. In furtherance of this goal it has issued several publications that deal with various phases of municipal accounting. These publications are the product of men of experience in municipal affairs, and every public accountant engaged in municipal practice should have them in his library. Progress toward the Committee's goal can be greatly accelerated if public accountants will coöperate with the Committee. The goal is certainly deserving of that coöperation.

In brief, the essential statements recommended by the Committee furnish the following information:

1. The present financial condition.
2. The factors causing the change in the financial condition from the previous year.
3. The relation between planned and actual results of the year.

Without this information intelligent fiscal administration is impossible.

Another statement that furnishes interesting information, particularly when comparison can be made between years, is one wherein, in summarized form, is shown revenue by sources,

expenditures by functions, and the percentage and per capita of each item to the total. In preparing such a statement, elimination should be made of duplicate charges and credits resulting from service enterprises that furnish services and materials to other departments. Utilities' results should be shown net, that is, as revenue if there is a net revenue, or as expense if the operations require a subsidy. Interfund transfers should be eliminated and the revenue and expense consolidated when the same activity is being financed through several funds, which is often the case, especially in welfare work. Fund distinctions are usually legal requirements and must be observed in the records although the requirement may be incompatible with sound economics. However, the taxpayers' interest is in how much is being spent for each function of government and how much revenue is being derived from each source, regardless of fund distinctions. The statement supplies the information.

Unfortunately, many officials and citizens who are keenly interested in the affairs of their municipality are unable to interpret tabulated statements and, in fact, have an aversion to looking at them. Herein lies the function of comments. Haven't we all seen some people who never look beyond the comment section of a report? To these people, and I believe they constitute a majority, a report is incomplete unless the comments convey an adequate story of the auditor's findings and conclusions. Then, too, there are some matters developed by an audit which can only be expressed in narrative form.

Comments complement the statement section of a report and are the medium of critical discussion and recommendations; hence, their importance is obvious. Quality of comments will ever differ, as literary talent is not equally possessed. Arrangement of comments can add to their effectiveness if subject matter is in logical order and

treated under major and minor captions. Indexing of comments is often deficient. It is almost a common practice to list comments in the index as one item, although in the same index each statement will be separately listed. The reader may be just as interested in referring to a particular subject treated in the comments as in a particular statement, and I believe it would add to the reference value of a report if the comments were indexed by subjects.

The following statement of the National Committee on Municipal Accounting in its publication, "Municipal Accounting Statements," if accepted without qualification, would seem to obviate public accountants' reports as such and eliminate the necessity of comments beyond a certificate. The statement is: "Reports covering the same fiscal period are sometimes issued both by the municipal accounting officer and the independent auditor. There should be a single public report regardless of who prepares it."

This statement can be subscribed to readily under the following conditions:

1. If the municipality has an accounting system that fits into the preparation of the statements hereinbefore mentioned. In that event, all that is

necessary is a certificate of the auditor if one disregards those who cannot interpret tabulated statements.

2. If the state regulates and prescribes the methods of accounting and reporting for municipalities.

Rarely are the conditions cited in No. 1 above encountered in a first audit. Rather, it is necessary that the auditor reconstruct the accounts according to the principles enunciated by the committee and emphasize in his comments the desirability of having the accounts conform to these principles. Again, the municipal accounting officer usually desires to make his report in accordance with his established practice and is not willing to change the report to conform to the auditor's ideas. Under these conditions, one report is not practicable. Another condition that would make one report undesirable is when the accountant was primarily engaged to make an appraisal of present methods. Surely a separate report by the accountant would be desired in that case.

In conclusion, I repeat that the quality of an auditor's work is measured by his report and that the report may be an instrument of great force in securing improvements in fiscal administration.

Selection of Independent Auditors for Public Bodies

BY WILLIAM H. WELCKER, PHILADELPHIA

Member of special committee on governmental accounting, American Institute of Accountants

IN THIS paper we will not attempt to prove that independent audits are necessary or desirable, but will assume that they have passed the stage of experimentation and are now an important part of the administration of all public bodies.

Certainly no one who is a taxpayer will question the value of an independent audit of the municipality or county to which he pays his taxes. It may also be taken for granted that the purposes of the audit have been clearly defined and that the auditor of the public body requiring such examination has the necessary qualifications in connection therewith. Furthermore, that all parties involved sincerely desire to fulfill the purposes of an independent audit, including the furnishing of information as to its results.

In our modern age and with the present-day trend of government, as well as industrial development, these would seem to be fundamental principles.

In considering the question of the selection of independent auditors for public bodies, it is not only desirable to understand what is meant by an independent auditor, but also to define somewhat the status of the public bodies referred to.

As to what an independent auditor is, although the word "independent" is easy to understand, certain so-called independent auditors may not be able to so qualify, because of circumstances surrounding their appointments.

To explain what is included in a definition of public bodies, this would obviously refer to the governing bodies of counties, municipalities, school dis-

tricts, and also to those members of various boards and commissions of a public nature who might be appointed to carry out some specific purpose such as the operation of utilities or the furnishing of services requiring special consideration by a separate body.

According to a recent survey,¹ nine states require regular audits of all municipalities, which includes those appointing qualified accountants. Apparently, several others have so provided during the last few years. In twenty-three states, only certain municipal units are included in examinations required by licensed accountants or by state auditors upon local request or state authority.

Counties are audited more or less regularly. Twenty-six states audit all county units, and the accounts of specific county officers are examined on request in fourteen other states.

Some attention is being given to audit specifications by state officers in order to secure competent examinations by public accountants or state employees in place of hit-or-miss checking which has been common heretofore.

THE APPOINTMENT OF AUDITORS

In examining the various surveys which have been made, to ascertain the extent of auditing of public bodies, and in an attempt to learn who makes the audits which are now being made, we find that these auditors derive their appointments in four ways as follows:

¹ Dr. Wylie Kilpatrick, "State Administrative Supervision of Local Financial Processes," *Municipal Year Book*, 1936.

Selection of Auditors for Public Bodies

1. Qualified Accountants Appointed by Local Authorities

In a certain group of states, laws have been approved requiring *all* municipalities and counties to be audited by qualified accountants under state specifications, with a copy of the official report filed in the state capital for regulatory purposes. Complete and continuous information is available under this arrangement regarding all financial transactions of the local governments.

2. Appointment of the State Auditors

The appointment of employees of a department of the state government, to audit to some degree the accounts of local governments, seems to be customary in a large number of states, certainly in more than half of them. In these cases where state auditors examine the accounts of local bodies and report to their superiors who are known either as state auditor, state controller, tax commissioner, examiner, etc., there is a measure of state regulation exerted over the expenditure of state and local funds, which is highly desirable.

3. Auditors Elected by the People

The oldest method of auditing public bodies was by auditors elected by the people, especially of the district which they are supposed to audit. There are some very great objections to elected auditors, and many of the states where such a plan has been in force have discontinued it as being highly political. This procedure places their selection in the hands of local politicians, who have quite frequently chosen persons who have little or no knowledge whatever of either accounting or auditing. A satisfactory and independent audit has not been obtained.

4. Elected Auditors for Pre-audit; Outside Accountants for Post-audit

Under this plan auditors or controllers are elected to make the pre-audit and, supplementing this, public accountants may be engaged to some extent to make a post-audit.

In these cases, the system is not uniform, because there are no requirements for annual independent audits and, as a result, the work is not provided for continuously.

There are doubtless other methods under which audits are being secured by public bodies, but the above are the ones found in general use. Of the four different procedures mentioned for the appointment of auditors, there is a considerable difference in their degree of independence.

Having outlined briefly the methods of securing auditors for public bodies, it will now be in order to examine more in detail the success of such methods in the various states and commonwealths.

QUALIFIED ACCOUNTANTS APPOINTED BY LOCAL AUTHORITIES

In a number of states it has been provided by law: (a) that there must be an audit of every public body by qualified accountants, that is to say, accountants who have passed an examination as certified public accountant, or have special qualifications as a municipal accountant; (b) that the municipality may only engage those accountants holding the credentials required by the examining authority; (c) that copies of the auditor's reports shall be filed in the state capital in some department which prescribes the scope of the audit, checks on the compliance with state laws by both accountant and public officials, and also examines the audit itself to make suggestions as to local policies.

The qualified accountants are required to be acquainted with the laws of their state governing municipal accounting, financing of municipal expenditures, and many other statutory requirements for municipal or local procedure. The auditors receive their appointments directly from the governing body and are not employed by any state department, but pursue their profession as firms or individuals.

Extensions of Auditing Procedure

Attempted first in New Jersey in 1918, this method has been extended to include Kansas, North Carolina, Idaho, Connecticut, and perhaps others. The author of the survey already mentioned² states that this system makes unnecessary the carrying of a large staff of state auditors, whose work would be more cumbersome and slower than would be the simultaneous auditing by public accountants. The use of accountants further accomplishes, in those states, the successful result of having all of the units audited within a reasonable time after the close of the fiscal year.

REGISTERED MUNICIPAL ACCOUNTANTS OF NEW JERSEY

The revised statutes of New Jersey (1937)³ require every county and municipality having an assessed valuation in excess of \$3,000,000 to have an annual audit of its accounts, and for that purpose must employ a registered municipal accountant of New Jersey. Those having less than \$3,000,000 may postpone the audit for one year, but this audit must be completed before the end of the second fiscal year by a registered municipal accountant of New Jersey. This requirement has been in effect since 1918.

The act further requires that a copy of the audit report furnished the municipality shall be filed with the commissioner of local government within five days after filing with the municipality.

Audit reports must be signed by the registered accountant in charge of the audit, but may also be signed by the firm or corporation engaged in the work. The accountant, however, is held to be personally responsible for full compliance with the act.

The license of registered municipal

accountant is issued by the New Jersey State Board of Public Accountants and all cancellations made by it for causes mentioned in the act. A fee of \$5 is stipulated as the cost of this certificate, which must be renewed annually. A fine of \$100 is imposed upon any person auditing accounts of municipalities without such registration license. The Board is also given the right to make all rules and regulations governing examinations and the issuance of licenses.

The law further requires that a synopsis or summary of the audit, together with the recommendations of the accountant, shall be published in the official newspaper of the county or municipality, the municipal clerk being charged with the responsibility of causing such publication to be made.

The principal advantage from the standpoint of the taxpayers and citizens of the New Jersey system is that not one county or municipality, small or large, in the state can escape having an audit with a copy of the report filed at Trenton for use of the public.

The system of accounts and terminology is uniform for the City of Newark with the smallest municipality in the state, which has an assessed valuation of only \$100,000 and consists of nothing but a golf club.

NORTH CAROLINA

The auditing of public bodies in North Carolina is required of private accountants whose qualifications are examined by the state. Only those approved are allowed to accept engagements. Auditors must file copies of all audits with the local government commission (director of local government). All counties and municipalities must have audits.

SUPERVISION IN KANSAS⁴

In 1935 there was established by Kansas, in the department of the

² Dr. Wylie Kilpatrick, "State Administrative Supervision of Local Financial Processes," *Municipal Year Book*, 1936.

³ Title 40, Chapter 4.

⁴ House bill 407, session of 1935.

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state budget director a subdepartment known as department of auditing and accounting, headed by the state accountant. The state municipal accounting board was also created to consist of five members for a term of four years appointed by the governor. This body comprises one county clerk, one member of governing body of a city of the first or second class, one member of a board of education, one county treasurer, and the state accountant.

The board determines the qualifications of all applicants for public accountant's license. It makes all rules and regulations governing issuance of licenses and arranges for examinations to secure competent auditors. No person will be granted a license unless he shall pass the examination prescribed by the board. Licenses cover a period of one year, and each applicant must enclose \$5 with the application.

Any person representing himself to be a registered accountant and is not so, upon conviction is fined \$100 or not more than \$1,000 for each offense. These persons are ineligible for licenses for a period of five years.

It is the duty of the governing body of each Kansas county and municipality of the first and second class to have the accounts examined by a licensed accountant at least once each year.

A copy of the audit with recommendations shall be filed with the state accountant within thirty days after completion of the field work.

Municipalities not included in the above classifications of first- and second-class cities may employ a registered accountant to audit the accounts, provided a petition has been filed by 20 per cent or more of the voters who voted at the last election, such audit to cover period outlined in petition.

If the audit discloses a violation of a penal statute or other grounds for removal from office, the accountant must file a copy of the report with the county

attorney. Boards, commissions, committees, bureaus, departments, etc., having independent control of disbursing of funds shall reimburse the municipality for their part of the cost of audit.

IDAHO REQUIRES BIENNIAL AUDITS ⁵

Each county and incorporated city or village in Idaho must have a complete audit once in two years by a recognized public accountant. It is the duty of the state bureau of public accounts to prescribe uniform specifications for the audit and all audits shall conform to such specifications.

Costs of the audit are to be included in the annual county or municipal budget, and one copy of the completed audit is to be filed with the state bureau of public accounts by the council or board within ten days of the receipt of same.

The Idaho State Bureau is required to review each audit within twenty days following receipt thereof and notify the local governing body and auditor of their opinion of the audit. If the report does not meet the specifications, the objections must be filed.

It is a misdemeanor and there is a penalty of \$200 upon each member of the local governing body for neglect or failure to comply with these acts.

CONNECTICUT HAS MUNICIPAL AUDITING ACT ⁶

In 1939 the State of Connecticut followed the lead of New Jersey, North Carolina, and other states and passed laws requiring annual audits of municipalities and counties.

The municipal auditing act of 1939 provides for annual audits being made by independent public accountants selected by the local budget-making authority. They must be approved by the state tax commissioner.

⁵ Chapters 80 and 133 of the 1935 Idaho Session Laws.

⁶ File 324, Laws of 1939.

Extensions of Auditing Procedure

School, sewer, and fire districts must have their accounts audited at least once biennially by the independent accountant. Any municipality whose receipts during the three years preceding do not exceed \$50,000 may request the tax commissioner to audit its books instead of employing an independent public accountant; in which event the cost shall be borne by the municipality.

Copies of all audits by accountants shall be filed with the state tax commissioner in addition to those filed with the budget-making authority.

Any independent accountant failing to file such reports with the state tax commissioner, forfeits one half of the compensation to the state and is barred from the auditing of municipal accounts for two years from the date of such failure.

It is required that the audit report together with the recommendations shall be included in the annual report of the municipality, city, or county, and published in a newspaper in such municipality, etc.

The state tax commissioner is required to review the audit report and report to the state's attorney any evidences of fraud or embezzlement.

Another provision is that the budget-making authority must file with the state tax commissioner, the name of the independent public accountant at least ninety days before the close of the fiscal year. If no notification is received before such date, the commissioner may appoint an independent public accountant to audit, and the expense shall be borne by such municipality.

The state tax commissioner has prescribed the duties and powers of independent public accountants practicing under the municipal auditing act of 1939.

APPOINTMENT OF STATE AUDITORS

Auditing by state employees arose out of a desire to check the local expenditure of state funds or grants

for specific purposes. State officials have hesitated to use the outside services of public accountants for various reasons, although many accountants with the degree are now employed in various state offices.

Where state auditors examine local accounts, it has usually been found impossible, through lack of time or appropriations, to audit all of the units in one state. State legislatures seem to be opposed to the engagement of a large number of state employees to audit local accounts because of the expense involved. In some cases the expense of the audit is charged to the municipality or other public body and is in the end not an expense of the state treasury. The state, however, has to advance the money which naturally requires abnormally large appropriations.

Furthermore the audit of all of the local government accounts of the whole state seems to be too big an accomplishment for any one department or bureau to complete within a reasonable time after the close of the fiscal year, although it is reported that some of the state departments are able to audit biennially.

There can be no question of the independence of the state auditors if they are not connected with or live in the municipalities or counties which they are required to audit.

There are many outstanding results of the state audits which should be noted.

In New Jersey the sinking funds were required to be audited by the state beginning in 1918. Many were found to be insolvent and were placed upon a sound basis by the mandatory audits.

The audit of a hundred counties in Virginia for 1931⁷, by the state auditor of public accounts, reported forty-six treasurers and three other officials as having sizable shortages in their funds. This condition was said to be the result of laxity in the collection of taxes,

⁷ Survey by Dr. Wylie Kilpatrick.

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archaic accounting, faulty budgeting, and inconclusive auditing. With the rebuilding of the fiscal system, the installation of modernized accounts, and complete audits of the county, financial condition being substituted for partial checking, brought order out of chaos.

The state auditing authority does not, however, include the two dozen Virginia cities of over five thousand population which are largely in the council-manager class and exempt from state supervision excepting for certain regulations concerning debt, taxes, and budget applicable to all units.

STATE AUDITING RESULTS IN NEW YORK NOT IMPRESSIVE

In New York State the bulk of local auditing is done by state employees usually at the request of local authorities. The examinations made are performed only spasmodically since there is no provision for annual audits.

During the year 1935, the last year for which a report is available, a very small percentage of the New York local units were audited as set forth in the following report of the state controller:

	Number of units	General audits completed by state controller	Per cent of municipalities audited
Counties.....	57	2	3.51%
Cities.....	57	9	15.79
Towns.....	932	64	6.87
Villages.....	554	31	5.59
Total.....	<u>1,600</u>	<u>106</u>	<u>6.63%</u>

Where they have been continuously made over a period of years, state audits have resulted in the recovery of large sums, but the lack of an annual requirement and actual completion of the audit for every year, it is believed — will fail to eliminate the defalcations of local officials or replace the former in difference with permanent, constructive, honest procedure.

AUDITORS ELECTED BY THE PEOPLE

Because of the inability of political organizations to select competent independent auditors in those states where auditors or controllers are elected, the elective system has failed to produce independent audits.

Generally those elected are without previous education or experience and mostly are not qualified to do any auditing work. The auditing is inclined to become a farce because of the incompetence of those selected.

Frequently the auditors are elected on the same ticket as the tax collector, controller, or treasurer, whose accounts they are expected to audit. When it is realized that all of the candidates on the election ticket usually travel about to the same meetings, making political speeches and helping each other get elected, an idea of how independent and disinterested an audit made by such auditors is likely to be is readily obtained. Occasionally an auditor is elected who has some qualifications for this work, but this is very rare.

Elected Auditors in Pennsylvania

For many years, for example, it has been customary in Pennsylvania⁸ to elect auditors in counties, boroughs, and first- and second-class townships.

⁸ Report of committee on local government accounting, William H. Welcker, C.P.A., chairman, submitted to annual meeting of Pennsylvania Institute of Certified Public Accountants, June, 1938.

Extensions of Auditing Procedure

The election of three auditors for each county is provided for in the state constitution and the law requires three to be elected in the other districts mentioned.

The only apparent justification of such an arrangement is the multiplication of jobs. However, the chance of getting one qualified person out of the three elected exists. Where this happens, it is natural enough for the incompetent ones to depend upon the experienced one who has to assume full responsibility and do all of the work.

Where a controller is elected, the auditing of county accounts has been delegated to this official and the same is true in third class cities having a city controller.

The reports filed by the elected auditors, without much exception, show their general lack of experience and knowledge of their duties. The best estimate of the work of these auditors and the status of accounting and auditing in their local governments has been given in the report of a local government survey.⁹

One of the auditors admitted that this method of auditing counties was excessively expensive and inefficient. "The elective process is poorly adapted to securing competent auditors. Small counties, where a controller would be inadvisable, could hire the services of an independent auditing company or auditor. It would be far cheaper and better.

"The city controller, like the treasurer, is elected by the people and is by law required to be a 'competent accountant.' In some cases he is so qualified, but in many others, he is not an accountant at all, although he may have had a little experience in bookkeeping."

The Pennsylvania survey reported

that "the amount of work involved in most cities is not sufficient to justify the full-time services of a competent man and, for that reason, council should be permitted to employ an expert accountant on a part-time basis."

"Irregularities are commonly overlooked by the auditors, many of whom only partially perform their own duties. In larger boroughs where the sums involved are greater and the activities of the borough more varied, the lack of training, incompetence, and occasional, but rare, dishonesty of the auditors have more serious results.

"What is the type of auditing personnel obtained under the elective system? In twenty Pennsylvania townships where information relating to the occupations of the sixty auditors responsible for local auditing, was obtained, the following occupations were included: store, railway, unemployed, factory, and ledger clerks, 12; coal miners, 6; bank teller, cashier, and messenger, 7; auditors for private firms, 3; chemists, 3; mill foreman, 3; carpenters, 2; painters, 2; printers, 2; housewife, 2; laborer, 2; accountants, 2; and one each of the following occupations: retail baker, shipper, manager of specialty shop, farmer, bricklayer, cost estimator, bookkeeper, boilermaker, manufacturer, fruit grower, sales manager, treasurer of private concern, and trucker.

"Their occupations indicate that only fifty per cent of their number have had any prior accounting, bookkeeping, or auditing experience. It is significant that those who have had some prior bookkeeping experience are distributed among only twelve of the twenty units, the books of the remaining townships being audited by men who, as far as their occupations indicate, are unqualified to perform such duty. Whether a simplified accounting system combined with state supervision would permit of an acceptable audit by such men is a question that only actual

⁹ The Pennsylvania Local Government Survey, published by the American Philosophical Society, New Series—Volume XXV, April, 1935.

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practice could verify. The annual auditing of township accounts by trained accountants is the only solution that can be unreservedly recommended."

ILLINOIS PRE-AUDIT AND POST-AUDIT EXPERIENCE

The auditing policies in the various states are not uniform, and even within the state there is much confusion, and few have a uniform policy for auditing the various public bodies. The experience in Illinois¹⁰ is fairly illustrative of the lack of uniformity in this regard. For instance, each county with a population between 75,000 and 300,000 is required by law to elect a county auditor, who is assigned extensive duties with respect both to the pre-audit and post-audit. Only thirteen out of a total of 102 counties, however, belong in the above classification. Where there is no elective auditor, the board appoints a competent auditor to make a post-audit.

The pre-audit responsibility is divided among numerous county officials and the county board. According to a recent survey¹⁰ of the local government situation in reference to the question of external post-audits:

"The inadequacy of many of the audits is attested by the periodical disclosures of defalcations that occurred over a period of several years prior to detection. An audit of one county in Illinois . . . disclosed that two county treasurers had misappropriated \$600,000 of county funds between 1918 and 1933. Because the Illinois statute of limitations against a crime of this type had expired, the defaulting officials could not be prosecuted. In another case, the county clerk incurred a shortage of \$534,000 between 1910 and 1934, but the defalcation was not discovered until 1935. Other similar cases of em-

bezzlement could be cited, but these are sufficient to indicate serious defects in county audits."

The article goes on to say that "low fees and competitive bidding have largely prevented independent audits, and recommends that counties and other local units of government should be free to select a reputable auditor at a price commensurate with the quality of service that is required of a good audit." Further that the office of county auditor should be made competitive rather than elective.

In connection with the treatment of school districts, the Illinois report states that:

"Many of the large districts have comprehensive audits made by independent outside agencies, but the smaller districts seldom have such audits. A large majority of the school districts therefore are not audited by disinterested persons.

"Many of the larger cities follow the practice of having an annual post-audit by an outside auditor, but a large number operate over a long period without such an audit. In cities and villages that have the commission form of government the council is required to have a full and complete examination of all books and accounts made by a competent accountant at the end of each year. Shortages that have recently been discovered indicate the need for a better system of municipal audits."

THE DEMAND FOR INDEPENDENT AUDITS

From the above we conclude that the demand for independent audits has been met by a number of the states in the working out of a complete system which will enable accountants to qualify for the audits referred to. The provisions of legislative enactments of these states set up a definite system for insuring:

1. That the audits will be independent;
2. That the auditors appointed will be qualified;

¹⁰ *Control of Expenditures in the Local Governmental Units of Illinois*, by H. K. Allen. Bureau of Business Research, University of Illinois, Urbana. July, 1940.

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3. That they will follow out a prescribed system laid down by the state department, which is given the authority of standardizing the auditing procedure, and such other regulations of local government as may be required by statute;
4. That they will be available for public inspection through the filing of copies with the local governing body and at the state capital.

Such audits are largely independent and serve their purpose as such. They have met the challenge in connection with the demand for independent audits and the selection of independent auditors, and it would seem beyond a doubt, that all reasonable expectations on the part of taxpayers and state regulatory officials had been fully complied with.

Outside of those referred to as having independent examinations, the other states will have to be classified in a group which does not have satisfactory audits, either because the auditor is not independent, he lacks qualifications, or else the audit is not uniform or complete.

All of the municipalities are not audited. The condition is due to legislative indifference or lethargy of the citizens themselves.

OBSTACLES TO INDEPENDENT AUDITING

The members of legislative bodies appear to have a misconception of what is meant by auditing and, in many of the instances where legislation has been passed, they have given no consideration to the importance of making an audit independent. Generally the question has been solved in their minds by an appointment of a controller and they have had no better knowledge of what a controller should do than they have had of the value of an independent audit. They have generally put down all controllers and accountants as auditors, or bookkeepers, and when a controller or auditor was elected as

either a state official or as a local official, he was supposed to be a qualified auditor even though the person selected by the politicians may have had no previous education or experience.

LACK OF EDUCATION

Public opinion is slow in developing and it requires much education of the public before demands are created for reforms of antiquated procedure.

For instance, the State of Connecticut was, until 1939, in the class of those states having a very unsatisfactory system of auditing. It required the graft disclosures involving the officials of the City of Waterbury to create the sentiment for a uniform audit law in that state. In the other states where such regulations have been heretofore passed, there have been doubtless other occurrences which prompted the legislatures to approve the much needed reforms.

The education, however, is not limited to the public, which is not stirred up easily unless a scandal occurs. Education of public officials may very well result in a demand for better auditing and more independent auditing throughout the country.

In 1933, the National Committee on Municipal Accounting began considering the various phases of municipal procedure. They have perhaps done more in the few years since that date to crystalize opinion and inaugurate reforms than any other agency.

The Municipal Finance Officers' Association of the United States and Canada, at its annual meetings and through its publications, has also consistently advocated independent audits by public accountants.

There would seem to be a remarkable opportunity offered to the American Institute of Accountants to line up its support in favor of independent audits of the public bodies by qualified accountants in every state.

The movement toward state auditing

should be confined to a department regulating the local auditing, the actual auditing work being in the hands of independent public accountants.

We conclude by reminding you of the constructive suggestions of Carl H. Chatters¹¹ on this subject:

"There are several points of misunderstanding between municipalities and accountants. You say that the jobs are political and you do not like the fact that you have to bid to get municipal jobs. On the other hand, the officials often feel that the accounting work is incomplete. The most common criticism is that one auditor will make suggestions for changes of system and the next year a succeeding auditor comes in and makes contrary recommendations. Another point of criticism is that accountants fail to understand the difference between municipal accounting and their other accounting practice.

"The greatest help in doing away with these criticisms is to have some standards and some principles upon which the public officials and the accountants can agree. Then the officials who are critical of the auditors or the auditors critical of the officials, could have some justifiable basis for their opinions. Now it is difficult to tell who is right. The audits should be more constructive, more thought given to the formulation of better accounting plans, and more work done that will bring about better budget control, with less emphasis on the audit as merely a means of discovering shortages.

"One of the big arguments among your own groups is the question of how far the state shall go in controlling municipal accounting, and whether the state itself should enter into accounting practice and audit local bodies. The first argument in favor of supervision by the state or state audits is that the state employees have a more accurate

knowledge of municipal law. There is, of course, the danger of standardized stupidity, as well as standardized intelligence. Some argue that the cost will be lower if the audit is performed by a state body. Others say that the state should require an audit of local accounts where the state is granting aid to the local governments. Then, too, the federal government sends in its auditors to audit the accounts of local bodies using federal P.W.A. funds. If one audit could be made properly, it ought to take care of all these things.

"On the other hand, there are certain arguments against a state system of auditing. The first is that an audit by the state tends to become purely legalistic and to overlook other important factors. Others say that the state may not have a competent staff to do the work, because of politics on the one hand and low fixed salaries on the other. In many cases the state agencies are no more qualified to check the localities than the localities are to check themselves.

"My own opinion on the question is this: I believe there should be in every state a state agency to deal with municipal affairs. Particularly where municipalities are having difficulties with their finances, we do need a central state agency to deal intelligently and coöperatively with municipal affairs. If there is a system by which the state audits local bodies it should not exclude auditing by independent accountants.

"Some control can be exercised by licensing municipal accountants or requiring them to pass a special examination. The state agency could prescribe the reports which the municipalities themselves must file. They should review the reports of private accountants, to be certain that all reports are up to a required standard. The state should have a small accounting staff, able to make supplemental or special audits where occasion demands.

"On the other hand, the bulk of the auditing to check the fidelity of the operation of the public officials should be done by private accountants. The accountants should be able to establish a system of accounting for a local com-

¹¹ Carl H. Chatters, former auditor and director of finance of the City of Flint, Michigan, and now executive director of the Municipal Finance Officers' Association of the United States and Canada, *The Accountants Digest*, Vol. 1, No. 3, March, 1936. Page 299.

Extensions of Auditing Procedure

munity which will be usable by the operating executives. He should be trained to the point where he can act as a financial adviser of the municipality."

The preceding advice comes from a very practical man. One who has served as director of finance of a large city in addition to being the executive director for many years of the Municipal Finance Officers' Association of the United States and Canada. We therefore believe that the advice is worth calling to the attention of the members of the American Institute of Accountants, and it seems that it would be quite proper for the Institute—through its members, the state societies in every state, and through its extensive and close connections with representative business and

professional groups everywhere—to do something which would foster the question of independent audits of public bodies. The Institute is now engaged in various kinds of activities which will assist the members of the profession. Would it not be opportune to engage actively in this?

It would not only be an outstanding public accomplishment, but also a tremendous benefit to the profession for us to give some consideration to the question of the field of municipal auditing. Considering the conditions in the various sections of our country, should we not propose a uniform law, which would be practical for adoption in the states which are now unacquainted with independent audits?

Municipal Financial Reports from the Standpoint of Investors in Municipal Securities

BY JOHN S. LINEN, NEW YORK

Vice president of The Chase National Bank

THE PAST decade has witnessed major improvements and additions in the field of municipal reports on finances. During this time weaknesses and shortcomings in government fiscal policies not commonly realized, made themselves known. Improved accounting technique, as well as a wider range of subjects, is now found in the more formal and comprehensive annual reports or audits. This is necessary for an intelligent analysis and understanding of the credit position of the municipality under review. There are of course other factors and considerations which enter into the final judgment, but an adequate portrayal of the financial condition is essential to a sound conclusion.

I am not an accountant. I must talk with you, therefore, not as an expert, but one who seeks financial information from municipal reports and endeavors to understand them. In spite of the progress which has been made there are still many difficulties encountered.

Those of us who are in the business of underwriting municipal bond issues have the problem of satisfying ourselves before we attempt to satisfy prospective investors regarding the economic and financial soundness of numerous municipal credits. Circulars must be prepared for the sale of such bonds and the availability of adequate and complete figures in an official report is not alone a convenience, but of such value on occasions as to justify the underwriter or dealer in paying a higher price for the bonds.

INDEPENDENT AUDITS

Members of your profession are called upon from time to time to audit

the accounts of municipalities. Sometimes we see such reports, but this, you may be surprised to learn, is on quite rare occasions. The reason is not because the municipality wishes to withhold the information, but because it is usually considered superfluous or unnecessary.

Fortunately, in my judgment, the practice is growing throughout the country of requiring independent audits of municipal accounts. There is no more reason why municipal accounts should not be checked and verified than those of private corporations. In some states, however, this protection is provided in some measure by state bureaus or departments which are charged with this responsibility.

In either case an audit of this character is likely to appear quite voluminous and contains necessarily a great deal of detail which is of no direct interest, under normal circumstances, to the investment dealer. This is in no sense a criticism of the audit unless it might be that the summarizing of the essential information in a brief, clear statement of the facts would make many audits far more intelligible and useful to the public generally as well as the investment dealer. Critical or constructive comments in the letter of transmittal or introduction can on occasions be both enlightening and valuable to the reader as well as to the public body for whom the audit is made.

UNIFORM REPORTS DESIRED

The investment banker who specializes in municipal bonds has a concern with respect to municipal accounting systems and municipal financial reports which varies little from that of the

taxpayer or the citizen interested in good government. He wants to know about a municipality's financial transactions, financial position, financial trends, and financial plans. He is interested, therefore, in a sound, comprehensive system of budget making and budget control; in a system of accounts which ties in with the budget and sets forth a municipality's financial transactions with completeness and clarity; in an audit which supports the accuracy of the accounts; and in published financial reports which summarize adequately a municipality's financial operations and its debt position in relation to its assets in a manner which is reasonably intelligible.

The American Institute of Accountants has had, I know, a most helpful and coöperative attitude in working for improved practices and standards in the field of municipal accounting. The chairman of this meeting and his associates have rendered a service of great value as members of the National Committee on Municipal Accounting. From the sidelines I have observed with keen interest some of the splendid contributions which this committee has made towards a better standardization of terms and practices which in times past have proved so confusing, especially to the uninitiated.

The investment banker has a very genuine interest in the work of the National Committee on Municipal Accounting, as it seeks to formulate a standard system of municipal accounts and work out a standard set of accounting statements. His interest is a practical rather than a purely academic one, moreover, because of the obstacles to municipal financial analysis which are now imposed by the lack of uniformity in accounting and reporting standards throughout the country.

One who has followed the trend of municipal financial accounting and reporting over the past several years knows that some cities are outstanding

in the high standards which they maintain; that there has been a very marked improvement in the extent and quality of financial reporting; and that there has been some rather noteworthy progress in accounting standards. Boston and Providence deserve to be mentioned among the large cities which very recently have substituted excellent accounting systems for systems that were defective or outmoded. New York City is now in the process of installing a more modern system of accounts. This will result in greater efficiency as well as simplification.

But it is still unfortunately true that not only is there no general acceptance of a standard system of municipal accounts throughout the country, but in very few states has there ever been state-wide standardization on an acceptable basis. Cities generally are still on a go-as-you-please basis in so far as accounting and reporting systems are concerned, and when it comes to counties the majority appear to have made little progress in the past generation or more.

The investment banker has no illusions about the ready attainability of nationwide standards for municipal accounts and reports. Under the cherished principles of local self-government it is likely to be a long and sometimes discouraging process. But it does seem reasonable that certain minimum standards could be followed universally—could be agreed upon and insisted upon as essential to the soundness of local government throughout the country.

SOURCES OF INFORMATION

Information sought by investment dealers is for two purposes. The first is to satisfy themselves as to the economic soundness and financial stability of the municipal unit under consideration and to have adequate authoritative factual data at hand so that this may be made available to prospective purchasers.

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The second purpose is the securing of essential information for the preparation of an offering circular. The offering circular usually follows a rather prescribed form and does not include or even touch upon some of the supplemental information.

While a few of the larger institutional investors make independent investigations, most of the investors in municipal bonds rely upon information supplied by the investment dealers. This information is contained in municipal circulars and supplemental material which on occasions may be made available. The service agencies such as Moody's Investors' Service, Standard Statistics, the Commercial and Financial Chronicle "State and Municipal Compendium," etc., provide valuable statistics in their manuals and reports. There is another source of information widely used by investment dealers and institutional investors upon which a good deal of reliance is placed. This is the special service provided by the municipal research department of Dun & Bradstreet. Dr. Frederick L. Bird, who is in charge of this division, has gained for himself a position of high respect among municipal dealers. You will be interested to know that this department endeavors wherever possible to obtain copies of independent audits as well as official reports, in analyzing the financial condition of municipal units.

This Dun & Bradstreet service analyzes municipal reports and presents the results in a standard pattern with explanatory comment and interpretive observations, with the result that complicated statements are greatly clarified. In order that you might have the benefit of the reflections of one who has had a far broader and more diversified experience than I have in reviewing municipal reports, I asked Dr. Bird if he would be good enough to cite a few specific cases that might be profitably discussed. He responded generously,

and I make acknowledgment to him for some of the statistical studies and illustrations to which I will later refer.

There is certain information which is always expected to be found in municipal circular presentations, some of which may deserve special comment. This information is usually supplied officially by the municipality at the time when some financing is in contemplation. Such information should be prepared by the municipality and available to any prospective bidders upon inquiry.

Instead of attempting to comment upon a large number of items, it will be more profitable, I feel sure, to discuss a few of the more difficult ones in sufficient detail to clear away some of the present ambiguities. There is some information which, although important, it is hardly reasonable to expect independent accountants to secure, as the scope of the audit which they are engaged to make does not contemplate studies that may be necessary if an informed opinion is to be rendered on such subjects. Yet failure to make some reference to a condition which should be studied or reported upon may result in some persons reaching entirely unwarranted conclusions. It is in such situations that the value of an independent audit with comments can manifest itself, as official reports from municipal governments, even though thorough in their content, are frequently not sufficiently informative.

ASSESSED VALUATION OF TAXABLE REAL PROPERTY

To be more specific, let us consider the subject of the officially assessed value of taxable real property in relation to the actual or fair market valuations of such property. In the large majority of cases there is no reason to be concerned on this subject. The great advantage of sound accounting procedure, however, is the disclosure of hidden or half hidden weaknesses or

faults which might otherwise go unnoticed. It is the custom of most municipal units to list the estimated "actual" or "true" value of taxable real property. In those instances where the assessed value is substantially below the estimated actual value there is not usually much reason to check the question further. Where, however, the assessed and actual values are the same, and this is frequently the case as the law in some states requires that taxable property shall be assessed at the full value for purposes of taxation, it is well to determine if there is any wide variance in local opinion regarding the fairness or reasonableness of the assessed valuations.

This is one of those subjects where it is easy to criticize but difficult to prescribe an effective remedy. It is no simple task to determine what is the fair or reasonable value of widely scattered and diversified types of real estate.

As real property represents the most important source of income and affords the principal security for the payment of municipal bonds (I would except state bonds here as they are usually supported largely by other revenues) the accurate appraisal of such property can in some cases become a vital consideration. It is a matter which, in principle, should be adequately answered in the financial statement, but which in experience is frequently not so answered.

The fault is not essentially with the accounting procedure, but rather with the cumbersome assessment formalities. There is a lack of uniformity in assessing real property, not only within the same states, but frequently within the same county. A county may be assessed on one basis, a city within the county on another, and a school district within the city on still another. This is not only confusing, but makes extremely difficult the determination of debt ratios and satisfactory comparisons.

Progress is being made in developing more uniform standards for assessing real property and the National Association of Assessing Officers has, I am told, been responsible for constructive recommendations. As frequently happens, however, after developing a workable system by much labor and effort, the resistance offered to new ideas and methods sadly delays the adoption of greatly improved procedure and technique.

In addition to human inertia there are other practical reasons why there is an indisposition on the part of public officials to adjust assessed values downward even when they know this should be done. There is undoubtedly in many instances an honest expectation, where values have been slipping, that time will shortly correct the margin of error by producing an improving trend in the demand for and value of such properties. More important than this optimism is the effect of reduced assessed values upon the debt margin and the revenue budget where legal limitations so prescribe. Both debt and tax limitations are usually applied in relation to the assessed valuation of taxable real property. Tax limitations on occasions apply not only to revenues for operating purposes, but to debt service as well.

It should be understood that excessive valuations where tax limitations must be dealt with, especially when such limitations are constitutional and not statutory, may result in serious difficulties. If the tax limit includes both debt service and operating costs the whole structure of security of the outstanding debt is undermined. If it applies only to operating costs, problems are apt to develop in the current operations. Therefore, where tax limits exist the extent of their application should be determined, as should also the margin still available within the limitation and the effect upon needed income of any substantial adjustment of the assessed values.

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COMBINED OR OVERLAPPING DEBT

Brief reference should, I believe, be made to combined or overlapping debt. It is seldom that a municipal financial statement gives as much information on this subject as is desirable. A complete statement of the debt position of the municipality may be supplied, but this many times does not reflect satisfactorily the combined debt burden which the taxable assets must support and service. Only when the indebtedness of the municipality, plus the proportionate share of the indebtedness of overlapping areas or districts which the same taxable property must support, is made available can a proper understanding be had of the extent to which indebtedness may be a reasonable or excessive burden upon the taxpayers. As such debt represents the indebtedness of several public agencies or political subdivisions, it is not always a simple matter to obtain an accurate and up-to-date statement. Where there is an office in the state government which keeps rather fully advised on the debt position of the various political subdivisions within the state, this information can be secured much more readily than when each independent unit must be dealt with separately. Usually the municipality interested in selling new bonds in preparing a financial statement of this character can secure this information from the other local political subdivisions, and this as a matter of policy should be done wherever possible. Even approximate figures, which can be reported as such, if officially given, are very helpful when accurate figures cannot be secured.

TAX DATA

The matter of reporting on tax collections is a somewhat larger subject than is frequently recognized by municipal officials and the different methods of reporting lead to confusion and uncertainty.

In addition to reporting the actual collections against the current tax levy and, separately, the collections against delinquent taxes, the following subjects are frequently dealt with much too casually if an accurate understanding is to be obtained by the person seeking tax information.

In reporting the transfer of tax delinquencies to tax title liens it sometimes appears that the delinquent taxes were collected in cash form instead of showing clearly that the property was transferred.

The reporting of tax liens on occasions includes, in addition to liens, foreclosed properties as well, all as one item. More frequently tax liens are reported alone and no indication is given of foreclosed property held. At other times liens are reported in principal amount only, or interest and costs are included without so indicating.

The removal of property from the assessment rolls, upon which foreclosure proceedings have been completed, is sometimes delayed intentionally; thereby maintaining assessed values at a higher figure than is correct.

Tax abatements are not reported on occasions. Thus they sometimes appear as an asset in the form of uncollected taxes.

REPORT ON 100 CITIES

I referred some time ago to minimum standards which it seemed might be reasonably agreed upon. What are some of the subminimum conditions which the investment banker encounters when he endeavors, for the protection of his institution and his clients, to analyze a municipal financial situation on the basis of available records? One hundred large cities of over 50,000 population have been selected for purposes of illustration. Cities of considerable size have been chosen because they seem to be in a position to offer the best in the way of accounting and reporting adequacy.

Extensions of Auditing Procedure

In the first place, 21 of the 100 publish no annual financial reports, except possibly a newspaper summary or a four-page folder with a few statistics. Thus one fifth of these larger cities provide the analyst no readily available basic material to work with.

Of the 79 published annual reports, only 47 can be classified as good reports. This does not mean that all 47 measure up to high standards of financial reporting as to arrangement, clarity, etc., but that these reports do provide most of the necessary basic data if one digs hard enough to find them.

Among the data which it is important for a banker to have are the facts regarding a municipality's current assets and liabilities. Short-term loans cannot be made wisely without such information and an accurate knowledge of the operating account for the past several years is of distinct value in ascertaining the trend, which at times is a matter of considerable significance. Yet of the 100 cities 26 have no current-account balance-sheets at all and 10 more carry hybrid balance-sheets which are such a mixture of capital and current items as to be relatively uninformative. In other words, 36 per cent of these 100 cities do not afford adequate means to the banker or to the public for checking their financial positions at the close of the fiscal year.

About 36 of the 100 may be said to have accounting systems that are either so inadequate or so cumbersome that they fail to meet the minimum of clarity necessary to permit a satisfactory appraisal of their finances. In attempting to define an "inadequate system of accounts," it might be added that the tests applied are not as severe as would be necessary under the standards established by the National Committee on Municipal Accounting. Systems of accounts have been classified as inadequate here if they are characterized by any of the following: (a) no attempt at accrual accounting; (b) no reasonably

intelligible current-account balance-sheet; (c) so many separate funds as to make for confusion; (d) failure to set up separate, clear-cut accounts for utilities; (e) lack of good statements and schedules covering debt.

LEGISLATIVE HANDICAPS

Accounting progress in some cities is thwarted by the antiquated requirements of state legislatures, which call for the maintenance of literally scores of separate funds, each often with its own tax rate. One Iowa city, for example, operates through forty-eight different funds and reports its over-all transactions in an annual-receipts-and-disbursements statement which lumps together the current, capital, bond, and trust funds in a meaningless jumble. Long familiarity with such systems may make them informative to local officials and citizens, but they are practically unintelligible to the outside analyst.

GOOD ACCOUNTING PAYS DIVIDENDS

The installation of improved accounting systems in some cities in recent years has not only facilitated interpretation of their finances but has disclosed, and eliminated, errors or poor practices which had long remained concealed under former accounting procedures. One outstanding illustration is that of Worcester, Mass. In 1937 the city adopted the system of accounts and setup of balance-sheets prescribed by the state, and in the process the state accountants discovered a revenue deficit of \$1,500,000, which the city cared for adequately by a funding bond issue. Progress of this sort is most encouraging, but at the same time it leaves one in a questioning state of mind regarding the situation in cities and counties still fumbling under antiquated fiscal arrangements.

PROVISION FOR DEBT SERVICE

Investment bankers are particularly interested in those sections of municipal

financial records and reports which deal with bonds outstanding and provisions for payment. Here again the records of many municipalities are so complete and so readily available that one hesitates to complain about the minority of failures. Yet it is true that in a sizable minority of even relatively large cities the available data on debt are so inadequate as to suggest that local officials do no long-term financial planning whatever. Among the more rudimentary and fundamental of shortcomings to be noted are the absence of complete bond maturity schedules, of summary statements of debt broken down adequately as to purpose, and of informative sinking-fund data. Audits frequently do not extend to determination of the sufficiency of sinking-fund reserves, and it seems to come as a surprise to many city officials that investors are vitally interested in the precise nature of sinking-fund investments.

COMPARISONS OF VALUE

Experience has shown that it is well to observe the trend of both operating and capital figures. Comparative figures over a period of years are therefore highly desirable. The "Report on Finances" issued by the City of Miami, Florida, is an excellent example of a report which includes valuable comparison tables and, because of its contents and simplicity, finds high favor with the careful analyst.

VALUE OF INDEPENDENT AUDITS

One of the most hopeful means of producing progress in raising and unifying standards of municipal accounting and financial reporting, would appear to be a more universal use by public bodies of independent audits by qualified accountants. The degree of hopefulness in such a development, however, depends entirely on the qualifications of the auditors and on their feeling of responsibility for the establishment and maintenance of high standards.

The mere fact that a municipality has an independent audit periodically of its accounts carries no assurance of accounting progress. Too many so-called audits are nothing but a perfunctory counting of cash and checking of figures. It seems clear, also, from scrutiny of numerous independent audits, that some accountants have never heard of the National Committee on Municipal Accounting and its years of work to agree upon methods and standards. In some instances new systems have been installed which fail to meet even the minimum of acceptability, while in others the perfunctory auditing of confused, uninformative accounts continues year after year, apparently without a suggestion from the accountant as to ways and means of improvement.

A FEW EXAMPLES

It occurs to me that a few specific illustrations might be more profitable than general comments. I will therefore briefly refer to a few.

Columbia, South Carolina, has audits made faithfully annually and oftener. The city has a water system, financed partially with revenue bonds and with water revenues pledged for payment. Bankers and investors naturally are interested in clear-cut, separate operating and balance-sheet statements of the water department. Yet water department finances are so intermingled with general fund finances in the audit that it is impossible to determine precisely what the department's financial situation is from year to year and why inadequate appropriations are made to the water-bond sinking fund.

Savannah, Georgia—The only balance-sheet is a hybrid mixture of capital and current items.

No central general fund revenue-and-expense statement and no general fund balance-sheet.

Current operations are presented in from twelve to fifteen separate segmentary receipts-and-disbursements

statements, about eight of which would normally form a general fund. There are many discrepancies between opening and closing cash balances because of transfers which do not show in the audit.

To make a satisfactory consolidated statement from the above it is necessary to go to the controller's books,—the auditor's figures are not adequate.

With respect to debt, there is no break-down of bond issues—just one single figure—and there is no bond maturity schedule. For the former it is necessary for the investigator to go to the controller's bond records; for the latter, to the original bond ordinances.

Greensboro, North Carolina—This audit illustrates how one can be, in many respects, very thorough and complete and yet be uninformative on a few important points. In Greensboro the special-assessment account happens to be especially important from a credit angle. From the audit, however, it is impossible to determine the amount of special assessments collected in any year. Also there is no special-assessment balance-sheet. With respect to the general fund, the statement of revenue and expense challenges interpretation and there is no general fund receipts-and-disbursements statement.

It would appear that the independent auditor has an almost unlimited opportunity for improving municipal accounting methods and helping to establish uniformly high standards if he is willing to assume the responsibilities of adviser and constructive critic. In technical financial matters he should have a relation to the municipality similar to that of the bond attorney in legal matters pertaining to finance. Perhaps nowhere is the value of such a relationship so generally clear as in the State of New Jersey, where all municipalities must have their accounts audited periodically by certified public accountants approved by a state board, which supervises local budgets and ac-

counts. As one goes through scores of the best audits in this state and notes the many constructive criticisms and suggestions incorporated in them it is impossible not to be impressed with the potentialities of such service for municipalities throughout the country.

One outstanding situation will serve as an illustration of the independent auditor's function at its best—the City and County of San Francisco. Here one finds a combination of a system of accounts which meets high standards, a controller's annual report which is one of the best in the country, a controller who includes explanatory comment of utmost value, and independent auditors who exercise their full function and prerogatives in clarification, suggestion, and advice.

CONCLUSION

I would like to conclude with the above favorable references. Although my remarks have included a good deal of critical comment, I believe we all need criticism as well as constructive thinking, vision, and encouragement if true progress is to be made. The American Institute of Accountants has given evidence of open-mindedness in seeking the views of one such as myself not versed in your profession. The opportunity for improved methods in the financial reports and audits for public bodies is a sufficient challenge to stimulate action.

Fortunately, there are examples and models as well as standards and formulas which pave the way for more uniform use and, I trust, adoption. Because assessed values on occasions introduces one of the serious inaccuracies into municipal financial statements, I devoted considerable time to this subject. Your assistance is desired in dealing with this problem as are also your comments when conditions obviously call for some warning signal.

Simplified current account statements, information on overlapping in-

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debtedness, comparison of current and capital positions for a period of years, clear reports on tax data, and concise summaries of the more detailed figures giving essential information in a manner which can be readily understood by persons inexperienced in accounting technique—appear to be most of the ingredients for the formula.

Explanatory comment or suggestions of possible shortcomings or omissions can, on occasions, be almost indispensable. With the approach towards a greater uniformity and standardization of reports, present obscurities will be eliminated automatically and the goal, which now appears so far away, in large part will be realized.

X

ROUND-TABLE DISCUSSION

**Accounting for Contractors under State
Highway Department Contracts**

Leader: THEODORE W. MOHLE

October 16, 1940

Objectives in the Prequalification of Bidders

BY JOHN L. HARRISON, WASHINGTON, D. C.

Secretary of the road construction committee, American
Association of State Highway Officials

BROADLY speaking, the objective in prequalification is a reasonably accurate predetermination of the responsibility of prospective bidders. Contractors and those responsible for making awards have a common interest in this matter. Responsible contractors favor it in part because it has proved a pretty effective means of reducing the amount of speculative bidding, but more definitely because experience has demonstrated that it also effectively prevents them from overexpanding their activities.

It may be well to lay a bit of emphasis on the second of these aspects, for it is a fact that overexpansion in one form or another is responsible for a large percentage of the failures annually reported in all lines of business. In the past it has been rather easier for a contractor to overexpand than it has been for men in most other businesses, and the result of his overexpanding has been, in general, more promptly fatal. The very ease with which, in the past, a contractor could bid in too great a volume of work and the fatal results of doing so have led thoughtful contractors actively to look for some reasonable method of reducing this tendency.

While responsible contractors favor prequalification, it is not unnatural for many of them to feel that in its application to them, individually, there should be a liberal interpretation of the rules on which prequalification rests. If this attitude is to be effectively offset by counsels of caution, it is important that accountants appreciate that this dominant objective in prequalification—that it does act as a definite deterrent to overexpansion—is of real and of direct value even to the most active operators

working in this field. This being the case, the contractor is best served by his accountants when they assist him in obtaining a realistic view of his financial position. I am well aware that this is not always certain to be the most popular position an accountant can take. However, contractors, like other businessmen, are better served by exact information conservatively evaluated than they are by information and comment which tends to encourage speculative activity.

From the standpoint of the awarding officer, prequalification is desirable because of the opportunity it affords for a calm evaluation of contractors' responsibilities and because it provides a sound basis for declining to receive bids from those who are not qualified financially or by experience or in other ways to undertake specific projects. Necessarily, the awarding officer must look further than the contractor's balance-sheet if a correct appraisal of his responsibility is to be made. Nevertheless, his balance-sheet is of vital importance, for contracting officers do not intentionally award work to the bonding companies. When an award is made, it may be assumed that the awarding officer believed that the contractor could and would finish the work himself. But if he is to be able to reach sound conclusions as to a contractor's financial position, the statements the contractor presents must be both sound and realistic. This involves the contractor's accountants, and they should appreciate the use that is to be made of the financial reports they sponsor and the responsibility they carry for seeing that these reports present both a clear and an accurate picture of the contractor's ability to finance construction work.

Extensions of Auditing Procedure

For two reasons stress has been placed on this matter of making reports both clear and realistic. The first of these—well known to all of you—is that a financial statement is not a statement of unquestionable fact. In many of its particulars, it is merely an intelligent estimate. It may, therefore, be intelligently liberal or intelligently conservative without involving impropriety of any sort. It is evident that the report should avoid both of these extremes.

The second point is that if a financial statement is fully to serve the purposes here involved, the estimates of which it is so largely composed must be neither too liberal nor too conservative. It must protect the contractor and, at the same time, without encouraging the awarding officers to permit him to take too large a volume of work, avoid imposing unnecessary restrictions on the volume of work he may be given.

While it is important that when an award is made it shall appear certain that the contractor can complete the work contemplated, it is also important that the restrictions placed on the volume of work which may be taken shall not be so severe as unduly to restrict competition. It may be urged that this is a matter of policy which is in the hands of the awarding officers and of those for whom they act. However, the fact remains that under any given set of conditions there is a fairly definite relationship between the liquid assets a contractor can command and the volume of work he can handle. It is at this point that the accountant's judgment as to what a contractor's financial position really is and, therefore, what he may safely undertake, becomes important both to the contractor and to the awarding officer.

To illustrate one angle of this matter, if contractors were paid promptly every week for all of the work done and all of the materials delivered during the week, without a retent of any sort, all of the free cash they would need would be that

required to bring their equipment to the job, to erect job buildings and otherwise to prepare to start operations, plus enough to meet the first weekly payroll. For most types of work this would be a very modest amount. On the other hand, if only work completed and in place is paid for and, as is customary, estimates are prepared only once every month, the cash required to maintain operations at a given rate is sharply increased. It is further increased if these monthly estimates are conservative—that is, if they generally understate the amount of work that has been accomplished. It is again increased if retents exceed the contractor's profit in the job—as they usually do. Finally, the cash required is further, and very sharply, increased if estimates are not paid until from thirty to sixty, or perhaps ninety, days after the end of the estimating period.

Practices in regard to all of these matters differ widely as between localities and as between organizations, a situation which is largely responsible for the wide differences that exist in the expressed opinions of well informed men as to what relation should exist between the working capital a contractor can command and the volume of work he may reasonably undertake. There is no such thing as a generally reasonable relationship between these two matters. Controlling factors such as these must be studied with a great deal of care by a contractor's accountants before reliable conclusions can be reached as to what, for the conditions under which his work will be done, this relationship should be.

It may be observed that when a state highway department or other organization that is handling a large volume of construction work undertakes the pre-qualification of prospective bidders, one of the first things to which it must give careful and thorough consideration is this very matter of what, under its practices as to estimating, as to retents,

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as to paying approved estimates, and as to other factors of importance the ratio between the working capital available to a contractor and volume of work he should be permitted to take should be. The differences that exist, as between the prequalification practices of the various state highway departments, are largely due to differences in their average practice as to these very matters. This again emphasizes the importance of accountants knowing in detail all of the conditions under which the contractors are operating, as this knowledge is bound greatly to influence the advice they give.

It is assumed as a matter of course that accountants, more fully than men in other professions, realize that contracting requires working capital. Prequalification practices usually fix some relationship between working capital, that is, cash available and assets readily converted into cash, and the volume of work that a contractor may have in hand at any time, though this relationship will be found to differ from state to state for the reasons just stated and for others it has not seemed important to mention. They also differ in their conclusions as to what things will be rated as current assets and as to what, if any, influence fixed assets will be allowed to have in determining the volume of work a contractor will be permitted to undertake. These differences are natural enough. It has been remarked that in the ordinary conduct of any type of business working capital is a prime requisite. The objective is a fair determination of what assets other than cash are in such form as to warrant the presumption that they can be promptly converted into cash when and if that becomes necessary. A contractor's fixed assets must also be considered. However, in the matter of fixed assets, and their use in deciding how much work a contractor can safely carry, the problem, obviously, is not "What are they worth?" but "What can be borrowed on

them if the need arises?" or to put it a little differently "To what extent can they be made to provide working capital if and when additional working capital is needed?"

Many of the differences that exist between the various plans under which contractors are now prequalified result from differences in the conclusions that have been reached on points of this kind. Cash in hand and in bank is, of course, universally accepted as a current asset. It is customary, also, to accept as current assets approved estimates that are due but unpaid. Sometimes, in the interest of greater accuracy, "work performed but not yet estimated" will be accepted as a current asset. Notes receivable within some reasonable period are also as a rule accepted at face value as current assets. But as to the last three items it is well to observe that an assumption is made, the assumption that the conversion into cash will take place at least approximately as planned, and at book value. Obviously, if liquidation of such assets is slow, the affected asset is not as current as had been expected. We are passing from the realm of fact—cash in hand—into the field of assumption. Business is transacted in this way—and must be as long as we adhere to our present system—but just as fast as there is a departure from fact, there is an accumulation of risk, and this implies a larger margin to allow for errors in judgment.

While approved estimates due a contractor from undoubtedly dependable clients are good current assets, the status of the retained percentage is not as clear, though for purposes of prequalification it is accepted as a current asset more often than not. However, it should not be accepted at full value unless all of the work that is generating it is up to schedule, for possible charges for liquidated damages will be deducted from it. Then, too, the retained percentage may be held up for months if there is trouble in reaching a final settlement. The

accountant who is dealing realistically with the affairs of contractors will give his treatment of this item careful thought.

There are also such items as listed securities, the cash-surrender value of life-insurance policies, materials in stock, and other items, each of which offers its own special problems. Such items as these have some quick asset value and so are generally included or includible in the financial statements on which prequalification rests. But most items of this type should be considerably offset by reserves. The price of listed securities fluctuates over a wide margin. Materials otherwise than on the job are apt to be of doubtful value as quick assets. Materials on the job should be discounted at least to the extent of the losses that are normal for such materials when stored on construction work.

This list might be extended and the offsetting current liabilities similarly discussed. However, the purpose here is to stress the thought that as the purpose of prequalification is to predetermine on a fair and reasonable basis what amount of work a contractor can safely be permitted to undertake, and as this will depend very largely on the working capital he can make available when needed, the determination of his working capital position becomes a matter of real importance.

If it were possible to stop at this point it would be safe to conclude that the rendering of reasonable conclusions in this field involved few seriously complex problems. But it is not possible to stop at this point, for contractors have fixed assets as well as current assets, and it is not an uncommon practice for them to borrow against these assets and, in a good many instances, on little more than the confidence bankers have in them as businessmen. For this reason most systems of prequalification, as currently in effect, make some allowance for fixed assets in determining the amount of work contractors can handle.

This allowance is, of course, based on the assumption that funds can be borrowed against these fixed assets, if the need arises.

The simplest solution of this problem is to accept as working capital letters of credit at face value. The assumption here is that whether the letter of credit is based on fixed assets or on the banker's confidence in the contractor as a businessman is immaterial, since available cash can be increased by the amount of such letters of credit whenever this cash is needed. This solution is not as simple as it sounds, because bankers sometimes withdraw letters of credit with rather scant notice. In spite of this problem the use of letters of credit involves, they appear to afford the best means of determining the extent to which assets, other than current assets, can be made to provide cash. They are, for this reason, to be preferred to estimates based on arbitrary rules.

To put this matter in a little different way, the practice of basing a contractor's position wholly on the amount of his current assets has no more to recommend it than such a practice would have in considering the financial standing of men operating in other lines of business. Strong business concerns maintain relatively large current assets because conducting business in this way is easier, safer, and more economical. But even of the very strong firms many find it desirable, at times, to call on the banks for assistance. Indeed, many strong concerns borrow a considerable part of the capital that is employed in the businesses they conduct. The fact that borrowed funds will be required, if a normal volume of business is to be conducted, is not the matter of prime importance in considering the financial position of a given concern. The question of importance is whether such borrowings are adequately protected. If they are not, the support they give to the business will, as a matter of course, be withdrawn if there is the

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slightest suspicion that the protection is inadequate.

In the field of prequalification it has already been observed that letters of credit are, in many places, recognized as a valuable and a useful appraisal of the banking support on which a contractor can depend—in short, as a part of the cash on which he can depend, the volume of work he will be permitted to take being increased accordingly. But the use of letters of credit in establishing contractors' ratings is not universal. Where they are not used, other methods of determining the effect to be given a contractor's fixed assets are in use. The most common of them is to allow something for the value of the equipment owned. Equipment naturally is a large element in a contractor's fixed-assets account, but normally it has such a low resale value that banks do not rate it very highly as an asset suitable for protecting loans. There is, therefore, little logic in using it as a factor in determining the amount of work a contractor may carry. Just how illogical it may be can be shown by the following illustration. Owner A at one time prequalified contractors as capable of handling work to the amount of five times net current assets plus the determined value of equipment owned. Determined value was accepted as cost when new, less reasonable depreciation.

The statement of contractor X showed net current assets—practically all cash—of \$10,000 and equipment worth \$250,000. The statement of contractor Y showed current assets of \$60,000 and equipment worth \$50,000. The first was rated as able to handle \$300,000 worth of work, the second \$350,000 worth. Actually, because of his inadequate cash resources and for other reasons not fully disclosed in this brief statement, contractor X was not in a position to finance a third of the work for which he was prequalified under this rule or to make use of twenty-five per cent of his equipment. Nor could he help

himself much by borrowing on his surplus equipment.

Contractor Y, on the other hand, had all the equipment he needed in order to handle the work for which he was prequalified and possessed plenty of working capital to finance his operations. It is evident that contractor X had depleted his working capital by excessive purchases of equipment.

The value of this illustration does not lie so much in the fact that it shows the difficulties into which arbitrary rules can lead a prequalification officer as in the fact that it stresses the point that unless contractors are required to limit their activities to work they can finance out of their own resources,—and no one assumes that this is desirable,—the problem of determining what allowance should be made for other things is one difficult to reduce to any set rule. This is an important fact, for where public officials are involved, though they may be fully competent to rate the financial strength of a contractor as accurately as a banker could, they are not in a position to do so except when they act uniformly under some rule or law. If they act otherwise, they are liable to be subject to the criticism that their decisions are arbitrary and capricious.

These comments have served to indicate that, though controlling conditions differ a good deal from place to place, for any given place these conditions being known, it is possible to determine the ratio that ought to be maintained as between the volume of work a contractor should carry and the amount of his working capital. Also, it is not difficult to determine a contractor's net quick assets with a reasonable degree of accuracy. If, then, a contractor uses no working capital except his own net current assets, the determination of the amount of work he should be permitted to carry is quite simple. But if he has large investments in fixed assets—equipment, plant, real estate, etc.—and, with entire propriety, depends on loans

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based perhaps directly, perhaps indirectly, on these things, to provide a considerable fraction of his working capital, the problem is not so simple because no rule has been devised which will accurately evaluate all of the factors that are involved. Although we get along fairly well without such a rule, one would certainly be useful.

In these comments some stress has been laid on the objectives the prequalification of contractors attempts to reach and on the practices that are followed. Those of us who are interested in the prequalification of contractors look forward to a greater standardization of the rules for prequalification. As a matter of fact, the Associated General Contractors and the American Association of State Highway Officials are at present actively working in that direction.

It is the usual practice to require that financial statements presented by contractors seeking prequalification be prepared by properly accredited public accountants. There appears to be no thought of eliminating requirements of this sort. But the fact that reliable financial statements are required sug-

gests that the standards applicable in their preparation are of quite enough importance to warrant close coöperation between your local organizations and those organizations interested in prequalification. In particular, the maintenance of frequent contacts with the various state highway departments which prequalify contractors, and the exchange with these departments of views and comments, should prove of value to them and to the members of your organization.

Finally, one of the matters currently of some importance to contractors is the fact that the form and arrangement of financial statements—even the financial data required—to be used as a basis for prequalification, differ a good deal from place to place. Efforts are being made to standardize the information called for. Progress is being made toward standardization but a great deal still remains to be done. I feel certain that suggestions by your organization as to how the form, arrangement, and subject matter of these statements can be improved would be welcomed by all of those dealing with this matter.

Accounting for Highway Contractors

BY B. W. COULTER, AUSTIN, TEXAS

Prequalification engineer, Texas Highway Department

IT OCCURS to me that the subject of accounting for highway contractors falls into two general classifications, both very simple, (1) *Why* accounting for highway contractors, and (2) *How* accounting for highway contractors.

The first, or "why," means in its simplest term the prequalification of highway contractors. Prequalification means determining before bids are opened how much work a contractor should have under way at one time.

Most public bodies in advertising for bids insert a clause that states in effect that the work will be awarded to the lowest and best bidder, and both terms have the same force. It's easy to determine the lowest bid, but it's not easy to determine the best bidder; the lowest bid is not always the best bid.

Prequalification undertakes to determine the best bidders before bids are opened and read, so that the awarding authority will only have to determine the lowest bid; in short, all bids read on a project are the best bids.

Now to determine the best bidders, we must have some definite rules and regulations, and, as cash, or items that can be quickly turned into cash, is the principal factor in rating, we come to the reason for submitting financial statements.

When Texas first inaugurated prequalification of contractors we stated, "A financial statement must be on file," etc.—rather broad and a lot of loopholes. Contractors or their bookkeepers prepared their own statements and they were all good, and naturally so. A highway contractor is the greatest optimist in the world—if he were not an optimist he would not be a contractor—and his old statements reflect his

optimism. Every dollar owing the contractor was easily collectible, and every dollar he owed was a long-time obligation, "fixed liability." We saw our error and changed our rule to read: "A *satisfactory* financial statement," and had the commission pass a minute requiring "The statements to be audited by an independent certified public accountant." Then quite a change took place.

What, if any, are the advantages and disadvantages of prequalification?

Perhaps state highway departments are not legally responsible for debts incurred on highway work, but they are certainly morally responsible to the laborer and small-material furnishers in the community in which work is being done, and prequalification assures the highway commission that the low bidder has sufficient funds to carry the contract through, and the same statement holds for material and equipment dealers. Financial statements submitted to us are submitted to banks and bonding companies, and in several of the counties of Texas which had county road bond issues the county required statements that the contractor desiring to bid must be qualified with the state highway department.

Since prequalification has been in effect in Texas some ten years, we have not had a forfeited contract, and this covers more than \$250,000,000 worth of construction work, some of it during the worst period of the depression. Contractors themselves are for prequalification; it assures them fair and legitimate competition.

Now for disadvantages. Some complain that prequalification restricts competition. This might be true to a certain extent but it restricts only those

who should not be allowed to bid. Another complaint is that we do not allow a contractor his entire net worth, and if we err we are erring on the safe side. Our answer is that contracting is big business, and when a contractor ties up part of his liquid assets he is also dividing his time and energy, and he should not have too much construction work under way.

Now let us consider the "how" of "Accounting for Highway Contractors." Perhaps we can name this "uniformity" of accounts.

Suggested Liquid Assets:

Cash on hand and in bank.

Listed stocks and bonds at market value.

Approved accounts receivable within 90 days. (One year?)

Approved notes receivable within 90 days. (One year?)

Amounts earned but unpaid on completed contracts.

Amount of bid deposits.

The amount of all retained percentages on contracts not behind schedule.

The value of unused materials delivered at the site of the work on going contracts.

Any other assets readily convertible into cash, including cash-surrender value of life-insurance policies.

The amount reflected in properly certified letters of credit.

Suggested Current Liabilities:

Notes payable to banks.

Equipment obligations payable within one year.

All notes payable to materials companies.

Notes payable to others within one year.

All sums due subcontractors.

All accounts payable for materials.

Other accounts payable.

Net Liquid Assets:

The difference between liquid assets and current liabilities.

These suggested assets and liabilities were drawn up by a joint committee of state highway officials and the associated general contractors. If these were all submitted, we prequalification engineers would have no trouble, but on the statements accountants sometimes speak in a language hard for at least one engineer to understand. Here let me mention some items on which we differ.

First, utility and insurance deposits are nearly always listed as liquid assets. These might be cash items, but if turned into cash the utilities cease and insurance stops; hence, we believe these should be listed as fixed assets.

Second, notes or accounts receivable from officers and employees. The value of these accounts hinges on whether the employee remains in the contractor's employment. Cannot this be determined as well as whether the accounts are being repaid?

Now the real bugaboo—"work under way" or "work in progress." Often this item runs into real money. It often involves "move in expense," "cost of bond," "plant set-up," and others before an estimate can be earned. These items should be distributed through the various bid items, and more often these items are distributed in those items which will be constructed first, for which the contractor will receive early payment. It might be that "work in progress," or part of the item at least, could be classified as "inventory." Some items are not paid for until completed, and some "work in progress" might come under this category. Make an effort to determine how this should be classified. Make a note on your audit and perhaps we can clear it up.

Inventory: An item that can be easily duplicated. A report from the field might show the "material on hand" and the office might show it under "work in progress." Material en route to a project should be shown, provided invoices are on hand offsetting the material.

Accounting for Highway Contractors

On midyear statements estimate the amount of income tax accrued. This is an item often not shown.

Stock in affiliated companies: If possible, get us a valuation of this stock—and tell us whether the stock can be sold if necessary.

You will note we are asking a good deal of the accountants preparing

financial statements, but on the statements the financial rating of the contractor is based. What was previously said about the highway departments' and the general public's confidence in prequalification is strictly up to the accountants, for it is on statements prepared by you that the rating of a contractor is based.

Prequalifying Financial Statements of Bidders on State Highway Work

BY W. A. HIFNER, JR., LEXINGTON, KY.

Member of special committee on accounting for state highway departments, American Institute of Accountants

WITH the advent of motor vehicles some thirty to forty years ago, the demand for more and better highways grew by leaps and bounds. Most of the roads had then become "free turnpikes" under the control, in each county, of the county fiscal court, and it was at first thought that the building of new and better roads was a county problem. After most of the counties east of the Mississippi River had practically bankrupted themselves in an endeavor to supply the ever-increasing demand, it was realized that through highways are a state and federal problem. (In September, 1940, Perry County, Kentucky, became the first county in the nation to file petition in bankruptcy, under the recent federal law authorizing such procedure, in order to adjust its indebtedness incurred for building roads.)

With the assumption of responsibility by the states for the construction and maintenance of primary roads, the functions of state governments were greatly augmented and state highway departments were created to handle the situation. Today such departments in each state vie with or even outrank the department of education, both in number of employees and annual expenditures.

The highway departments usually perform maintenance work by day labor, and no contracts are involved other than the purchase of materials at unit prices. Both new construction and reconstruction of highways are usually performed under contract. The contracts are awarded as the result of competitive bids, but in most of the

states only those who have previously qualified are now entitled to submit bids.

Originally, no prequalification was required of bidders, and the gates were open to all who cared to enter. The day of opening and letting bids was a gala event, with political leaders much in evidence, and, all too frequently, an utterly incompetent contractor was awarded a contract. The highway departments were saddled with irresponsible parties without sufficient equipment to perform the work and without sufficient means to carry it on. They were burdened with litigation and became veritable collection agencies. While bonds are required for specific performance, experience in their enforced collection has not always been satisfactory.

PURPOSE OF THE FINANCIAL STATEMENTS

A number of years ago, in order to protect the responsible contractors and weed out the irresponsible, and in order that the highway departments might know something definite in advance of those desiring to bid on contracts, there was developed, at a joint conference on construction practices of the American Public Works Association and the Associated General Contractors of America, a combined "financial statement and experience questionnaire" to be required of prospective bidders before submitting bids. We are presently concerned only with the "financial statement," which is unique and presents one of the anomalies in accounting procedure. The statements are for a definite

purpose and have little or no value for any other purpose. The highway departments are interested only in whether the prospective bidder has sufficient equipment to perform a definite class of work and sufficient current assets (practically the equivalent of cash) to discharge definite contractual liabilities. The departments are wholly uninterested in how such assets may have been acquired and in the earnings over any period of time. Based upon the financial statement, the prospective bidder is given a rating of, usually, fifteen times the net current assets, provided he has sufficient equipment to perform that amount of work. Thus, if a prospective bidder shows net current assets of \$50,000, he is given a rating that will permit bids on contracts up to \$750,000, provided he has sufficient equipment to carry on a contract of that magnitude. However, the method of computing ratings is not uniform throughout the states. Some of the states give considerable weight to bank letters of credit, whereas other states do not appear to take such bank letters of credit into consideration.

Inasmuch as construction work in progress is financed, in large measure, from the proceeds of bank loans, it would seem that such bank letters of credit should be given due weight in computing the ratings.

The combined "financial statement and questionnaire," either in original or modified form, is now in use by more than half of the state highway departments. Only a few states, however, require that it be verified by an independent certified public accountant. The Kentucky highway department adopted this rule some four years ago, and it reports that the results have been very satisfactory. The first year the rule was adopted it eliminated a number of small and unscrupulous would-be contractors that had theretofore caused the department much annoyance.

Inasmuch as the form is already in

such wide use, it has been the purpose of our committee and it is the purpose of this meeting to determine what modifications are either necessary or desirable to standardize the form from an accounting viewpoint, and then to urge its uniform adoption by the highway departments of the various states. When this is accomplished, it will greatly simplify and make less expensive the qualification of contractors in states other than that of their domicile.

APPROACH TO THE PROBLEM

Such modifications of the original form as may be determined to be desirable will depend upon the approach of the accountant in the verification of the financial statement. Such approach involves two distinctly different procedures.

One such procedure is to let the form itself provide sufficient space in the supporting schedules, under the heading of "Method of verification," to permit the accountant to state exactly what he has done or not done in verifying that particular item. Many prospective bidders engage in some form of business other than contracting, such as coal, quarries, building materials, etc. They have inventories not usable in road construction and numerous small accounts receivable that will be paid sometime—maybe. By centering his time on those items in which the highway department is interested and which enter into the bidder's rating, and avoiding waste of time on those items in which the highway department is wholly uninterested, the expense of the preparation of the statement may be considerably curtailed.

The states of Indiana and Kentucky make use of the form modified in this manner.

The other approach to the verification of these statements is to make use of the form in practically its original draft, together with printed or mimeographed instructions as to how the

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accountant should proceed in the verification of each item. The form is predicated on the assumption that the accountant has so proceeded. Thus if a contractor happens to be also a retail dealer in coal and has an inventory of ten thousand tons, the accountant is presumed to take some steps to verify such quantity, notwithstanding the fact that to the highway department the item is of no consequence whatsoever. The instructions are usually either similar or identical to the precepts in "Extensions of Auditing Procedure" adopted by the American Institute of Accountants.

Typical of this approach is the procedure now in use by the highway department of the Lone Star State.

PREPARATION OF THE STATEMENT

The verification of the balance-sheet items and the resultant preparation of the statement does not deviate materially from routine accounting procedure except in two items, viz.:

1. Accounts receivable—contracts in progress.
2. Plant and equipment.

The statements are, as a rule, prepared as of December 31st and filed not later than March 15th. The highway department then has thirty days to compute the rating and this rating remains in effect for one year. New statements and new ratings are required annually.

In computing its rating, the highway department gives no consideration whatever to the spread between the contractor's costs on December 31st and the engineer's estimate of amount earned as of that date. In fact, the form does not seem to contemplate there should be any such spread, whereas, in actual practice, it is sometimes of considerable magnitude. On a \$500,000 contract, 25 per cent completed, the contractor's costs on December 31st may easily be \$25,000 in excess of the

engineer's estimate of the amount earned on that date. This is especially true in the southern states where work is not interrupted by winter weather. This spread is due to a number of causes.

In the first place, the engineer, in order to complete his work by December 31st, begins his field measurements around December 10th to 15th, and materials furnished and work completed after that date are not included, although the report is dated around December 31st when signed and delivered. He also follows the inherent trait of human nature to play safe, knowing that any errors in the monthly reports will be taken care of in the final estimate when the work is completed.

In the second place, the contractor's initial costs, such as moving in, stripping quarries, bonds, field offices, etc., are applicable to the job as a whole.

In the third place the spread may be due to the fact that the contract price is too low and the spread is only a part of a much larger amount that will be a loss when the contract is completed.

The contractor invariably wants this spread as a credit on his rating. If it represents materials and labor furnished on work not included in the engineer's estimate, it would be proper to so include it as a credit on the rating, provided the amount may be determined. As the accountant has no means of making such determination, he has no recourse but to list the amount among other assets that are not considered in the rating.

The schedule of plant and equipment was prepared for the purpose of informing the highway department of the various classes of equipment available for performing the different kinds of work. It is not only designed to give a detailed list of each major item, but, under the heading of "Remarks," it is desired there be indicated the previous conditions of servitude and present state of well being. Due to the heavy obsolescence and rapid depreciation of

the equipment used, it seems that some phases of this schedule are more properly within the sphere of engineers than of accountants. Where equipment is purchased new from the manufacturers and the purchaser has retained original invoices, it is usually possible for the accountant to obtain much of the desired information. On the other hand, where used equipment is purchased in lots for a lump sum, as so frequently happens, considerable difficulty may be encountered. The ease or difficulty in preparing the statements depends, in very large measure, upon the records of the contractor. If records are kept in order, the burden on the accountant is made much lighter. Experience demonstrates, however, that the records of most individuals and partnerships in the contracting business consist, like that of the farmer, almost exclusively of passbook and checkbook, without supporting vouchers, and in such cases the burden on the accountant is sometimes rather heavy. It is in such cases that the assistance of an engineer in inventorying and classifying equipment is almost imperative.

RECOMMENDATIONS

The following recommendations are now made:

1. It is recommended that the modified form now in use by the Department of Highways of the Commonwealth of Kentucky be adopted as a standard, subject to the changes and further modifications hereinafter proposed.
2. It is recommended that the "certificate of audit" be changed to conform to the requirements of the revised financial statements.
3. It is recommended that the accountant's responsibility in regard to plant and equipment be limited to dates of acquisition, costs, accrued depreciation, and recorded encumbrances. The names of manufacturers, motor and serial numbers, and, particularly, availability for use, should be determined by an engineer capable of examining and appraising the property. Such catalogue and description might be made under an independent schedule, subscribed and sworn to by such engineer, referred to under "Method of verification" and submitted as an exhibit. This would require no change in the form.
4. It is recommended that the several states adopt a uniform system in computing ratings, and that bank letters of credit be given due consideration in such computation.
5. It is recommended that prospective bidders be required to qualify, in the first instance, in their state of domicile or place of business, and that the highway department in such state then issue the contractor a "certificate of qualification" to be filed with the application for qualification in any foreign state. This may lead, eventually, to qualification by reciprocal agreements among the states. Such "certificate of qualification" might be worded somewhat along the line of the annexed exhibit.
6. It is further recommended that when the form, as so modified and changed, has been approved by the American Institute of Accountants, the president of each state society of certified public accountants be furnished with a copy, with the request he present the matter to the prequalification clerk of his state highway department and urge that the form be adopted in such state.

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STATE HIGHWAY DEPARTMENT
STATE OF

CERTIFICATE OF QUALIFICATION

TO WHOM IT MAY CONCERN, GREETINGS:

This is to certify that
(Name)

.....
(Address)

has submitted to this department a "Financial Statement and Experience Questionnaire" on the standard form approved by the American Institute of Accountants and verified by
a certified public accountant of the State of,
under date of19.....

Based upon the information so submitted this department has rated the
said, as being
(Name)

qualified to bid on highway work within this state upon the basis and not in excess of the amount indicated below, viz:

Net current assets	\$..... x	\$.....
Bank letters of credit	\$..... x	\$.....
Total rating	\$.....

Done in the city of and State of
this the day of 19

[SEAL] Attest: <i>Chief engineer</i>
..... <i>Prequalification clerk</i>	

Current Assets and Current Liabilities

BY RENÉ J. LEGARDEUR, NEW ORLEANS

Member of special committee on accounting for state highway departments, American Institute of Accountants

THE PART specifically assigned to me in this round-table discussion has no reference to scope and extent of audit, nor to accountant's certificate; these phases will be covered by someone else. My subject covers current assets and current liabilities, to be included or excluded as such, as they approach the borderline variety, with some reference to construction work in progress, and its estimate as a current asset either on the completion or the cost basis. My conclusions to include not only the initial balance-sheet, but also the interim financial statements.

Even under these restrictions the subject is rather an extended one, for after all the true position and value of current assets and liabilities constitute items of major importance in the analysis of such a balance-sheet.

I assume, of course, that the audit made is adequate and conforms with the standards of recognized and required accounting practice, and that I must analyze these current assets and liabilities without any consideration of the effect on them of the fixed and deferred assets and liabilities.

The first part of the problem is the consideration of the current liquid position of the contractor at the signing of the contract and, second, his improved or weakened current position indicated in the interim statements during the progress of the contract.

Assuming that the cash funds are verified and confirmed, no further discussion need be had on this current asset.

The same conclusions hold true as regards securities owned, provided they have a marketable value, and are shown at their realizable net value.

At the signing of the contract the notes and accounts receivable carried on the balance-sheet have presumably no bearing on the contract just entered into.

Contractors are expected to collect all the receivables arising out of any contract shortly after the completion of that contract and therefore, any past-due receivables of that nature, unless fully secured by collateral, should be rejected as a current liquid asset and should under no circumstance be accepted, even under a recognized moral value, except with an adequate reserve.

The contractor at the beginning of the contract should have a clear, definite current liquid net worth, of such established value, with reference to the contract entered into, and invested in the carrying out of said contract, that his risk of financial loss for failure to carry out the contract is as great, if not greater than that of the highway department contracting with him.

Naturally, in the consideration of this initial current position, items of value of securities and receivables of the borderline variety, might consistently be resolved in favor of the contractor if his fixed position warrants this.

We now must take up the current liabilities and we consider as current those liabilities that will or may become due and payable during the course of the contract, whether actual or contingent and those that are unsecured and are expected to be paid out of the proceeds of the contract. Fully secured liabilities, or liabilities which will become due long after the completion of the contract, may be ignored as current.

The initial tableau of the current position is now determined and should

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be compared with the current position of the previous year to determine whether or not the prospective contractor is progressing.

We now come to the second phase, being the consideration of the interim positions.

The contractor is paid on engineer's estimates with a certain percentage retained; this retained deposit becomes a current asset. To the current assets is now added the receivables arising out of the operation of the contract, provided that the amount due by these debtors, either as subcontractors or furnishers of supplies and material, does not exceed the amounts recoverable by them as subcontractors for progress work done by them, or as merchants. A new current asset arises now, being work in progress; the contractor, of course, on his balance-sheet carries this work at cost. At the time of the examination of the interim balance-sheet, the highway engineer in charge should take up this work in progress, and its value set forth in the balance-sheet should be not cost to the contractor but, conservatively, in the amount which under the contract the highway department would pay for it if it was then taken up, regardless of whether this is higher or lower than cost.

Another new current item on the

balance-sheet is the inventory of supplies and material on hand, to be consumed in the contract; this should be conservatively taken up at cost, for it was on this cost that the contractor based his estimate. Any substantial difference between cost and replacement cost should, however, be noted on account of its effect on future balance-sheets, as additional material is purchased.

In the liability section, it must be established that current liabilities secured or unsecured and having no bearing on the contract, were taken up in full as due, and that liabilities incurred for and in the progress of the contract are met fully when the interim payments are made, for completed work for which these liabilities are incurred, so that at no time will completed work be taken up and paid for, unless and until the liabilities directly resting against this completed work are fully paid or the funds for their payment provided for and set aside.

In closing it might be stated that in Louisiana, besides requiring a very complete audit and a detail reflecting actual cost on different types of operations, the contractor is required to file a complete statement of experience with the character and kind of work on which he is bidding.

XI

ROUND-TABLE DISCUSSION

Accounting for the Oil Industry

Leader: T. DWIGHT WILLIAMS

October 16, 1940

Accounting Policies and Practices as Reflected by Published Statements of Several Oil Companies

BY J. F. S. ARTHUR, DALLAS

Member, American Institute of Accountants

IN EXAMINING the questions raised by the subject under consideration, I have had the opportunity to review the published statements of thirty-two oil companies for the calendar year 1939. I have also had available the statements for two or three prior years of certain of the companies. These companies include a representative cross section of oil companies, ranging from the largest to the smaller concerns, down to some few companies with gross assets of less than ten millions of dollars each. In all, the gross assets of the companies considered amounted to over eight and one-half billion dollars at December 31, 1939. If size and extensive operations are criteria, then one should be able to glean some indication of what established and accepted, or acceptable, accounting practices exist for this most important industry.

However, this discussion should be within the bounds of the limitation: "as reflected by published statements." What does the lay reader gather? What may the analyst and statistician determine from the face of the statements and the relative notes? Not a great deal perhaps, and in many of the cases where there is any indication, it has been necessary to refer to the president's letter accompanying the financial statements to obtain any information at all.

A large proportion of the companies makes little, if any, reference to the various subdivisions of this subject, and from the statements of those which do indicate, it is evident that there is a considerable variety of treatment of the problems involved. It strikes me

that we are presented with an approach to the accounting matters concerned, not so much on a "generally accepted" basis, but rather on what may be termed—at least by the individual company concerned in a given peculiar case—an "acceptable" basis.

I. TREATMENT OF INTANGIBLE DRILLING AND DEVELOPMENT COSTS

Of the thirty-two published reports examined, in only twenty cases is there any reference to intangible drilling and development costs in the financial statements themselves or in the notes thereto; in seven of the cases the only indication is to be found in the accompanying president's letter; while in the remainder of the applicable cases neither the financial statements nor the letters contain any reference to the treatment accorded by the company to intangible drilling and development costs.

In four of the cases where reference is made, such costs are charged to income account as incurred, two of the companies being of medium size and two of them being smaller concerns. There does not appear to be any logical basis for such accounting treatment. In sixteen cases there is the definite indication that intangible drilling and development costs have been capitalized and are being written off to income account, generally on the same basis as depletion of producing properties. However, in three of the cases, such costs are indicated as being written off on an annual percentage basis, one case noting that the rate is 6 per cent annually, being the

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same rate as used for well and leasehold equipment. In another of the three cases last noted, it is stated that the annual write-off is computed on the same basis as depreciation of physical property. In the remaining one of the three special cases noted, it is stated that capitalized drilling costs are amortized at straight-line rates of 8 per cent annually in all cases, except as to wells located in Illinois (a state which became an important factor in production in 1939, and in which there is no conservation law in effect), which are amortized at 50 per cent a year. Does this indicate that the company in question believes proration regulations to be beneficial and that in territories where they prevail an average life of producing properties may be taken as a little more than twelve years, whereas in the State of Illinois, which has been the cause of considerable recent disturbance in the oil industry, an average life of two years for a producing property is probable?

In four of the applicable cases there is not any indication of the procedure followed, and in the seven cases in which there is a reference in the president's letter accompanying the financial statements, a partial indication only is made, to the effect that intangible drilling and development costs are capitalized, one being left to assume that such costs are charged to income account on the same basis as depletion is charged. It is always assumed that companies charging off these costs on an annual percentage basis are in a special and limited category. However, the estimate (or guess, if you care to consider it such) as to the length of life in years may not be at any greater variance from the facts, as ultimately developed, than are estimates based on geological data. But it must be stated that the latter procedure is based on a determined effort to ascertain as many of the controlling factors as may be possible and is, one imagines, the basis on which prospective producing properties are purchased.

It may be noted that in many cases the capitalization of intangible drilling and development costs has been a comparatively recent procedure, many of the companies now following this procedure having previously charged such costs directly to expense, advising the reader in the published statements or president's letter as to the date on which the change in procedure was adopted. A number of the concerns state in effect that as to the readjustment of accounts at the date stated, nothing has been done. The matter perhaps has been considered, but the subject having been raised, is left in suspense, and the reader of the statements is left to do his own guessing, on the very solid basis of being in possession of few, if any, of the facts. Some of the companies do state that intangible drilling and development costs, in an amount sometimes stated and sometimes not stated, are still claimed as deductions for federal income-tax purposes. This inevitably leads one to the thought that accepted accounting practices in this industry are at least reasonably elastic, sometimes controlled by the concepts of tax assessors and sometimes changed to accord with a proper conception of the economic difference between a capital and a revenue expenditure.

It is perhaps reasonable to state that few manufacturing or utility concerns ever charge directly to income the costs of excavation for a power station or other facility necessary for the continued production of income, but rather capitalize such costs, charging them to income over a period of time, in accordance with some attempt at an economic concept of the diminution of utility value. Why, then, should the oil industry be peculiar, except that it is?

Summarization of statements

Treatment of intangible drilling and development costs:

Policies and Practices of Oil Companies

Financial statements indicate treatment.....	20
President's letter only indication	7
No indication made.....	4
Partial indication only made...	7
Amounts capitalized and amortization deducted in income account.....	16
Amounts written off as incurred	4
Not applicable.....	1

II. TREATMENT OF INVENTORIES, LAST-IN, FIRST-OUT, OR OTHER BASIS

It is necessary, in considering the accounting treatment of inventories, to consider three subdivisions of the subject: first, that relating to the crude-oil inventory; second, as to the inventory of refined oils and products; and third, as to the inventory of materials and supplies. Before considering these subdivisions, it is to be noted that of the financial statements reviewed, in twenty-three of the thirty-two cases, there is not any indication as to whether the last-in, first-out basis is used, and in seven of the cases there is the statement (appearing in the financial statements of five companies, and in the president's letter of two companies) that such is the basis of considering the inventories of crude oil and/or refined oils and products. However, in two cases, where an indication of procedure is noted, a special treatment is accorded in respect of crude oil and refined products.

The Continental Oil Company states as follows:

"The policy of the companies in valuing inventories at the end of each year is to use the lower of book value or market as described below. The book value of crude oil is determined on the average basis, i.e., to the value of the inventory at the beginning of each month are added the purchases at cost and the production at posted prices during the month plus transportation to refineries at tariff rates, which results in a new average unit price for calculating the cost of current sales,

crude oil consumed, and closing inventory. No difference existed between the book value of crude oil at December 31, 1939, and the market value thereof based on posted prices plus transportation at tariff rates as crude oil was written down to market at December 31, 1938, and there were no changes in the relative posted prices and transportation rates during 1939. The book value of refined products at refineries is also determined on the average basis, i.e., to the value at the beginning of the month is added the cost of crude oil consumed calculated at posted prices plus transportation at tariff rates plus refining expenses, and the average of this total is used in calculating the cost of sales and transfers.

"Depreciation of refining facilities is not used as an element of cost in computing cost of refined products. The book value of refined products at distributing stations is based on wholesale tank car prices at refineries plus cost of transportation to stations. The book value of refined products as so determined was less than market value based on wholesale tank car prices. The inventories calculated on the foregoing basis contain an element of anticipated profit but the amount thereof cannot be readily or accurately determined."

In this connection the following comment in the accountant's report may be noted:

"The valuation of inventories, the basis of which is explained in note one, contains an element of anticipated profit. While this basis of valuation does not follow the general practice of valuing inventories at the lower of cost or market, in that it does not exclude said anticipated profit, it is a generally accepted practice of valuation in the oil industry to which we take no exception."

The Ohio Oil Company states that its procedure is as follows:

"The amounts included herein for reserve crude oil stocks of the companies located in Illinois and Ohio represent the balance after write-down to posted

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market prices at January 1, 1939, and other inventories of crude oil are included at 'cost' (based on market as of date of production for oil produced) after relieving inventories at the average cost of produced and purchased oil (but excluding reserve stocks from computations), except as to relatively small amounts at refineries which are included at cost to the refineries based on market as of date purchased. Refined products are included at approximate cost to the refineries. The amounts included for inventories, in the aggregate, did not exceed market at December 31, 1939."

As to the basis of valuation of crude oil, nine concerns state that market price is used; ten use cost, which is asserted by the reporting company to be lower than market; three use cost or market whichever is lower, and three state that inventories are stated at lower than market, with no indication, however, as to how much lower or what the relationship is to cost.

Two concerns make note of a special valuation basis, one of which, the Ohio Oil Company, has been mentioned previously, while the Union Oil Company of California states in the following note to its financial statements, that basic prices have been used since December 31, 1935:

"Since December 31, 1935, the principal commodities in the inventories have been priced at basic prices which, except for relatively minor reductions in a few instances, have not since been changed, and all other commodities have been valued at the cost levels obtaining in the third quarter of the calendar year. Inventories of crude and refined oil products at December 31, 1939, priced by these methods, were in the aggregate \$900,000 below costs in the latter part of 1939, which costs were below market. Costs in the latter part of 1939 were decreased chiefly by the larger proportion of Company production of crude oil as compared with purchases."

In three cases, one of them being Phillips Petroleum Company, there is no indication made as to the basis of valuation, and in two of the cases, both of small companies, crude oil is valued on the basis of sales prices to refiners and others.

Referring now to the basis of valuation of refined oil and products, the same three companies as mentioned in the case of crude-oil valuations are silent, and the same two small companies as noted previously refer to valuations on the basis of sales prices to refiners and others, this latter group being joined by one small concern reporting that refined products are priced at values based on wholesale tank-car prices.

The same two companies noted as using a special valuation procedure for crude oil are consistent in using a similar basis for refined oil and products.

Two concerns note market value as the basis for the valuation of this character of inventory; eleven concerns use cost values, asserted to be lower than market; four use the cost or market, whichever is lower, basis; and three companies, the same ones as mentioned previously in connection with crude-oil values, state that their refined oil and products inventories are priced at lower than market.

With respect to the basis of valuation of inventories of material and supplies, there is a certain variation in procedure in those reporting on new items, but a unanimous voice is heard in the case of those reporting on used items. In the latter case twenty-four companies make no comment, but in the case of the eight companies making any indication, all indicate that used items are valued at conditioned or estimated usable values. In the case of new items, eleven concerns report cost to be the basis, one states the basis to be cost or market, whichever is lower, and three companies give no indication.

In the remaining seventeen cases,

including among their number the largest of the concerns being considered, the statement is made that materials and supplies are valued at cost or less, one being left to consider that perhaps the "or less" refers to used items of the inventory.

Summarization of statements

Treatment of inventories—last-in, first-out, or other basis:

A. Oils and refined products:	
(a) Last-in, first-out basis noted.....	7
Other bases noted.....	2
No indication made.....	23
(b) Basis of valuation for crude oils:	
Market.....	9
Cost (stated to be lower than market).....	10
Cost or market, whichever is lower.....	3
Lower than market.....	3
On basis of sales to refiners and others.....	2
No indication made.....	3
Special valuation.....	2
(c) Basis of valuation for products:	
Market.....	2
Cost (stated to be lower than cost).....	11
Cost or market, whichever is lower.....	4
Lower than market.....	3
On basis of sales.....	3
Special valuation.....	2
No indication made.....	3
Not applicable.....	4
B. Basis of valuation for material and supplies:	
(a) New items:	
Cost.....	11
Cost or market, whichever is lower.....	1
Cost or less.....	17
Not indicated.....	3
(b) Used items:	
Conditioned value.....	8
Not indicated.....	24

III. TREATMENT OF DRY HOLES AND EXPLORATION COSTS

With respect to exploration costs there is almost a complete omission of reference in the financial statements and reports under review. Of the total of thirty-two companies considered, twenty-five make no comment, one indicates indirectly a special treatment, and five of the companies indicate that such costs are charged to income account.

Of the last-noted five concerns, four indicate a deduction in the income account, while one in its president's letter states that such costs are charged off as incurred although no specific item therefor is to be found in the deductions in the income account. The company which indicates, by inference, what may be termed a special treatment, is one of the most minor concerns being considered. In this case an item of "unallocated exploration costs" is shown in the balance-sheet as a subdivision of the income account, but it is to be noted that geological expenses and seismograph expenses are to be found as deductions in the relative income account.

As regards the matter of dry holes, fourteen companies make no comment, in one case the subject does not arise and in the remainder of the cases, seventeen in number, the reporting companies are unanimous in considering such costs as being charges to income account.

However, in one of these cases, namely, the Creole Petroleum Corporation, a qualification is made to the effect that "all dry holes, except obligatory wells drilled to acquire leases, are charged to expenses." This seems to be a proper observation and a satisfactory treatment of such costs, the cost of such drilling, whether productive or not, being certainly part of the cost of acquisition of the leases in question.

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Summarization of statements

Treatment of dry holes and exploration costs:

A. Dry holes:	
No indication.....	14
Charged to income account.	17
Not applicable.....	1
B. Exploration costs:	
No indication.....	25
Charged to income account.	5
Not applicable.....	1
Special treatment:	
Unallocated exploration costs carried as part of property accounts.....	1

IV. PRACTICES AS TO THE COMPUTATION AND PROVISION FOR DEPLETION AND DEPRECIATION

It will be necessary in considering this subject, which might readily become very extensive, to limit oneself to the terms of the discussion and within the bounds of the qualification as noted in my preliminary observations, namely "as reflected by published statements of several oil companies," otherwise little time would remain for other topics.

First, as to depletion, it is found that exactly one half of the number of companies makes no reference to the basis of the computation of depletion, and incidentally the same concerns make no reference to the matter of depreciation policies.

One company carries all leaseholds at the amount of one dollar only, and charges expenditures for oil and gas leases, and intangible development costs to expenses as incurred, and consequently the annual income account does not receive any charge for depletion.

In the remainder of the cases, fifteen in number, it is noted that depletion of producing properties is based on the unit of production method, twelve of the companies relying on estimates of the company's own geological and engineering staff, while three concerns, small in size, rely on the estimates of independent geologists, retained for the

purpose of preparing the estimates of recoverable oil in the producing properties involved. In the three latter cases, depletion is noted as being computed on the unit rate of production, by leases, while of the twelve former cases, one concern makes its computation on a "field basis," eight companies do not specify, and three use what they term the "over-all basis." In this respect the following quotations from the statements or reports of the three concerns using the "over-all basis" are of interest.

Cities Service Company states as follows:

"Effective January 1, 1939, all the oil-producing subsidiaries adopted the policy, previously partially in effect, (1) of providing for depletion of oil-producing properties on an "over-all" per barrel basis, such provision having previously been based on a percentage of the gross revenue from oil production, and (2) of charging lease cancellations and dry-hole costs against income instead of against the reserve for depletion."

The Pure Oil Company states, in a note to its financial statements, the following:

"Since January 1, 1934, the company has provided for depletion and depreciation of producing properties by applying to the total barrels produced an "over-all" rate (per barrel) determined by dividing the total amount of producing properties subject to depletion and depreciation by the net oil reserves (in barrels) estimated by the company's production engineers. The "lease" or unit method of providing depletion and depreciation is used by many oil producing companies. Both the "lease" and "over-all" methods contemplate the ultimate amortization of the investment in oil producing properties on the basis of estimated oil production; however, the yearly provisions to date under the "over-all" method have been materially less than would have been the case under the "lease" method.

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This is due to the fact that a disproportionate amount of oil has been produced from leases having a relatively high book value. The application of the "lease" method to such production would require a depletion and depreciation provision on a basis believed by the management to be inconsistent with the company's total oil reserves. Under the "over-all" method the provision for depletion and depreciation is computed upon the basis of the average rate for all producing leases."

Superior Oil Company states:

"The basis followed by the company, since January 1, 1932, for providing for depletion and depreciation, contemplates the amortization of the cost, less salvage value, of producing properties and other equipment (except automotive equipment) as a group proportionately with the recovery through production of the estimated gross revenue which will be derived from the underground oil reserves, which reserves are determined annually by the geologist for the company."

The following interesting cases as to the bases for depletion may be noted:

Transwestern Oil Company states:

"Depletion of producing leases and royalties, depreciation of tangible equipment on leases and amortization of intangible drilling expenditures have been provided for from the inception of the company on the unit rate of production method applied in each case to individual properties.

"To determine the rate used:

"1. As to producing leases and royalties—

The net depleted book value of a given producing lease or royalty is divided by the company's interest in the estimated remaining recoverable oil from such property, including the amount estimated to be recoverable as a result of estimated additional development.

"2. As to tangible equipment on leases—

The net depreciated book value of tangible equipment on a given property, plus an amount estimated to be sufficient to develop economically such property, is divided by the recoverable oil reserves computed as explained in 1, above.

"3. As to intangible drilling expenditures—

The net unamortized book value of intangible drilling expenditures on a given property, plus an amount estimated to be sufficient to develop economically such property, is divided by the recoverable oil reserves computed as explained in 1, above.

"Provision for depreciation of other equipment has been based on the estimated life of the equipment."

Union Oil Company of California notes that:

"The company capitalizes all expenditures for oil lands and development including the cost of fee lands and lease bonuses, lease rentals, wells and equipment and intangible drilling costs. For the most part such expenditures are amortized by charges to the income account as oil is produced on the basis of a per barrel rate determined at the beginning of the year by dividing the net property account plus expenditures estimated to be necessary to fully develop the proven properties by the estimated crude oil reserves in barrels."

while Republic Natural Gas Company indicates as follows, in a note to its financial statements:

"The allowance for depletion and depreciation, since January 1, 1934, and the provision for the year, have been based on combined unit rates for depletion and depreciation, which in the opinion of the management, are adequate to recover the present investment and the anticipated future investment

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in the properties, over their estimated ultimate productive life."

Now, as to depreciation, first of equipment of producing properties, it has been noted that half of the number of companies does not make reference to the company policy relating to depreciation, while fourteen of the companies indicate that the basis of computing depreciation of equipment of producing properties is the same as employed for the computation of depletion.

In one case, that of the Houston Oil Company of Texas, "depreciation" of development, including intangible drilling costs, and equipment of producing properties is at an annual rate of 6 per cent for 1939, as compared with 5 per cent per annum previously. It is to be noted that in this case the accountant's report makes an exception of the adequacy of the provisions for depreciation and depletion.

Depreciation of refinery, marketing, and other physical property, is only noted in eleven of the cases considered, all indicating that the straight-line basis is being used, three noting that it is by units, two noting that it is by groups of properties, and six concerns making no further comment.

Summarization of statements

Practices as to computation and provision for depletion and depreciation:

A. Depletion of producing leasehold costs:	
No specific indication	16
Unit rate of production basis used, company's own geological estimates used:	
By fields	1
Not stated	8
Over-all basis	3
Unit rate of production basis used, independent geologists retained:	
By leases	3
Certain cases involve estimates of future expendi-	

tures to obtain ultimate recovery	(3)
Leaseholds carried at \$1 only, consequently no depletion charges	1
B. Depreciation:	
(a) Producing property equipment:	
No specific indication . . .	17
On same basis as depletion of leasehold costs .	14
On straight-line basis . . .	1
(b) Refinery, marketing, and other property:	
No specific indication . . .	21
Straight-line basis by units	3
Straight-line basis by groups	2
Straight-line basis, not indicated	6

V. POLICIES REGARDING THE AMORTIZATION OF UNDEVELOPED LEASES

In six of the statements reviewed, we do not find any indication as to the companies' policies with respect to the amortization of undeveloped leases, and in one case the question does not apply. In the remainder of the cases, twenty-five in number, eleven indicate "lease amortization" as income deductions, one concern shows all oil properties carried at one dollar only—costs being deducted, as incurred, in the income account; one case made an explanation in a prior year, as to the restoration to property accounts of the unexpired portion of such costs, with subsequent amortization deductions being made, and twelve cases show undeveloped leases carried as a subdivision of the property accounts, but without any indication of amortization in the income account.

With respect to these last twelve cases, it is to be noted that either in the footnotes of the financial statements or in the president's letter of ten of the companies, there is the statement to the general effect that such costs are charged off, if, as, and when the leases are surrendered or forfeited.

Policies and Practices of Oil Companies

One concern of reasonable size, now listing "lease amortization" as a deduction in its income account reported as follows in its financial statements for the year 1936: "During the year the company restored to its accounts the unexpired portion of the cost of its nonproducing leaseholds . . . , and by action of the board of directors, credited the excess of x dollars to reserve for contingencies." The accountants' report comments on this change and notes the subsequent practice of amortizing such costs.

Summarization of statements

Policies regarding amortization of undeveloped leases:

Not applicable.....	1
No specific indication.....	6
Lease amortization included in income deductions.....	11
Explanation as to restoration of whole or unexpired portion and lease amortization now being deducted in income account.....	1
Costs carried in balance-sheet, but no indication of amortization in balance-sheet or income account.....	12
Leaseholds, developed and undeveloped, carried at \$1 only and consequently no amortization, but rather costs deducted in income account....	1

VI. POLICY REGARDING PROVISION FOR CHARGING OFF MINERAL RIGHTS OTHER THAN LEASES, PROVEN WORTHLESS DURING THE ACCOUNTING PERIOD

Little, if anything, can be found in the published reports considered on this subject. In four cases the income account does show that "worthless royalties charged off" have been deducted; in one case there is a reserve for property abandonments shown in the balance-sheet. This latter item may cover a great many items, just as may be the situation in the cases of the

eleven concerns which make no specific indication, but do list among the income deductions the item of "abandonments." Fifteen statements and reports give no indication of any character. Consequently, this question cannot be answered within the scope of the references of this discussion.

Summarization of statements

Policy regarding provision for charging off mineral rights, other than leases, proved worthless during the accounting period:

Not applicable.....	1
No indication:	
No reference of any character.....	15
Income account does make note of abandonments....	11
Balance-sheet shows special reserve for abandonments.....	1
Income account shows "worthless royalties charged off"...	4

VII. PRACTICE AS TO WRITING DOWN THE "VALUE" OF PROPERTIES, WHERE THE ESTIMATES OF RECOVERABLE OIL DISCLOSE THAT THE OPERATION OF AN OIL WELL WILL RESULT IN A LOSS EVEN THOUGH THE OPERATION FOR A PERIOD OF YEARS MAY RESULT IN DECREASING THE PRESENT INVESTMENT AND THE ULTIMATE LOSS

The published statements and presidents' letters give us little help or indication as to what the practice of the various companies may be, or may have been, in respect of this subdivision of oil-company-accounting procedure. Twenty-six of the companies give no indication whatever, and one case is not applicable. In the remaining five cases, little but indirect reference is to be found, as may be noted from the following quotations from the respective reports or presidents' letters:

Barnsdall Oil Company, in its president's letter, makes the following statement:

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"During the year, because of production being reduced to an uneconomical limit, 243.85 net wells were sold or abandoned."

However, there is no indication in the income account of such abandonments nor is there any separate showing of profit or loss on the sale of capital assets.

The Continental Oil Company's president's letter states:

"The company's investments in producing properties and prospective acreage located in Mexico and Canada were adequately reserved in previous years to cover any probable losses on such investments."

The company's balance-sheet carries a reserve of some \$624,000, and this may be the item to which reference is made. It is not clear why properties in Mexico and in Canada should be considered together; perhaps the phraseology in the quotation given may be read to indicate that "producing properties" refer to Mexico and "prospective acreage" refers to Canada, the former being reserved by reason of danger of governmental interference, and the latter by reason of doubt as to the possibility of profitable development.

Consolidated Oil Corporation carries a reserve item in its balance-sheet designated "Reserve set up January 31, 1932, for property abandonments," in an amount in excess of \$4,500,000, and in this connection it is to be observed that January 31, 1932, is the date noted in the balance-sheet description of the property accounts as the date as of which the property values existent at

that time were determined by the board of directors.

Tide Water Associated Oil Company notes in its president's letter as follows:

"A number of parcels of land leased in former years were quitclaimed, test wells drilled thereon by this company, or on adjacent lands by other operators having indicated that they would not prove productive."

Finally, Union Oil Company of California includes in its president's letter a tabulation showing changes in the property accounts during the year under report, and as a deduction lists a substantial item for "Lands relinquished, wells abandoned and other properties written off."

All these cases are inconclusive, and as one's reference is limited to the disclosures in the published statements and reports, the reader is left in the dark.

Summarization of statements

Practice as to writing down the "value" of properties, where the estimates of recoverable oil disclose that the operation of an oil well will result in a loss even though the operation for a period of years may result in decreasing the present investment and the ultimate loss:

No indication given.....	26
Note of wells being disposed of or abandoned by reason of uneconomical production.....	2
Note of adequate reserves previously set up.....	2
Note as to lands relinquished and wells abandoned.....	1
Not applicable.....	1

Computation of Allowable Depletion under Federal Income Tax Law as Applicable to the Oil Industry

BY WILLIAM L. CLARK, TULSA

Member, American Institute of Accountants

THE PRODUCTION of crude petroleum and of natural gas literally results in the exhaustion of such natural deposits, since they exist in but limited quantities as to a given pool.

Therefore, funds invested in an oil-and-gas-mining lease or royalty, or in the perfection or defense of title thereto, and, in some cases, funds expended for drilling productive wells, exclusive of equipment, constitute investments which, by reason of the exhaustion of value through the process of production, become worthless. The exhaustion of the mineral deposit and the approach to a state of worthlessness of the investment therein, are proportionate one to another, and usually occur over a period of time extending beyond the annual accounting period within which such processes first begin. This is to say that, excluding speculative fluctuations, when a portion of the mineral content of a property has been produced, the same proportion of the investment is thereby extinguished.

In accounting, whether for financial or tax purposes, and whether upon a cash basis or an accrual basis, this wasting away of investment must be recognized in each accounting period or subdivision thereof. The asset must be written down ratably by charges to profit or loss, designated "depletion," and contra credits to a valuation reserve, or to the asset account itself. Such depletion charges are part of the cost of the mineral produced to the surface and saved. If the accounting recognizes inventories of petroleum, and it should, such inventories may be priced at cost, composed of the depletion per

barrel, producing or lifting costs, and some portion of overhead. However determined, the inventory of crude petroleum is a factor in the determination of depletion for tax purposes.

Disregarding earlier attempts at taxing incomes in the United States, the excise tax imposed upon corporations under the act of August 5, 1909, measured by the amount of corporate income, may be said to be the first contemporary taxing act requiring the determination of net income, but that act made no mention of an allowance for depletion.

The first income-tax act, subsequent to the adoption of the sixteenth amendment, was passed October 3, 1913, and provided for deduction from gross income of individuals of a "reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per cent of the gross value at the mine of the output for the year for which the computation is made." That part of the revenue act of 1913 which defines deductions to be allowed corporations reads: "In the case of mines a reasonable allowance for depletion of ores and all other natural deposits, not to exceed 5 per cent of the gross value at the mine of the output for the year for which the computation is made." This act provided for depletion in the case of oil and gas, which were held to come under the classification "other natural deposits." The Commissioner of Internal Revenue construed this provision to allow a producer of oil or gas to deduct from gross income an amount equal

to 5 per cent of the oil or gas sales for the year without regard to the cost of the property remaining to be recovered or the value thereof as at March 1, 1913.

✓ The revenue act of September 8, 1916, provided in the case of both individuals and corporations, for deduction of "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade; in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow." As first administered by the Bureau of Internal Revenue, that proportion of the investment in an oil or gas property which was equal to the percentage of decline in production within the year, was allowed as depletion. In the case of oil, the decline in production was equal to the number of barrels of oil in daily production on the first day of the year less the number of barrels of daily production of oil on the last day of the same year. The percentage which this decline in barrels was of the total barrels per day being produced from a particular property on the first day of the year, was also the percentage of the investment to be allowed as depletion for the year. This often resulted in the allowance of no depletion due to the fact that, by reason of additional drilling during the year, the property was producing as much on the last day of the year as on the first day of such year.

While many income-tax returns still remained to be examined, the Bureau of Internal Revenue changed the method of calculating depletion in recognition of the fact that depletion occurred even though the average daily production did not decline during the year. As a result, the rule was amended to allow as depletion that proportion of the recoverable capital which equaled the ratio of one year to the total number of years

during which it was estimated the property would produce. Properties were rather arbitrarily estimated to have a life of from ten to fifteen years, and allowances for depletion were made in amounts generally ranging from one tenth to one fifteenth of the unrecovered investment. This often resulted in excessive allowances for depletion, and while many returns for 1916 still remained to be disposed of, the Bureau of Internal Revenue adopted the unit-of-production basis for depletion as to oil—the rule in effect today, but there was then no well established method of estimating the quantity of oil to be recovered over the life of a property. Both the decline in flow and the unit-of-production method continued simultaneously to be applied in settling income-tax returns for some time.

As to natural gas, for which no depletion was allowable under the act of 1909, and exactly 5 per cent of the sale price of the gas produced within the year was allowed under the act of 1913, the decline in rock pressure came to be the basis of depletion under the act of 1916. If the rock pressure in a gas well was, at the end of the year, equal to 80 per cent of the rock pressure at the beginning of the year, the decline in flow was estimated to equal 20 per cent, and 20 per cent of the recoverable capital was allowed as depletion for that year. Today, gas depletion is computed by this method, by the lapse of time against the estimated life of a gas property expressed in years, and by the ratio of volume of gas produced within the year to the total estimated volume to be produced over the productive life of the property, expressed in cubic feet. None of these methods of computing gas depletion is highly accurate.

The revenue act of 1917 did not change the provision that depletion, in the case of oil and gas wells, was to be computed upon the decline in flow. Some cases were settled on that basis, many on the productive-life-in-years

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basis and later, on the production-unit basis.

The revenue act of 1918 introduced two innovations as to depletion of oil and gas wells. It provided that the capital to be recovered through allowances for depletion should be "based upon cost including cost of development not otherwise deducted; provided, that in the case of such properties acquired prior to March 1, 1913, the fair market value of the property . . . on that date shall be taken in lieu of cost up to that date." The courts have applied this rule to years prior to 1918, and the statutes have continued the rule to this day, with the result that where a property acquired prior to March 1, 1913, increased in value before that date, the accretion is free from tax by reason of the fact that such accretion is added to the lesser cost in determining the amount of capital recoverable through depletion, over the productive life of the property. This rule is still in force, and notwithstanding the lapse of years has diminished the value thereof. There are still some properties producing today which were producing before March 1, 1913, and on that date were worth more than the previous cost thereof.

The revenue act of 1918, which applied to the years 1918 to 1920, both inclusive, contained a far more startling innovation (commonly referred to as "discovery depletion") in respect of oil and gas producing properties "discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the value of the property (was) materially disproportionate to the cost." In the administration of this unique provision, the Commissioner of Internal Revenue was persuaded to establish the rule that a commercially profitable oil or gas well created a "proven area" of exactly 160 acres, in the form of a square, the sides of which were due north and south and east and west, and the center of which was the mouth of a

commercially profitable well, not necessarily on the property of the taxpayer. For instance, the owner of the northeast quarter of a given section of land (congressional survey) on which no well had been drilled, would find that the northwest forty acres of his land was in a proven area, by reason of the fact that on his neighbor's land, a well had been drilled, an offset to his northwest corner. This neighbor's well established a proven area running exactly a quarter of a mile due north, a quarter of a mile due south, and the same east and west from such well. This area would take in all of the first-mentioned owner's northwest quarter lacking four hundred feet along the east side and four hundred feet along the south side of his northwest quarter, the distance from his line to such offset well. If the first-mentioned owner drilled a well on his own land in this area proven by his neighbor's well, he could not have the benefit of depletion based upon discovery value, unless he had purchased such tract, within such proven area, *before* his neighbor drilled such discovery well, but if he had risked his investment before the neighbor's well was drilled, he could wait until the neighbor's discovery well minimized the hazard of a dry hole upon the first-mentioned owner's land, then drill a well offsetting the neighbor's well, or anywhere within the proven area, and if a commercially profitable well, the first-mentioned owner would also be credited with a discovery well, although he had discovered no new pools. He would enjoy the benefit of depletion based on discovery value.

If he drilled other wells on his land within the area proven by his own well, the value added thereby was not the basis of additional discovery value recoverable through depletion, but if, on the same quarter section of land, he drilled a second well outside of a proven area, and such second well was commercially profitable, additional discovery value was thereby added, and

recoverable through depletion allowances.

The discovery value was held to be the value as on any given day within thirty days of the date of completion of the discovery well. The taxpayer usually elected to take the value as of the day within that period on which the value was the highest. The determination of such value was made by estimating, through the use of a projected production-decline curve, the ultimate production to be expected from the entire property, including therein all undrilled locations to the limits of a taxpayer's private bounding lines, multiplying the taxpayer's share therein, expressed in barrels, by the highest price per barrel being paid for oil in that pool at any time within said thirty-day period, subtracting therefrom the estimated average lifting cost per barrel over the life of the property, multiplied by the number of barrels estimated to be the ultimate production of the property, and further subtracting the cost of drilling future wells and equipping the same. The remainder was discounted for deferment by the use of Hoskold's 10 per cent time-weighted tables of discount, by which process from thirty to sixty per cent of the value might disappear as discount for present worth. Later on, the Bureau of Internal Revenue insisted upon a still further arbitrary discount of from five to twenty per cent for hazard.

Notwithstanding all these discounts, some taxpayers demonstrated values so high that the depletion equaled and even exceeded their net income from the property, and reported no taxable income whatsoever. The justification for the arbitrarily established 160-acre proven-area rule and resultant large depletion deductions was said to be that the relief from taxation thereby afforded induced accelerated oil exploration and production at a time when the country greatly needed oil due to the world war, but the war was over three

months before the law was passed.

This provision so highly favorable to the oil industry was somewhat curtailed when on November 23, 1921, Congress passed the revenue act of 1921, effective as of January 1st of that year, and provided in the statute that "such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made." However, with overhead and general expenses, it was still possible for oil companies to report no income from properties which were operated at substantial profits, all of which were absorbed by discovery depletion. The 160 acre proven-area rule continued to be in effect.

On June 2, 1924, the revenue act of 1924 became law and was made to apply to the calendar year 1924. The same discovery depletion provisions and administrative rules continued to apply, except the radical change by which the act limited discovery depletion to not more than 50 per cent of the net income from the property upon which discovery was made. By that time the Bureau had greatly reduced its idea of value by restricting the same through lower estimates of recoverable oil, lower prices per barrel and higher operating costs as well as other factors. So the reduction from 100 per cent of net incomes to 50 per cent net income was not as abrupt in initiation as the passage of the act nor as severe as the difference in percentages would seem to indicate. Nevertheless, the liberal times were gone. Depletion was getting down to a much lower basis than that in the revenue act of 1918.

On February 26, 1926, the revenue act of 1926 was enacted. The complicated procedure of discovery depletion was entirely swept aside. In place thereof, depletion was allowed on a basis of cost or value as at March 1, 1913, unless depletion computed upon a "percentage-of-income basis" resulted

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in a greater allowance, in which event "percentage depletion" was allowable. Percentage depletion was fixed by statute at "27½ of gross income from the property during the taxable year" but not to "exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property." This continued to be the statutory provision of the revenue acts of 1928, 1932, 1934, 1935, 1936, 1937, 1938, 1939 and the first revenue act of 1940, now known as the Internal Revenue Code. (Sec. 114 (b) (3).)

However, many changes have occurred since percentage depletion was inaugurated in 1926. At first, net income of the taxpayer from the property was accepted by the Bureau to be gross receipts from the sale of oil and gas, less the direct operating expenses, depreciation and taxes directly applicable to such production, without reduction thereof for any portion of overhead, intangible costs incurred within the year in drilling additional wells on the property, interest and financing charges, bad debts, etc. Now the courts have held that where intangible costs of drilling a well on the property are paid or incurred within the year (depending upon the method of accounting) all such costs must be deducted from gross income from the property in arriving at net income of which but 50 per cent may be allowed as depletion. All forms of overhead, financing and indirect expense, losses, if in any way connected with the business of producing oil or gas or both, must be used in reduction of net income the measure of the depletion limitation. However, if the taxpayer in addition to production is engaged in more than one line of business, such as drilling wells for hire, refining, trading in oil properties, or other unrelated activities, the expenses, taxes, losses, etc., related thereto, and the portion of overhead properly allocable thereto, may be excluded from the calculation of "net income from the prop-

erty" in determining depletion. Incidental operating revenues, such as steam sales or fees paid by oil-purchasing agencies for pumping oil from lease tanks into purchasers' lines, rentals of tools used in lease operations, etc., are not additions to gross income upon which 27½ per cent gross income depletion is to be computed, but are to be deducted from operating costs thereby increasing "net income" from the property and affecting the amount of allowable depletion if the basis thereof is 50 per cent of net income.

Thus it may almost be said that if a taxpayer had no business other than drilling for and producing oil or gas, "net income from the property" would be substantially such taxpayer's net income before depletion, after provision for all other profit-and-loss debits, except that upon a sale of a property which during the year of sale has produced, the proceeds of sale are not to be included in gross income from the property nor in net income therefrom.

Royalty owners invariably find that their percentage depletion allowance is 27½ per cent of gross income, for they do not have a sufficient amount of other deductions, and no operating expenses, to reduce net income to an amount less than 27½ per cent of gross income. If operating expenses, depreciation, overhead, etc., amount to less than 45 per cent of gross income from the property, then depletion is limited to 27½ per cent of gross income, but if such expenses are more than 45 per cent of gross income, the depletion allowable is limited to 50 per cent of net income from the particular property.

If in any event percentage depletion upon a given property, regardless of other properties, is less than the depletion deduction would be if computed upon the statutory cost basis, or on the value as at March 1, 1913, then the deduction for depletion is to be computed upon such cost basis rather than on the percentage basis, but this cost basis

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sometimes is not the amount paid for the property by the taxpayer, with additions to cost after acquisition by reason of title litigation, etc., as will be noted, for example:

If in the first year in which a property is produced, provided that first year is subsequent to December 31, 1931, depletion based upon a cost of say \$100,000, is \$30,000 and percentage depletion allowable for that year amounts to \$40,000, the differential of \$10,000, the excess of percentage depletion over cost depletion, must also be used in reduction of subsequently recoverable capital so that while in the financial statements the recoverable capital in the property after the first year is \$70,000, the recoverable capital for federal-tax purposes is but \$60,000. If in the second year, say by reason of a decline in the price of oil, percentage depletion is very low, it may be that cost depletion will apply, but this cost depletion will be based on a residual cost of \$60,000 and not \$70,000. This differential will likewise affect any subsequent year in which cost depletion applies in lieu of percentage depletion. Hence cost depletion, under the Internal Revenue Code, and residual cost in a property, will differ from cost depletion and residual cost as computed correctly for the financial statements of the taxpayer.

If for any period *prior* to January 1, 1932, percentage depletion on a given property was in excess of cost depletion, then for the purpose of computing taxable income under federal statutes, the recoverable capital in the property is not to be reduced by such excess of percentage depletion over cost depletion accrued prior to January 1, 1932. The result is that if for any year after December 31, 1931, percentage depletion is used as a deduction because greater than cost depletion for that year, then in any *subsequent* year in which the depletion deduction is based upon cost depletion because greater than percentage depletion, the cost depletion

for that year will be less than true-cost depletion such as would be used in compiling a financial statement, and this for the reason that in such previous year recoverable cost has been reduced by more than actual cost depletion for such previous year.

Furthermore, in computing the cost of a sale of an oil- or gas-producing property, the cost basis thereof must be reduced, not merely by depletion sustained based on actual cost (as would appear in financial statements) but also by any excess of percentage-over-cost depletion which may have been allowable for the taxable year 1932 or any year thereafter. This provision first appeared in the revenue act of 1932 (section 113 (b) (1) (B)) and is today contained in the Internal Revenue Code (section 113 (b) (1) (B)).

Thus it will be seen that, since discovery value depletion has not been allowable for any year since enactment of the revenue act of 1932 (nor since the year 1924), in no event is the basis for computing profit or loss or depletion of an oil- or gas-producing property to be reduced by the excess of discovery depletion over cost depletion; while on the other hand, the greater of all depletion allowed or allowable since December 31, 1931, whether upon a cost basis or a percentage basis, must be used to reduce the basis for computing profit or loss upon sale, exchange, loss or abandonment, or calculation of cost depletion, for any subsequent year. Percentage depletion confers a boon upon the taxpayer by permitting some actual profit to be untaxed, to the extent of the excess of percentage depletion over cost depletion, but this boon is entirely lost if the property is sold, or exchanged in a taxable transaction, and the total depletion deduction is not equal to the total cost basis of the property. If, however, the total depletion deduction is in excess of the cost of the property, then even though the property is sold, the taxpayer will have realized untaxed in-

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come equal to the excess of the total depletion deduction (over the entire period of ownership) over his total cost.

The factors necessary to determination of depletion in the case of oil or gas properties are three in number: (1) the cost or other basis of the property; (2) the estimated quantity of oil or gas in reserve, which it is believed can be recovered in profitable operation over the productive life of the property; and (3) the number of barrels, or thousands of cubic feet of gas produced during the taxable year.

The first factor, cost, presents no particularly difficult problems as a rule. It represents the cash or equivalent paid for the property, value of any services rendered as consideration for the acquisition of a property, the expenses of examining and recording title, and in case of litigation for the purpose of either perfecting or defending title, all costs in respect thereto.

Regardless of his election in any taxable year ended before January 1, 1925, to expense or to capitalize intangible development costs, any taxpayer who incurred such expense in drilling an oil or gas well during the year 1925 is held, by the Commissioner, to have exercised an option in his return filed for that year by his treatment in that return of such intangible costs. If he deducted such intangible drilling expenses in that return, he is thereby bound to deduct such expenses in all subsequent returns and may not capitalize the same and recover such items through annual allowances for depletion. If in his return for 1925 he capitalized such intangible expenditures, he must in all subsequent returns capitalize all future expenditures and recover the same through annual allowances for depletion. If in some year subsequent to the year 1925, a taxpayer for the first time has incurred intangible drilling expense in developing an oil or gas property, his treatment of such item in the particular

return for that identical year constitutes an election thereon. Neither the Commissioner nor the taxpayer has authority at law to alter such an election once made. The treatment of such intangible drilling costs upon the taxpayer's books is not an election, nor need it be the same as that in the income-tax return, but if not the same, adequate auxiliary records of recoverable capital and depletion must be maintained in some consistent form. Copies of returns, if containing detailed schedules of properties and additions to costs, by years, may serve as such a record.

All expenditures in drilling an oil well which do not relate to the acquisition of physical, personal property, the normal, useful life of which extends beyond the current accounting period or its equivalent in months, constitute intangible drilling costs or expense and are within the scope of the aforementioned election. Therefore, if the taxpayer has elected to capitalize intangible drilling costs, the amount thereof is, at the time of completion of a producing well, to be added to the cost of the oil or gas property and is to be recovered through periodic allowances for depletion.

Taxpayers' efforts before courts of law to have such intangible costs construed to be improvements the cost of which is recoverable through allowances for depreciation rather than depletion, have been defeated. Had the effort succeeded, then wherever drilling has been capitalized and percentage depletion is limited to 50 per cent of net income from the property, only half of the annual extinguishment of investment in such intangibles (depreciation) would serve to reduce the depletion allowance. The advantageous differential, if one existed, between cost depletion and percentage depletion, would not be absorbed by one half of the annual retirement as depreciation of capitalized drilling, and the deduction for cost of leasehold and for intangible drilling

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would be greater, but such is not the law as found by the courts.

Where there are additions to capital, occurring in years subsequent to a year or series of years in which depletion has been sustained, whether such additions are to the cost of the property or are capitalized cost of drilling producing wells, the amount thereof as at the end of a given year, is added to the residual cost of the property as at the beginning of the year, and the total is spread over the number of barrels of oil or quantity of gas estimated, as of the end of the year, to be recoverable over the productive life of the property. The division of the amount of the investment by the number representing the recoverable quantity of oil or gas, produces the estimated cost per barrel of oil or unit of gas, and this unit cost is the depletion per barrel, basis of cost.

The second factor in computing cost depletion in the case of oil or gas production is the indefinite factor, usually the only indefinite factor. It must be based upon estimate. It is the determination of the quantity of oil or of gas to be recovered from the property over the entire productive life thereof, which extends until such time as the quantity of mineral removed in any period brings insufficient return to meet annual operating expense, the economic minimum. The tendency is to produce properties somewhat beyond this point. When the price of oil is high, properties are produced to a much smaller minimum quantity per day, sometimes down to one barrel a day, and in the high grade oil in Pennsylvania, even down to an average of a quart a day, by allowing the oil to accumulate, and pumping at intermittent intervals of days.

Before proration of oil wells interrupted the normal decline in production of a well or wells, the decline in the Mid-Continent area was roughly said to be equal to daily production on the last day of a year equal to 60 per cent of the daily production on the first day of the

same year, or the annual production equal to 60 per cent of the annual production of the year before, until the property was quite old and the decline curve almost leveled out. This rule of thumb was not greatly out of line.

It was then well demonstrated that by plotting the monthly production of a given property on logarithmic paper, the direction and angle of the line representing the average decline through a period of three years or even one year, indicated the direction and curvature of a line extended into the future which was fairly representative of the decline in daily or annual production in future years. By summing up the estimated production for future years thereby indicated and adding thereto the actual production to the date current, a fair estimate of the oil ultimately to be recovered from the property could be made. Undrilled locations were estimated as being likely to produce as much as from 50 per cent to 100 per cent of the producing wells upon which the estimate was based.

Gas was estimated upon the decline in rock pressure which is consistent with the decline in recoverable volume. When the rock pressure is extinguished, nothing remains to force gas to the surface. Pumping would not be profitable.

By making annual corrections by additions to or reductions from the estimated residual oil reserve, the theoretical decline curve was brought closer to the actual decline, and the older the property became, the smaller became the margin between estimated ultimate recovery and actual lifetime recovery, so that by the time the property reached the point of abandonment, the unrecovered capital was reduced by depletion allowances to substantially nil.

With statutory limitations upon quantities of oil which may be taken from wells, in effect in almost every oil-producing state of large production (Illinois being a notable exception) due to the excess of supply over de-

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mand, wells are often permitted to produce no more than two or three per cent of their potential daily production. There is no perceptible decline from which ultimate production can be estimated. Petroleum engineers have devised other methods of estimating recoverable quantities. Porosity of oil sands is compared with like sands from wells that produced to exhaustion and whose total productive volume is therefore known. Degree of saturation of sand is considered, thickness and area of producing sands are measured, and the cubical content of the producing sand under a given property is thereby estimated and expressed in the number of barrels per acre. The portion thereof which is recoverable is influenced by well spacing, fluidity of the oil, porosity of the sand (freedom with which it gives up its oil content), gas pressure available to move the oil to the bottom of the well, and distance to the well (well spacing). These methods seem to be about as accurate as was the old decline-curve procedure.

Gas is not affected by proration. Generally there is a market or there is none. Most states permit only a portion of the potential production of a gas well to be produced each day. This is said to prolong the life of the well and result in a greater ultimate recovery than if 100 per cent of available gas output were taken.

The third factor in computing depletion is the quantity produced to the interest of the taxpayer in a given accounting period. Oil is measured in terms of barrels of 42 gallons; gas by thousands of cubic feet. Actual depletion is calculated by multiplying the unit cost by the number of barrels produced within the period under consideration. Depletion related to gas, if not metered, is determined by the ratio of the decline in rock pressure within the current period to the rock pressure as at the beginning of the period and applying the percentage

thus obtained to the capital recoverable as at the beginning of the year with the additions made during the year if any.

These calculations, as are those based upon percentage of income, are to be made by properties rather than by groups of properties. The taxpayer's entire interest in each separate mineral property, whether acquired at one time or at numerous times, is one property for such calculations. Where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single "property" provided the treatment is consistently followed. (Art. 23 (m) (1) Reg. 401 CCH 1850 No. 240.)

Where a taxpayer's accounting is upon a cash basis, the depletion is to be computed upon the quantities of oil sold within the year, regardless of when such oil was produced. (19.23 (m) (2) 401 CCH 1859 No. 242.) If upon an accrual basis, then if the inventory of oil produced and not sold is taken into income, obviously the depletion related to the units in the inventory must be taken into account. If the calculation is upon a basis of percentage of income, the inventory is to be included in gross income and net income from the property.

Where the owner of a fee simple grants a lease upon his property for the mining of oil and/or gas and receives a bonus therefor, such bonus is considered to be an advance royalty, and depletion in respect thereto may be deducted. If depletion is upon the income basis, and in such case it usually is, the amount thereof is $27\frac{1}{2}$ per cent of the bonus, for there is seldom any expense or sufficient expense to effect the calculation by limiting the allowance to 50 per cent of net income. The courts have held that this allowance may be taken although the property has not produced.

Where the owner of an oil-and-gas-mining lease consisting, say, of a $\frac{3}{8}$ working interest, sells same for \$100,000 cash, and \$50,000 out of $\frac{1}{4}$ of the oil

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produced to the credit of said $\frac{7}{8}$ working interest, payable if, as, and when produced, the courts have held that such \$50,000 or any part thereof had by the vendor out of production, was not a part of the thing sold, but was property reserved from the sale by the vendor, whether or not the word "reserve" is used in contracts or conveyances pertaining to the same. Notwithstanding that, when \$50,000 is, if ever, received by the vendor, all further interest in the property ceases; it has been held by the courts that the oil which produces any or all of said \$50,000 is the property of the vendor, and the production and sale thereof results in depletion of his investment therein, and in lieu of cost depletion, $27\frac{1}{2}$ per cent of the oil when and as produced and sold out of vendor's reserved interest, may be deducted by him as depletion. Such arrangements are commonly referred to as "oil payments." It is essential that no liability for payment of any part of said \$50,000 attach to the vendee in the event the property fails to make \$50,000 for the vendor. If that is not the case, there may have been created an account receivable and an outright sale as to which depletion would not relate.

Where depletion is claimed based upon cost, then as to each property, adequate schedules must be filed with the return or separately in a depletion report, setting out the factors enumerated herein as items (I), (II), and (III). Such statements should show the unrecovered capital at the beginning of the year, additions and reductions during the year, and the depletion for the year and unrecovered capital at the end of the year, and the same information with respect to quantities of oil recovered in previous years, the current year, and additions or reductions by way of adjustment, and the unrecovered oil reserves at the end of the year. Similar schedules should support gas depletion. However, where gas properties are relatively unimportant the Bureau of In-

ternal Revenue has frequently permitted a flat percentage of investment to be taken as depletion each year. The percentage should indicate the ratio of the current year to the total years of estimated life of the gas property.

When percentage depletion is taken, for each property a schedule should be submitted with the income-tax return itself, setting out the identification of the property, gross income for the year, total operating expenses for the year, depreciation for the year, overhead for the year allocable to that property, taxes directly applicable to the property or its production, net income before depletion, cost depletion (unless waived by the taxpayer), percentage depletion and the allowable depletion which will be the lesser of $27\frac{1}{2}$ per cent of gross income and 50 per cent of net income from the property, unless cost depletion is greater than the lesser of the two, in which event it is the allowable depletion.

The fact that a taxpayer may have a loss for a current year, before provision for depletion, may tempt him to forego the calculation of depletion, but if at some future time he sells the property for either a profit or loss, he will be required to reduce his cost of sale by the depletion allowable in all prior years back to January 1, 1932, and prior thereto by all cost depletion allowable, whether such depletion was or was not taken. If greater amounts than were lawfully allowable, were taken as depletion in earlier years and the Commissioner does not elect to correct the same or cannot correct the error, the cost of sale, exchange or abandonment of the property must be reduced by the amount of depletion allowed, even though greater than that legally allowable.

Percentage depletion still affords the oil industry a bonus of tax-free income and will do so as long as the spread between cost of production and sale price of crude is as much as it is now.

Accounting Records, Statements, and Problems Peculiar to Oil Production Accounting

BY THORNTON G. DOUGLAS, LOS ANGELES

Member, American Institute of Accountants

THE PREANNOUNCED title of this paper suggests a wealth of detail which it is manifestly impossible to cover in the time available and I doubt whether this group would be greatly interested in the particulars of forms or statements or in the details of bookkeeping. Consequently, these remarks will be directed chiefly to some of the more important problems that arise in accounting for oil production—first as to quantities and then as to the assignment of money values to those quantities.

On the assumption that some of you may not be familiar with practices of the petroleum industry, it may be helpful to state the following at the outset:

With a few exceptions that do not concern us in a discussion of production accounting, gross quantities are determined by gauging (i.e., measuring) the level in feet and inches of fluid in tanks or reservoirs at the commencement and completion of a movement into or out of such tanks, and also at such other times as may be required—for example, at a specified time each day (usually 7 A.M.) in order to establish production for the preceding twenty-four hours and to establish inventories.

The gaugers also determine the level of the sediment and water at the bottom of each tank, and ascertain the temperature and gravity of the oil by thermometer and hydrometer readings; from time to time samples from the various tanks are sent to the field laboratories where the gravity is checked and the percentage of water in suspension is determined.

Simultaneous runs into and out of a tank are never made if an outside party

has an interest in the transaction; occasionally, operating conditions make it expedient to do this if no outsider is involved and in such instances allowance is made for the rates of flow at intake and outlet.

Each tank and reservoir bears an identifying number and each is measured by engineers at the time it enters service to determine the number of barrels or gallons it will hold at any designated level within fractions of an inch. These quantities are entered on a tank table, of which as many copies are prepared as may be required by the operator and by other operators who may take deliveries from the tank. Tanks are remeasured and new tables prepared whenever their physical condition appears to require it or if a succession of unaccounted-for gains or losses suggests errors in the original calculations; in trade jargon, tank measuring is known as "strapping."

By reference to these tank tables and to temperature-correction tables the measurements of fluid in feet and inches at observed temperatures are converted into equivalent barrels of clean oil at 60 degrees Fahrenheit and, with certain exceptions that need not concern us here, all quantities are accounted for on this basis.

A wide variety of circumstances may govern the ownership of, or the equities in, production from oil and gas properties, the proceeds from sale of production, or the results from operations of a property. The extreme of simplicity is the instance where the operator owns in fee simple the surface, mineral, and water rights of the property and has not disposed of any interest in the equip-

ment, production, or profits. A common and fairly simple situation is the typical lease where the operator as lessee pays the landowner as lessor a royalty of, say, one eighth of the proceeds from oil, gas, and other hydrocarbon substances produced and saved from the property; this royalty interest (which may be taken in kind at the option of the lessor) is subject to a pro-rata share of charges for certain state and local taxes and in some instances for the cost of cleaning and dehydrating oil but not for other operating expenses or for amortization of capital expenditures. Beyond these, the possible divisions of interest seem limited only by man's imagination in working out "deals." The complications of these deals affect the accounting for quantities to some extent but they are likely to bear more directly upon the accounting for money values.

ACCOUNTING FOR QUANTITIES

It appears that the best method of discussing the fundamental problems involved in determining quantities of oil produced and the subsequent accounting for those quantities is to describe in broad outline what happens after the oil reaches the surface of the ground. Such description must necessarily cover not only physical movement but also the accounting procedures and controls wherein to a large extent lies the solution of the problems.

It may be well to consider as typical a leasehold property having two or more producing wells connected to two or more tanks situated on the property, which tanks may have outlet connections both to the operator's own pipe line and to pipe lines of other operators who purchase oil directly from the property; these tanks are usually connected also to one another for convenience of operation. The oil runs directly from the wells to these tanks but oil from different wells is not run simultaneously

into the same tank unless the operator has no reason or desire to know how much each well is producing. In theory, the tanks are gauged by the pumper at about 7 A.M. daily, and at such other times as may be necessary, and the time of gauging, the measurements, temperature, gravity, etc., are entered in a gauge book which the pumper passes on to the man who relieves him on the next shift ("tour" in trade jargon); the pumper also prepares a gauge report which is sent to the crude-oil accounting division. In practice, it is frequently impossible for a man to gauge all his tanks reasonably close to 7 A.M. and if the interval between that hour and the time of actual gauging is appreciable, the gauge reading is adjusted to allow for the rate of flow although the gauge report may not show that such allowance was made. Neither will it show that on a cold, rainy morning the pumper may have yielded to temptation and remained in the warmth of the pump house, referred to the gauge book for information regarding the last previous gauge, and estimated that "she's making two inches an hour" and prepared his gauge report accordingly. (Incidentally, such estimates can be surprisingly accurate.) However, it is probable that this device is seldom employed for the 7 A.M. gauge on the first of each month and rarely, if at all, for gauges at the commencement and completion of runs either to an outside pipe line or to the operator's own pipe line; the reasons for this will be apparent later.

At the commencement of a run from a lease tank to a pipe line, a gauger representing the purchaser or the operator's own pipe-line department ascertains that the pipe-line outlet is closed and bears the prenumbered seal (similar to the seal commonly used on freight cars) that was placed thereon at the completion of the last previous run. He then closes and seals all other tank outlets, gauges the tank, ascertains the temperature and gravity, and obtains a sample for

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subsequent confirmation of gravity and determination of water percentage at a field laboratory. The seal on the pipe-line outlet is then broken and the valve opened; upon completion of the run the pipe-line gauger closes and seals the pipe-line outlet, records the number of the seal, ascertains the fluid level, checks the seal number on all other outlets and removes them. A prenumbered run ticket is prepared in multiple, usually quadruplicate, and signed both by the pipe-line gauger and the lease pumper each of whom retains a copy; the run ticket shows the name of the property, tank number, commencing and ending measurements, and collateral information regarding gravity, temperature, percentage of water, etc.

The lease pumper confirms the pipe-line gauger's findings either by independent measurements and readings or by observing those taken by the latter and obtains one half of the sample taken from the tank for subsequent analysis. By his signature on the run ticket, the lease pumper accepts responsibility for the correctness of such findings; thus in the practical, if not the legal sense, the pumper acts as agent for his employer if the run is to an outside purchaser and as agent for the landowner if the run is to the employer's own pipe line.

In passing it may be well to explain the pipe-line gauger's reasons for ascertaining that the pipe-line outlet on the tank was not opened between runs. At first glance it might seem that this happening would benefit only the pipe-line operator; however, it is possible for the main pipe-line and gathering-line pressure to exceed the pressure created by the volume of oil in the tank and in this event a reverse movement of oil would occur if the pipe-line outlet valve were open.

Apart from runs to pipe lines, oil is withdrawn from lease tanks from time to time for consumption by the operator as fuel, and for dehydrating if the water

content is excessive; basic sediment and water is also withdrawn from time to time and is subsequently treated so as to recover good oil if it is economical to do so. Appropriate reports are prepared to cover these movements which reports show substantially the same information as the run tickets.

The quantities shown by gauge reports, run tickets, etc., are summarized daily in the operator's accounting department; the totals may be accumulated for any period desired. The production from the property determined from lease-pumpers' gauge reports is compared with the algebraic sum of

- (a) Runs to pipe lines
- (b) Own consumption
- (c) Runs to dehydrator, less returns
- (d) Increase or decrease in sediment, less recovery from treatment
- (e) Known losses from line breakage, etc., and
- (f) Increase or decrease in inventory.

The difference may reflect a gain, but usually reflects a loss, and is attributable to many factors among which are evaporation losses, pumping losses, errors in gauging and in converting measurements into barrels at 60 degrees Fahrenheit, failure of lease pumpers to report own consumption, and other errors of omission and commission. If such loss or gain appears unreasonable in relation to the quantity produced and to past experience it is investigated and major differences can be fairly well localized as to date and probable cause.

When oil is run from lease tanks to the pipe line of an outside purchaser, the accounting for quantity (and for amount) is substantially complete, barring possible differences in calculations between seller and purchaser both of whom have the same basic data from which to work. However, quantities run to the operator's own pipe line require further accounting and this serves in part as confirmation, or otherwise, of the correctness of the total of runs from

the operator's own properties and from the properties of others. The quantities delivered from the pipe lines into storage tanks or reservoirs along the pipe line, or at refineries, marine terminals and the like, are determined by gauging the tanks before and after delivery and determining gravity, temperature, water content, etc., and making the conversion into barrels in the manner described above. Thus pipe-line receipts and deliveries are compared and the reasonableness of the resulting loss (or gain) is considered in relation to normal pumping and other losses in transit; through investigation, abnormal losses in this category may also be fairly well localized as to districts and dates and sometimes as to cause (such as errors in run tickets) and steps taken to prevent their recurrence.

Control over run tickets is probably the most important single factor in accounting for quantities. Under proper organization these tickets are printed in, say, quadruplicate, numbered, and bound in books which are kept under the control of a responsible employee whose duties do not involve the recording of oil movements. The books are issued to pipe-line gaugers only upon written request of the pipe-line superintendent and are accompanied by a transmittal notice showing the numbers of the run tickets; a copy of the transmittal advice is furnished to the crude-oil accounting division where the numbers of the issued tickets are listed in a register of outstanding run tickets. Signature cards of each gauger are kept in the crude-oil division for periodic test comparison with signatures appearing on run tickets; it should be remembered that these run tickets may cover the operator's purchases of oil from outsiders as well as runs from its own properties to its own pipe lines.

As run tickets are received by the crude-oil accounting division, the number of each is checked off against the record of outstanding tickets and any

numbers missing or out of sequence are investigated; the complete set of each ticket voided must be returned by the gaugers. By these methods, the crude-oil accounting division is able to ascertain the numbers of tickets outstanding at any time and has evidence of the validity of each run ticket. No employee other than an authorized gauger of the operator is permitted to accept crude oil into the operator's pipe line or its storage tanks or to countersign run tickets of other oil operators evidencing the sale of oil to them; for the latter purpose, a lease pumper may be regarded as an authorized gauger.

The procedures outlined above afford the means of detecting with reasonable promptness the failure to prepare run tickets or to suppress run tickets that have been prepared, but they cannot of themselves prevent either of those happenings. Consequently, in a well run organization they are supplemented in various ways, chief among which are: the frequent transfer of lease pumpers and pipe-line gaugers from one tour to another and from district to district; the division of duties within the crude-oil accounting division and the internal auditing of its transactions including the accounting for run ticket numbers; having the operator's internal auditors, or other disinterested persons, take or closely observe the taking of inventory gauges at occasional intervals.

But none of these steps would prevent a lease pumper, let us say, acting in collusion with another operator's pipe-line gauger from running oil without preparing a run ticket provided he correspondingly understated his production gauges during that same tour; if this were done to any considerable extent, the lease foreman or district superintendent would soon become concerned over the decline in production, and subsequent investigation would develop the absence of run tickets at times when the inquirer had observed the outside pipe-line gauger on the premises.

Determining quantities of dry gas and wet gas produced from wells necessarily involves metering, determination of pressures, and the stabilization of wet gas at a workable vapor pressure before conversion into natural gasoline. Dry gas may be sold directly from wells, or as the residue of wet gas from which the natural gasoline has been extracted, or it may be consumed in operations. While there are many points of difference in detail, the methods of accounting for quantities of natural gasoline are fundamentally the same as those relating to crude oil.

ACCOUNTING FOR MONEY VALUES

It would be futile in the time available to attempt a discussion of the problems in accounting for money values under some of the complicated "deals" that are entered into between oil operators; suffice it to say that such problems may sorely tax the ingenuity of the ablest and most imaginative accountant even in instances (unfortunately rare) when the parties at interest interpret the agreement in the same manner.

Resuming the illustration of a typical leasehold property, no particular problem arises in so far as settlement with the royalty owner is concerned. The quantity shown by each run ticket is extended at the posted price for the gravity and field involved and entered on what is known as the oil-settlement statement which shows gross barrels, water and sediment, temperature correction, etc., and any deductions (such as cleaning cost) that are to be borne by the lessor; a copy of this statement accompanies the royalty check. For convenience, separate statements and checks are usually prepared to cover gas and natural gasoline although it is possible to devise an all-inclusive statement. For the operator's own accounting purposes the money value of its share of production delivered from its leases to its pipe line may be recorded either at posted price or at cost of production.

The use of posted price creates the problem of eliminating interdepartmental profit from inventories. The use of cost for the month in which produced will delay the monthly closing of the accounts and may result in some rather wide fluctuations particularly in periods of well cleaning and other lease rehabilitation work; both of these difficulties can be minimized, and satisfactory results obtained, by using average cost for, say, the three months preceding the month of production.

We may now consider some of the problems of determining the cost of producing the operator's share of crude oil. There is clearly no satisfactory method of assigning a cost to wet or dry gas produced nor any reasonable alternative to treating the proceeds therefrom as revenue because if they were applied in abatement of production cost, the result might be a negative figure particularly while a field is new.

As will presently be indicated, numerous assumptions and prorations have to be made in calculating production costs by properties. The number and complexity of these would be greatly increased if costs were calculated by individual wells and this would serve no useful purpose unless the interests in the several wells differ as between parties or as a test to help in deciding whether to continue producing from all of the wells.

There are certain expenses that are definitely attributable to a particular property; among these are wages of persons employed solely on that property, supplies consumed, pumping cost, cleaning wells, dehydrating oil, automobile expense, direct taxes, and the like. The cost of pumping, cleaning wells, dehydrating oil, automobile expense, and certain other items regarded as direct may result from prorations of cost or from the application of fixed unit rates approximating cost because the related facilities serve more than one property; however, the determina-

tion of these on sound bases presents no great difficulty.

The allocation to properties of indirect expenses is not so simple. These include among other things salaries and automobile and other expenses of foremen, district superintendents, and others engaged in production activities whose efforts are not confined to a particular property or even district; operation and maintenance of warehouses, trucks, machine shops, telephone and telegraph systems, field laboratories, field offices, etc.; insurance, taxes, and amortization of investments relating to these general facilities. They may or may not include, depending upon one's accounting philosophy, expenses of land, engineering, geological and geophysical departments, rents of undeveloped leases, and cost of lands relinquished and exploratory wells abandoned; also, a portion of head-office administrative and general expenses.

It is apparent that the amounts of some of the indirect expenses are influenced chiefly by the volume of production, others by the amount of direct labor, while still others are influenced very little, if at all, by either of these factors. Many refinements may be introduced to allocate certain of the items to individual properties but the major ones must be allocated on the basis of barrels produced or of direct labor. Either of these bases may produce obvious inequities but the barrelage basis is likely to be the greater offender; this is particularly true when production is curtailed to meet regulations imposed by law or by voluntary agreement because the decrease in production to allowable quantities is not necessarily ratable as between properties.

As an illustration of some of the problems that arise, consider the case in which all wells on a property are completely shut in for a period of time; despite lack of production, expenses (including labor) directly attributable to the property will continue in some meas-

ure. Should these properties be charged with a proportionate share, based on direct labor, of district and other overhead and the total treated as a separate charge to profit-and-loss account? Or should the direct expenses of such properties be regarded as part of district overhead and apportioned to other properties?

Amortization of the direct investment in producing properties has not heretofore been mentioned as an element of production cost, although it is sometimes the largest single element. A reasonably comprehensive discussion of the ramifications of this problem alone would require more of your time than has thus far been consumed; therefore, it is not feasible to do more than mention certain of the highlights.

In the first place, the amount of such investment will vary widely depending upon whether certain expenditures are capitalized or are written off when incurred; chief among these are intangible development expenditures, but others of significance are rents of undeveloped leases, cost of predevelopment geophysical and geological surveys, and cost of dry holes drilled on properties having producing wells thereon. Accounting precedent affords ample support for either alternative, although the trend in recent years seems to favor more the capitalization at least of intangible development expenditures.

Having established the amount of direct investment, the method of amortization offers a number of justifiable and accepted alternatives such as: (1) straight-line rates based upon estimated useful life from the standpoint either of wear and tear or of the probable period of production and applied (a) to equipment that is not an integral part of a well, or (b) to all equipment; (2) the unit-of-production method, based on estimated recoverable oil content and applied (a) to land or leasehold costs, (b) to well costs, or (c) to the entire investment; (3) combinations of these

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methods, any of which may be further modified by allowance for estimated salvage value and may be applied by districts or larger geographical areas rather than by individual properties.

I trust that these remarks have brought into focus some of the major problems peculiar to oil production accounting even though they have con-

tributed nothing to their solution. In common with other accounting problems, it is not possible to demonstrate that any one solution is so eminently correct that all others are necessarily wrong. Probably the best results may be achieved by conforming to acceptable accounting principles applied in a manner consistent with realism.